2019 Al Todd Estate Planning Workshop

19-25

Friday, July 12 & Saturday, July 13, 2019

presented by
The South Carolina Bar
Continuing Legal Education Division

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SC Supreme Court Commission on CLE Course No. 194060

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S.C. Bar Probate, Estate Planning & Trust Section

S.C. Bar Tax Law Section

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Al Todd Estate Planning Workshop
Friday, July 12 & Saturday, July 13, 2019
Kiawah Island Golf Resort, Turtle Point Clubhouse

This program qualifies for 9.25 MCLE credit hours, including up to 1.0 LEPR credit hours, 9.25 Estate Planning & Probate Specialization credit hours and 9.25 Taxation Specialization credit hours

Friday, July 12, 2019

8:00 a.m. **Registration and Continental Breakfast**
Continental Breakfast sponsored by GreerWalker, LLP

8:20 a.m. **Welcome and Opening Remarks**
Professor S. Alan Medlin
William M. "Bill" Reynolds III
Jonathan E. Spitz

8:30 a.m. **The Past Year's Most Significant Curious, or Downright Fascinating Fiduciary Cases (2018 Edition)**
Dana G. Fitzsimons, Jr.
Principal and Fiduciary Counsel, Bessemer Trust, Atlanta, GA

9:30 a.m. **The Year in Review: An Estate Planning Perspective of Recent Tax Developments**
Howard M. Zaritsky

10:30 a.m. **Coffee Break**
Sponsored by Colony Trust Company

10:45 a.m. **The Year in Review: An Estate Planning Perspective of Recent Tax Developments, continued**
Howard M. Zaritsky

12:00 p.m. **Working Lunch**
Sponsored by South State Bank

12:15 p.m. **Table Discussions of Current Estate Planning Trends and Topics**

1:30 p.m. **Dealing with Basis in Modern Estate Planning**
Howard M. Zaritsky

2:15 p.m. **Adjourn**

6:00 p.m. ***Reception (for attendees and families; dress is business/resort casual) Ocean Course Clubhouse**
Sponsored by Argent Trust Company

*On-island transportation provided from hotel and villas. Call from room for pick-up.

Saturday, July 13, 2019

8:00 a.m. **Continental Breakfast**
Sponsored by Colonial Trust Company

8:30 a.m. **The Intersection of Probate Law and Family Law**
David H. Kunes
Evans Carter Kunes & Bennett, PA, Charleston
C. Vance Stricklin, Jr.
Moore Taylor Law Firm, Columbia

9:30 a.m. **Attorneys as Fiduciaries: Ethical and Practical Considerations for Estate Planning Attorneys**
Frederick W. Faircloth, IV
James C. Hardin III, PLLC, Rock Hill

10:30 a.m. **Break**
Sponsored by Colony Trust Company

10:45 a.m. **Retirement Benefits Payable to Trusts**
Thomas G. Sinclair
Thomas, Fisher, Sinclair & Edwards, P.A., Greenville

11:45 a.m. **Continuation of table discussions – Discussions of Current Estate Planning Trends and Topics**
Moderated by Jonathan E. Spitz

12:45 p.m. **Adjourn**

2019 Al Todd Estate Planning Workshop

SPEAKER BIOGRAPHIES
(by order of presentation)

Jonathan E. Spitz
Todd & Johnson, LLP
Columbia, SC
(Course Planner and Moderator)

Jonathan E. Spitz is an associate attorney with Todd and Johnson, LLP and represents clients in matters involving estate planning and administration; probate litigation; guardianship and conservatorship issues; and corporate formation. Jonathan graduated from Wofford College and received his Juris Doctor from the Charleston School of Law where he served as a research assistant to Professor Ginny Meeks. After law school, Jonathan clerked for the Honorable Amy W. McCulloch, Probate Judge for Richland County. Jonathan also has his Masters of Laws Degree in Taxation from the University of Alabama School of Law. Jonathan has been selected as a "Rising Star" in the area of Estate Planning and Probate in the 2018 and 2019 editions of Super Lawyers.
Jonathan grew up in Anderson, South Carolina, but now considers Columbia home along with his wife, Jescelyn, and their Cavalier King Charles Spaniels.

Dana G. Fitzsimons, Jr.
Bessemer Trust
Atlanta, GA

Mr. Fitzsimons is Principal and Fiduciary Counsel at Bessemer Trust. In this role, he is responsible for working with clients and their advisors to develop practical and efficient wealth transfer plans and for guiding the firm on fiduciary issues.
Prior to joining Bessemer, Dana was a partner with McGuireWoods LLP, where he practiced in the areas of fiduciary litigation and estate planning.
He is a fellow of the American College of Trust & Estate Counsel (ACTEC) and serves on its Business Planning and Charitable Planning and Exempt Organizations Committees. Dana has been recognized in *Chambers USA: America's Leading Lawyers for Business*, has served in the ABA RPTE leadership, and frequently lectures on fiduciary topics.
Dana earned a J.D. from William & Mary Law School, where he was a member of the law review and graduated *Order of the Coif*, and a B.A. in music from Ithaca College School of Music. He continues to perform actively as a jazz drummer.

Howard M. Zaritsky

Rapidan, Virginia

Howard M. Zaritsky is a retired attorney and a nationally-recognized expert on estate, gift, and generation-skipping transfer taxes, fiduciary income taxes, estate planning, and estate administration. He has published over a dozen books, including *Tax Planning for Family Wealth Transfers At Death, Tax Planning for Family Wealth Transfers During Life,* and *Tax Planning With Life Insurance* (all published by Thomson-Reuters/WG&L), three Tax Management Portfolios (*Revocable Inter Vivos Trusts; Grantor Trusts; and Foreign Trusts, Estates, and Beneficiaries*), and more than 150 articles in various law reviews and professional journals. He has lectured at all of the major tax and estate planning institutes, including the University of Miami Heckerling Institute on Estate Planning, where he is a member of the advisory board, and the Douglas W. Conner Advanced Estate Planning and Administration Seminar.

Mr. Zaritsky was for nearly 20 years a partner in Zaritsky & Zaritsky, Fairfax, Virginia, where his practice was limited to estate planning and related tax matters.

David H. Kunes

Evans Cater Kunes & Bennett, PA
Charleston, SC

David Kunes is a partner at the law firm of Evans, Carter, Kunes & Bennett in Charleston. He attended Davidson College where he graduated with a degree in Economics. David completed his law degree at the University of South Carolina in 2007 and obtained a Masters Degree in Tax Law at NYU in 2010. David has been active with the Probate, Estate Planning and Trust Section of the South Carolina Bar since 2015 and is currently the Chair-Elect. The Supreme Court of South Carolina has certified David as a Specialist in Estate Planning and Probate Law. David has previously presented lectures on topics ranging from property taxation to grantor trusts.

C. Vance Stricklin, Jr.

Moore Taylor Law Firm
Columbia, SC

C. Vance Stricklin, Jr., is a partner in the Moore Taylor Law Firm, P.A. and served two years as the managing partner. His practice focuses primarily on family law, including domestic litigation. He has been practicing in the Family Courts for over 20 years.

A Dreher High School graduate, Mr. Stricklin graduated from Winthrop University in 1991, with a double major in Political Science and Philosophy/Religion, and in 1994, graduated from the University of South Carolina School of Law.

He has served as the Past President of the Lexington County Bar, and Past Chair of the South Carolina Bar Family Law Section Council. He is a current member of the South Carolina Bar Family Law Section Council, South Carolina Supreme Court Docket Task Force, and is the co-chair for the South Carolina Bar Family Law Section Council's Subcommittee on Alimony. Mr. Stricklin also served for several years as a member of the Lexington County Public Defender Board and is a long-time member of the South Carolina Association of Justice.

Over the years, Mr. Stricklin was named several times as one of the "Midlands Legal Elite" by the *Columbia Business Monthly* magazine and has been selected by his peers as one of the Super Lawyers by *Super Lawyer* magazine for multiple years. Mr. Stricklin is a frequent speaker at Continuing Legal Education seminars on the topic of family law, with an emphasis on alimony issues, and in the past, taught classes for new judges.

His personal service to the community includes serving as an active member of the Dreher Booster Club and past member for the South Carolina Chapter of the March of Dimes.

Frederick W. "Freddy" Faircloth, IV

The Law Offices of James C. Hardin III, PLLC
Rock Hill, SC

Freddy Faircloth joined the law firm of James C. Hardin III, PLLC in 2011 as an associate. His practice focuses in the areas of taxation, corporate formation and dissolution, business succession planning, asset protection, estate planning, probate, trusts, and nonprofit and tax-exempt organizations. Mr. Faircloth is particularly focused on representing businesses and their owners, and he joins the firm with seven years of technical and practical experience representing a range of businesses. Prior to starting his legal career, Mr. Faircloth earned his Master of Law in Taxation from The University of Florida.

Mr. Faircloth earned his LL.M. (Taxation) from University of Florida in 2004, his J.D., cum laude, from the University of South Carolina School of Law in 2003 and B.S., cum laude, from Clemson University in 2000 with a major Accounting, minor in Political Science. He is admitted to practice in South Carolina (2003) and North Carolina (2005).

Mr. Faircloth is a member of the American Bar Association, The North Carolina Bar Association, The South Carolina Bar (Member, South Carolina Bar Tax Section Council, 2010 – present) and York County Bar Association.

Thomas G. Sinclair

Thomas, Fisher, Sinclair & Edwards, P.A.
Greenville, SC

Thomas G. Sinclair is a shareholder with the law firm of Thomas, Fisher, Sinclair & Edwards, P.A. in Greenville, South Carolina. He practices in the areas of taxation, estate planning, trusts and estates, probate, employee benefits, pension and profit-sharing plans, partnership, limited liability company and corporate law, mergers and acquisitions, and non-profit and tax-exempt organization law. He is a certified specialist in the fields of both Taxation Law and Estate Planning and Probate Law by the Supreme Court of South Carolina. He is listed in The Best Lawyers in America in the fields of Taxation Law, Trust and Estate Law and Employee Benefits (ERISA) Law. He is also listed in Legal Elite of the Upstate in Greenville Business Magazine. Mr. Sinclair earned his Master in Taxation Law Degree (LL.M.) from the New York University School of Law and his Juris Doctor Degree, cum laude, from the University of South Carolina School of Law. He was a member of the South Carolina Law Review, Moot Court Bar and the Order of Wig and Robe. Mr. Sinclair was published in the South Carolina Law Review, and his article has been cited by several Circuit Courts of Appeals, one of which adopted its reasoning. He received the Albert C. Todd III Estate Planning Award. Mr. Sinclair is a member of the Greenville County Bar Association, the South Carolina Bar, the Greenville Estate Planning Council (President, 2014-2015) and the Greenville Estate Planning Study Group. He is also a member of the Probate, Estate Planning and Trust Section of the South Carolina Bar and a member and past Chair of the Tax Law Section of the South Carolina Bar.

South Carolina Bar

Continuing Legal Education Division

The Past Year's Most Significant Curious, or Downright Fascinating Fiduciary Cases (2018 Edition)

Dana G. Fitzsimons, Jr.

BESSEMER TRUST

The Past Year's Most Significant, Curious, or Downright Fascinating Fiduciary Cases (2018 Edition)*

**At least it seems to me. Your mileage may vary.*

Updated December 31, 2018

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THE PAST YEAR'S MOST SIGNIFICANT, CURIOUS, OR DOWNRIGHT FASCINATING FIDUCIARY CASES (20187 Edition)*

**At least it seems to me. Your mileage may vary.*

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Updated December, 31, 2018

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THE PAST YEAR'S MOST SIGNIFICANT, CURIOUS, OR DOWNRIGHT FASCINATING FIDUCIARY CASES (2018 Edition)*

**At least it seems to me. Your mileage may vary.*

I. Elder Abuse, Powers of Attorney, Guardianship, Special Needs & Disability

A. *Knox v. Vanguard Group, Inc.*, 2018 U.S. Dist. LEXIS 1993 (Mass. 2018). Claims dismissed that brokerage firm should be liable for additional taxes with respect to an IRA, where it refused to accept a bare durable general power of attorney and insisted on completion of its own forms.

1. In 1999, Kenneth opened an IRA with Vanguard and signed the account opening agreement in which he approved Vanguard's standard agreement terms. Those terms provided that Vanguard could amend the agreement and that the client would be deemed to consent to any amendment if the client did not object within 30 days of notice of the amendment. Kenneth named his wife Margaret as beneficiary of the IRA and died in 2012. The IRA had assets of $45,000 at that time. At that time, the agreement provided that: (a) a beneficiary's request for distributions must be made in a form and manner acceptable to Vanguard; (b) Vanguard would not be responsible to make any distributions until it receives directions in a form and manner acceptable to Vanguard; and (c) that the agreement was governed by Pennsylvania law. Vanguard generally requires that distribution requests be executed on its own forms, including special forms when a person is acting as agent. Vanguard will accept externally drafted powers of attorney on a transaction by transaction basis, subject to its determination that the agent has authority to act, and in some instances, that a power of attorney be certified independently (such as by an attorney). Those policies were established to protect itself and its account holders from potential fraud.

2. Margaret named her son, Peter (a Massachusetts lawyer), as agent under a durable general power of attorney signed in 2009. Peter sent the DGPOA to Vanguard in 2009, they sent him their standard agent authorization form, but Peter refused to sign it and believed the DGPOA was sufficient.

3. In 2012 after his father's death, Peter called Vanguard to transfer the IRA to an inherited IRA in his mother's name. Vanguard resent him the agent authorization form, which he declined to execute. Vanguard sent an IRA opening package to Margaret at her address of record (Peter's address), and Peter signed Margaret's name and submitted the papers without indicating he had signed as agent. He named himself and his sister as beneficiaries on the account. The paperwork he signed for Margaret provided that Margaret accepted the standard Vanguard account terms (described above). Peter made prohibited handwritten changes to Vanguard's forms, and when Vanguard called to say the changes were unclear, Peter demanded that the account be closed and the funds moved to Fidelity. Peter submitted email trade instructions to Vanguard and attached the DGPOA, but still refused to provide the requested certification. Vanguard issued a check but stopped payment on the check when its fraud prevention department flagged the transaction for

lacking certification and for the agent naming himself on the account. Vanguard renewed its request for third party certification, Peter admitted he had signed her name to the forms, and Vanguard refused to accept his signature on the forms without Margaret designating him as agent on its forms. Vanguard explained that an externally prepared DPOA could be used but it needed to have a certification for each transaction that it is still valid. Peter repeated his demands for action and Vanguard repeated its request for the forms. Peter never informed Vanguard about his concerns about his mother's incapacity. While he had Margaret sign a demand letter, he never had her sign the Vanguard standard forms.

4. Peter sued Vanguard in federal court alleging breach of contract, breach of the covenant of good faith and fair dealing, negligence, breach of fiduciary duty, violation of the Massachusetts consumer fraud statute, and unfair trade practices under Pennsylvania law. He alleged that the delay caused Margaret to incur the tax on the funds when she could not file jointly with her deceased husband and use medical expense deductions, increasing her tax burden by $25,000, and she incurred penalties of $13,000 for failure to take required minimum distributions from the IRA.

5. The federal district court granted Vanguard's motion to dismiss all of the claims on the following grounds:

    a. A binding contract between the parties was in place at all times. Peter executed an agreement for Margaret agreeing to the Vanguard account terms. He cannot claim he did not have authority to sign as her agent, and at the same time sue Vanguard for not recognizing his authority as agent. Margaret was also a third-party beneficiary of the contract signed by her husband when he opened the IRA and is bound by the agreement. The argument that no contract exists between Vanguard and Margaret would lead to absurd and unworkable results – some portion of its customers die every day, and if contracts evaporated on the death of the account owner there would be chaos and ample opportunities for fraud and other misconduct.

    b. The contract provided that: (a) a beneficiary's request for distributions must be made in a form and manner acceptable to Vanguard; (b) Vanguard would not be responsible to make any distributions until it receives directions in a form and manner acceptable to Vanguard; and (c) that the agreement was governed by Pennsylvania law. By the terms of the contract, Vanguard was not required to accept a DGPOA valid under state law and could establish reasonable procedures to ensure that transactions were not fraudulent and were made in accordance with the account owner's intent. Vanguard had such a policy, Peter acted in direct contravention of Vanguard's repeated instructions, and failed to submit a distribution request in a manner and form acceptable to Vanguard. The Vanguard conditions were clearly reasonable and did not breach the contact. The issue is not (a) whether Vanguard provided good customer service to Peter or could have found a more amicable way to resolve the situation or (b) whether Peter brought the problem on himself by his own stubbornness and inflexibility. The issue is simply whether Vanguard breached its account agreement terms, and it did not.

c. It was reasonable for Vanguard to insist that distribution requests include basic protections against fraud and self-dealing. Once Peter signed his mother's name without indicating it was his signature, coupled with naming himself as beneficiary of his mother's IRA, Vanguard had a specific basis to suspect potential fraud and could reasonably refuse to relax its requirements.

d. Vanguard was a mere custodian for Margaret and did not owe her fiduciary duties.

e. The account agreement provides that it is governed under Pennsylvania law and therefore Peter could not sue under Massachusetts statutes. Further, choice of law principles would result in the application of Ohio law (where Margaret, the real party in interest, resides) or Pennsylvania law (where the allegedly wrongful conduct occurred), and not Massachusetts law (where Peter resided).

f. Vanguard's conduct could not be considered unfair or deceptive. Vanguard repeatedly informed Peter about its policies and procedures and did not breach its contract. Stopping payment on a check was not a "trade" under consumer protection laws, and by declining Peter's instructions it did not "seize" the accounts. The account grew from $45,000 to $69,000 by the time the assets were withdrawn.

B. *In re Guardianship of Robbins,* 2018 Ind. App. LEXIS 262 (2018). Court cannot refuse funding of self-settled special needs trust due to its disagreement with federal and state policy for severely disabled persons.

1. Timothy's car was hit by a semi-truck, resulting in his being ejected from his car and receiving a traumatic, catastrophic, permanent and degenerative brain injury. His father was appointed as guardian, and following an $18.5 million tort award, settled the tort lawsuit for $17.75 million. The parties agreed that, after payment of legal fees, reimbursement of Medicaid for already incurred medical costs, and funding an annuity for Timothy's benefit, the amount of $6.75 million would be placed into a self-settled special needs trust for Timothy, with the requisite Medicaid and SSI reimbursement provision upon Timothy's death and before any remaining assets would pass to his heirs.

2. The parties presented the settlement to the court for approval. The court held that only $1 million could go into the trust, and the rest would be funded directly into the guardianship estate, based on the court's view that: (a) fully funding the trust would shift considerable expenses to the taxpayers; (b) the settlement amount is adequate to provide for his care without public assistance benefits; and (3) the trust is for the benefit of Timothy's heirs. The court stated that it "disagreed with the legislative policy" and that "it's the legal fiction of impoverishment which I'm having trouble buying into when we have 12 million sitting here". The father as guardian brought an uncontested appeal.

3. On appeal, the Indiana Court of Appeals reversed the trial court on the following grounds:

   a. Special needs trusts are a creation of, and approved by, both federal and state legislation, and both federal and state law permit disabled persons to shield assets for purposes of determining Medicaid or SSI eligibility, so

long as the trust provides for paying back the state for the total benefits paid upon the death of the disabled person. This serves the public policies of allowing disabled persons to obtain services not paid for by Medicaid and eliminates the need for a disabled person to spend down resources to qualify for benefits.

b. The trial court may have a genuine disagreement with the policy decisions of the state and federal legislatures but is still bound to abide by them. Here there are no constitutional concerns with those policy choices. It is a mistake of law to hold the trust is for the benefit of Timothy's heirs, where the trust is for his exclusive lifetime benefit, but the state has a priority right to reimbursement ahead of any interest of any heirs.

C. *Colburn v. Cooper*, 2018 Ohio 5190 (2018). Daughter has standing under UPOAA to petition court for accounting of acts of agent under durable power of attorney, even after the death of the principal.

1. Cheryl alleged that her brother mismanaged their mother's assets when acting as her agent under a power of attorney from 2008 until 2016. She petitioned the court to compel him to provide an accounting (she brought other claims that were dismissed but did not pursue them on appeal). Their mother was placed into guardianship in 2016.

2. The court dismissed the claim and Cheryl appealed. Their mother died while the appeal was pending. On appeal, the court of appeals reversed on the following grounds:

   a. The Ohio UPOAA grants standing to petition the court for an accounting to persons including "presumptive heirs" of the principal and the beneficiaries of the principal's estate plan. The "presumptive heir" category does not apply only after the principal's death, because only a living person has "presumptive" heirs, and a deceased person has only actual heirs. Cheryl was also named as a beneficiary under her mother's will. There is nothing to support the position that a principal must be deceased before a presumptive heir or designated beneficiary has the right to seek review of the agent's conduct.

   b. The statute that lists the parties to whom the agent is required to provide information upon request (i.e. the principal, the guardian or conservator, a governmental agency, or the principal's personal representative) does not require a different result by excluding the presumptive heirs and beneficiaries. That statute provides that an agent must provide accountings when ordered by the court, and Cheryl has standing to ask the court to compel the accounting. If the court finds merit in her request, it will issue an order and the agent is required to comply.

   c. The mother's death does not render Cheryl's petition for an accounting moot. While the UPOAA provides for disclosure to the personal representative upon the principal's passing, this provision is not exclusive. While no longer a presumptive heir, Cheryl is still a beneficiary of the estate plan and there is nothing in the statute that prevents the existence of two viable alternative means of seeking an accounting. Judicial prudence and economy favor ruling on the merits of the case.

II. State Nexus & Taxation

A. *Fielding v. Commissioner of Revenue,* File Nos. 8911-8914-R (Minnesota Tax Court 2017); A17-1177 (Minn. 2018). Minnesota statute that taxes worldwide income of an irrevocable non-grantor trust based solely on the domicile of the grantor violates the due process clauses of the Minnesota and U.S. constitutions.

1. In 2009, Reid McDonald, a Minnesota domiciliary, created separate irrevocable inter vivos trusts for each of his four children and transferred nonvoting common stock in a Minnesota Subchapter S corporation into the trusts. The trusts were grantor trusts (by virtue of a swap power) until 2011. All trust distributions were discretionary, and distributions were made to the children from their respective trusts. None of the trustees were domiciled in Minnesota, and for tax year 2014 there was first a Colorado trustee and then a Texas trustee. Both trustees made discretionary decisions about the trusts and maintained the books and records of the trusts outside of Minnesota, and neither travelled to the state for trust business. For part of 2014, the original trust instruments were retained in the Minnesota drafting lawyer's office. Neither trustee was involved in any trust related court actions in Minnesota other than this tax dispute. Three of the children lived entirely outside the state, with just the settlor's son being domiciled in Minnesota in 2014 but attending college in New York.

2. In 2011, the trusts became Minnesota "resident trusts" under a state statute that defined non-grantor trusts created and irrevocable after December 31, 1995 as resident trusts based solely on the domicile of the grantor in the state at the time the trusts became irrevocable (or for testamentary trusts, the in-state domicile of the decedent at death). The statute applied a different test based on the circumstances of the in-state administration activities of the trust (rather than only the domicile of the grantor) to pre-1995 trusts.

3. In 2014, the trusts sold their stock in the S corporation and opened investment accounts with Wells Fargo that were administered in California. The trusts timely filed resident tax returns and paid tax as resident trusts on their worldwide (and not just their Minnesota source) income under protest, and then filed amended returns and claims for refund that were denied. The trusts appealed to the Minnesota Tax Court and moved for summary judgment. The trusts sought to exclude from tax the gain on the sale of the stock and the subsequent investment income in the Wells Fargo account.

4. The Tax Court awarded the trusts summary judgment that the Minnesota definition of a resident trust, as applied to these trusts, violated the Due Process clauses of the Minnesota and U.S. constitutions on the following grounds:

    a. The parties agreed that the state was imposing tax on the worldwide income of the trusts as "resident trusts" and the applicable statute for post-1995 trusts clearly bases taxation solely on the domicile of the grantor. Therefore, the state's arguments about benefits the trusts received from the state are irrelevant. The only issue is the constitutionality of taxation based on the historical domicile of grantor.

b. Other courts have held that the historical domicile of the grantor is not a constitutionally sufficient nexus to justify taxing the worldwide income of the trusts, and this approach is problematic in that it (1) reaches back through time to a discrete historical moment and does not rely on protections afforded by the state during the time period where the income was earned, and is an immutable and perpetual characteristic with a worsening due process concern each year, (2) reaches across persons and relies on connections with the grantor rather than connections with the trusts themselves, and (3) is a relatively superficial connection. Domicile of the grantor does not amount to present and substantial connections to the taxing state, and standing alone is not a sufficient basis to justify the resident tax treatment of an inter vivos trust.

c. Therefore, the state statute as applied to these trusts in 2014 violates the due process provisions of the Minnesota and U.S. constitutions, the state did not have authority to tax the gain on the stock sale and the Wells Fargo investment income which are intangible items of personal property not located in Minnesota.

5. On July 28, 2017, the Commissioner of Revenue petitioned the Minnesota Supreme Court for review of the tax court decision.

6. On appeal, the Minnesota Supreme Court (with one dissenting justice) affirmed on the following grounds:

a. Looking at all relevant facts about the contacts between the taxpayer and the state, the income attributed to the state, and the benefits the taxpayer received from the state, the trusts lack sufficient relevant contacts with the state during the tax year to be taxed on all sources of income as a resident.

b. The grantor's connections to the state are not relevant. A trust is its own legal entity separate from the grantor and beneficiaries, and the relevant connections are those between the state and the trustee. Here the trusts are the taxpayer and the grantor did not retain any control over the trust assets. For similar reasons, the residency of a single beneficiary in the state does not justify taxation.

c. The drafting of the trusts by a Minnesota law firm is not sufficient to support taxation where the firm represented the grantor and not the trustee. The firm's storage of the original trust instruments in the state is not to be awarded legal significance and was likely nothing more than a service or convenience to the grantor.

d. The trusts did not own physical property in the state, and ownership of a Minnesota S corporation interest is an intangible asset held outside the state and not adequate to support taxation.

e. Contacts with the state before the tax year at issue cannot justify taxation. Contacts must be assessed in the tax year at issue, and it is only contacts in the tax year that can establish a rational relationship to the taxing state. Allowing the state to look to historical contacts outside the tax year would create uncertainty for taxpayers and be unworkable, because there is no reasonable way of determining when past contacts have sufficiently decayed such that they no longer support taxation.

f. Here, all trust activities occurred outside the state in the tax year, and the trustees never visited the state for trust matters. The trustees, and not the grantor, made trust decisions including the decision to sell the stock in the Minnesota S Corporation, and those decisions were made outside the state.

g. The choice of Minnesota substantive law to govern the trusts is not enough to allow taxation. The state laws protect residents and non-resident alike, and the court will not demand that every party who chooses to look to state law (without invoking the jurisdiction of its courts) must pay resident income tax for the privilege, and (i) these inter vivos trusts have not been probated in the courts and have no existing relationship to the courts and (ii) the trustees were never plaintiffs or defendants in any suits in the state as trustees.

h. The state lacks sufficient contacts with the trusts to support taxation of the trusts as residents. The state cannot fairly ask the trusts to pay taxes as residents in return for the mere existence of Minnesota law and the physical storage of a trust instrument in the state, and therefore the state taxing statute is unconstitutional as applied to the trusts.

7. Minnesota petitioned the U.S. Supreme Court to grant *certiorari* in the case.

B. *Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Department of* Revenue, 2015 NCBC LEXIS 39 (2015); 2016 N.C. App. LEXIS 715 (July 5, 2016); 2016 WL 7189950 (2016); 2018 B.C. LEXIS 431 (2018). Taxation of wholly discretionary trust based on residence of beneficiaries, without other contacts, violates the Due Process and Commerce Clauses. The North Carolina Court of Appeals affirmed the decision. The state Supreme Court also affirmed the decision.

1. In 1992, Joseph Rice created an inter vivos trust under New York law for his three children, which divided on its terms into separate trusts in 2002 (the assets were physically segregated in 2006). The original trustee resigned in 2005 and a new trustee located in Connecticut was appointed. The separate trust at issue was for the benefit of residents of North Carolina.

2. All trust distributions were discretionary, and none were made for the tax years at issue (although the trust made AFR loans for the benefit of the North Carolina beneficiaries or trusts for their benefit, which were repaid). The trust assets, all of which were financial, were custodied in Boston. The trust records were maintained in New York, and tax returns and accountings were prepared in New York. The trustee communicated with the primary beneficiary about the trust occasionally, and met with her in New York. After the tax years at issue, the trustee decanted the trust assets into a new trust that eliminated the mandatory distribution of trust assets at age 40, with the consent of the primary beneficiary.

3. North Carolina taxed the trust income in the amount of $1.3 million under a state statute that imposed tax on out of state trusts that are for the benefit of state residents. The trust paid the tax, and after its request for refund was denied, petitioned to seek the return of the tax paid. On cross motions for summary judgment, the court granted the trust summary judgment for the following reasons:

a. As applied to this trust, the statute imposing tax based on the residency of the beneficiaries alone violates the Due Process Clause of the U.S. Constitution and the Law of the Land Clause of the North Carolina Constitution on the grounds that: (i) the trust did not have a physical presence in the state, own real or personal property in the state, or invest directly in state investments, trust records were kept out of state, and its principal place of administration was out of state; (ii) the trust did not purposely avail itself of the benefits of state law; (iii) the trust is a separate legal entity from the beneficiaries and the contacts of the beneficiaries are not relevant; (iv) the equitable interests of the beneficiaries, even if relevant, were an inadequate nexus with the state where the beneficiaries had no control over discretionary distributions, investments, or income, and receipt of loans from or information about the trust are not sufficient contact with the state; and (v) the tax is not rationally related to state values, as the state has not provided the trust for which it can ask for tax in return.

b. As applied to this trust, the statute also violates the negative sweep of the dormant Commerce Clause of the U.S. Constitution on the grounds that: (i) the trust, as a legal entity separate from the beneficiaries, lacks minimum contacts with the state to form a substantial nexus; and (ii) the benefits provided to the trust beneficiaries by the state are not relevant.

4. On appeal, the North Carolina Court of Appeals affirmed and found that the imposition of tax would violate the Due Process Clause, on the following grounds:

a. The U.S. Supreme Court case of *Brooke v. Norfolk*, 277 U.S. 27 (1920) is controlling. In that case, a bank was directed to pay the income of a trust created by a Maryland resident to a Virginia beneficiary. The trust property remained in Maryland and was never in Virginia. The trust property was not controlled by the beneficiary. The U.S. Supreme Court found that the imposition of tax by Virginia on the trust corpus was unconstitutional (the beneficiary paid Virginia the tax on the income received).

b. The trusts in both this case and in *Brooke* were created and governed outside the taxing state, the trustees resided outside the taxing state, and the trusts did not own property in the taxing state. In addition, in this case the beneficiary did not receive any distributions.

c. The connection between North Carolina and the trust is insufficient to satisfy the requirements of due process and the application of the tax violated the Due Process Clause of the U.S. Constitution and the Law of the Land Clause of the North Carolina Constitution.

5. The Commerce Clause issues were not addressed on appeal.

6. On December 8, 2016, the North Carolina Supreme Court agreed to hear the appeal of the case.

7. On appeal, the North Carolina Supreme Court (over one dissenting Justice) affirmed the taxpayer victory, and held that the North Carolina statute violated the Due Process Clause *as applied* to the taxpayer (and not on its face) on the following grounds:

a. For tax purposes, a trust has a separate existence and is a separate legal entity. Therefore, the trust's minimum contacts with the taxing state cannot be established by contacts with the state by third parties (the beneficiaries). Here, the beneficiaries reaped the benefits and protections of North Carolina law by residing there, but due process is not satisfied by their contacts with the state.

b. The trustee's contacts with the beneficiaries are not adequate to support taxation because (i) meeting with the beneficiaries occurred outside the state; (ii) any loans made to the beneficiaries happened outside the tax year at issue; and (iii) the U.S. Supreme Court has directed that minimum contacts analysis looks to contacts with the taxing state itself, and not contacts with persons who reside in the taxing state. Mere contact with a North Carolina beneficiary is not purposefully availing itself of the benefits and protections offered by the state.

c. To satisfy due process considerations, there must be minimum contacts between the trust and the taxing state such that the trust enjoys the benefits and protections of the state. Imposing tax solely based on the beneficiaries availing themselves of those protections would violate due process guarantees, and therefore the state taxing statute is unconstitutional as applied to the trust.

8. North Carolina petitioned the U.S. Supreme Court to grant *certiorari* in the case, which was granted by the U.S. Supreme Court on January 12, 2019.

C. *Hansjoerg Wyss 2004 Descendant's Trust,* Docket 1608934 (2017). The Pennsylvania Board of Finance and Revenue reversed the Board of Appeals, and ordered a refund of 2012 income taxes imposed on a trust created by a Pennsylvania settlor as a Pennsylvania resident trust, on the grounds that: (1) the trust was administered outside the state, the books and records were out of state, the trust did not have any in-state assets during the tax year, and the trust had no in-state beneficiaries; (2) taxing the trust based on the domicile of the settlor is constitutionally prohibited under McNeil v. Commonwealth, 67 A. 3d 185 (Pa. Commw. 2013); (3) the presence of two of the four co-trustees in the state cannot support taxation because the tax department regulations state that "the residence of the fiduciary and the beneficiaries shall be immaterial"; (4) simply retaining legal and accounting services in the state cannot provide sufficient nexus for taxation; and (5) the Board is constrained by McNeil and the failures of the legislature and tax department to act since the case was decided, causing a loss of funds to the public fisc.

D. *Paula Trust v. California Franchise Tax Board,* Case No. CGC-16-556126 (2018). The San Francisco Superior Court granted summary judgment in favor of a trust reversing The California Franchise Tax Board, and ordered that 50% of the income taxes paid by the trust on the sale of trust owned business assets (that were also located in California) in the tax year be refunded, on the grounds that: (1) the trust had one California co-trustee and one out of state co-trustee, and any in-state beneficiaries were contingent; (2) Cal. Rev. & Tax Code Section 17743 apportions California trust income based on the number of California versus non-California fiduciaries; and (3) while California law also apportions income based on California non-contingent beneficiaries, none were present. The California Franchise Tax Board filed a notice of appeal of the ruling.

E. ***South Dakota v. Wayfair, Inc.*, 585 U.S. ____ (2018).** A divided United States Supreme Court (in a 5-4 decision) overruled its precedent in National Bellas Hess, Inc. v. Department of Revenue of Ill., 386 U.S. 753 (1967) and Quill Corp. v. North Dakota, 504 U.S. 298 (1992), and held that South Dakota could within constitutional Commerce Clause limits require out-of-state sellers without a physical presence in the state to collect sales tax on internet sales inside the state, on the grounds that: (1) the physical presence test in Quill is not a necessary interpretation of the "substantial nexus" test under the Commerce Clause jurisprudence, in modern commercial life physical presence is not necessary to create a substantial nexus, and physical presence is a poor proxy for the compliance costs of companies that do business in multiple states; (2) Quill creates market distortions; (3) Quill imposes an arbitrary distinction that modern precedent disavows, and the court should instead ground its jurisprudence on functional marketplace dynamics; (4) it is not the purpose of the Commerce Clause to relieve companies engaged in interstate commerce from their just share of the state tax burden, or to create market distortions that put businesses with a physical presence at a competitive disadvantage to remote sellers, create a judicial tax shelter for remote businesses, and incentivize companies to avoid a physical presence in the state; and (5) the physical presence rule is an extraordinary judicial imposition on state taxing authority and does harm to federalism, state sovereign power, and free market principles, has become an increasingly more egregious error since it was decided as a result of the Internet revolution, and is therefore unsound and incorrect and overruled.

F. ***Comptroller of the Treasury v.* Taylor, 2018 Md. App. LEXIS 717 (2018).** Maryland may not impose state death tax on QTIP trust at death of surviving spouse.

1. Under his will and upon his death in Michigan in 1989, John created a marital trust for his wife Margaret funded with $2.3 million. A QTIP election was made for the trust on a timely filed estate tax return. Margaret moved to Maryland in 1993 and died testate in 2013. At the time of her death, the trust had a value of $4.1 million.

2. Margaret's executor included the trust on her federal estate tax return but excluded it from her Maryland estate tax return. The Maryland comptroller disallowed the exclusion, and imposed tax, interest, and penalties against the estate (for a total of $440,000). On petition for review by the executor, the Maryland tax court affirmed the tax on the grounds that the tax provisions link the federal and Maryland taxable estates, and affirmed the interest assessment, but reversed the imposition of penalties. The executor appealed.

3. On appeal, the Maryland Court of Special Appeals reversed the tax court and held that Maryland could not impose its estate tax on the trust on the following grounds:

    a. The Maryland tax code imposes its state estate tax on the transfer of the Maryland estate of a Maryland decedent. The Maryland estate is defined as the "federal gross estate", but the tax code further provides that the Maryland estate is "the part of an estate that [Maryland] has the power to subject to the Maryland estate tax". Another tax code provision provides

that "for purposes of calculating Maryland estate tax, a decedent shall be deemed to have had a qualifying income interest for life under [IRC Section 2044(a)(2)] with regard to any property for which a marital deduction [QTIP] election was made for the decedent's predeceased spouse on a timely filed Maryland estate tax return". Other provisions recognize a federal QTIP election and also allow a Maryland state only QTIP election.

b. The court will not extend a tax statute by implication beyond the clear import of the text. In cases of doubt, tax statutes are construed most strongly against the government and in favor of the citizen. The statutes contemplate the possibility that there would be property in the estate of a Maryland decedent that the state did not have the authority to tax. The statute explicitly delineates that an election be made on a timely filed Maryland estate tax return. No such election exists here, and the court will not ignore that statutory requirement.

c. The assets were not transferred as part of Margaret's estate. Trusts vest at the time of the testator's death, absent trust terms to the contrary. The federal QTIP election did not miraculously convert these trust assets so that they become her property. She started receiving income in Michigan, and she paid Maryland income tax on all income received after she moved to Maryland. She had no legal right to control the entire value of the trust and did not have power of disposition over its assets. Her terminable interest in the trust did not transfer at her death, it terminated. The QTIP fiction that includes the assets in the estate of the surviving spouse does not prevent the transfer of legal title to the trust, and therefore there was no transfer by her at her death.

G. *Estate of Evelyn Seiden,* 2018 N.Y. Misc. LEXIS 4477 (New York County Surrogate 2018). New York may not impose state death tax on QTIP trust at death of surviving spouse.

1. Jules died in 2010 during the year of temporary estate tax repeal. Under his estate plan, he created a trust for the benefit of his wife, Evelyn. Due to repeal, no federal QTIP election was made for the trust. However, the executor filed a New York estate tax return and made a state QTIP election (and filed a pro forma federal return). A marital deduction was taken against the state estate tax and the state taxing department issued a closing letter accepting the return in 2012.

2. Evelyn died in 2014. Her executor excluded the trust assets from her estate on the basis that no federal marital deduction was claimed or allowed in the husband's estate that would require inclusion under IRC Section 2044 (and New York defines its gross estate by reference to the federal gross estate). The IRS issued a closing letter accepting the return as filed. New York disagreed and assessed tax, interest, and penalties in the amount of $529,342.86. The executor appealed the Notice of Deficiency to the surrogate's court.

3. The surrogate vacated the notice of deficiency on the following grounds:

   a. New York law defines the state gross estate by reference to the federal gross estate.

b. The relevant tax law is the tax law in 2014 when Evelyn died, and not in 2010 when the husband died, because it is the tax on the wife's estate that is at issue. In 2014, the state tax law was rewritten to change references to the 1998 federal tax laws (which would not include the temporary repeal) to refer to updated 2014 federal tax law. Under the federal tax law in effect for 2014, no marital deduction was allowed for decedents dying in 2010. Even under the tax prior to 2014, no federal marital deduction was allowed in the husband's estate. To be allowed as a QTIP trust, a federal QTIP election was required. No such election was made, IRC Section 2044 does not apply, the property is not included in the federal gross estate and the property is therefore not included in the state gross estate.

c. A New York Technical Services Bureau Memorandum (stating that a state QTIP election is enough to cause state inclusion) is merely the state taxing department's position and has no legal effect, does not set precedent, and is not legally binding. The memorandum cannot be used to override statutory provisions.

d. The duty of consistency, a form of estoppel, does not apply because the husband's estate did not make an error or omission and the wife's estate is not taking a contrary position. Both estates followed the law in effect at the time of death. The positions were lawful, and there is no authority that the state could have denied the state QTIP election at that time.

e. The executor can rely on the plain language of the statute, without resorting to speculation about what the legislature intended. The legislature has amended the tax law in other ways to take into account the federal changes in the eight years since 2010, but has not acted to change the effect of the repeal on QTIP property in this type of case. Tax statutes are to be strictly construed, with any doubt resolved in favor of the taxpayer.

f. As for the concerns about "opening the tax floodgates", the legislature can still amend the tax law to apply to future estates, trust property might decrease in value or be distributed, or surviving spouses might change domicile to other states.

H. *Estate of Chernowitz,* 2018 N.J. Tax Unpub. LEXIS 63 (2018). Estate failed to rebut the presumption that gift within three years of death is subject to state inheritance taxes.

1. Edith and her husband signed similar wills in 2001, leaving their estates to their surviving spouse and otherwise $500,000 to nephew Richard and the balance to charity. They did not have children. Edith's husband died in 2002, she relocated to a continuing care community closer to Richard, and she regularly attended family events held by Richard. She made annual exclusion gifts and invested heavily in tax-free municipal bonds to reduce income taxes. In 2011, she developed colon cancer, and in 2012 she was found lying in vomit in her apartment. She regularly read the New York Times and the Wall Street Journal, and in 2012 she notified Richard that the federal tax laws were changing and she discussed making a one-time $5 million gift before the end of 2012. She met with a lawyer suggested by Richard who prepared the gift paperwork (he also discussed revising her estate plan but did not sign new documents before her death).

2. On December 18, 2012, Edith signed the gift paperwork at her financial advisor's office, and then spent the balance of the day walking around Manhattan. That day she gave $2.8 million to Richard, $2 million to a trust for his family, and $300,000 to a special needs trust for another nephew that she had previously supported through annual exclusion gifting. In total, she gifted $5.1 million of her total assets that were valued at $18 million. She was 98 at the time.

3. Edith died on October 24, 2014. New Jersey sought to impose its state inheritance tax on the gifted assets as gifts made in contemplation of death. New Jersey law presumes gifts made within three years of death that are of a material part of the estate to be made in contemplation of death, but the presumption is rebuttable (with the estate having the burden of persuasion by a preponderance of the evidence, and upon consideration of factors set out by the state supreme court). On competing motions for summary judgment, the court granted summary judgment in favor of New Jersey and against the estate on the following grounds:

   a. A gift of 28% of the estate is a material part of the estate.

   b. Courts have consistently held that gifts made within three years of death by persons over age 80 are made in contemplation of death.

   c. Despite her vitality for her age, Edith's colon cancer scare, anemia, and health incidents would have been a reminder of her mortality shortly preceding the gifts. There is a natural inference that she was confronting her mortality at the time of the gifts. Gifts do not have to be in contemplation of imminent death to give rise to the tax, and the health problems that support a conclusion of contemplation of death do not have to be the actual cause of death.

   d. The fact that the gift was not a deathbed gift is favorable to the taxpayer, but that positive impact is easily eroded by the gift immediately following the cancer diagnosis that would remind any person of their mortality.

   e. At the time of the gift, the December 31, 2012 federal gift tax deadline was looming, Edith was acutely aware of the tax aspects of her financial affairs (most of her income was from investments in tax-free bonds) and the expiring gifting opportunity, she understood there was a possible $2 million federal estate tax savings from the gift, and she had a desire to evidence federal estate taxes. She had an impelling tax motive for the gift during life rather than at death, it is unclear how much weight to give to the 2001 will that she was talking about changing, and her gift fell "well within the rubric of gifts in which the decedent is more concerned with when to make the gift to a certain donee, not whether to make the gift".

   f. While her prior will only gave Richard 10% of what he received by the lifetime gift, that will predated her husband's death, her life changed afterwards, and she was planning to change that will before her death. Edith did not have a history of making substantial gifts prior to the 2012 gifts. Richard and his family were the natural objects of her bounty.

   g. While gifts made for emergency situations are usually considered gifts in contemplation of life, a change in the tax code is not an emergency situation that prompted the gift. It was merely an opportunity to avoid estate taxes.

III. Business Interests

A. *Lund v. Lund,* No. 27-CV-14-20058 (Minnesota District Court 2018). Court rejects experts and determines value of company for statutory buyout of trust interests, and removes company CEO as co-trustee following buyout under no-fault removal statute.

1. Kim is the eldest grandchild of Russell Lund, the founder (in 1939) of the grocery company Lunds, Inc. Through various trusts, Kim was the indirect owner of 25% of the family businesses (a grocery company, a food processing company, and a real estate company that rents property to the other businesses). 11% of her interest would pass to her in the future when estates had been paid and the administration of a marital trust for the benefit of her grandmother was completed. Russell started the process of transferring the businesses to trusts for his children and grandchildren in the 1960s. Kim's brother, Tres, also owned 25% of the businesses and was the only family member involved in the companies (as president, CEO, and board chairman). He also served as co-trustee of several trusts for Kim's benefit. Russell's estate planning attorney also served as co-trustee of various trusts for Kim's benefit for more than 20 years. Kim's siblings were contingent beneficiaries of the irrevocable trusts for her benefit. Kim did not have the power to choose trustees for her trusts, and a bank was named as default successor trustee (the named bank was familiar with the family and the businesses).

2. Kim sought liquidation of her business interests and financial independence for over 20 years. She sued to compel a statutory company buyout of her interests, and filed additional claims for breach of fiduciary duties, civil conspiracy, removal of trustee, and attorneys' fees. The court ordered a statutory equitable buyout of Kim's interests in the businesses, excluding the marital trust interest, but denied her claims for breach and conspiracy. The court held that it could not order buyout of her interest in the marital trust due to the outstanding estate tax obligation for that trust and the joint and several liability of the four grandchildren for that liability.

3. The parties proceeded to trial on the issue of valuation of the buyout price. Kim's expert valued her interest at $76 million. The company's expert valued Kim's interest at $21.28 million. The court discounted the valuations of both expert on the following grounds:

    a. Despite their qualifications, their zealous advocacy compromised their reliability. The income (DCF) approach is most appropriate for valuing the non-real estate businesses, and the adjusted net asset value method is appropriate for valuing the real estate business. The market (guideline public company) approach used by both experts is rejected because of the uniqueness of the Lund companies and the lack of comparable companies.

    b. Neither expert met their burden of proving value by a preponderance of the evidence. Their valuations were tailored to suit the party paying them, and this cold fact cuts against their credibility in equal measure.

    c. Kim's expert took an overly optimistic view of the grocery business and minimized market competition and disrupting forces. The company's

expert undervalued the company by improperly considering pension obligations as impacting cash flow, ignoring a hypothetical sale, improperly applying a discount of lack of liquidity (which is not allowed under state law in this setting), and ignoring the company's success and impressive history of maintaining market share even amidst enhanced competition.

d. With respect to cash flow analysis: (i) Kim's expert ignored market forces and ignored management's own projections and assumed inadequate capital expenditure; and (ii) the company's expert was more reliable but improperly took into account the pension plan obligations that were not payable on the valuation date and the payment of marital trust estate taxes (which would not be paid by a hypothetical buyer).

e. With respect to long-term growth rate: (i) Kim's expert assumed too low a capital expenditure and too high (4%) a growth rate which was not supportable in the grocery industry, either nationally or locally; and (ii) the company's 3% projected growth rate was more reasonable.

f. With respect to the discount rate, while the company had zero long-term debt (which was unusual in the industry), it was not proper to assume no debt in the valuation (which would reduce the enterprise value by $100 million). The actual capital structure, which was established as a result of the particular needs and desires of the owning family, would be as improper as using the specific capital structure of any other investor. Fair value is obtained by considering the behavior or market forces, and the value of the company to itself is not the same as the value to the marketplace. The market places a value on how it expects a company will perform in the future and expects a company to move to its optimal position in terms of debt structure. The median debt-to-capital ratios of comparable companies supports a debt-to-capital ratio of 10% debt to 90% equity, and this discount rate results in an enterprise value reduction of $45 million.

g. Kim's expert did not consider the value of the real assets in valuing the real estate company. It was appropriate to use available appraisals of those properties (even though some were three years old) because commercial properties do not fluctuate like residential real estate in a way that would meaningfully impact the valuation.

h. Under Minnesota law, it was improper for the company's expert to apply a discount for lack of marketability or control. The statutes are silent, but the state Supreme Court held that discounts in the court-ordered buyout context should only be applied in extraordinary circumstances, such as wrongdoing by the minority shareholder, the availability of other remedies, or an unfair transfer of wealth, none of which apply here. There is no unfair wealth transfer here because Kim's interest is not exponentially greater than the company net worth, the other shareholders are not being left with a company with a doubtful potential for growth, the company pays a strong dividend, and the company management are very good at what they do. The circumstances here are not extraordinary – they are expected when a family business is undergoing a court-ordered transition.

4. The court made its own determination of value and held that the fair market value of the businesses was $191.5 million, and that Kim's trusts were entitled to $45.2 million (excluding her future inheritance from the marital trust). In the interest of meeting the goal of the terms being fair to all parties, the court ordered the sale to be accomplished through a 5% cash down payment and a 20 year note at the long-term AFR rate. The deferral of principal payments allows the company to still reinvest in the business as needed.

5. Applying the UTC no-fault removal statute, the court removed Tres as co-trustee of Kim's trusts, and appointed the default bank trustee, on the following grounds:

   a. The deterioration of his relationship with Kim and her family, which included Tres not providing her with any trust information for two years, and the eradication of their ability to collaborate or rely on each other in any capacity.

   b. The sale of the company interests held in the trusts is a material change of circumstances negating any reason for involvement in the trusts.

   c. Kim's nominated successor trustees did not appear at trial or respond to the court's inquiries about their credentials. No evidence was presented of their knowledge of trusts, and there were allegations that one nominee had a conflict of interest as head of a charity to which Kim had donated. In contrast, no one contested the bank's qualification to serve.

6. The court refused to remove the settlor's attorney as co-trustee in order to maintain consistent administration across the trusts for the siblings and because he was best suited to guide Kim's trusts through the transition.

B. *Menhennick v. Menhennick*, 2018 Mich. App. LEXIS 2658 (2018). Son validly exercised option to purchase shares from trust at mother's death.

1. Upon his death in 1993, under the terms of his revocable trust Alva created a family trust for his wife's lifetime benefit, with the assets passing equally to his sons upon her death (a marital trust was not funded because the total estate was below the $600,000 exclusion amount). The trust terms provided that "at the time of distributing Grantor's trust assets", those of his children then actively involved in Harvey Oil would have the right to have Harvey Oil shares allocated to their shares, and purchase any excess, at the value finally determined for settling Alva's estate, or at estate tax values if it was necessary to file an estate tax return (which is was not). Alva stated it was his intent that the children actively involved in the company be given the option to acquire all of the company stock, and stated that "the right to acquire the shares…shall expire six months from the date of the approval of the Grantor's 706 return by the Internal Revenue Service", which never happened because no return was ever filed. At Alva's death, he owned 65 shares of Harvey Oil with a then total value of $115,635.

2. Alva's wife dies in 2014, and the one son involved in the company, Timothy, sought to exercise the allocation and purchase option, and the other three sons objected. Timothy petitioned the court to approve the option exercise, which was denied based on the trial court's holding that the option had expired. Timothy appealed.

3. On appeal, the Court of Appeals reversed the trial court on the following grounds:

    a. The option was not available until Alva's wife's death, which is when assets would actually be distributable. There was no residue to allocate shares to until that time, and the number of shares that must be purchased could not be determined until that time.

    b. The conclusion that the option did not mature until his wife's death is consistent with his statements of intent. The probate court erred by concluding that the option expired shortly after Alva's death. Because no Form 706 was filed or approved by the IRS, the option limitations period never began to run, and the trust terms contemplated that the Form 706 might not be filed.

    c. Nothing in the trust supports the argument that Alva wanted his children to acquire control after his death, rather than after his wife's death. There is nothing in the trust to suggest that Alva was concerned about capital gains on the sale, and the purchase price is fixed under the trust terms. There is nothing to support the argument that Alva was concerned that a son would not be able to obtain purchase financing after the 6 months period after Alva's death.

C. *Milliette v. Milliette,* 2018 Wisc. App. LEXIS 485 (2018). Surcharge award affirmed where trustee failed to make required trust distributions through limited partnership structure.

1. Audrey created a trust for her daughter Margarete in 1997, with her son Gary as trustee. She created a limited partnership to hold her bed and breakfast business called the "Eleven Gables Inn", located on Lake Geneva. She gifted 30% to the trust, 60% percent to Gary, and retained 10% for herself. Audrey was the initial general partner until 2003. In 2003, Gary formed a limited liability company that he owned, and leased the Inn from the partnership for 10% of the gross Inn revenues under a triple net lease (the lessee paid all of the expenses, utilities, and maintenance).

2. The trust terms provided that, upon Margarete reaching age 50, the trust was to distribute all of its income annually to her, but Gary did not distribute any income to her. The trust also provided that at age 50 the trustee annuitize the value of the trust and pay the principal out to her over her life expectancy under the IRS actuarial tables, but Gary did not distribute any principal to her. Gary also failed to maintain any trust records and did not provide her with access to the trust records or accountings as required by the trust terms. Margarete lost her home, had no health insurance, received public assistance, and could not afford rent for an apartment.

3. Audrey died in 2014 and Gary inherited her 10% interest in the partnership, and also became general partner. In 2015, Margarete petitioned to remove and surcharge Gary as trustee of her trust and terminate the trust.

4. The trial court removed Gary as trustee, surcharged him $100,000, surcharged him $10,000 for the legal fees he paid out of the trust, and ordered the termination of the trust and the distribution of all of the trust assets to Margarete. Gary appealed only the surcharge awards.

5. On appeal, the Wisconsin Court of Appeals affirmed the surcharge awards on the following grounds:

   a. Gary failed to make the required income and principal distributions under the trust terms. Gary failed to maintain trust records to support his defense that the trust did not earn income, and made no effort to try to comply with the trust distribution requirements. He didn't consult a financial advisor or attorney, or seek guidance from the court. The partnership interest was an asset that could be used for distributions. Gary participated in the creation of the LLC that diverted 90% of the partnership's income to himself through the LLC. Gary was paying only $1,000 per month in rent for his use of the Inn. By doing so, Gary clearly breached his duty of loyalty to Margarete.

   b. Even if the only income in the partnership was the lease payments from the LLC, there still should have been something distributable to Margarete's trust, where the partnership agreement required distribution of net cash flow to the partners (and under a triple net lease all expenses would be borne by the LLC). To the extent Audrey refused to distribute those funds, Gary's fiduciary duties as trustee obligated him to pursue a claim against Audrey to collect the funds owed to the trust, or at a minimum, to seek court guidance on how to comply with his duties as trustee in light of Audrey's breach of her own fiduciary duties.

   c. Gary could have annuitized the partnership interests, because the trust terms provided a mechanism for sale of interests without the consent of the general partner, and the sales proceeds could have been used to purchase an annuity for Margarete. Gary did not take any actions to explore ways to comply with the principal distribution requirements under the trust terms.

   d. If the lease terms were dictated by Audrey, Gary would have breached his duties in the transaction by failing to represent the trust's minority interests. He should have sought the advice of independent counsel concerning the lease, and instead he accepted lease terms that diverted a substantial portion of the Inn's income away from the trust and to himself. Under those circumstances, his acceptance of the lease was a clear violation of his fiduciary duties as trustee.

   e. The $100,000 measure of damages was appropriate because: (i) Gary failed to keep records, making a precise damage calculation impossible; (ii) there was factual support for the approximate award based on Inn revenues; (iii) Gary failed to account as trustee; (iv) any uncertainty in calculating damages was caused by Gary, and a party that causes the uncertainty cannot demand a more precise damages measure; (v) the court could credit Margarete's testimony about her financial hardship as a result of the breaches of duties by Gary; and (vi) the damages were compensatory in nature and not punitive damages.

   f. Surcharging Gary for the attorneys' fees he paid out of the trust was proper because the court can award fees as justice and equity may require, the trust terms that allow him to retain counsel do not preclude the court from making the award, Gary's violations were found to be egregious and blatant, and Gary failed to notify Margaret of the payment of the fees as required by state statute.

D. *Rollins v. Rollins,* 2013 Ga. App. LEXIS 332 (March 29, 2013); 20 Ga. LEXIS 179 (March 3, 2014); 329 Ga. App. LEXIS 780 (2015); 2015 Ga. LEXIS 230 (2015); 2015 Ga. LEXIS 904 (2015); 2016 Ga. App. LEXIS 453 (2016); 2017 Ga. LEXIS 286 (2017); 345 Ga. App. 832 (2018). Appellate court holds that trustees must account for corporate level activities of entities held in trust where they have the individual control over the entities, and are subject to trustee duties for their entity level actions; Georgia Supreme Court reverses. Court of appeals remands to trial court for fact finding on the fiduciary nature of each action by the defendants, but Supreme Court vacates and assigns standards of care to each claim for breach, and remands back to the Court of Appeals. On remand, the Court of Appeals finds numerous issues of fact remaining, and remands the case back to the trial court; Georgia Supreme Court denied appeal. Related claims brought by trustees of marital trust dismissed as being barred by the statute of limitations, or otherwise as claims that must be brought as a shareholder derivative suit and not individually.

1. In 1968, O. Wayne Rollins created the Rollins Children's Trust (RCT Trust) for the benefit of his nine grandchildren and his great-grandchildren. His sons, Gary and Randall, were named as trustees along with his friend Tippie. The trust terms provided for the distribution of part of the trust principal to the grandchildren at ages 25 and 30, with the remainder distributed after their deaths to Mr. Rollins's great-grandchildren. The trust was funded with stock in Rollins, Inc.

2. In the 1970s and 1980s, Mr. Rollins created several family entities to hold the trust assets primarily for the purpose of reducing taxes.

3. In 1986, again to limit tax liability, Mr. Rollins established separate Subchapter S Trusts for each of his nine grandchildren, with his son Gary as trustee of the trusts for his children and Randall as trustee of the trusts for his children. These trusts were initially funded with one of the entities created by Mr. Rollins, and the trusts later purchased additional shares of the same entity from other family entities created by Mr. Rollins. In 1988, Mr. Rollins created another family entity held within the S Trusts, again to minimize tax liability. The S Trusts required annual distribution of trust income, and required outright distribution of the trust assets upon the beneficiary reaching age 45.

4. Gary's four children sued the trustees for breaches of fiduciary duty for allegedly changing the business entities held in the trusts to shift power to themselves, making trust assets illiquid and nontransferable, and implementing a non-pro rata distribution system that is contrary to the trust terms.

5. The trial court granted summary judgment for the trustees. The trial court held that the trustees were not required to account for the entities held in the trust because the interests were minority interests, and that trustee fiduciary duties did not attach to actions taken at the entity level. The beneficiaries appealed.

6. On appeal, the Georgia Court of Appeals reversed the trial court and held that the trustees were required to account for entity level actions on the grounds that: (1) the minority interests in this case did not mean the trustees lacked control over the entity making it impossible to produce information about

entity level transactions, because the trustees are controlling members of the various family entities; (2) the trustee is obligated as fiduciary to provide beneficiaries information that is within his control; (3) a trustee with a controlling interest in an asset held in a trust is required to account for the entity.

7. The Georgia Court of Appeals reversed the trial court and held that trustee fiduciary duties attached to the trustee's entity level actions on the grounds that: (1) trustees may not shed their fiduciary duties in their management of, and distributions from, entities held in their control within a trust; (2) fiduciary duties may adhere to a non-trustee whose control of entities within a trust is such that his actions may be attributed to the trustee itself; (3) the trustees acquired legal authority to manage the family businesses by virtue of their trusteeships; (4) even when they do not hold minority interests, the trustees exercise control of the entities; (5) once a trust relationship is established between a beneficiary and a trustee managing a corporation for a trustee, the fiduciary standard of care applies to his conduct regarding the affairs of the corporation; (6) where trustees elect themselves as officers and directors, they actually operate the business as representatives of the estate; and (7) therefore the trustees may be held to the fiduciary standards of care as to their actions related to the family entities which they control and which are held in the trusts.

8. The court refused to grant summary judgment for the beneficiaries on their claims, finding that issues of fact existed that required the involvement of a jury and precluded summary judgment. The beneficiaries claimed breaches of trust arising out of the following alleged actions by the trustees taken at the entity level:

    a. Amending the partnership agreement for one of the family entities to take management power from the partners and placing it exclusively with themselves as managing partners;

    b. Six months after the beneficiaries sued the trustees, distributing $9 million out of the partnership to the S Trusts for those other beneficiaries that did not join in the suit; and

    c. Imposing, at the entity level, a "code of conduct" establishing conditions on distributions to the trust beneficiaries, which considered (1) attendance and meaningful participation at family business meetings, (2) engaging in "serious pursuits that are meaningful, respectable, and worthwhile in the opinion of the trustees", (3) investment performance, and (4) contributions to the family, and (5) the beneficiaries personal conduct, none of which were part of the trust terms.

9. The Georgia Supreme Court granted *certiorari* in the case, and held that the Court of Appeals erred as follows:

    a. With respect to the issue of accountings, the Court of Appeals failed to consider the impact of and give deference to the trial court's equitable discretion to require or excuse an accounting for a trust, and therefore the court vacated the decision and remanded the case to the Court of Appeals to "place the sound discretion of the trial court on the scales".

b. With respect to whether the trustee's duties attach to corporate level activities, the court reversed the Court of Appeals and held that trustee duties did not attach to corporate level activities in this case, on the grounds that: (1) by making one son the sole trustee of the Subchapter S Trusts, but giving that son shared control over the businesses with his brother (who was not co-trustee of those trusts), and because Mr. Rollins was an experienced businessman who understand the roles he gave to his sons, Mr. Rollins clearly must have intended that the trustees would not be held to higher fiduciary standards when carrying out their corporate duties; (2) the intent of the settlor controls issue of trust construction; and (3) the trust only holds minority interests in the entities, and it is generally best to allow the corporate directors to act in the interests of all shareholders, and not just the trust beneficiaries, and be held to a corporate level fiduciary standard when acting as directors.

10. On remand from the Supreme Court, the Court of Appeals again reversed the trial court on the following grounds:

    a. The trial court erred by granting summary judgment for the trustees on the breach of fiduciary duty claims because: (i) the alleged wrongful amendment of the corporate documents was signed by Gary and Randall as "trustees"; (ii) facts are needed on whether the partnership amendment was an act taken as directors (which the Supreme Court held are subject to corporate duties), or as trustee; (iii) there is a factual dispute as to whether Gary and Randall exercised good faith in amending the partnership; (iv) partners owe a duty to disclose material information to each other, and the amendment of the partnership documents, allegedly done in secret, was likely a material act, and the concealment of that act may give rise to a claim requiring a factual record; (v) because of their statements and documents indicating they were acting through their authority as trustees with respect to the family conduct code imposition, it is necessary to determine as a matter of fact whether they acted as trustees with respect to the conduct code, as directors, or as a combination of the two; and

    b. The trial court granted summary judgment on the accounting issue based on its determination that facts were not needed on the fiduciary duty claims. However, because the Court of Appeals is remanding to the trial court to determine a full factual record on the fiduciary duty claims, the trial court must reconsider its accounting decision to determine whether the factual requirements of those claims justify a change to its decision on whether the trustees must account for corporate level activities.

11. The Georgia Supreme Court granted *certiorari* to hear appeal of the Court of Appeals decision. On appeal, the Georgia Supreme Court vacated the decision of the Court of Appeals, and remanded the case back to the Court of Appeals with directions, on the following grounds:

    a. The facts of the case do not require a jury to determine the fiduciary standard that applies to each challenged transaction, because no material fact dispute exists as to the capacity in which Gary and Randall acted in each transaction.

b. For claims arising out of transfer of corporate assets to a new entity under their control and for retention of excessive corporate earnings, the corporate fiduciary standard applies.

c. For decisions made as trustee of the trusts, the trustee standard applies, such as claims for: (i) improperly investing trust assets and S Trust assets in entities they control, and that were contrary to the outright distributions required at age 45; (ii) improperly conditioning trust distributions on a code of conduct; (iii) executing shareholder agreements on behalf of the trusts; and (iv) executing partnership agreement amendments and voting in favor of the amendments on behalf of the trusts.

d. For claims of breach of the duty owed to other partners of the partnership, the duty is one of general good faith and fair dealing owed among partners.

e. For claims about using the power as general partner to condition distributions on conduct-based criteria, the duties are determined under the amended partnership agreement that grants the managing partners sole and absolute discretion for distribution decisions and imposes liability only for willful misconduct, gross negligence, or bad faith. However, the decision to vote trust interests in favor of this amended agreement is subject to trustee fiduciary duties.

12. On remand, the Court of Appeals again reversed the trial court grant of summary judgment for the defendants, and remanded the case back to the trial court, on the following grounds***:***

a. For claims for breach as trustee arising out of amendments to the partnership agreement, there is a jury question as to whether the actions were in good faith and consistent with the trust terms and purposes, and the jury could also consider actions under the amendment and what they reveal about intent at the time of execution, statements about that intent, and the fact that in the amendment they limited their own liability. A jury could find that the trustees acted in bad faith, and even in an arbitrary or retaliatory manner, or that there were legitimate reasons for the amendments (such as tax advantages, to fulfill a charitable pledge, or to concentrate family management for their benefit). Because fact questions exist, summary judgment for the defendants was not proper.

b. For claims arising out of voting as partners in favor of the partnership amendments: (i) fact questions remain about whether the defendants acted in good faith; (ii) the trial court must determine, since the defendants as trustees have not brought claims against themselves on behalf of the trusts, whether the trustees have failed or refused to act in a way that allows the beneficiaries to bring the claims themselves; and (iii) the trial court has not addressed related statutes of limitations. Because fact questions exist, summary judgment for the defendants was not proper.

c. For claims arising out of the imposition of a family code of conduct: (i) the trial court must determine, since the defendants as trustees have not brought claims against themselves on behalf of the trusts, whether the trustees have failed or refused to act in a way that allows the beneficiaries to bring the claims themselves; and (ii) a jury could find that evidence of bad faith or self-dealing, or could find that they acted in good

faith. Because fact questions exist, summary judgment for the defendants was not proper.

d. For claims arising out of imposing a code of conduct on distribution decisions, fact questions remain and summary judgment was not proper.

e. For claims for breach as directors in locking up stock so that it would not pass free of trust to the beneficiaries at age 45, fact questions remain as to whether the actions were in bad faith, or to protect S-corporation status, to keep stock in the family, or to generate tax savings for future generations.

f. While a small portion of the balance of the trial court award of summary judgment for the defendants was allowed to stand, most other claims were remanded to the trial court in light of the many fact issues outstanding.

g. Claims arising out of the failure to generate a sufficient amount of income, the trial court made no prior rulings on this issue and remand is necessary. Similarly, in view of the decision to remand on numerous factual issues, the trial court must also reconsider its decision denying the claim to compel the defendants to render an accounting of their actions.

13. The Georgia Supreme Court unanimously denied the petition of certiorari from the decision of the Court of Appeals, without a published opinion.

14. 2018 Marital Trust Dispute.

a. In 1993, Gary transferred his lifetime interest in non-voting company stock (56,507 shares) to a newly created marital trust for the sole lifetime benefit of his wife, with his four children as trustees. The trust held 18.3% of the non-voting stock, and its only income was the dividend distributions. The trust was a grantor trust for federal income tax purposes. In 1995, Gary transferred $5.7 million from the marital trust to himself. From 2001 to 2008, a total of $8.3 million in dividends that were owed to the marital trust were used to pay taxes directly to the IRS rather than being paid to the trust. To create the trust, Gary gave the children a series of blank, unnumbered signature pages, which included only the signature line with their names followed by the designation of "trustee". The pages were later attached to the trust. This followed a custom of how Gary or the Rollins family office asked the children to sign papers. The trustees relied on Gary's representation that Gary would sign as trustee of the marital trust until his death, even though the trust named the children as current trustees. They were told their signatures were needed for administrative purposes. One son, Glen, signed the trust tax returns from 1995 until 2009 above the designation "signature of fiduciary" without asking any questions.

b. In 1994, the trustees signed the signature pages (with their names marked as trustee) for a custody agreement that provided that all communications for the trust would be sent to the company and not to the trustees. The company worked with Gary, and not the trustees, on distribution policy, and the marital trust was administered by Gary and the family office without involvement of the trustees. In 1996 and 1999, the trustees signed signature pages (with their names marked as co-trustees) to shareholder agreements that they were not allowed to review. In 2005,

the trustees signed paperwork agreeing to a preferred partnership arrangement that they did not understand, that would give Gary and Randall control over partnership distribution decisions and fix the marital trust income at $360,000 annually.

c. In 2010, Gary and Randall asked the trustees to sign documents approving a plan to restructure the various Rollins entities and trusts, demanded that they sign the papers at the meeting without any information, threatened to stop distributions to the trustees if they did not agree, and declared they would implement the plan without the consent of the trustees. The trustees, in their individual capacities brought the litigation described above, and Gary and Randall retaliated as set forth above. On December 8, 2010, the trustees were informed for the first time that they were trustees of the marital trust, and they began controlling the trust.

d. The trustees retained counsel and determined that: (i) the $360,000 annual distributions to the spouse were low in comparison to the company assets and income; (ii) Gary and Randall's claimed personal ranches were actually company assets for which they paid only nominal leasing fees; (iii) their private planes were actually company assets; and (iv) Randall's customized luxury bus was actually a company asset. The trustees sued Gary, Randall, and the company and brought claims for: (i) inspection of corporate records; (ii) failure to pay dividends; (iii) dissolution; and (iv) conversion, unjust enrichment, and breach of fiduciary duty.

e. The defendants moved for summary judgment and the trial court dismissed most of the claims as time-barred, but allowed some claims (for example, the claims related to self-dealing with the ranches, planes, and bus) to proceed as not being derivative claims. Both parties appealed.

f. On appeal, the Court of Appeals affirmed the dismissal of most of the claims as time barred, and reversed the finding that other remaining claims were not derivative, on the following grounds:

g. Claims for conversion, unjust enrichment, and breach of fiduciary duty are subject to a four-year statute of limitations. The record is devoid of any evidence that Gary and Randall prevented or deterred the trustees from discovering their status as trustees of the marital trust or obtaining information that they were legally entitled to as trustees, or that the trustees exercised any level of diligence to do so. The eldest trustee testified on deposition that he was given a copy of the marital trust and he at least skimmed it.

h. The trust clearly identifies the children as trustees, they signed several signature pages identifying them as trustees, and they should have known they were signing documents as some kind of trustees for the marital trust. Glen also signed tax returns, under penalty of perjury, above the designation "signature of fiduciary", and should have known that he and his siblings were fiduciaries of record for tax purposes. He was given dozens of tax papers annually with hundreds of pages. Regardless of whether he actually read them, he swore an oath that he did review them and it cannot be said that Gary and Randall concealed them.

i. A shareholder, like the marital trust, is not entitled to negligently refuse to acquire knowledge that was open and available through inspection of

books and records, and cannot turn a blind eye to information that is available to him. There is no evidence that the defendants prevented the trustees from obtaining information they were legally entitled to. There is therefore no evidence that the trustees committed actual fraud to deter the trustees from discovering their causes of action.

j. The trustees have failed to produce evidence that they exercised the requisite level of diligence to discover their causes of action within the limitations period. They identified no efforts to discover why they were asked to sign numerous documents, including tax returns, on behalf of the marital trust if they were not actually the trustees. As early as 1993, when Glen skimmed the trust instrument, they had actual notice of wrongdoing when Gary claimed to be the sole trustee. Any confidential relationship they had with Gary and Randall does not eliminate their duty to discover their claims. They signed papers over 15 years that stated they were the trustees. Gary's representation that the papers were for "administrative purposes" is not totally inaccurate. Where trustees make no attempt at all to obtain information they fail to exercise even the minimal due diligence to discover their claims as a matter of law.

k. The alleged breaches occurred in the mid-2000s when the dividend for the marital trust was fixed, and Gary and Randall did not take new actions, wrongful or otherwise, with respect to the distribution on a quarterly basis. The partnership changes occurred in 2002 and 2003. All of these claims are time barred.

l. The remaining claims not barred by limitations are derivative in nature and cannot be brought by the trustees individually, rather than in a shareholder derivate action (on behalf of the corporation), because the trustees cannot show a harm that is separate and distinct from the injury to the other shareholders. There are several non-party shareholders that could be prejudiced if damages are awarded to just the marital trust. Even though those shareholders consented to actions complained of, they have not consented to any successful recovery being paid to the marital trust and not to the company.

IV. Investments

A. *In re Trust of Ray D. Post,* 2018 N.J. Super. Unpub. LEXIS 1932 (2018). Trustee breached its duties by diversifying assets after passage of prudent investor act in violation of mandatory retention provision in trust.

1. Ray owned a fuel oil distribution business, was a customer of the bank, and was on the bank's board. In 1975, he created an irrevocable trust with the bank as trustee, and funded the trust with 2550 shares of AT&T, 304 shares of Exxon, and a $4500 AT&T 30-year bond, for a total funding of $157,000. The trust terms stated that "the trustee shall retain, without liability for loss or depreciation resulting from such retention, the property received from the grantor". It also provided for compensation of the trustee by a side agreement of 5% of the annual trust income. The income was paid to Ray until his death in 1989. The trust terms for the income to then be paid to his wife, Enid until her death or remarriage, and then to Ray's grandchildren Deborah and Sarah. At Ray's death the assets consisted of 1169 shares of Bell South, 520 shares of NYNEX, 1040 shares of Pacific Telesis, 780 shares of South Western Bell, 2432 shares of Exxon, and 2200 shares of AT&T, with a total value of $483,172.

2. In 1993, the bank was acquired, and the acquiring bank became trustee. The new trustee acquired assets from the prior trustee totaling $157,000, consisting of 2600 shares of AT&T, 2432 shares of Exxon, and 7000 shares of companies created as part of AT&T's divestiture. The new trustee began taking statutory commissions in addition to the 5% of trust income under the fee agreement.

3. In 2000, the trustee's in-house counsel raised the issue of diversification following the passage of the prudent investor act in 1997, and outside counsel opined that the trust terms did not relieve the trustee of the duty to diversify. Counsel advised that the trustee could notify the beneficiaries of the need to diversify and seek their consent or seek judicial authorization for a diversification plan. The trustee began diversifying in 2000 and sold 864 shares of Exxon. The trustee's counsel again advised the trustee that it should not unilaterally deviate from the trust terms and act at its own peril and should apply to the court for instructions or approval. Despite that advice, the trustee continued diversification until Enid's death in 2008, without notice to the grandchildren or seeking court approval.

4. The trustee did not send the grandchildren a copy of the trust until after Enid's death, but did send them statements that reflected the stock sales after they requested them. In 2004, the trustee sent them a letter seeking their approval of a 70% equities/30% bonds allocation, and they both approved although at that time neither had seen the trust agreement. Sarah did not recall seeing the trust agreement as part of settling Ray's estate and filing his estate tax return, and Deborah did not recall seeing the trust until she asked for information in response to the trustee's asset allocation request. None of the communications from the trustee contained information about the trust terms.

5. Enid died in 2008 and the trustee wrote to the grandchildren, sent them a copy of the trust for the first time, and informed them the trustee was preparing an accounting. According to the account synopsis, the value of the trust was $1.4 million in 2001, $1 million in 2006, and $1.2 million in 2008. Neither grandchild noticed the stock retention provision and did not become aware of it until the trustee petitioned to approve its final accounting. The trustee asked them what type of accounting they wanted, they did not respond because the trustee was not responsive to their requests for information and because they did not understand the question, and the trustee prepared an interim accounting for them. The bank's counsel asked them to waive a formal accounting and neither agreed because they did not receive information requested and felt that they were being pressured for more fees.

6. Deborah met with the trustee to complain about performance and excessive fees. She asked for the fee letter but was told there was no agreement. However, the trustee provided the fee letter a month later. In 2012 (4 years after the termination date), the trustee petitioned to approve its final accounting and to be discharged. The trustee blamed the delay on waiting to hear from the beneficiaries about the type of accounting they wanted. The final accounting stated that the trust value was $900,000 (563,000 in cash and the balance in stocks and mutual funds). Over the subject time period, the trustee took $485,000 in income commissions and $96,000 in corpus commissions. Deborah objected to the accounting. On the eve of mediation,

she read the entire trust, understood the stock retention clause, realized that the trustee should not have "sold her grandfather's good stocks", and filed claims for breach of fiduciary duty, negligence, conversion, and lack of good faith and fair dealing, all arising from violation of the retention clause, and claiming over $900,000 in damages. Sarah joined in her claims.

7. The trial court dismissed all of the claims other than breach of fiduciary duty and lack of good faith and fair dealing. The court found in favor of the beneficiaries on their breach of fiduciary duty claims, rejected the other claims, and held that the proper date for valuation of the stocks was May 2, 2008 when the trustee sent the trust agreement for the first time. The court awarded damages against the trustee in the amount of $520,000 as calculated by the trustee's expert, along with $57,000 in prejudgment interest, and denied all motions for counsel fees and the trustee's motion for corpus fees. Fees were denied after 2010 because of the court's finding that no management took place after that time, the inexplicable delay in preparing the accounting, and as a remedy for breach of trust. The court rejected claims based on failure to invest cash after 2011 for lack of proof.

8. The trustee appealed. On appeal, the court of appeals affirmed on the following grounds:

    a. The prudent investor act mandates diversification but recognizes that the grantor's intent controls. It is a default rule. The settlor clearly directed that the stock be retained and protected the trustee when doing so. Nothing in the trust terms made that provision optional. If the trustee felt it should diversify in violation of this provision, it was obligated to seek authorization from the court in advance. The act recognizes the power of the court to approve a deviation from the trust terms concerning investments.

    b. The trustee's argument that the claims were barred by laches, equitable estoppel, avoidable consequences, or ratification are "without sufficient merit to warrant discussion in a written opinion". Those defenses are also not favored because the trustee is in a position of confidence and because its own actions contributed to and caused the delay.

    c. The AT&T spinoff and the merger of Exxon and Mobile do not void the retention provision, and the trustee's contentions to the contrary are totally without merit. There was no evidence that the resulting stocks were substantially different than the original stocks placed into the trust. There was no change in the underlying businesses of the resulting stocks and no meaningful change in the portfolio from the spinoff and merger. The identity and substance of the original shares were not destroyed.

    d. The doctrine of "innocuous breach" is not available to protect the trustee because the trustee disregarded its counsel's advice without explanation.

    e. The court properly denied commissions after 2010 because no administration took place as a proper remedy for breach. The court's calculation of damages adequately compensated for the breach of trust. The court did not err in allowing the trustee corpus commissions from 1993 to 2008 because: (i) the fee letter addressed only income commissions and was silent on corpus commissions; (ii) there was no fee letter with the acquiring bank; and (iii) there was no additional finding of

breach of duty beyond the retention issue for which the damages award fully compensated the beneficiaries. Denying an award of attorneys' fees was proper because the court properly determined that the trustee did nothing to promote its own self-interest by diversifying and acted in what it believed was the best interests of the beneficiaries.

B. *Matter of Wellington Trusts,* 2015 NY Slip Op 31294(U) (Nassau County Surrogate, 2015); 2018 N.Y. App. Div. LEXIS 6675 (2018). Bank co-trustee did not breach duties by retaining concentrated positions in U.S. large-cap securities during a market down turn, where co-trustee refused diversification, had power to remove bank trustee, and was not clearly incapacitated, the trust terms permitted the investments, and the investments were part of a successful long-term family investment philosophy.

1. Herbert Wellington, Sr. and Elizabeth Wellington created trusts for their son Thomas. Thomas died in 2000, and part of the trust assets passed by their terms or by Thomas's exercise of his power of appointment to trusts for the benefit of Thomas's daughter Sarah Wellington. Bank served as co-trustee for more than 50 years, usually along with a family co-trustee, and the trust assets increased from $2 million to $36 million. During the time period at issue in the case, the co-trustee on all but one of the trusts was Herbert Wellington, Jr. Herb had the power to remove and replace the bank at any time. At Thomas's death, the trust assets were almost entirely invested in equities, and included a 29% concentration of Merck, a 19% concentration of GE, and other large positions. Thereafter, the value of Sarah's trusts had a sharp down turn in value. Herb resigned as co-trustee in 2005 and died a few months later. The bank began diversifying the trust where it served as sole trustee in 2003, but Herb refused to consent to diversification of the trusts where he served as co-trustee. The trust terms authorized the trustees to retain inception assets without any need to diversify the investments.

2. Sarah objected to the accountings of the co-trustees for only the time period after Thomas's death, and claimed the bank breached its duties by failing to diversify the trust and failing to make appropriate distributions to her and sought relief only from the bank co-trustee. Sarah settled with Herb's estate for $100,000. Sarah claimed Herb lacked capacity from a series of strokes, and that the bank had failed to seek his removal as co-trustee.

3. The surrogate dismissed the claims against the bank on the following grounds:

   a. the bank's conduct during this time was in compliance with the prudent investor standard;

   b. the conduct was consistent with the settlor's intent under the trust terms, and as indicated by appointing Herb as trustee to carry out the family investment philosophy, with the power to remove the bank at any time;

   c. the success of these trusts by implementing the family investment philosophy, and the fact that the objections were limited to one short time period during a market down turn, and did not include the years of success from the investments, and did not take into account the long-term investment strategy the bank put in place for the Sarah trusts on account of her age;

d. the disputed stocks were all on the bank's approved list; (5) the bank complied with its own internal policy of diversification within 5 years for this type of investment;

e. there were regular investment reviews and the bank had a long-term 50-year investment strategy for Sarah's trusts;

f. Sarah failed to provide proof of inadequate distributions, and she received regular and increasing distributions, including a unitrust conversion and large principal distributions at her request; and

g. Herb's position on investments remained consistent, and despite a decline in his physical ability and mental acuity following a series of strokes, he was not declared incapacitated, no one notified the bank claiming he lacked capacity, and the bank could reasonably rely on his capacity.

4. Sarah appealed. On appeal, the appellate division affirmed on the following grounds:

a. The bank recommended to Herbert that the trust assets be diversified and recommended alternatives, but Herbert did not consent to diversification. Herbert was not a passive or lay trustee – he was a professional investment manager and his preferred strategy resulted in a 1,750% increase in the largest of the trusts.

b. The trust terms evidence the settlor's intent that Herbert have ultimate control over investments by giving Herbert the power to remove the bank trustee at any time and without cause. The trust terms also stated that the trustees were under no obligation to diversify investments.

c. Sarah failed to establish that the bank knew or had reason to know that Herbert was not competent after a 2001 stroke.

d. While the court was correct in awarding the bank attorneys' fees, the court erred by not considering the required factors as to the reasonableness of the fees. On remand, the court must determine the reasonable fees that should be allowed to the bank.

C. *In re Trust of Jones,* 2018 Minn. App. Unpub. LEXIS 682 (2018). Trustee is not required to invest trust assets in silver upon demand by beneficiary.

1. Kent, acting pro se, sued the bank trustee of the trust for his benefit, alleging that: (a) the trustee breached its duty of loyalty by not investing the trust in physical assets and responding to his communications about his investment concerns; and (b) by failing to protect the trust from an economic calamity by investing in physical tangible assets. Kent argued that the trustee should be required to invest the trust in a house and silver coins and breached its duty by not yielding to his interest in "preserving the trust as he sees fit".

2. The trial court dismissed the claims and Kent appealed. On appeal, the court of appeals affirmed on the grounds that:

a. The duty of loyalty does not require a trustee to abdicate its responsibility to exercise its discretion in determining which investments are in the best interests of the beneficiaries. The powers granted the trustee under the trust terms provide the trustee with authority to choose from a wide variety of investment types.

b. Kent's allegations that "he fully expects in his lifetime a current crash of the United States dollar that shall affect all investments in dollars" and that "only the portions of the trust invested in assets that are not based on the dollar shall withstand the economic crash" are not supported by record evidence.

c. The evidence showed that the trustee was responsive to Kent, including offering to move the trust to a more conservative asset allocation strategy in response to his concerns.

V. Distributions & Disbursements

A. *Zarske v. Reynolds,* LC No. 15-016022-TV (Unpub. Michigan Court of Appeals 2018). Land given to sons during lifetime properly taken into account in equalizing residuary trust distributions upon settlor's death.

1. In 1997, Norma signed her revocable trust agreement, which provided upon her death that: (a) "any Farm Assets [which included farmland by definition] which the Trust owns (if any)" would be distributed to her two sons; and (b) the Non-Farm Assets would be distributed to her daughters in equal shares, but only in amounts sufficient to assure that each daughter receives a share equal to the shares received by the sons; and (c) all remaining property would be divided equally among the children. Attached to the trust was a legal description of farmland. Her son Duane was named as successor trustee to serve after her death.

2. On the same day, Norma leased and quitclaim deeded the farmland (valued at approximately $700,000) to her sons, excluding mineral rights, and retained a life estate in the property. The deed was recorded the next year.

3. Norma died in 2014, and her daughters petitioned to have the farmland taken into account in the distribution of the trust assets, asserted that the trust was ambiguous on this issue, and later added claims for undue influence against the brothers. Duane as trustee excluded the farmland as a trust asset. The trial court found that the farmland was never a trust asset, but because the trust terms defined "Farm Land" as "all farmland", and by attaching the legal description of the property to the trust, Norma intended that the farmland be considered in making trust distributions even thought it was not a trust asset. Duane appealed, primarily focusing on his view that the trial court was interfering with the ownership of the farmland by the sons and that the trust was unambiguous and the court should not have considered facts outside the trust terms.

4. On appeal, the Michigan Court of Appeals affirmed the trial court on the grounds that: (a) the trial court recognized the brothers' property ownership and never ordered that the farmland be distributed to the sisters; (b) there is no authority for the argument that the court could not consider parol evidence later in the proceedings, after it first grants a motion *in limine* to exclude that evidence; and (c) the finding that Norma intended the value of the farmland to be considered in making distributions is not inconsistent with recognizing the ownership of the property by the sons.

B. ***Peterson v. Peterson,*** **303 Ga. 211 (2018).** Priority given to widow's needs as beneficiary in trust terms is not sufficient standing alone to support summary dismissal of claims that she breached her duties as trustee.

1. Under his will, Charles created in part a bypass trust to be funded upon his death in 1994 with $600,000 for the benefit of his wife, Mary, and their children, Alex, David, and Calhoun. All four of them were named as co-trustees. The trust was funded with various stocks, including stocks in severally financially distressed companies. The trust provided for mandatory income distributions to Mary for life, discretionary principal for her support, and for the support and education of their descendants taking into account their other available means of support. After any descendant completed his education, the trustees were not required to support the descendant unless the trustees thought there was ample property to support Mary or unless the descendant could not support himself. The trust stated that the "primary desire is that my wife be supported in reasonable comfort during her lifetime and that my children be supported in reasonable comfort during their lives". Mary had a power to direct the trustees to distribute trust assets to the descendants but not to herself. At Mary's death, the trust assets were to be distributed to their sons. The will also provided that a decision of the majority of the trustees then acting would control, provided the majority included Mary while she served as co-trustee.

2. Alex and David sued Mary and Calhoun alleging that: (a) they made all the decisions as trustee without consulting them and had ignored their stated concerns about the trust administration; (b) they improperly encroached on the trust assets for Mary's benefit and disregarded the trust purpose of also supporting them; (c) wasting trust assets by continuing the operation of financially distressed companies; and (d) converting the trust assets for their own benefit. They sought support from the trust and a change of trustees.

3. The co-trustees moved for summary judgment which the trial court granted, despite the fact that Mary did not put on any evidence and did not point to any absence in the record to support the claims against her. The plaintiffs appealed. On appeal, the Georgia Supreme Court reversed the trial court and remanded the case on the following grounds:

    a. The court erred by finding that David had resigned as trustee in 1996 because there was no evidence in the record to support that finding.

    b. The testator clearly stated that one of his primary trust purposes was to support his children in reasonable comfort during their lives. The mere fact that Mary must be a part of a majority of the trustees for a decision regarding the trust to be controlling says nothing about whether she and the other trustees diligently and in good faith investigated whether the conditions precedent for the discretionary payments to the sons have been satisfied. Under the trust terms that would require considering the health of the trust assets and the ability of the sons to support themselves. The court erred by finding there was no requirement to support the sons. The settlor clearly stated that he had two primary trust purposes and one was to support his children. The court's conclusion that the primary purpose of the trust was to support Mary was clearly erroneous. Finding that one primary purpose was to support Mary does not permit the trustees to ignore the other primary purpose.

c. The fact that Mary had a limited power to appoint the trust assets to any of the descendants does not eliminate the fiduciary duties of the trustees where that power has not been exercised.

d. The power granted to the trustees to retain and carry on the business of inception trust assets does not relieve them of their fiduciary duty to not commit waste and to exercise their powers in good faith. The proper issue was not whether the trust gave the trustees the power to retain and operate the businesses, but rather whether their operation of the businesses was in accordance with their fiduciary standards.

C. *Kliman v. Mutual Wealth Management Group,* 2018 Ind. App. Unpub. LEXIS 526 (2018). Damages demand derived from denied discretionary distributions dismissed.

1. Upon his death in 2010, Dr. Kliman created a trust with a corporate trustee. The trust provided for net income to his wife, Marjorie, during her lifetime, and also allowed discretionary principal distributions for his wife and descendants for reasonable support, maintenance, health, and education. Upon the wife's death, the assets would be divided into separate trusts for the children that included distributions for a wedding and age-based principal distributions. The trust terms stated the settlor's intent that the beneficiaries not depend on the trust to defray normal living expenses, and expressed the precatory intent that a beneficiary receive only limited distributions unless the beneficiary was pursuing study that would lead to gainful employment, gainfully employed or seeking gainful employment, not employed to care for a child, supporting himself, or unable to support himself due to age or impairment. The trust also provided that the interests of the children as remaindermen were subordinate to the wife's interests as income beneficiary.

2. Dr. Kliman's oldest child Andrew (from his first marriage, and not Marjorie's child): (a) attended several colleges but had earned no degree; (b) completed a culinary program but only worked as a sous chef for a few months; (c) had unstable employment during adulthood and was home with his two children; and (d) was twice convicted of drunk driving. From 2011 to 206, the trustee made 28 discretionary distributions to Andrew from the trust, including: (a) $15,000 for a Jeep that Andrew then sold for $10,000; and (b) regular distributions to address the monthly shortfall for his living expenses. The distributions during this time exceeded $168,000.

3. In December 2015, Andrew sued the trustee for declining 55 other distribution requests totaling $92,000, and sought to have the court compel monthly distributions to him of $3,500. His challenges included: (a) requests that lacked documentation; (b) requests he had not actually ever submitted to the trustee; (c) requests to be reimbursed for expenses he later admitted he had not actually incurred; (d) requests for disbursements the trustee had actually already paid to him; and (3) a request for $10,000 for his first marriage even though that trust term did not apply until after Marjorie's death.

4. The trustee filed an accounting and Andrew admitted in a written statement filed with the court that he did not have any objection to the accounting. The trial court dismissed Andrew's claims and awarded the trust attorneys' fees payable by Andrew personally. Andrew appealed.

5. On appeal, the Indiana Court of Appeals affirmed the dismissal of the claims and the award of attorneys' fees on the following grounds:

   a. Andrew waived his right to object to the accounting.

   b. Andrew cannot make initial distribution requests by suing the trustee.

   c. His testimony about what the settlor would have wanted does not control over the trust terms.

   d. Andrew never argued to the trial court that the trustee had a duty to equalize distributions among the beneficiaries, and the trust terms did not require equal distributions.

   e. There was no proof that the trustee declined distributions because Andrew was caring for a child.

   f. The trustee did not err by refusing Andrew's request for funds for CPR training where he never actually incurred nor was he going to incur any costs for the training.

   g. There was no support for Andrew's claim that the trustee breached its duties by refusing to distribute $500 for a headboard and footboard, despite the following pleading: "Picture a room with a mattress and box springs only. No headboard and no foot board. Looks like a dorm room for a single 19-year old college student. Not many married couples with three children live like this. Trustees should not have discretion to require it".

   h. The trust terms did not provide for $10,000 for Andrew's marriage until after Marjorie's death, which had not yet occurred.

   i. There is no support for Andrew's argument that his own understanding of appropriate support should be controlling over the trustee's discretion, and that would be contrary to the trust terms, relevant authority, and cogent reasoning.

   j. Andrew had failed to even request from the trustee most of the distributions he sued the trustee for allegedly denying.

   k. The award of attorneys' fees was proper because Andrew's claims were frivolous, and the court could award the fees without inquiring into Andrew's ability to pay.

D. *In re Weitzel Trusts,* 2018 Minn. App. Unpub. LEXIS 753 (2018). Trustee did not breach duty to distribute where settlors stopped funding the trust, and trustee did not have a duty to compel the settlors to keep funding trust or protect beneficiaries from alleged abuse by settlors.

1. John and Mary created an irrevocable trust for the benefit of their daughter and grandchildren, with a bank as trustee. The trust gave the beneficiaries withdrawal rights over additions and allowed discretionary distributions to the beneficiaries by an ascertainable standard. The trust terms also allowed the trustee to make loans to a beneficiary. From 2007 to 2016, the trust assets were used to pay for private school tuition for the grandchildren. In the midst of undescribed conflict among the family, the settlors stopped making contributions to the trust and trust distributions stopped. At that time, the only assets in trust were stock with no value and a loan receivable from the daughter.

2. Their son-in-law, as representative for the one minor grandchild, sued the trustee for failure to account, failure to make distributions, failure to gather assets by failing to compel the settlors to make additional gifts to the trust, failure to provide income to the beneficiaries, intentional infliction of emotional distress on the beneficiaries, and failure to protect the grandchildren from abuse by the settlors and wrongfully allowing the settlors to retain the power to exclude trust beneficiaries from the *Crummey* withdrawal rights.

3. The son-in-law moved for emergency relief, summary judgment, and leave to amend his complaint to add a count for RICO racketeering. The trial court denied all of his claims and he appealed. On appeal, the court of appeals affirmed the trial court on the following grounds:

   a. The son-in-law cannot represent his adult child on appeal and all claims on that child's behalf are dismissed.

   b. Denial of the motion to amend to add RICO claims was proper because no proposed complaint was submitted to the trial court and there are no facts of a criminal enterprise or the trustee's involvement of a criminal enterprise, and no support for the argument that "a trustee…may commit a RICO violation by administering a trust according to its terms".

   c. The trustee complied with the trust terms in making distributions and the trust terms do not obligate the settlors, or anyone else, to make additional contributions to the trust. In the absence of contributions, the trustee is left with no funds from which to make distributions. The record shows that the trustee made regular and proper distributions until the settlors stopped funding the trust. While the trustee did loan the daughter money from the trust, the trust terms expressly allow the trustee to make loans to a beneficiary.

   d. The power retained by the settlors to exclude a beneficiary from withdrawal rights over trust additions does not make the trust a revocable trust and does not render the trust invalid, the power was never exercised, and there is no connection to that reserved power and the cessation of distributions to the grandchildren. The trust stopped making distributions because it ran out of money to do so.

   e. A trustee does not have a special relationship with a beneficiary that requires the trustee to protect the beneficiary from alleged abusive acts by the settlors, and nothing suggests that the beneficiary relies on the trustee to do so. The cessation of funding for private school by the settlors is not a form of "abuse" from which the grandchildren require protection by the trustee.

   f. The trustee complied with its duty to provide information by sending regular financial statements to the home where the grandchildren (and their father) reside, even though they were initially addressed only to the daughter. The trustee responded to all requests for information by the son-in-law, even after litigation was initiated. There is no allegation of a false statement by the trustee that would support a fraud claim.

   g. The trust terms did not require additional gifts by the settlors, and the trustee did not breach its duty to control the trust assets by not compelling additional gifts, and the trustee has no duty to interfere with

the settlors' funding decisions. The beneficiaries have suffered no harm by the trustee's retention of valueless shares gifted to the trust. There is no right to an equitable accounting because the trust is not complicated.

h. There was no proof of any intentional, reckless, or extreme and outrageous conduct by the trustee that would support a claim for intentional infliction of emotional distress. Whatever distress the grandchildren have felt by the settlors' cessation of trust funding and their not being able to continue attending private school of their choice, does not rise above the level of what people commonly encounter and endure in their lives. The focus is on the conduct of the trustee, and the court does not review here the actions of the settlors who are nonparties to the case.

VI. Estate & Trust Account Closings

A. *Restaino v. Northern Trust Company*, 2017 Ill. App. Unpub. LEXIS 2171 (2017); Second District Appellate Court 123144 (2018). Trustee did not breach duties by liquidating trust assets and retaining cash while litigation was pending and seeking dismissal of claims, and an oral contract to make a will and related claims are dismissed where both settlors expressly retained the unrestricted power to revoke their respective trusts. Illinois Supreme Court denied leave to appeal.

1. Jeanette and Charles married in 1960. At the time, each had two children from prior marriages. They moved to Florida in 1993, and each executed Florida revocable trusts, both with the bank as successor trustee. Both trusts provided, at the death of the surviving spouse, for distribution equally to all 4 children. They each reserved the right to amend or revoke their respective trusts and authorized the trustee to distribute assets in cash or in kind. They moved into an assisted living facility in 2000 and Charles died in 2001. Through a series of amendments to her revocable trust, Jeanette disinherited Charles's children and left her assets to her own issue. Jeanette then moved to Illinois in 2006 and died in 2014.

2. Charles's son, Frank, found out about Jeanette's death in 2015 from his children. He called the bank to ask about the trusts, and the bank sent Frank a letter discussing Charles's trust, asking that the beneficiaries mutually agree on whether to retain or liquidate the trust assets, and informing Charles that, in the absence of an agreement, the bank would liquidate the trust assets worth $540,000 and distribute cash. Frank then called a bank trust officer about Jeanette's trust, and was informed he was no longer a beneficiary. The bank then sent Frank a letter informing him that Jeanette's daughters wanted to receive cash and that the assets would be liquidated, and the bank liquidated the assets that same day the letter was sent.

3. The bank then informed Frank that they would settle its accounts judicially at the expense of the trust if Frank did not settle its accounts by a release agreement. Frank, through counsel, demanded various documents and information and the bank informed Frank again that he was not a beneficiary of Jeanette's trust and they would not provide those documents and information. The bank then informed Frank that if Frank did not proceed by release, the bank would proceed to settle its accounts judicially and charge the costs to Frank's share of Charles's trust. The bank then informed all of the beneficiaries that it would proceed to settle its accounts judicially.

4. Frank then filed a 7-count petition and the bank moved to dismiss the entire petition, in which Jeanette's daughters joined. The trial court dismissed the petition with leave to amend, but cautioned Frank and his counsel about the deficiencies in the claims and asked Frank to consider whether his suit made economic sense given the amount at issue. The bank and daughters moved to dismiss the amended petition (which restated the original 7 counts but added hundreds of additional paragraphs and exhibits), and the court dismissed the petition again, but this time with prejudice. Frank appealed the dismissal.

5. On appeal, the court of appeals affirmed the dismissal with prejudice of all 7 counts on the following grounds (and by applying Florida substantive law as provided in the trust terms):

   a. Breach of fiduciary duty. The claim that the bank breached its duties by failing to timely inform Frank of Jeanette's death (where her death was the measuring life for when Frank's interest in Charles's trust vested) fails because, even if the failure of notice was a technical breach of the Florida notice status, Frank did not allege any harm resulting from the breach and Frank learned about the death from his children.

   b. Liquidation of trust assets. The bank did not breach its duties by liquidating the trust assets because: (i) the trust terms expressly authorized the bank in its discretion to distribute in cash or in kind without the consent of the beneficiaries; (ii) there was no duty to obtain consent before liquidating; and (iii) the bank had informed the beneficiaries that it would liquidate assets if the beneficiaries did not reach a unanimous agreement. In response to Frank's claims, the bank was not required to keep the trust assets invested in the market and file an interpleader action, because there was no dispute about the beneficiaries of Charles's trust, Frank was not a beneficiary of Jeanette's trust, and therefore there was no duty to file an interpleader action for either trust.

   c. Duty to remain impartial. The bank did not breach its duty of impartiality because the bank did communicate with Frank with respect to Charles's trust, and Frank was not a beneficiary of Jeanette's trust. Also, even though the bank was only directly named as a defendant in Count I of the petition, the bank properly responded to the other six counts because significant parts of the claims against the bank were related to the other counts.

   d. Prudent investment. The bank could properly retain the trust assets in cash, consistent with the Prudent Investor Rule, because: (i) the bank did not prematurely liquidate the investments as noted above; (ii) there is no authority cited for the argument that a trustee is not allowed to retain assets in cash; (iii) the law required the trustee to manage assets "with care and caution" considering the facts and circumstances of the trust and suitable risk and return objectives; and (iv) here the bank retained the assets in cash in view of Frank's refusal to sign a release and his suit against the bank and others, and the bank could properly retain assets in cash in consideration of the uncertainties of the litigation by Frank.

   e. Breach of contract**.** The claim for breach of contract to make a reciprocal will (that left all assets to all of the children) against Jeanette's estate was properly dismissed because: (i) the allegations of an oral agreement to make a will are vague and lacking specificity; (ii) an oral agreement to

make a will is unenforceable under Florida law; and (iii) the plain terms of the trusts show no agreement because Charles and Jeanette both reserved the unrestricted right to amend or revoke their respective trusts.

f. Fraud. Frank could not prove Jeanette induced Charles to leave part of his trust to her children by fraud, because he did not allege any statements or actions by Jeanette that amounted to fraud or that she even told Charles that if he included her children in his trust, that she would include his in hers.

g. Lack of capacity. Frank failed to adequately plead lack of capacity and the other parties moved to dismiss his complaint without having admitted that Jeanette lacked capacity. Frank also made contradictory allegations about Jeanette's capacity in different counts of his petition. The allegation that Jeanette required Frank and his sons to shower in the pool locker room, rather than in her house, does not give rise to an inference of incapacity and the court will not speculate on her reasons for requiring this.

h. Undue influence. Allegations that Jeanette's children alienated Frank from Jeanette are not adequate to support a claim of undue influence because Frank did not allege that they had any involvement in the preparation of the documents, or how they influenced Jeanette's free will to be overcome. A conclusory statement of undue influence is not adequate to meet the pleading requirements.

i. Tortious intentional interference with economic expectancy to inherit. This was dismissed due to conclusory and inadequate pleadings, and because Frank could not have an expectancy to inherit in trusts where the settlors retained the power to revoke.

j. Trust modification. There are no circumstances that would support modification of Charles's trust to exclude Jeanette's children as beneficiaries, because the express and unrestricted right to amend the trusts contradicts Frank's claim that Charles did not anticipate that Jeanette would amend her trust.

6. On March 21, 2018, the Illinois Supreme Court denied the petition for leave to appeal the decision of the court of appeals.

B. *Patrick v. BOKF*, N.A., 2018 Kan. App. LEXIS 204 (2018). Successor cannot sue beneficiary and prior trustee for tortious interference with the trust administration.

1. Kerry and Kay were brother and sister and beneficiaries of several trusts, and became co-trustees after their father died. Kay filed lawsuits against Kerry, and they jointly requested that the court appoint a successor trustee to wind up and distribute the trust assets. The court appointed a bank as trustee.

2. The bank accepted the role as trustee on March 16, 2015. Kerry continued to represent himself as trustee until June 1, 2015, traded trust assets at least eight times after his tenure as trustee ended, and reported trust bonds as lost then refused to disclose the location of replacement bonds. Kerry sued the bank on June 16, 2015 to remove the bank as trustee, alleging that the bank failed to act diligently in marshaling assets, making distributions, and providing information to the beneficiaries, and asserting breaches of the UTC. The bank denied the claims and counterclaimed that Kerry was tortiously interfering

with a contract, business relationship, or advantage. Kerry's own expert testified that completing the in-kind distribution of the trust assets could take at least six months to complete.

3. The trial court found Kerry liable for tortiously interfering with the trust administration and awarded the bank attorneys' fees against Kerry's trust shares in the amount of $80,000. The court held that the bank breached its duty to inform, but that no damages resulted. Kerry appealed only the tortious interference and fees decisions. On appeal, the court of appeals reversed on the following grounds:

   a. Tortious interference with a prospective business advantage or relationship requires a showing that the conduct was accomplished by a third party unrelated to the business relationship between the principal parties. The court could not find Kerry liable for the tort without implicitly finding that Kerry was a third party to the trust.

   b. Although Kerry acted as a "false trustee" this did not make him a third party to the trusts. He could not be both a stranger and a party to the trusts at the same time. As a beneficiary and removed trustee, he was a party to the trusts and could not, as a matter of law, be found liable for tortious interference with the trust administration.

   c. There was evidence he violated his duties as trustee by not expeditiously delivering the trust property to the successor, but this cannot be pursued through a tortious interference claim.

   d. On remand, the trial court should deny the bank reimbursement of its attorneys' fees for pursuing the tort counterclaim.

VII. Limitations & Other Defenses

A. *Vietor-Haight v. BNY Mellon*, N.A., 2018 Conn. Super. LEXIS 816 (2018).

Litigation over accounting after trust termination date does not toll the limitations on additional future claims under the continuing course of conduct doctrine.

1. In 1978, Charles T. Haight created a trust that he funded with commercial and residential property in Greenwich. The trust terminated in 2012. The trustee filed papers with the court to terminate the trust, and the sole income beneficiary, Ilse, objected to the trustee's accounting and alleged failures to account and prudently invest the trust assets. The income beneficiary also alleged below market rate income distributions, excessive trust tax payments and fees, and failure to collect rents. The probate court criticized the trustee and ordered the trustee to reimburse the income beneficiary in the amount of $800,000 out of the trust assets, but also held that the trustee did not act in bad faith or breach its fiduciary duties. The trust terms exonerated the trustee absent a showing of bad faith.

2. In a 2016 complaint, the income beneficiary alleged breaches of fiduciary duties, negligence, and recklessness, and sought compensatory, punitive, and treble damages, interest, and fees. The trustee moved to dismiss the claims, which the trial court granted on the following grounds:

a. The claims for breaches of fiduciary duties and negligence are duplicative. Count Two (negligence) merely repeats the allegations in Count One (breach of duty) and fail to allege a single element of a claim for negligence.

b. The beneficiary had adequate opportunity to raise her claims in the prior probate proceedings. The claims were not only raised in the prior proceedings, they were adjudicated, and are barred by *res judicata*.

c. The beneficiary is collaterally estopped from asserting breach of fiduciary duty because the probate court has already found that the trustee did not breach its fiduciary duties.

d. The probate court, however, did not previously adjudicate the claims of recklessness. Those claims, however, are barred by the statute of limitations. The claims are based on factual allegations from 1994-2012. The doctrines of continuing course of conduct and fraudulent concealment do not extend the statute of limitations on the claims. The trust terminated in 2012, and there is no evidence that the trust imposed an ongoing duty to file annual accounts or provide income distributions to income beneficiaries after the termination date. There is also no evidence that the alleged tortious acts continued to evolve well after the trust termination. There is no evidence of any knowledge or awareness that the trustee fraudulently concealed facts from the beneficiary in an attempt to avoid or limit its liability.

B. *In re Adrian Chen Trusts,* 2018 Pa. Super. Unpub. LEXIS 1144 (2018).
Surcharge not allowed where trustees reasonably relied on advice of counsel concerning tax status of trust as domestic non-grantor trust for the benefit of a citizen of Hong Kong.

1. Stella Chen, a resident of Hong Kong, hired a prominent trusts and estates attorney who drafted a trust she created in 1987, with her husband and three other individuals as co-trustees. Her husband died in 1988 and the trust was divided into sub-trusts, one of which was for the benefit of her son, Adrian (a resident and citizen of Hong Kong), and his issue ("Trust 1"). Trust 1 was a domestic non-grantor trust that minimized taxes by not subjecting to U.S. income tax any distributions of capital gains to a foreign person or foreign trust, and imposing U.S. income tax only on dividend income from a U.S. source.

2. In 1994, Adrian received a large inheritance from his father's estate but declined the attorney's advice to place those funds into a trust.

3. From 1988 to 1995, gains from Trust 1 were distributed to a foundation the father created. In 1995, the trustees liquidated the assets as part of changing investment managers and realized $2 million in capital gain. The attorney advised creating a foreign grantor trust to receive that gain and future gains, and Adrian agreed and created the new trust ("Trust 2") for the benefit of himself, his wife, and his issue, with the same trustees as Trust 1. At that time, Adrian had just graduated college, and was married but had no children. Under the law at that time, Trust 2 qualified as a foreign grantor trust. Trust 2 was funded with distributions from Trust 1. The intent of Trust 2 was to minimize Adrian's U.S. income tax liability. As a foreign grantor trust, all of the trust's income (which included funds received from Trust 1) was to be taxed

to Adrian who was not a U.S. citizen and was therefore subjected to a reduced federal tax liability. Adrian could not revoke Trust 2, but the trustees could, with court approval, amend the trust to reduce taxes so long as consistent with the trust purposes.

4. In 1996, the U.S. tax laws changed in a way that disqualified Trust 2 as a foreign grantor trust, because its income could be distributed to Adrian's children. The trustees did not know about this law change. Adrian then had children. None of Adrian, his wife, or his children were ever U.S. residents or citizens, and only Adrian received trust distributions. The trustees continued to use the same counsel that drafted the trusts, and employed an independent accounting firm. Adrian retained his own counsel who concluded that Trust 2 was no longer a foreign grantor trust because Adrian's children were beneficiaries, and the 1996 tax law change prohibited children from being beneficiaries of a foreign grantor trust. The trustee's counsel then advised that there was a qualification issue, but that the problem could be remedied. The trustees relied on the advice and continued treating the trust the same way, and tax returns were still filed the same way.

5. The trustees retained new counsel, a Harvard law graduate with expertise in domestic and international estate and tax planning and 35 years of experience, to file trust tax returns, and that counsel continued treating the trust as a foreign grantor trust.

6. In 2013, Adrian sued the trustees for treating the trust as a foreign grantor trust and not seeking advice of new counsel and for continuing to file as a foreign grantor trust, and for the "potential adverse tax consequences" flowing from the possibility that Trust 2 would lose its tax status. Adrian also asked that the court reform the trust to remove his children as beneficiaries and the trustees joined in that request so that the trust would still qualify. Even though Adrian had first asked for the modification, he then opposed the trustee's motion to amend the trust, and instead sought termination of Trust 1 and Trust 2 and outright distribution of all assets to himself. The trustees opposed the termination as inconsistent with Mrs. Chen's intent. The trustees also filed accountings, and Adrian and his children (through a guardian ad litem) objected. Adrian also added claims that the trustees overpaid withholding taxes at a rate of 30% on U.S. dividend income, even though that withholding was directed for foreign non-grantor trusts by the financial institution retained by the trustees.

7. The court reformed the trust to remove the children as beneficiaries, conditioned on receipt of a PLR from the IRS that the reformation would be respected as retroactive to inception. The court rejected the surcharge claims and rejected Adrian's objection to any professional or trustee fees being paid out of the trust (the total fees were in the amount of $7 million).

8. Adrian appealed the denial of the surcharge claims and the approval of the trustees' fees. The trustees supplemented the appellate record with a 2017 PLR from the IRS that approved the modification of Trust 2 retroactively to its inception. On appeal, the superior court affirmed on the following grounds:

a. At trial, Adrian objected to *any* trustee professional or trustee fees being paid out of the trust, based on his positon that the trustees had breached their duties. His claim on appeal that the fees were unreasonably high bears no resemblance to his claims at trial. He clearly sought to surcharge the trustees for all the fees they had paid to themselves, the lawyers, and the accountants since the inception of the trusts. He argued that none of them were ever entitled to any compensation, premised on his claim of breach of duty by the trustees. His claims are clear case of overreaching. There were no legal grounds to deny fees prior to any alleged breach, no basis to deny the fees for preparing court-ordered accounts, and no basis to find that the accountants knew or should have known that the trust was not a qualified foreign grantor trust or knowingly filed false tax returns. Adrian's challenge was to the payment of any fees at all, and not a challenge to whether they were reasonable. He failed to prove a basis for surcharge of those fees, and never specified the amount he was contesting. He made no attempt at trial or on appeal to parse out the proper fees from the allegedly improper ones.

b. The court cannot surcharge a trustee unless it finds both a breach and also that the breach caused a loss to the trust. There was no breach shown. The trust terms allowed the trustees to retain counsel and act without independent investigation of their recommendations. The trustees' original counsel was a qualified and prominent trusts and estate expert who practiced with a preeminent firm, and who was hired by Mrs. Chen. Upon learning of the trust flaw, that attorney informed the trustees he could remedy the situation with a retroactive modification and told Adrian's counsel about the solution. His advice was proven right with the issuance of the PLR. Adrian's counsel told Adrian about the proposed solution, but that lawyer never informed the trustee's counsel that Adrian would oppose the solution. The trustees had no reason to seek other counsel. Adrian never proved that there was a subspecialty in foreign grantor trusts that the original attorney should possess. That lawyer's credentials as a trusts and estates attorney were impeccable and the trustees were permitted to rely on his advice without independent investigation.

c. After this suit was filed, the trustees hired another attorney who continued the trust tax filing position. The lawyer was a Harvard law graduate with expertise in domestic and international estate and tax planning and 35 years of experience, his credentials were uncontested, and every testifying expert agreed with his expertise.

d. The grantor trust issues were too complex for the trustees to have known the issue on their own. For example, the four tax experts that testified in the case did not reach consensus. The trustees reasonably hired professionals and relied on their advice. All of the trustees advised that the trust continue filing as a foreign grantor trust, an approach that was vindicated by the PLR-approved retroactive trust modification. The trustees were never definitely told the trust did not qualify, and therefore never knowingly filed a false tax return.

e. The trustees could also reasonably rely on the advice of banking professionals on the amount of withholding required for the trust.

VIII. Arbitration

A. *Ali v. Smith,* 2018 Tex. App. LEXIS 5129 (2018). Filing claims against predecessor and receiving fees by court order do not bind successor administrator to arbitration provision under will by direct-benefits estoppel.

1. Under his will, Amjad Sultan appointed Shafqat Ali as independent executor. Ali resigned after Sultan's adult son accused him of mismanaging the estate. The trial court appointed Darlene Smith as successor administrator with the will annexed, and approved the $52,000 in fees she would receive for service. Smith sued Ali alleging mismanagement of the estate that caused financial harm to the estate in the amount of $250,000.

2. The will provided in part that disputes between or among the beneficiaries, the executor, or the trustee, or any combination of them, would be submitted to binding arbitration. Another provision defined executor to include successors. Ali moved to compel arbitration under a theory of direct-benefits estoppel arising out of Smith's filing of the claims and receiving fees from the estate. The trial court denied the motion to compel arbitration and Ali appealed.

3. On appeal, a divided Texas court of appeal, with one dissenting justice, affirmed the trial court on the following grounds:

   a. Direct-benefits estoppel may apply to bind a non-signatory to a contract to arbitrate through the filing of a claim, when the claim depends on the contract's existence and cannot stand independently and the claim must be determined by reference to it. Equity prevents a person from avoiding the arbitration clause that was part of that agreement. However, when the substance of the claim arises from general obligations imposed by state law, including statutes, torts, and other common law duties, or federal law, direct-benefits estoppel is not implicated even if the claim refers to or relates to the contract or would not have arisen but for the contract's existence. Direct-benefits estoppel will not apply if the contract benefits are either insubstantial or indirect.

   b. This case is different than *Rachal v. Reitz* where a trust beneficiary sued to enforce rights under a trust, and no case cited addresses arbitration in the context of will administration. Here, Smith's claims all derive from statutes and common law, irrespective of the terms of the will. Ali had a statutory duty to deliver assets to Smith as successor, and Smith had a statutory right to ask the court to enforce the delivery of the estate assets. Smith's fiduciary duties were also derived from statutes and common law. The substance of Smith's claims arise from general duties under statutes and the common law, and Smith did not allege that Ali violated any terms of the will, making this theory of direct-benefits estoppel inapplicable.

   c. Similarly, Smith's fees as administrator were pursuant to state law and a court order, and not under the terms of the will. Because those fees were awarded without reference to the will, the fees do not support application of direct-benefits estoppel to bind Smith to the arbitration provision in the will.

d. One dissenting justice would hold that, by accepting the appointment as administrator, Smith became a party to the arbitration provision and that it was necessary to enforce the provision to carry out the testator's intent.

IX. Mediation, Settlement, Releases & Indemnification

A. *Lambrecht v. Lambrecht*, No. 339632 (Michigan Court of Appeals, Unpublished 2018). Location of signed trust amendment after death of settlor does not justify vacating settlement of dispute about validity of amendment during settlor's lifetime.

1. Frank Jr. executed a revocable trust in 1997 that he amended in 2007. The trust provided after his death for his assets to pass equally to his sons Frank III and David, with the share for any deceased son passing to the son's children.

2. In 2011, Frank Jr. suffered a stroke and become blind. David died in early 2012 survived by two daughters. An attorney, claiming to represent Frank Jr's guardians (although none had yet been appointed), petitioned the probate court to approve as valid an unsigned trust amendment from 2008 that would disinherit David's children and leave the entire estate to Frank III. Neither the attorney nor Frank III had located the signed amendment. The petition was signed by a successor trustee. Later in 2012, Frank III and Frank Jr.'s girlfriend were appointed as guardians for Frank Jr. The probate court entered an order approving the trust amendment.

3. In 2015, the granddaughters petitioned to vacate the order approving the trust amendment based on allegation of misrepresentation by the petitioning attorney, and the lack of signed instrument. The court (a) appointed counsel for Frank Jr. out of concern that the guardians were not acting in his best interests and (b) removed and replaced the guardians. Frank Jr.'s court-appointed counsel raised other concerns about the amendment, including the settlor's capacity and the suspicious circumstances around the petition to validate it.

4. The parties entered into mediation and settled the issue by agreeing that after the settlor's death the trust assets would pass 58% to Frank III and 42% to the granddaughters. The probate court approved the settlement.

5. Frank Jr. died in 2016. Frank III then found a signed (but not dated or notarized) trust amendment in the drawer of the desk located in Frank Jr.'s bedroom and petitioned the court for relief from the settlement on the grounds, in part, of mutual mistake of fact about the existence of the signed amendment. The probate court denied the petition and Frank III appealed.

6. On appeal, the Michigan Court of Appeals affirmed the probate court on the following grounds:

   a. Public policy favors the finality of judgments. While the presumed non-existence of a signed instrument was material to the settlement negotiations, there were also other concerns with the validity of the amendment that impacted the decision to settle.

b. The doctrine of mutual mistake does not require vacating the settlement where: (i) Frank III was aware of the possibility that a signed document existed; (ii) the parties decided to settle claims before an evidentiary hearing where the existence of the signed document might have been discovered, and to drop all factual inquiries; and (iii) there is always the possibility that questions of fact or law will be answered after settlement and one side may have buyer's remorse, but setting aside judgments under those circumstances would discourage settlements and public policy favoring the finality of judgments.

c. Frank III had to have been aware of the possibility of a signed document and entered into the settlement without searching the settlor's desk for the document (the most logical place it might be located, and where it was found). As guardian, Frank III had access to the settlor's desk and a duty to act in the settlor's interests. The settlor's counsel did not search there, but he was prohibited from doing so by one of the guardians. None of the parties could have definitively believed the signed document did not exist when they each entered into the settlement. Frank III therefore bore the risk of mistake when he entered into the settlement.

d. The settlement need not be vacated for the discovery of new evidence because Frank III did not exercise reasonable diligence to locate the signed amendment. He failed to look in the obvious starting place for the document, and his duties as guardian undermine the reasonableness of his claimed deference to his father's privacy. Frank III had access to his father's desk, whereas counsel was prohibited from accessing the desk (and counsel did not have authority to override the restrictions imposed by the guardians).

e. Statutory equitable remedies are not available where Frank III failed to use reasonable diligence to locate the document, there were other issues in the case besides the existence of a signed document (including competency and undue influence, the conduct of the guardians, and the validity of service of process on the settlor who was blind and debilitated). It was therefore not inequitable to hold Frank III to the terms of the settlement.

B. *In re Estate of Marrazzo*, 2018 N.J. Super. Unpub. LEXIS 2258 (2018).
Nondisclosure of failure to file estate tax returns does not require vacating settlement agreement resolving will contest and estate litigation.

1. Francis died in 2014 and was survived by his sons, Brandon and Todd. Brandon was appointed as executor, and Todd filed a caveat against probate of the will. They settled the suit and executed a consent order. In the order, Todd had the option to purchase a house from the estate, subject to the following conditions: (a) that he pay the estate taxes he failed to pay as executor of their deceased mother's estate; (b) that he pay the outstanding tax sale certificate on the property; and (c) Todd's obtaining a firm funding commitment by a set date. If he didn't timely exercise his option, Brandon would have an option to purchase the property or it would be sold to a third party.

2. Even though the option deadline was extended by a supplemental consent order, Todd failed to obtain financing and timely exercise his option by the deadline. Two weeks after the expiration of the extended deadline, Todd

received notice from the New Jersey Division of Taxation that Brandon had not timely filed an estate tax return for Francis's estate. Brandon rejected Todd's request for an additional extension to exercise the option.

3. Todd moved to vacate the consent order, alleging that Brandon's failure to disclose that he had not filed the estate tax return was a material misrepresentation and that, without a return being filed, Todd could not obtain clear title to the property. The trial court denied the motion and Todd appealed.

4. On appeal, the superior court affirmed the denial of the motion to vacate the consent order on the following grounds:

   a. Both parties were in equal bargaining positions, and were represented by counsel, and there was no duty on Brandon to affirmatively advise as to the status of the estate tax returns. There was no allegation that Todd ever inquired into the status of the tax returns, and therefore no affirmative misrepresentation.

   b. Payment of taxes was expressly addressed in the settlement and part of the negotiations. As an accountant, tax professional, enrolled agent, and former federal revenue agent with the Treasury Department, and having served as executor of his mother's estate, Todd was presumably well versed in the tax code and its obligations.

   c. Todd's option had already lapsed by the time he learned about the estate tax returns, and the returns were not the only reasons he sought an extension, as he had also failed to obtain funding for the purchase.

C. *Kent v. Kerr,* No. 55A01-1612-ES-02907 (Indiana Supreme Court 2018). Statute authorizing settlement of estate disputes cannot be used to enforce pre-mortem estate settlement agreement.

1. Gary signed a will in 2008 dividing his assets equally among his children, Cindy and David. About a month before his death, Gary requested that his children enter into an agreement about how specifically his assets would be divided upon his death. The children signed the agreement, and Gary signed the agreement indicating it conformed to his wishes. A week later, David sent notice to Cindy purporting to rescind the agreement. A few weeks later, Gary died.

2. David, as co-personal representative, petitioned to probate the will without reference to the agreement. Cindy challenged probate of the will without incorporating the agreement as either a codicil or a settlement agreement under a state statute (the Compromise Chapter of the probate code) authorizing settlement of estate disputes. The trial court held the agreement was not a codicil and was enforceable under the state statute. Cindy appealed, the court of appeals reversed the trial court, and then David appealed.

3. On appeal, the Indiana Supreme Court, over one dissenting justice, reversed the court of appeals and held that the state statute could not be used to enforce a pre-mortem estate settlement agreement, on the following grounds:

a. The Compromise Chapter of the probate code does not unambiguously state whether it applies to only post-mortem agreements, and therefore it is open to judicial interpretation. By using the terms "decedent", "estate", "testamentary trust", and "probate" in the statute, the legislature used terms that can only apply after death. The statute does not include any language that would expressly apply to pre-mortem disputes, and therefore the legislature wrote statutes that could only apply post-mortem.

b. Applying the statute to only post-mortem agreements is consistent with the legislature's intent to compromise disputes over a decedent's estate, since there is only a decedent and an estate after death has occurred.

c. Post-mortem compromises have been part of Indiana law for at least 130 years. This agreement is a pre-mortem agreement, and Cindy cannot use the Compromise Chapter to enforce it. The door is not closed on these types of agreements – the court is only holding that this one particular method cannot be used to enforce them.

d. The issues of whether David validly rescinded the agreement, and whether it is enforceable under general contract law, should be addressed by the trial court on remand.

e. One dissenting justice would hold that state policy strongly favors freedom of contract, and that this statute should be available to enforce contracts unless the statute expressly states that it is not available to pre-mortem contracts.

X. No Contest Clauses

A. *EGW v. First Federal Savings Bank,* 2018 WY 25 (2018). Contest by father validly triggered clause disinheriting his children.

1. Allen created and funded his revocable trust in 2001 with his ranch property. He originally named his son as trustee and the trust was originally for the son's children after his death. Allen amended the trust in 2006, 2009, and 2014 to add his wife and her descendants as beneficiaries, remove the son as trustee, name a bank as trustee, and provide that his son and grandchildren should not serve as trustee. He also added a forfeiture clause that provided that "any challenge to this trust made directly by or on behalf of my son or grandchildren shall immediately terminate any interest in the trust of any descendant of mine".

2. In 2013, Allen listed the ranch for sale and the son sued Allen as trustee to block the sale and remove Allen as trustee of his own trust due to alleged incapacity and undue influence. He also alleged that Allen's wife unduly influenced Allen to amend the trust. Allen died a month later. The case went to trial and the court upheld the trust amendments. The son appealed, and the Wyoming Supreme Court affirmed the trial court. While the appeal was pending, the son filed another action on behalf of his minor children (he was later prohibited by the court from representing his own children due to conflicts of interest) to block the sale of the ranch, declare that the forfeiture clause would not apply to them, remove the bank trustee, and sue the bank for damages. The trustee moved for summary judgment on the grounds that,

as a result of the son's prior suit, the son's children were no longer trust beneficiaries by operation of the forfeiture clause. The trial court granted summary judgment for the trustee, and the grandchildren appealed.

3. On appeal, the Wyoming Supreme Court affirmed the trial court and the application of the forfeiture clause to disinherit the grandchildren on the following grounds:

   a. Contrary to the son's assertions, his prior challenge to the trust was not dismissed due to his lack of standing to contest a revocable trust. His claim that the trust amendments were the product of undue influence was tried and submitted to a jury, the jury found no undue influence, and the court held that because of that jury finding the son had no further interest in the trust. Even if he did lack standing to bring that first lawsuit, that fact did not prevent him from challenging the trust under any interpretation of the word.

   b. The enforcement of the forfeiture clause against the grandchildren as a result of the actions of their father (rather than their own actions) does not violate public policy and is valid because: (i) a testator has the right to dispose of his property as he sees fit; (ii) the Wyoming Supreme Court has rejected attempts to avoid forfeiture clauses on public policy grounds even where the challenge is made in good faith and with probable cause; (iii) the court's policy is that the testator's intent is controlling; (iv) Wyoming rejected Section 3-905 of the Uniform Probate Code and the court will not do what the legislature chose not to do; (v) while no Wyoming court has addressed a clause like this one, where the clause is enforced against beneficiaries not participating in a challenge, there is no grounds for departing from the court's precedent; and (vi) the grandchildren have no right to property by inheritance and therefore enforcement of the clause against them does not deprive them of any statutory or constitutional rights.

   c. There is no support that the son's challenge does not trigger the clause because it was brought during the settlor's lifetime. The plain language of the clause requires forfeiture regardless of the fact that the settlor chose not to remove the grandchildren as beneficiaries during his lifetime and after the son's challenge to the validity of the trust amendments.

B. ***Montoya v. Connell,*** **2018 Nev. LEXIS 72 (2018).** Breach of fiduciary duties by trustee that was also a trust beneficiary does not trigger forfeiture under no-contest clause.

1. Eleanor was sole trustee of a 1972 trust. The trust provided for distribution of the trust income 35% to Eleanor and 65% to her daughters. The trust included a no-contest clause that would disinherit any beneficiary or any other person that asserts a claim to the trust assets or attacks or opposes the trust administration and distribution.

2. As trustee, Eleanor improperly cut off income distributions to her daughters. The daughters sued and the court: (a) ruled in their favor and held that Eleanor breached her duties as trustee; (b) ordered the trustee to account; and (c) due to concerns with the accounting, replaced Eleanor as trustee. The court found that Eleanor failed to protect the 65% interest, filed an intentionally inaccurate

accounting and false records with the successor trustee, and improperly removed $1 million from the trust before turning assets over to the successor trustee. The daughters sought surcharge and also to enforce the no-contest clause against Eleanor. The court ordered the surcharge but declined to apply the no-contest clause. The daughters appealed.

3. On appeal, the Nevada Supreme Court affirmed on the following grounds:

   a. Eleanor's actions were taken in her fiduciary capacity. While there could be instances where a no-contest clause applies to trustee-beneficiaries who abuse their trustee status as a means of presenting personal views as a beneficiary, it was not shown here that Eleanor's breaches of fiduciary duty were motivated by her own interest.

   b. The trust vests the trustee with broad administrative powers. Interpreting the no-contest clause as applying to any actions taken by a trustee-beneficiary in her trustee capacity, even if later determined that those actions were breached of duty, would conflict with the latitude afforded trustees in order to effectively manage and control the trust in the normal course of their duties. In the absence of specific language to the contrary, the trust as a whole indicates that the settlors did not intend for the no-contest clause to apply to actions taken by a beneficiary acting in her dual capacity as trustee, regardless of whether those acts benefitted or were intended to benefit the trustee in her beneficiary capacity.

   c. To the extent that the settlor's intent is unclear, this interpretation produces the most fair and reasonable result. Imposing a no-contest clause on a trustee-beneficiary for actions taken in a fiduciary capacity would not disincentivize litigation or minimize disputes. Rather, it would seem to incentivize challenges by the beneficiaries to the trustee-beneficiary's administration in order to eliminate a beneficiary. Imposing the no-contest clause in this manner also ignores the variety of remedies available for the breach of duties, including surcharge, damages, and award of attorneys' fees.

XI. Standing & Parties

A. *Gervasi v. Warner/Chappell Music,* 2018 U.S. Dist. LEXIS 76757 (M.D. Tenn. 2018). Under New York law, only personal representative may sue music publishing company for alleged missing royalties during life of the decedent.

1. Richard A. Whiting was a composer who wrote "On the Good Ship Lollipop" and "Hooray for Hollywood". In 1936, he entered into a music publishing agreement with Warner Bros. He died in California in 1938 leaving his intellectual property to his wife, Eleanore, and his daughters, Barbara and Margaret.

2. Eleanore signed a publishing deal in 1943 with Music Publishers Holding Corporation. The agreement was amended to increase her share of international licensing fees. She died living in California in 1981, leaving her rights to Barbara and Margaret. Margaret died in New York in 2011, leaving her rights to Deborah. Warner/Chappell Music, Inc. is the successor to Warner Bros. and Music Publishers Holding Corporation.

3. Starting in 2006, Deborah disputed whether full royalties were being paid. She sued the publisher in 2012 in federal court, individually and on behalf of Richard's estate, asserting diversity jurisdiction. The publisher moved to dismiss for lack of diversity based on Richard's estate and the publisher both being in California. Deborah amended her complaint to state that she was not the formal representative of Richard's estate, but was suing to vindicate the rights of his heirs. The publisher then moved for partial summary judgment on all claims that accrued before Margaret's death, on the grounds that only the lawfully appointed representative of Margaret's estate could sue for claims that accrued during Margaret's lifetime. The federal district court granted the partial summary judgment on the following grounds:

   a. Under California statutory law (which would have governed Richard's estate), a beneficiary of a decedent's estate may succeed to a cause of action. A cause of action that originally belonged to a decedent may, through ordinary laws of inheritance, come to belong to an heir, and an estate representative would not be needed to pursue the claim under California law.

   b. However, Deborah inherited her rights through her mother's estate that was administered in New York. Unlike California law, under New York statutory law a decedent's cause of action may be brought or continued by the personal representative of the decedent. The New York statute does not provide for the cause of action to pass to the heirs.

   c. Deborah has been aware of this pleading defect since 2012, but elected to amend her complaint both to salvage federal jurisdiction and to reflect the reality that she does not have the legal right to proceed on behalf of any decedent's estate. By proceeding only individually, she must accept the limitations that New York estate placed on how her mother's rights can and cannot be vindicated following her death. Accordingly, all claims that accrued prior to her mother's death are dismissed.

B. *Hartnett v. Farm Service Agency*, 2018 U.S. Dist. LEXIS 98245 (Kansas 2018). Trustee, who is not an attorney, may not sue in propria persona for a trust, notwithstanding extensive personal experience as a pro se litigant.

1. Ronald was trustee of a trust for the benefit of his relatives, Lonnie and Lex. The trust was denied Conservation Reserve Program benefits by the Department of Agriculture in 2013 and lost its administrative appeals. He then sued the Department of Agriculture and various individuals alleging a conspiracy against the trust. He sued as trustee and identified himself as "not pro se, but in propia persona, by Right of Visitation, and by his own authority, make this Special Appearance, in his natural person" and brought claims for "depriving Plaintiffs of Constitutional protected Birth Rights under color of Federal Law, in the abuse of Administrative Due Process, custom or usage, conspiracy to so deprive and/or failure, neglect and refusal to protect plaintiffs from said conspiracy in using only selective Statutes/Federal Regulations (CFR) for enforcement".

2. The defendants moved to dismiss the claims. After the court informed Ronald that he could not represent the trust in federal court, he moved the court to stay the case, explaining that he had been inflicted with the West Nile Neuroinvasive Disease, was unable to file the complaint until the limitations

period had almost run, and had difficulties of memory, motion, thinking process, reliable voice, and the ability to produce the necessary documents in this case. He also noted that in his vast experience as a pro se litigant, he has never been questioned on his ability to represent others (although no case showed that he had ever sued on behalf of another person). No licensed attorney ever made an appearance in the case to represent the trust.

3. The federal district court dismissed the claims on the following grounds:

   a. In all the courts of the United States the parties may plead and conduct their own cases personally. But where the litigant is not the beneficial owner of the claims, he is not conducting his own case personally. As only a trustee, and not also the sole beneficiary of the trust, Ronald is not the beneficial owner of the claims and is not a party conducting his own case.

   b. While Ronald has significant experience as a pro se litigant, this does not make him an attorney. Only a licensed attorney, subject to the Rules of Professional Conduct, may represent the rights and interests of others.

C. *Estate of Lee,* 2018 Tex. App. LEXIS 3771 (2018). Parties cannot confer standing to contest a will by contract.

1. Lucy signed a will in 2013 that gave the residue of her estate to a trust for son Jack, with the trust assets passing at Jack's death to her grandsons. In 2015, she signed a first codicil that replaced the grandsons as remainder beneficiaries with her niece, Mary. In 2016, she signed a second codicil that gave the residue outright to Jack and not in trust. The will included a spendthrift provision.

2. Lucy died in 2016. Her grandson, Michael, and Mary entered into a contract under which Michael agreed to contest the second codicil and if successor, Mary agreed to give Michael 40% of anything she received under the trust. Michael sued to contest the second codicil only, and Jack moved to dismiss for lack of standing. The trial court dismissed the claims for lack of standing and Michael appealed.

3. On appeal, the court of appeals affirmed on the following grounds:

   a. Michael does not have standing individually as a trust beneficiary because, to have an interest, he would have needed to successfully challenge both codicils, yet here he only contested the second codicil. Even if he prevailed on contesting the second codicil, he would still not have an interest in the trust.

   b. Michael is not an "interested person" with statutory standing because his former remainder interest was terminated by the first codicil and he did not challenge the validity of that codicil. Standing to contest a will requires a pecuniary interest that will be directly and immediately affected by the probate or defeat of the will.

   c. Jack had the ability to question the validity of the agreement to defend against Michael's claimed standing to contest the second codicil. Subject matter jurisdiction cannot be conferred on the court by agreement of the parties or by waiver. Michael cannot establish standing by arguing that

Jack is powerless to challenge the source of his standing because he is not a party to the contract. This would amount to standing by default and would allow Michael to use the agreement as both a sword and a shield. By asserting the agreement as the basis for standing, Michael consents to the scrutiny of the agreement's validity in this litigation, even if Jack would otherwise be unable to do so.

d. The trust included a spendthrift clause, and beneficial interests in trusts cannot be assigned when they are subject to spendthrift clauses. Assuming the contest to the second codicil were successful, the trust would be an active trust with duties imposed on the trustee with respect to distributions and investments. Enforcement of the spendthrift trust does not violate public policy favoring settlement of disputes, because there was not actual apparent dispute between Michael and Mary, and the validity of the agreement is not before the court other than on the issue of whether it is effective to confer standing. Enforcement of the spendthrift clause does not violate the settlor's intent because the settlor imposed the spendthrift provision on the interests of the remainder beneficiaries.

XII. Situs, Jurisdiction & Venue

A. *In re JP Morgan Chase Bank, N.A.,* 2018 Tex. App. LEXIS 1883 (2018). Court erred by refusing to enforce trust forum selection clause.

1. James C. "J.C." Penney created a trust in 1934 for the benefit of his daughter and her descendants. The trust was executed in New York and provided that "the validity and effect of the provisions of this Agreement shall be determined by the laws of the State of New York, and the Trustee shall not be required to account in any court other than one of the courts of that state".

2. The beneficiaries asked the corporate co-trustee to resign, the corporate co-trustee petitioned New York court for permission to resign, and the beneficiaries sued the trustees in a Texas court for alleged breach of fiduciary duty. The trustee moved to enforce the trust forum selection clause and the trial court refused to enforce the clause. The trustees appealed and sought a writ of mandamus.

3. On appeal, the court of appeals reversed and granted mandamus relief on the following grounds:

   a. Mandamus relief is available to enforce forum-selection agreements because there is no adequate remedy by appeal when a trial court abuses its discretion by refusing to enforce a valid forum-selection clause.

   b. Forum-selection clauses are generally enforceable and presumptively valid. Failing to give effect to the clause amounts to clear harassment, injecting inefficiency by enabling forum-shopping, wasting judicial resources, delaying adjudication, and skewing settlement dynamics. A trial court abuses its discretion in refusing to enforce the clause unless: (i) enforcement would be unreasonable or unjust; (2) the clause is invalid due to fraud or overreaching; (3) enforcement would violate strong public policy where the suit was filed; or (4) the forum would be seriously inconvenient for trial.

c. The parties agree that the validity and effect of the trust is determined under New York law. At the time the trust was drafted, the word "account" as used in the trust was a verb, rather than a noun, and it was used as a verb by the phrase "to account". The term encompasses more than actions for an accounting. The phrase "required to account in" was used as a broad, unrestricted phrase and means the trustees may not be sued or otherwise required to explain alleged wrongdoing regarding the trust or its administration in any state other than New York. This conclusion is supported by the broad use of "account" elsewhere in the trust. The trust was crafted carefully and the settlor could have written the forum-selection more narrowly and chose not to.

d. The Texas statute on mandatory venue does not supersede a contractual forum-selection clause. Absent any evidence supporting the trial court's decision to refuse to enforce the clause, refusal to do so is an abuse of discretion. Mandamus relief is therefore appropriate.

B. *In re Doll Trust,* 2018 Mich. App. LEXIS 3316 (2018). Court lacks jurisdiction where trustee moved situs of trust using discretionary power in trust terms.

1. In 2001, Elizabeth Doll created a revocable trust with herself as trustee. In 2013, her daughter acting as her agent under a durable power of attorney, resigned Elizabeth as trustee and Elizabeth's daughters became co-trustees. Elizabeth tried unsuccessfully to regain her trusteeship and then died in 2014. The trust terms provided that the trust was exempt from registration in any state and gave the trustees the power to change the trust situs and governing law at any time (without any notice to the beneficiaries required). In 2015, the trustees gave the beneficiaries notice that the trust situs was moving from Michigan to Florida. Only one beneficiary, Teresa, sent a written objection, but she sent it to the wrong address and it was never received by the trustees.

2. In 2017, Teresa sued in Michigan court to remove the trustees and the trial court dismissed the suit for lack of jurisdiction. Teresa appealed. On appeal, the court of appeals affirmed the dismissal of the suit on the following grounds:

   a. By statute, the probate courts are not to hear proceedings involving trusts with a principal place of administration in another state, unless the other state could not bind the parties to the suit or justice would be seriously impaired.

   b. Because the trust terms gave the trustees discretion to change the trust situs without notice or other requirements, the requirements for changing situs and governing law under the Uniform Trust Code do not apply. The UTC provision is a default rule where the trust is silent, and here the trust was not silent. The trustees were not required to provide notice under the UTC, the situs was changed, and the suit involved a trust administered outside the state.

XIII. Disclosure & Information Access

A. *Millstein v. Millstein,* 2018 Ohio 1204 (2018); 2018 Ohio 2295 (2018). Grantor of defective grantor trust does not have right to trust information beyond grantor trust tax letter and other disclosure permitted in trust terms and cannot sue the trustee to compel the trustee to reimburse the grantor's income taxes where not authorized in the trust terms.

1. In 1987 and 1988, Norman Millstein established two irrevocable trusts for the benefit of his children and their descendants, with himself as initial trustee. He resigned in 1997 and named his son, Kevan, as sole successor trustee. The trusts were grantor trusts for federal income tax purposes with Norman as the grantor, but did not provide for reimbursement of Norman's taxes. Norman signed a 1988 letter stating his intent, separate from the trusts themselves, which included the prospect of offsetting the income attributable to Norman. The trust terms provided that the trustee must provide Norman annually with "a full financial report of the trust assets".

2. In 2010, Norman requested reimbursement of the taxes he paid on behalf of the trusts. Kevan declined, but agreed to use assets of another unrelated trust to defray Norman's tax expenses.

3. In 2013, Kevan informed his father that the other trust no longer had liquidity to offset Norman's taxes. Kevan took steps so that the trust for his own benefit would no longer be a grantor trust for federal income tax purposes, but did not take such steps for the trust for Norman's other child. Norman paid income taxes for the trusts of $6.5 million for tax years 2013-15, and remained responsible for future taxes for the trust for Kevan's sibling.

4. Norman sued the trustee to compel the trustee to provide him with a "fiduciary accounting". The trustee moved for summary judgment dismissing the claim, which the trial court granted. On appeal, the Court of Appeals affirmed the trial court's dismissal of the claim on the following grounds:

    a. The trust terms do not require the trustee to provide the grantor with a full accounting, and a "full financial report of the trust assets" is not the same as a complete fiduciary accounting as demanded by the grantor. The Uniform Trust Code requires a report to the beneficiaries, and not to the grantor, and requires a "report" and not an accounting, and does not require the full formality of a fiduciary accounting.

    b. In exchange for certain cash payments, a monthly salary for life, health insurance, and use of properties in Florida and Las Vegas, Norman signed an agreement in 2005 to waive any right to sue Kevan, including as trustee of the trusts.

    c. Federal tax laws only require that the trustee provide the grantor with an annual grantor tax letter. The tax laws do not impose any requirement that the trustee provide the grantor with additional information so that the grantor can verify the accuracy of the annual tax information provided by the trustee. If the grantor believes the trustee has not furnished the grantor with proper tax information, the grantor should contact the IRS.

5. Norman also sued the trustee for reimbursement of taxes, which the trial court dismissed. On appeal, the Court of Appeals affirmed the dismissal of the claims on the following grounds:

        a. The trust terms do not authorize the tax reimbursement. The Uniform Trust Code allows for reformation of a trust to accomplish the grantor's tax objectives. However, under the Uniform Trust Code only a trustee or a beneficiary may petition the court to reform a trust under this section. The court may not apply equitable principles to circumvent valid legislative enactments.

b. Equity will not aid a volunteer, and Norman admitted that he intentionally set up the trusts as grantor trusts, and did not allege that Kevan or any other parties took any actions that were inconsistent with the terms of the trusts that Norman created. Norman voluntarily created the situation that he now claims is inequitable.

B. *Whitehead v. Westinghouse,* 2018 Nev. Unpub. LEXIS 238 (2018). Nevada trust beneficiary does not have a right to compel a trust accounting where all interests are discretionary.

1. Keehle, a minor, was the beneficiary of Nevada trust that provided for discretionary distributions of income and principal for support, and for age-based principal distributions at ages 35, 40, and 45. The trust terms allowed a "Trust Consultant" to cause the trustee "to distribute some or all of the principal and/or undistributed income of the Trust either to the Beneficiary free of the trust or to another trust established for the primary benefit of the Beneficiary and/or her descendants". Kheele's mother asked the trustee for a trust accounting, the trustee refused, and the trustee petitioned the court. The court ordered the accounting and the trustee appealed.

2. On appeal, the Nevada Supreme Court reversed and held that the beneficiary was not entitled to an accounting, on the following grounds:

   a. Trust accountings are governed by the Nevada Uniform Trustees' Accounting Act. One exception to the duty to account under the Act is that a trustee is not required to provide an accounting to a beneficiary of an irrevocable trust while that beneficiary's only interest is a discretionary interest as defined in the statutes.

   b. The beneficiary's present interest is clearly discretionary. The beneficiary's remainder interest would, at first glance, appear to be a mandatory interest from the age-based principal distributions. However, that mandatory language is qualified by discretionary language because the Trust Consultant, at any time, can direct the trustee to make a distribution of principal and undistributed income to the beneficiary and determine the amount to be distributed. By statute, if a trust provision contains mandatory language but that is qualified by discretionary language, the interest is classified as a discretionary interest. Therefore, the remainder interest is also discretionary.

   c. Because the beneficiary's only interests are discretionary, the trustee is not required to provide an accounting under the Act.

C. *Ajemian v. Yahoo,* 2013 Mass. App. LEXIS 73 (2013); SJC-12237 (Mass. Supreme Judicial Court, October 16, 2017). Massachusetts appellate court determines enforceability of email user agreement in dispute over decedent's email accounts. Massachusetts Supreme Judicial Court holds that the Stored Communications Act does not prevent Yahoo from turning over emails to the personal representatives, and remands case to determine whether email user agreement allowing withholding or destruction of emails was a valid contract. U.S. Supreme Court denies Yahoo's petition for a writ of certiorari.

1. Siblings, as administrators of their brother's intestate estate, brought suit in the Massachusetts Probate and Family Court seeking a declaratory judgment that the decedent's Yahoo e-mails were assets of this estate. In an initial action, the administrators filed a complaint in which they sought subscriber records for the e-mail account (they did seek the contents of those e-mails). They limited their complaint as they had reached a partial resolution of their dispute with Yahoo under which the plaintiffs would seek a court order requiring Yahoo to produce basic subscriber and e-mail header information only and Yahoo would not oppose this application. The Court granted this relief. Thereafter, the administrators filed this second action in which they sought the contents of the e-mail account. Additionally, one of the administrators claimed to be the co-owner of the account and therefore claimed to be individually entitled to the contents.

2. Yahoo moved to dismiss the action on the grounds that the action was not properly before the Massachusetts court as a forum selection clause in the website's Terms of Service ("TOS") required suit in California, that the action was time-barred, *res judicata* barred the action, and that the complaint failed to state a claim upon which relief could be granted. The Court would not apply the *res judicata* doctrine to bar the action. It noted that the administrators' claim for the e-mail contents could not have been pursued in the first action without violating the parties' partial settlement agreement and that the issue over the rights to the contents was explicitly carved out from the first complaint. The Court also refused to enforce the forum selection clause. The Court noted that Yahoo had the burden to demonstrate that the clause was reasonably communicated and accepted and that if Yahoo met its burden, the administrators would have to demonstrate that the clause was unreasonable in the circumstances. The Court found that Yahoo did not reasonably communicate the clause as there was no evidence that the TOS was actually displayed on the decedent's computer screen – users were only given the opportunity to review the TOS. The Court also noted that the TOS was never accepted by the decedent or by the administrator who claimed co-ownership over the account. Yahoo did not require its users to click "I accept" after reading the TOS's terms. The Court further found that even if the terms were reasonably communicated and accepted, it could not conclude that it was reasonable to enforce the terms against the estate because the administrators were not parties to the contract, only the Massachusetts probate court had *in rem* jurisdiction over the estate, and because the TOS had unreasonable breadth. The Court did not determine whether the contents of the e-mails were property of the estate as the parties did not fully brief the issue and held that the question would be addressed on remand after full briefing.

3. On remand, the parties filed cross motions for summary judgement and the trial court held on summary judgment in Yahoo's favor on the grounds that: (1) the estate has a common-law property interest in the contents of the account; (2) however, the Stored Communications Act ("SCA") prohibits Yahoo from disclosing the contents of the emails to the estate; and (3) there were disputed issues of material fact concerning the formation of the TOS, which purported to give Yahoo discretion to refuse to turn over (or even destroy) the contents of the account, and summary judgment was denied on that claim by Yahoo. The administrators appealed the ruling, but Yahoo did not appeal the

ruling on the estate's property interest. On its own initiative, the Massachusetts Supreme Judicial Court transferred the case to its docket from the court of appeals.

4. The Massachusetts Supreme Judicial Court vacated the trial court decision and remanded the case to the trial court on the following grounds:

   a. The SCA prohibits unauthorized third parties from accessing stored electronic communications and regulates when service providers may voluntarily disclose stored electronic communications. Voluntary disclosure is restricted unless a statutory exception applies. The exception for disclosure to an agent cannot apply here because "agent" is not defined and must take its common law meaning, and at common law a personal representative is not an agent, was not appointed by the principal, and is not subject to the control of the principal.

   b. Another statutory exception permits disclosure upon receipt of "lawful consent" which is also not defined. Lawful consent does not mean "actual consent" by the principal, and can include consent by the administrators of the principal's estate, because: (i) requiring actual consent would preempt state probate and common law, and there is presumption against interpreting statutes to preempt such laws; (ii) an actual consent standard would prevent personal representatives from performing their fiduciary duties and create a class of assets that could not be marshaled and interfere with estate administration by precluding access to financial information; (iii) the plain meaning of "lawful consent" means consent permitted by law and does not preclude consent by a personal representative, and personal representatives give lawful consent for a decedent in other contexts, such as under HIPAA, for waiving privileges, and to sell property, bring claims, and vote stocks; (iv) Congress could have required actual consent and did not do so; and (v) nothing in the legislative history suggests that Congress intended to preempt state law.

   c. Yahoo is not required under the SCA to divulge the contents of the email to the personal representatives, but the trial court erred by going further than finding disclosure to be discretionary by Yahoo and holding on summary judgment that the SCA prevented it from doing so.

   d. The express language of the TOS, if enforceable, would give Yahoo the unfettered right to deny access to the emails or destroy them. The trial court correctly denied summary judgment for Yahoo under the TOS on the grounds that the record was not adequate to show that a valid contract was formed and whether the TOS was an enforceable contract.

   e. A concurring and dissenting justice, because Yahoo did not appeal the ruling on the estate's property rights in the email account, would find remand to be unnecessary (and unfair economically to the estate because of legal costs) and would hold that Yahoo's TOS cannot be enforced to prevent estate access to the emails in which it has a property interest, because such a result could lead to spoliation of evidence and contempt of court orders to turn over the emails, because the Supreme Judicial Court would surely reverse any ruling that the TOS was enforceable in

that way, and because the personal representatives "should not have to spend a penny more to obtain estate property in the possession of Yahoo that they need to administer the estate".

5. On March 26, 2018, the U.S. Supreme Court denied Yahoo's petition for a Writ of Certiorari.

D. *In re Willard R. Sparks Revocable Trust 2004,* 2018 Tenn. App. LEXIS 746 (2018). Court upholds sanctions against trustee for filing false demand for accounting from trustee.

1. Willard Sparks placed his interests in several agribusinesses, with a total value of over $200 million, into a trust for his children that would manage his interests until seven years after his death, at which time the interests would be distributed to his children.

2. In 2013, due to several multi-million dollar claims against the trust, the trustees, with the concurrence of the beneficiaries, entered into an agreement to appoint a single managing trustee and to extend the trust term until the claims against the trust were resolved, and to facilitate liquidation of the trust assets.

3. In 2015, Brian, one of the co-trustees and beneficiaries sued the managing trustee and his brother, Robert, who was also a co-trustee and beneficiary, to seek a detailed trust accounting. The defendants moved to dismiss the claims and impose Rule 11 sanctions. The motion for sanctions identified numerous inaccuracies in the petition and sought payment of the attorneys' fees incurred by the trust. Brian did not amend his petition. The trial court held a six-day hearing on the sanctions motion, and imposed Rule 11 sanctions in the amount of $200,000 against Brian on the grounds that: (a) monthly financial statements and yearly audited statements were provided to the co-trustees and all beneficiaries for the past 10 years; (b) as co-trustee, Brian had access to all the information he had requested; (c) Brian falsely claimed he did not receive the information he requested; (d) Brian falsely claimed his brother had not repaid certain funds to the trust; (e) Brian objected to loans he had approved in advance in writing, falsely claimed he had not signed the approval papers, and falsely claimed the loans had not been repaid; and (f) driven by has anger against his brother, Brian had filed willful and untruthful pleadings. The managing trustee had sought sanctions in the amount of all of the trust's attorneys' fees totaling $1.9 million, but the trial court concluded that $200,000 was enough to deter petition of the conduct by Brian. Both sides appealed, and expressed displeasure with the amount of the trustee's attorneys' fees.

4. On appeal, the court of appeals affirmed on the following grounds: (a) the proper measure of sanctions is the amount necessary to deter the conduct; (b) the trial court's measure of the amount of sanctions was not clearly erroneous, and is subject to the court's discretion; (c) the trustee bears some responsibility for their selection of counsel and the litigation strategy and conduct of their counsel and cannot expect Brian to pay for it entirely; and (d) whether to award attorneys' fees in trust actions is a matter of judicial discretion and the court did not clearly abuse its discretion.

XIV. Fiduciary Privileges & Exceptions

A. *Huber v. Noonan,* 2018 Pa. Super. Unpub. LEXIS 3980 (2018). The law of the state where the decedent dies applies to determine the scope of the testamentary exception to the attorney-client privilege.

1. Susan was a Pennsylvania attorney who drafted estate planning documents for Clara when she lived in Pennsylvania. Clara discharged her when she moved in with her niece, Karen, in Florida in 2015. Clara then executed new estate planning documents that left her entire estate to Karen. Clara died the next year and her other relatives sued in Florida to contest the new Florida documents on the grounds of lack of capacity, undue influence, and tortious interference. Their lawyer subpoenaed Susan's entire estate planning file including her notes, correspondence, and other memoranda that were attorney work product.

2. Susan moved to quash in the grounds of the attorney-client privilege and the attorney work product doctrine. The court granted her motion, but then on reconsideration denied the motion on the privilege and only allowed her to withhold documents that were attorney work product. Susan appealed.

3. On appeal, the Pennsylvania Superior Court affirmed on the following grounds:

   a. Florida has a broad statutory provision that applies the fiduciary exception to the attorney-client privilege. In contrast, Pennsylvania has no appellate cases recognizing the exception and the lower court cases are much more limited than the Florida statutory rule. There is therefore a real conflict between the laws of the two states.

   b. Florida has the largest interest in the outcome of the litigation. The lawsuit is pending there, the defendants reside there, the trusts at issue have Florida situs, and the case will be decided by a Florida court. Florida law should therefore be applied to determine the scope of the fiduciary exception to the attorney-client privilege.

   c. Florida has a broad statutory exception and presumes the testator would want to have her intent known if the alternative would result in a wrongful disposition of her estate. The plaintiffs are arguing that the Pennsylvania documents should control under dependent relative revocation and require the Pennsylvania information to establish their standing to sue and also evidence of the decedent's longstanding testamentary intent. The plaintiffs also believe that the file will have evidence of undue influence, such as the cloistering of the decedent from those she trusted.

   d. Pennsylvania has no interest in the outcome of the case and is only involved due to a derivative subpoena.

B. *In re: Amendments to the Florida Evidence Code,* No. SC17-1005 (2018). Florida Supreme Court approves new evidentiary code provisions eliminating the fiduciary exception to the attorney-client privilege.

1. In Florida, new evidentiary code provisions generally require both passage by the Legislature and approval by the Florida Supreme Court (the procedural aspects of the evidence code are reserved to the courts under the state constitution).

2. In this decision, the Florida Supreme Court reversed its 2014 decision not to adopt Fl. Stat. 90.5021, which provides that a communication between a lawyer and a client acting as a fiduciary is privileged and protected from disclosure under the statutory attorney-client privilege to the same extent as if the client were not acting as a fiduciary. Florida had also amended its probate and trust codes to make it clear that the "real client" is the personal representative or trustee and not the beneficiaries, and to provide a mechanism for giving beneficiaries notice that the fiduciaries can retain counsel and assert the attorney-client privilege. See Fl. Stat. 733.212; 736.0813.

3. With this decision, the Florida Supreme Court has approved the new evidentiary code provisions eliminating the fiduciary exception to the attorney-client privilege to the extent the rule is procedural in nature, thereby resolving the uncertainty that arose from its 2014 decision.

C. *Morgan v. Superior Court,* 2018 Cal. App. LEXIS 496 (2018). Trust terms cannot eliminate the fiduciary exception to the attorney-client privilege.

1. Beverly completely restated her revocable trust in November of 2013 and named her son Thomas as sole beneficiary and successor trustee. She died in January 2014, and her daughter Nancy filed a series of claims against Thomas, including claims to invalidate the trust for lack of capacity, fraud, undue influence, claims to remove Thomas as trustee for alleged inappropriate personal use of the trust assets in the dispute with the other family members, and alleged self-dealing through millions of dollars in interest-free loans.

2. The trial court initially resisted motions to suspend Thomas as trustee, enjoined Thomas from dissipating the trust assets while litigation was pending and ordered Thomas to file an accounting. When the accounting filed was so inadequate as to be called mere "lip service" by the court, the court suspended Thomas as trustee, appointed successor co-trustees, and ordered Thomas to provide the successor trustees (but not the opposing parties) with all trust records and communications between Thomas with trust counsel (including billing statements, invoices, fee agreements, and payment history), without redactions. One of the issues in the case was whether Thomas was charging the trust for his personal costs in the dispute with the other family members about the validity of the trust.

3. At a hearing, Thomas's counsel informed the court that he would turn over the documents by July 12th, but then objected to entry of the formal order memorializing the court's minute order asserting attorney-client privilege. The terms of the trust provided as follows: "[A]ll communication (written or oral) between the Trustee and legal counsel, and all work product of legal counsel shall be privileged and confidential and shall be absolutely protected and free from any duty or right of disclosure to any successor Trustee to any

beneficiary and any duty to account". The trial court ordered Thomas's counsel to turn over the records and set a hearing to show cause for contempt against Thomas and his counsel for refusing to obey the court's order after counsel stated on the record that he would do so.

4. Thomas petitioned the California Court of Appeals for a writ of mandamus and prohibition asserting the attorney-client privilege, which the Court of Appeals denied on the following grounds:

   a. When a trustee seeks legal advice on behalf of a trust, the trustee is the client and the privilege vests in the office of the trustee and not in a particular person. The right to assert the privilege is transferred from a trustee to the successor trust.

   b. A settlor cannot totally exonerate a trustee from liability for intentional misconduct, gross negligence, or reckless indifference. The trust terms here, accordingly, only partially exonerated the trustee from liability and do not go past what is allowed by law in an exculpatory clause.

   c. The trust terms that provide that the trustee is not required to provide information to the successor trustee violates public policy.

   d. A trustee may be able to refuse to turn over to the successor trustee privileged communications in the trust files where the trustee can demonstrate that counsel was retained in a personal capacity and the trustee took affirmative steps to distinguish the purported personal advice from advice obtained in a fiduciary capacity. The trustee must distinguish, scrupulously and painstakingly, his or her own interests from those of the beneficiaries.

   e. If Thomas did not distinguish his interests from the trust, and used the trust assets for his own benefit, the documents cannot be protected from disclosure by the trust terms. Here Thomas did not retain separate counsel and took no action to separate his individual advice from advice for the trust itself.

   f. Consistent with public policy, the trust protects the beneficiaries from malfeasance by the trustee by placing limits on the exculpatory clauses. To maintain effective and consistent trust operations, the trust terms must be interpreted in a manner that does not allow the trustee to withhold from the successor trustee materials that reflect Thomas's communications with trust counsel while he was serving as trustee, where, as here, there is nothing to suggest Thomas distinguished his own interests from those of the beneficiaries or retained separate counsel for this purpose.

D. *United States v. Fridman,* 2018 U.S. Dist. LEXIS 197038 (S.D.N.Y. 2018). The collective entity doctrine applies to a trust and is an exception to Fifth Amendment protections.

1. The United States petitioned to enforce two IRS summonses, in part against an individual as trustee of New York trust, in connection with an IRS investigation into that individual's tax liabilities. The trustee purported to invoke his Fifth Amendment privilege against self-incrimination, including with respect to documents sought in his role as trustee.

2. With respect to the trustee requests, the U.S. District Court for the Southern District of New York held that Fifth Amendment privileges do not apply, on the following grounds:

   a. The Fifth Amendment provides that no person shall be compelled in a criminal case to be a witness against himself. In addition to testimonial communication, the act of producing evidence in response to a subpoena has communicative aspects of its own, wholly aside from the contents of the papers, and may be subject to the privilege.

   b. However, there are exceptions to the privilege, including the "collective entity doctrine". Under this doctrine, a person cannot rely on the privilege to avoid producing records of a collective entity that are in his possession in a representative capacity, even if those records incriminate him personally. A collective entity is an organization that is independent apart from its members.

   c. The First, Fifth, Eighth, and Ninth circuits have held that trusts are collective entities, but that was an open question in the Second Circuit (although the U.S. District Court for the Southern District of New York itself had already recently held that trusts are collective entities). The court followed the reasoning of those cases and held that trusts are collective entities. The trust at issue had an established identity independent of the trustee, and was held out to the world as being separate and apart from the trustee and beneficiaries. Because the trust is a collective entity, the trustee must produce all trust related documents contemplated in the document requests.

   d. The doctrine is limited to documents and not oral testimony. The trustee can be compelled to produce documents but not oral testimony. However, the trustee is required to identify and authenticate the documents for admission into evidence.

XV. Cy Pres & Charitable Trusts

A. *In re Trust of William J. Cohen,* 2018 Pa. Super. LEXIS 540 (2018). Application of cy pres appropriate to transfer trust distributions to community foundation funded with proceeds of sale of hospital to for-profit health organization.

1. Under his will and trust, William J. Cohen created a perpetual charitable trust for the equal benefit of a church in Chester, a church in Philadelphia, a church in York, and a hospital in Chester. In 1964, a non-profit medical center succeeded to the interests of the hospital. In 2016, the medical center sold its assets to a for-profit company that was ineligible to receive trust distributions and used the sales proceeds to fund a community foundation. The community foundation petitioned to be substituted as a trust beneficiary in place of the hospital by *cy pres.* The state attorney general did not oppose the petition. One of the churches opposed the petition and asserted that the hospital share should lapse and the shares for the remaining three churches should enlarge. The trial court granted the petition and the church appealed.

2. On appeal, the superior court affirmed the trial court on the following grounds:

   a. The state statutes on lapsed gifts do not apply and the law of *cy pres* applies to the petition. Those statutes are limited to individuals, no reference is made to an entity that lacks a corporeal existence, and the statutes do not encompass residuary gifts to charitable entities. With respect to a charitable trust, these statutes are subjugated to the *cy pres* statutes.

   b. The fact that the community foundation is not a hospital does not preclude application of *cy pres* in its favor. While the settlors originally intended to benefit a hospital in Chester, the question is what institution he would choose to benefit if he had known the hospital had failed its charitable purpose. The community foundation's mission supports healthcare-related services in Chester and its mission is to improve the health of local residents. It has provided services related to breast cancer screenings, financial support of cancer patients, home hospice care, nutrition for mothers and infants, addiction prevention, child nutrition, and many other programs in the Chester area.

   c. Other than naming a hospital originally, there are no statements of intent that the settlor required the funds to pass to a hospital. Allowing the funds to pass to the three churches would ignore the medical component of the settlor's intention and would further violate the settlor's intent by dividing the funds in three shares rather than four. Further, the settlor did not mandate how the originally named hospital was to spend the funds received, supporting an inference that the settlor was primarily concerned with the provision of medical services rather than the functioning and maintenance of the hospital itself.

B. ***Horgan v. Cosden,* 2018 Fla. App. LEXIS 7375 (2018**). Commutation of charitable remainder trust rejected.

1. Under her revocable trust, Yvonne created a trust at her death that provided for net income distributions to her son for his lifetime, with the remainder passing to three colleges at the son's death. She named her son and her personal assistant as co-trustees. The trust was funded with approximately $3 million. In 2015, the beneficiaries entered into an agreement to commute the trust and distribute $2 million to the son outright and $1 million to the colleges. The co-trustee objected to the commutation. The son petitioned the court to approve the agreement, the co-trustee objected, and the trial court granted summary judgment approving the commutation. The co-trustee appealed.

2. On appeal, the court of appeals reversed, and awarded summary judgment rejecting the commutation, on the following grounds:

   a. The plain trust terms reflect the settlor's intent to provide the son with only incremental income distributions for life, and then give the principal to the colleges after his death. Terminating the trust would frustrate that intent and the trust purposes. The settlor could have given her son a lump sum (as she did for her personal assistant) but chose not to do so. She also included a spendthrift provision to protect the interests in the trust.

b. There has not been any waste of trust assets, proof that the trust purposes have been fulfilled, or proof that termination is in the best interests of the beneficiaries when considered in light of the settlor's intent. Trustee fees are customary, administration expenses were not unusual, and there has been no invasion of principal. Market fluctuations do not create a real risk that the settlor's intent will be thwarted. The beneficiaries simply prefer a different course than the one chosen by the settlor and want their money now. But the desire to have money now would violate the settlor's intent that the income beneficiary receive incremental distributions of income and not principal lump sum distributions.

c. The fact that the trust does not expressly prohibit early termination does not mean that the settlor did not express her intent. Many settlors decline to provide for lump sum distributions and may not want to spell out the reasons. The trial court's erroneous ruling would mean that beneficiaries could have trusts terminated simply by stating they don't want to pay trustee fees, administrative expenses, or be concerned with market fluctuations. Nothing suggests the settlor was unaware that markets fluctuate. The settlor expressly contemplated trustee fees and administration expenses by addressing them in the trust terms.

C. *Kirgan v. M&T Trust Co.,* 2018 U.S. Dist. LEXIS 203039 (E.D. Va. 2018). Allegations about charitable gift contracts and failure to take meeting minutes are not sufficient to justify removal and surcharge of corporate trustee of charitable trust.

1. Clarence Plitt established a charitable trust under his will that was funded after his death in 1976. His long-time partner, Mary, served as initial co-trustee along with a corporate co-trustee. She had previously unsuccessfully contested the will, resulting in entry of an order that the corporate trustee could only be removed for cause. Upon Mary's passing in 2004, her children Mary Anne and Robert (the "Kirgans") became individual co-trustees.

2. The trust provided for awards to educational institutions that agreed to use the funds for student loans based on financial need, and the schools must agree to use the funds for those purposes. The trust leaves selection of recipients and specific loan terms to the recipient institutions. The trust also precludes the trust from having any interest in the loan repayments and provides that the institutions should use such funds in furtherance of their educational purposes as they shall desire.

3. In the early years of the trust, Mary selected the gift recipients and the trustees worked on contracts for the schools to sign agreeing to use the funds for loans. Those contracts required the schools to use the loan repayments for additional student loans. The corporate trustee sought to make changes to the loan agreements with Mary and then the Kirgans, and the individual trustees also sought changes. Before the Kirgans become trustees, the agreements did not include terms addressing the interest rates to be charged, grace and deferment periods, preference for students with co-signed loans, or a requirement that life insurance be taken out on students who do not have a co-signer and receive loans in excess of $20,000. In 2013, Mary Anne signed an amendment to an agreement with Wellesley that added funds to the college and signed alone as alleged "primary trustee".

4. Starting in 2015, the bank trustee raised concerns that several terms of the contracts violated the terms of the will and communicated those concerns to the Kirgans. The trustees eliminated the offending language from the contracts in the 2015 agreement with Randolph-Macon. The bank trustee worked to revise any outstanding contracts that contained the offending language and maintained that the contracts had to comply with the will. The bank trustee also obtained a legal opinion about whether the contracts complied with the will. The bank also started sending payments to the schools directly, rather than sending the funds to the Kirgans for distribution. Before the Kirgans become trustees, 40 schools received trust distributions. After their appointment, only 5 received distributions (with the largest going to Randolph-Macon College and Wellesley). The Kirgans also refused to engage in a process to determine the appropriate compensation to be paid to all trustees.

5. The Kirgans responded by suing to remove and surcharge the bank trustee, alleging the bank breached its duties by failing to take meeting minutes, paying counsel out of the trust assets, sending checks directly to the schools, and not adequately communicating. The bank noted that the Kirgans were unresponsive to investment advice and refused to respond to requests to schedule meetings. The bank filed a counterclaim to prohibit contract terms that violated the will terms and to set trustee compensation.

6. The court rejected the claims to remove and surcharge the bank trustee on the following grounds:

    a. The evidence failed to show that by entering into the contracts the bank trustee violated the will, demonstrated inability to perform the duties of the office, or acted in a way that was not in the interests of the trust. While the contracts went through several iterations over the years, none demonstrated lack of fitness by the bank trustee.

    b. The lack of meeting minutes cannot support the claims because meeting minutes never existed for the trust and were not required by the terms of the will or trust law, and the Kirgans refusal to meet with the bank would hardly give rise to minutes.

    c. While the trustees did not agree on the contract revisions, this is not a breach of the duties of good faith or loyalty, and the bank's actions were not outside the bounds of protecting the trust.

    d. The bank obtained an opinion of counsel about compliance with the will and worked to revised contracts to bring them into compliance. The terms suggested by the Kirgans gave rise to the concerns, and the Kirgans suggested contract terms that went outside the terms of the will. The Kirgans' failure to meet with the bank made it more difficult for the bank to perform its duties, but the bank performed them regardless.

    e. The trust may not require the lending schools to use loan repayments to make additional student loans.

    f. A compensation analysis should be done to set the compensation of all trustees and all trustees must set a meeting schedule and meet to conduct trust business.

XVI. Revocable Trusts

A. *Rhea Brody Living Trust v. Deutchman,* 2017 Mich. App. LEXIS 1430 (2017); No. 330871 (Mich. App. 2018). Court of appeals holds that contingent remainder beneficiary of revocable trust may sue trustee, despite settlor being alive and regardless of any finding that the settlor is incapacitated and that the trust is irrevocable. Michigan Supreme Court vacates the decision and remands the case, and on remand the Court of Appeals affirms its prior decision.

1. Rhea created a revocable trust with her husband Robert as trustee. The trust provided at her death for marital and family trusts, and then at the death of her surviving spouse for equal trusts for her son Jay and her daughter Cathy. The trust assets included a 98% interest in Brody Realty, which owned another family business called the Macomb Corporation. Robert was also the manager of Brody Realty. Rhea was alive and had not been declared incompetent.

2. Robert acting as manager sold Brody Realty's interest in certain property to Jay and Jay's children, subject to 15% and 40% valuation discounts, and for a total purchase price of $3.35 million paid by a down payment of $1 million and a 9.5 year note at 1.65% interest. Robert also sold to Jay for $136,000 an option to purchase the trust's interest in Brody Realty and the Macomb Corporation, at fair value (and with 9 years to pay the purchase price with interest at the AFR rate) and subject to valuation discounts, for a period lasting from 9 months to 15 years after Rhea's death, during which time Jay would have proxy to vote the trust's interests before sale, and where the purchase price would be discounted by $2 million if Cathy or her husband attempted to interfere with Jay's right, with Jay being allowed to allocate the $2 million reduction between himself and his sister.

3. Cathy sued to remove and surcharge her father as trustee. The probate court removed Robert, found on summary judgment that he breached his duties as trustee, and that Jay was complicit, and: (a) modified the terms of the property sale to increase the sales price and the interest rate on the note; and (b) voided the option agreement. Robert appealed. On appeal, the court of appeals affirmed Robert's removal and the finding of breach of duty, reversed the modification of the property sales agreement, and remanded the case to revise the remedies for breach, on the following grounds:

   a. The fact that the trust assets are businesses is not alone enough to divest the probate court of jurisdiction over a trust lawsuit and force the case to be heard in the business court, and the probate court had jurisdiction to hear the case.

   b. As a contingent remainder beneficiary of the revocable trust, Cathy had standing to bring her claims regardless of whether Rhea had capacity and the trust was revocable. A court may intervene in a trust administration to the extent its jurisdiction is invoked by an interested person. Interested persons includes beneficiaries. Cathy has a future contingent beneficial interest in the trust, and will receive Rhea's clothing and jewelry at her death, and a sub-trust with 50% of the trust assets after both of her parents die. The court declined to adopt the approach of UTC jurisdictions in holding that a contingent beneficiary lacks standing to challenge the administration of a revocable trust, because those cases involve statutory

language that does not control here. It is unnecessary to determine whether Rhea was disabled under the trust terms or whether the trust is revocable to resolve the issue of Cathy's standing.

c. The trust terms prohibited Robert as trustee from possessing powers that would enlarge or shift the beneficial interests under the trust. If he had such a power, the trust terms required Robert to appoint an independent co-trustee. Robert failed to appoint a co-trustee to ensure that the beneficiaries' best interests were served while he served in a potentially conflicting role, and his failure constituted a breach of his duties under the trust. The sale of property was the sale of an asset held in an entity owned by the trust, and the option agreement would transform Cathy's interest from 50% of Brody Realty to 50% of its sales proceeds, and there was no guarantee those interests would be equivalent, especially given the income from the company. The option shifted beneficial interests under the trust. Rhea had a general intent to treat her children equally at the death of her spouse, and the option agreement was inconsistent with that intent (notwithstanding trust terms that allows discretionary distributions in unequal shares).

d. The court erred by reforming the purchase agreement because the parties to the sale intended the terms of sale, reformation is not permitted as a remedy for breach of trust because an order to recover sales proceeds could have been tailored to remedy the breach of duty, and because the reformation impacted Jay's children without evidence that they played any role in any improper conduct. Reformation was not permitted under the court's equitable powers because those powers are not unlimited, and the court did not weigh the sales terms against the parties responsible for the misconduct. On remand, the court should determine an appropriate remedy for breach.

e. The court correctly rescinded the option agreement because: (i) Cathy was not also given an option to purchase the interest; (ii) the option was part of a pattern of favoring Jay over Cathy; (iii) Jay would have the trust's proxy before sale was completed; (iv) the 15-year option would delay funding of Cathy's trust (which even if a "reasonable" delay under trust law would still unfairly burden Cathy but not Jay) while Jay had present rights to vote the stock; (v) there was a $2 million penalty that Jay could impose on Cathy; and (vi) the inequity in that arrangement is clear.

4. The Michigan Supreme Court vacated the Court of Appeals decision on Cathy's standing to sue and remanded the case to the Court of Appeals to reconsider its standing decision and take into account the arguments made by the Probate and Estate Planning Section of the Michigan State Bar. On remand, the Court of Appeals affirmed its prior conclusion that Cathy had standing to bring the claims on the following grounds:

a. MCL 700.1105(c) defines "interested person" in relevant part as a "child…, and beneficiary and any other person that has a property right in or claim against a trust estate". Applying rules of statutory construction, the phrase "and any other person that has a property right in or claim against a trust estate" does not modify or impose qualifications on the inclusion of a "child" or "beneficiary" as an interested person. The following sentence of that statute provides that the identification of interested persons may vary from time to time and shall be determined

according to the particular purposes of, and matter involved in, a proceeding, and by the Supreme Court rules. MCR 5.125 of the rules provides additional guidance on interested persons in trust matters and shows that the interested person inquiry is flexible and fact-specific. Read together, whether a child or beneficiary has standing in a trust matter is dependent on the purposes and matter involved in the proceeding under the facts at the time, and not whether the child or beneficiary has a property right or claim against the trust estate at that time.

b. Cathy qualified as an interested person because she would be a qualified beneficiary entitled to notice if the settlor was deceased, and she had a reasonable basis to believe the settlor was incapacitated. When Robert accepted the role as trustee, he had reason to believe his mother was incapacitated as a result of her dementia.

c. The court was dismissive of the State Bar's concern that a child could be included as having standing in trust matters even though the child was not included as a beneficiary, or for a revocable trust, where the settlor was alive and had capacity and the trust was funded for privacy and probate planning purposes.

XVII. Directed Trusts, Protectors & Special Fiduciaries

A. *Minassian v. Rachins,* No. 4D13-2241 (December 3, 2014); 251 So. 3d 919 (Florida Court of Appeals 2018). Drafting lawyer appointed as trust protector could validly amend trust to clarify settlor's intent in the middle of litigation between beneficiaries over ambiguous provisions. Children who are beneficiaries of new trusts that receive remainder of trust assets at death of spouse have standing to challenge distributions from trust during spouse's lifetime.

1. Zaven Minassian created a revocable trust with himself and his wife as trustees, for the primary purpose of taking care of himself and his wife. He died in 2010, and because of the one-year repeal of the estate tax in 2010, only the family trust was funded at his death pursuant to the trust terms. Wife served as trustee of the family trust, which provided the wife with discretionary income and principal by a standard and directed that the primary concern was the care of the wife, and not preservation of corpus. The trust provided that the family trust would terminate at the wife's death, and that Zaven did not desire to create a common trust for his beneficiaries. After the wife's death, the trust assets would pass to separate trust shares for Zaven's children by a prior marriage, with a bank as trustee. His lawyer (who was later named as trust protector), testified that Zaven wanted to provide his wife with the lifestyle of horse racing and legal gambling that they enjoyed together, did not want to create a common trust for his wife and children, and was concerned that his estranged children would challenge his wife's use of the trust assets.

2. The children sued the wife for breach of duty, the wife moved to dismiss on the grounds that the children were not beneficiaries of the family trust, but rather of new trusts that were not yet created. The court denied the motion, finding that the use of the term "trust shares" meant the children likely had standing to bring their claims.

3. The wife, under the trust terms, then appointed the husband's drafting lawyer as trust protector with the power to amend the trust. The trust protector then amended the trust terms to clarify that a new trust would be created at the wife's death, and that the children were not beneficiaries of the family trust.

4. The children challenged the validity of the amendments, both parties moved for summary judgment on the issue, and the trial court granted the children summary judgment and found the amendment was improper for favoring the wife and not leaving the children with the ability to question the wife's actions as trustee, and the wife appealed.

5. On appeal, the court of appeals reversed on the grounds that: (1) the Florida Uniform Trust Code (Section 808) allows the settlor to give a non-trustee the power to modify the trust; (2) this section overrides any conflicting common law principles of non-delegation, and permit the appointment of a trust protector with the power to modify the trust terms; (3) the trust was ambiguous as to husband's intent as to whether a new trust was created at wife's death; (4) the trial court's "single trust" interpretation is not unambiguously supported in the trust terms; (5) the trust protector's affidavit showed that the amendments were made to carry out the settlor's intent and were therefore within his powers; and (6) removing the authority from the trust protector and assigning it to the court would violate the settlor's intent.

6. On remand, the children filed an amended complaint alleging that the wife dissipated the trust assets due to a gambling problem. The complaint added the trust protector and his law firm as defendants, but the children did not serve the protector with the suit papers before his death. The wife and the law firm moved to dismiss the claims on the basis that the children lacked standing because they were not beneficiaries of the trust, and rather were beneficiaries of another trust that would only be funded upon the wife's death. The trial court entered summary judgment dismissing certain claims on this basis and the children appealed. On appeal the court of appeals reversed on the following grounds:

   a. The children are both beneficiaries and qualified beneficiaries of the trust because they have a future beneficial interest in the trust assets remaining at the wife's death, since the assets will be disbursed to a new trust for the children's benefit at that time. At a minimum the children have an equitable interest in any trust assets remaining at that time.

   b. The fact that the remaining trust principal would flow into a new trust, as opposed to being distributed to them outright, does not preclude the children from being statutory beneficiaries of the trust under the UTC definitions.

   c. The fact that the trust terminates upon the wife's death does not preclude the children from having a beneficial interest in the trust. By definition, a remainder interest in a trust refers to the right to receive property when the trust terminates.

   d. While in the prior appeal the court was hesitant to refer to the children's interest as a remainder, the court nevertheless recognized that the children had an interest in the trust. The UTC definition of "qualified beneficiaries" also includes the children, even though the trust terminates at the wife's death and the children receive assets in trust rather than

outright. While the husband may have intended to prevent the children from challenging the manner in which the wife spent the money during her lifetime, the children are qualified beneficiaries and are entitled to the corresponding protections afforded to qualified beneficiaries under the UTC.

e. The wife's unlimited power to invade the trust is subject to implied limitations to protect the beneficiaries with an interest in the trust assets that remain at the wife's death. Because the children are qualified beneficiaries with standing to challenge the trust administration, the trial court erred by dismissing the claims for lack of standing.

B. *Carberry v. Kaltschmid,* 2018 Cal. App. Unpub. LEXIS 3900 (2018). Trust protector does not have standing to compel trustees to account.

1. George created a trust for his widow and six children that became irrevocable upon his death in 2014. Two of his children were named as trustees. The original trust protector resigned in 2015 and he named Shaun (who was not related to any of the beneficiaries) as his successor.

2. The trust terms provided that: (a) the protector acted in a fiduciary capacity; (b) the protector had the powers to amend or modify the trust (but not to expand its own powers), construe the trust in the event of an ambiguity, the power to sign documents to exercise its powers, the power to appoint a special trustee, the power to appoint successor trustees if there is a vacancy not filled by other trust terms, the power to terminate an uneconomical trust, and the power to change the trust situs and governing law; (c) the protector had no duty to investigate the trustee's actions or inactions, audit the trust books, or evaluate portfolio performance; and (d) the protector was entitled to compensation.

3. In January 2016, the protector wrote the trustee to inquire about a trust loan and the status of an ongoing dispute among the trustees and requested an accounting. Counsel for a trustee advised that the parties were working on a settlement. In February, the protector wrote another letter asking for the settlement agreement and stated that "as Trust Protector, I have a fiduciary duty to keep myself informed of the condition of the administration of the Trust". Counsel for a trustee responded that trusts and estates counsel were working with the family to resolve the disputes, and that counsel for the trustees and the beneficiaries agreed that the protector would not be accused of not fulfilling his duties if he placed his work on hold while the family worked on resolution.

4. In September, the protector sued to compel the trustees to account and provide information (although the only "information" sought other that the accounting was a copy of the settlement agreement). The protector made allegations that the trust was delinquent with tax filings and had incurred high legal fees. He also sought confirmation of his ability to appoint a special trustee. A trustee opposed, arguing that: (a) the protector lacked standing to demand an accounting; (b) the high fees were the fees of the prior protector which were part of the dispute; (c) the parties were in mediation to resolve the trust disputes; and (d) that accountings had been provided to the beneficiaries.

5. The trial court dismissed the protector's claim for lack of standing and the protector appealed. On appeal, the court of appeals affirmed on the following grounds:

   a. The probate code provides that a trustee is to provide accountings to beneficiaries and that a trustee or a beneficiary has standing to compel a trustee to account. The protector is not a beneficiary and there is no authority giving a non-beneficiary protector standing to compel an accounting.

   b. The trust terms do not entitle the protector to compel an accounting. The trust terms require the trustee to account to the beneficiaries only. None of the powers granted to the protector include the power to compel an accounting.

   c. The trial court was not required to grant an amorphous request that the court compel the trustees to communicate generally with the protector when no specific information was identified.

   d. A concurring opinion noted that: (1) a law review article concluding that a trustee who has the power to remove a trustee has a duty to stay informed about the trust is irrelevant because this protector did not have the power to remove trustees; and (2) the authority granted the protector does not render the protector the functional equivalent of a trustee.

C. *In re Quintanilla Trust,* 2018 Tex. App. LEXIS 8223 (2018). Trustee could merge trusts into new trusts to remove trust protector.

1. In 2014, Oscar created separate irrevocable trusts for his three children, with Paul as trustee and Andrew as trust protector. The trust protector had the power to remove and replace the trustee. The trust terms expressly authorized the trustee to merge the trusts with new trusts for the same beneficiaries with substantially the same terms, if the trustee found the action desirable in is discretion.

2. Oscar and Andrew had a falling out in 2016 and severed their business relationship. As protector, Andrew requested accountings for the trusts and advised Oscar that he was considering removing Paul as trustee and appointing a bank as trustee. Oscar created new irrevocable trusts that were identical to the 2014 trusts but excluded Andrew as trust protector. His children, all of whom were adults, consented to the merger and waived formal notice of the merger.

3. The trustee then petitioned for a declaration that the 2014 trusts no longer existed and that the trust protector was not an interested person and had no right to demand an accounting of any of the trusts and seeking payment of its attorneys' fees from the trust. The trust protector counterclaimed to void the merger, demand an accounting, and for a declaration that he had fulfilled his duties as trust protector. The trial court granted the trustee partial summary judgment that the 2016 trusts were validly established and that the trust protector was not entitled to notice of the merger. The court then granted the trustee summary judgment on the balance of the claims and the court awarded the payment of the trustee's attorneys' fees out of the trusts. The trust protector appealed.

4. On appeal, the court of appeals affirmed on the following grounds:

   a. The trustee met the burden of proving the valid formation of the trusts by the trust instruments and the schedule reciting the funding of the trusts with $5,000, without the need to put on additional evidence of the transfer of the cash.

   b. The trust terms expressly allow the merger of the trusts in the discretion of the trustee and the merger documents state that the trustee determined that the merger will not impair the rights of the beneficiaries or impair the trust purposes. There is scant authority as to when a merger impairs the rights of the beneficiaries or impairs the trust purposes. Here, the trust is silent on the removal of the trust protector and the merger to remove the trust protector does not circumvent other methods provided in the trust for removal of the protector. In contrast, the trust terms expressly allowed the merger.

   c. Neither the trust terms nor the trust code merger provision require giving notice of the merger to the protector. The beneficiaries waived notice and consent to the mergers.

   d. A person who does not manage trust assets or have a beneficial interest in the trust is not generally an interested person with respect to a trust. There is little authority on the role of trust protectors, which the trust code only recognized in 2015. A trust protector only has those powers granted under the trust terms. Here the trust terms only give the trustee the power to remove and replace trustees. The trust terms do not give the protector the right to manage any aspect of the trust, demand an accounting, inherit any assets, or even receive compensation. The trust protector is therefore not affected by the trust administration in a way that makes him an interested person with the right to seek an accounting.

   e. The court could properly order payment of the trustee's attorneys' fees from the trust where the trustee submitted an attorney affidavit in support of the fees and the protector did not put on proof that the fees were unreasonable.

XVIII. Decanting

A. *Ferri v. Powell-Ferri*, 2013 Conn. Super. LEXIS 1938 (2013); 2015 Conn. LEXIS 161 (Ct. Supreme Court, 2015); SJC-12070 (Mass. 2017); 2017 Conn. LEXIS 234 (2017); 2018 Conn. Super. LEXIS 2148 (2018). Applying Massachusetts law, court invalidated decanting of trust to take away vested rights over trust assets and thereby protect trust assets from claims of divorcing spouse, where trust terms did not grant trustee absolute discretion over trust distributions and the beneficiary had right to withdraw 75% of the trust assets at the time of the decanting. The state Supreme Court refused to impose duty on beneficiary to oppose decanting and protect marital assets. On certification by the Connecticut Supreme Court, the Massachusetts Supreme Judicial Court held that the broad discretion granted the trustees included by inference the power to decant, even though not expressly granted, and the court could consider the affidavit of the settlor in making the determination of intent to allow a decanting power. The beneficiary's claims against his spouse's counsel for vexatious litigation were dismissed.

1. Connecticut divorce proceedings between Paul Ferri and Nancy Powell-Ferri were commenced in 2010. At that time, Paul was the beneficiary of a Massachusetts trust created by his father. The trust terms granted Paul a right to withdraw portions of the trust principal upon reaching certain ages, and at the time of the divorce proceedings could withdraw 75% of the trust principal. The trust terms also permitted the trustees to pay trust income or principal for Paul's benefit, or "segregate irrevocably for later payment to Paul".

2. In 2011, the trustees decanted the trust assets into a new trust that did not grant Paul withdrawal rights. In the divorce proceedings, Nancy sought to invalidate the decanting and have the trust assets over which Paul had a withdrawal right included as marital property subject to division in the divorce. Nancy also filed a counterclaim against the trustee for intentional interference with an equitable interest, and asked the court to recognize this new tort. The parties moved for summary judgment, and the trustees moved to strike the tort claim.

3. The court, applying Massachusetts trust law (and decided after *Morse v. Kraft*), invalidated the decanting on the grounds that: (a) the court will not consider the affidavit of the settlor, and will construe the trust on its terms; (b) because Paul had vested rights over the trust assets, the trust assets are marital property under Connecticut law and Nancy had standing to bring her claims; (c) the decanting occurred after Paul obtained an absolute right to the trust assets; (d) the trust terms that allow the trustee to segregate assets for Paul do not amount to the level of "absolute and uncontrolled discretion" required to recognize the power to decant; (e) the fact that Paul had not asked for the trust principal does not affect his uncontrolled right to the assets; (f) the decanting frustrated Paul's rights and cannot stand; and (g) the settlor could have granted the trustees broad rights that would permit decanting, but chose not to do so, and therefore the trustees decanted without authority. The court held that the remedy to Nancy will be determined at a later hearing.

4. The court refused (albeit narrowly) to recognize the new tort of intentional interference with an equitable interest on the grounds that: (a) the fiduciary, financial, and close nature of a marriage relationship is of the type to which the tort of intentional interference with business expectancy should apply; (b) the public policy of Connecticut supports such a cause of action, and injured spouses should have a remedy in these circumstances; (c) however, because damages cannot be calculated or quantified in this case, the court should not recognize this new tort in this case; (d) while the time for this tort may have come, it is not necessarily under the facts of this case.

5. Nancy separately sued Paul for breaching the alleged duty to preserve marital assets by failing to take affirmative steps to stop the decanting, which the trial court dismissed, and the state supreme court affirmed in a case of first impression, on the following grounds: (a) Nancy was asking the court to require a party to a marital dissolution action to take affirmative steps to recover marital assets taken by a third party; (b) Paul had no role in the decanting, and most courts require affirmative action before finding dissipation of marital assets; (c) the cause of action alleged does not exist in any state, and the court would not recognize a new cause of action where

state statutes and automatic orders address the obligations of spouses while divorce is pending, and reflect a public policy of preserving the status quo, and not imposing affirmative duties; and (d) adequate remedies are available through judicial sanctions for wrongful conduct.

6. The Connecticut Supreme Court certified the following questions to the Massachusetts Supreme Judicial Court: (1) whether the trust terms empowered the trustees to decant the trust assets; (2) if no, whether the assets should be returned to the original trust; and (3) whether the court could consider an affidavit of the settlor in interpreting the original trust. The Massachusetts court held that the trust terms empowered the trustees to decant the original trust on the following grounds:

   a. The trust did not expressly permit or deny the authority to decant and the state does not have a decanting statute. However, under *Morse v. Kraft, 466 Mass. 92 (2013)*, it is possible that the broad powers of the trustee in a particular trust may provide a trustee with the power to decant. The intent of the settlor is the paramount determination, and the power need not be expressly stated and may be inferred from the trust language as a whole and other relevant evidence of the settlor's intent. The language used by the settlor is viewed in light of the rule of law in effect at the time the powers in question were created.

   b. The trust terms, read as a whole, demonstrated the settlor's intent to permit decanting by: (1) granting the trustees the broad discretion to distribute trust income and principal as desirable for the beneficiary's benefit; (2) allowing the trustees to apply the income and principal for the benefit of the beneficiary rather than paying directly; (3) granting the trustees the discretionary full power to take any action with the trust assets the trustees deem necessary or proper without order or license of any court; and (4) allowing the trustees to "segregate irrevocably" the trust assets for later payment to the beneficiary as the trustees deem desirable for the beneficiary's benefit (and decanting is one way to segregate assets irrevocably).

   c. The trust's anti-alienation provision evidences the settlor's intent to protect trust assets from the beneficiary's creditors, and evidences the settlor's intent that the trustees have the means to protect the trust assets consistent with fiduciary duties.

   d. The beneficiary's right to withdraw 75% of the trust assets at the time of decanting (which later became a right to withdraw 100%) does not negate the trustees' power to decant, because the trust must be read as a whole to give effect to all of its provisions, and if the trustee could not decant the assets subject to withdrawal, the trustee would lose the ability to exercise fiduciary duties (including the duty to invest) over the assets subject to the withdrawal right, and would be without a role. So long as the assets were not withdrawn by the beneficiary, the trust assets remain subject to the trustee's authority and stewardship. Therefore, the mechanism for the beneficiary's withdrawal of trust assets does not limit the trustee's decanting authority, especially here where the power to segregate assets irrevocably under the trust terms extends for "so long as the beneficiary is living" meaning both before and after the vesting of withdrawal rights. Reading the trust terms as a whole and in harmony

requires finding that, until the trust assets are actually distributed in response to a withdrawal request, the trustees could exercise the power to decant if the trustees determined it was in the beneficiary's best interest.

e. The court could in this case properly consider the affidavit of the settlor (stating his intent that the trustees have all powers necessary to protect the trust assets) because extrinsic evidence is permitted to resolve a question of ambiguity. Because the trust did not expressly permit or bar decanting, the affidavit does not contradict plan trust language or attempt to vary the trust terms.

7. A concurring justice noted that the decision did not address the question under Massachusetts law (which was not certified to the court) whether the creation of a new spendthrift trust intended to solely deprive the beneficiary's spouse of marital assets during a divorce proceeding through decanting would be invalid as contrary to public policy.

8. The Connecticut Supreme Court adopted the Massachusetts Supreme Judicial Court decision in its entirety and reversed the decision of the Connecticut trial court, although the court agreed that Nancy had a right to be heard on her claims because the trustees initiated the lawsuit naming her as a defendant and because the resolution of the case would impact her rights in the divorce action. The court rejected the claim that the trustees should be removed merely because of Nancy's claims against them, on the grounds that there was no proof of any breach by the trustees and in view of the finding of the Massachusetts court that the trustees had the authority to decant the trust. The court also rejected Nancy's claim that the trust was self-settled by her husband as a consequence of his withdrawal rights on the following grounds:

   a. The 2011 trust was created by the trustees and funded with the 1983 trust assets through decanting, without informing Paul in advance, and without his permission, knowledge, or consent.

   b. Because Paul had no involvement in the creation and funding of the new trust, the trust could not be self-settled under Connecticut law. A beneficiary can only be deemed to be a settlor of a trust if he has some affirmative involvement with the creation or funding of the trust. Here, while Paul was entitled to withdraw the funds, he was still required to request the funds from the trustees, which was never done. In the 2011 trust, any distribution of funds rested in the discretion of the trustees.

   c. Because Paul took no active role in planning, funding, or creating the new trust, there is no authority for the proposition that the trust is self-settled.

9. Paul sued Nancy and her lawyers for common law and statutory vexatious litigation, and all parties moved for summary judgment. The trial court granted summary judgment dismissing the vexatious litigation claims against Nancy's counsel on the grounds that: (a) the claims were filed to advance Nancy's interests in the trust assets as marital assets and they acted within relevant ethical bounds: (b) the claims were made in good faith, and were non-frivolous arguments in support of an extension of existing law; (c) an attorney familiar with Connecticut law could reasonably believe that probable cause existed to initiate and prosecute the claims and appeals, and it was not frivolous to seek to have the courts extend the duties that divorcing spouses owe one another;

(d) the claims were not based on false premises; (e) the fact that no other jurisdiction had recognized the legal theory advanced does not, in itself, render its pursuit without probable cause – such a position could stifle the willingness of a lawyer to challenge established precedent in an effort to change the law, and the vitality of the common law system depends on the freedom of lawyers to pursue novel, although potentially unsuccessful, legal theories. The summary judgment motions by Nancy and Paul were denied.

XIX. Amendment, Revocation, Reformation, Modification & Termination Of Non-Charitable Trusts

A. *In re Trust of Shire*, 299 Neb. 25 (2018). Where court appointed attorney for unidentified beneficiaries objects, trust cannot be modified by consent under the Uniform Trust Code to increase distributions to the current beneficiary.

1. Jennie created a trust under her 1947 will for the benefit of her daughter, Ruth, with a corporate trustee. The trust was funded with $125,000 and provided only for the payment of $500 monthly to Ruth, and after Ruth's death to Ruth's daughter, Shirley. Upon Shirley's death, the trust assets were to be distributed to various parties identified in the residuary estate. Shirley began receiving the payments in 1983. By 2016, the trust assets had grown to $1 million. Shirley's total income excluding the $500 trust distributions was only $600. The trustee was able to identify 12 potential remainder trust beneficiaries, but the determination was incomplete.

2. The trustee petitioned the court for modification of the trust to increase the trust distributions to Shirley, pursuant to the modification by consent statute that was the Nebraska version of UTC Section 411. Six of the identified remainder beneficiaries consented. The rest of the identified remainder beneficiaries, including the state attorney general, did not object but did not affirmatively consent to the modification. At the trustee's request, the court appointed an attorney for the unknown and undiscovered remainder beneficiaries. The attorney objected to the modification. The trial court rejected the modification and Shirley appealed.

3. On appeal, the Nebraska Supreme Court affirmed the trial court rejection of the trust modification on the following grounds:

   a. The Nebraska version of UTC 411 provides that a noncharitable irrevocable trust may be modified upon consent of all the beneficiaries, if the court finds that the modification is not inconsistent with a material trust purpose. Modification under this provision requires unanimous consent of the beneficiaries. The unanimous consent requirement is not met simply because no known beneficiary has affirmatively objected after notice (affirmative consent is required, not mere negative consent). While virtual representation might otherwise have been available to satisfy the consent of the unidentified beneficiaries, here the trustee opted instead for court-appointed counsel, and that counsel objected.

   b. A later provision under the Nebraska version of UTC 411 provides for modification without unanimous consent of all beneficiaries, provided the interests of a beneficiary who does not consent "will be adequately protected". The trustee failed to meet the burden of proving this

protection and showing that such beneficiaries would not be negatively impacted or prejudiced by the modification. The phrase "adequately protected" in this UTC provision incorporates the safeguards discussed in the Restatements of Trusts to prevent prejudice to the nonconsenting beneficiaries. A court can also modify the trust under this section if it determines that it will not likely harm nonconsenting beneficiaries' interests, with or without safeguards. The court cannot force a modification on beneficiaries that will harm their interests. The court has leeway to fashion an appropriate order protecting the interests of nonconsenting beneficiaries.

c. Interpreting the phrase "adequately protected" to mean that a nonconsenting beneficiaries' interests are not harmed too significantly would create a lessened burden for modifying trusts that is not focused on the cardinal rule of carrying out the settlor's intent. To use this statute to modify a trust, the court must determine that modification will not affect the interests of nonconsenting beneficiaries and impose safeguards to prevent them from being affected, when deemed necessary. Here, the modifications would increase the distributions to Shirley at the direct expense of the remainder beneficiaries, and the modification cannot meet this test.

d. The trustee could have sought modification under other UTC provisions that do not require unanimous beneficiary consent, and that require proof other than adequate protection of the nonconsenting beneficiaries. For example, a trust can be modified on a showing that, due to circumstances not anticipated by the settlor, the modification would further the trust purposes.

e. A concurring justice commented that adequate protection might be arranged among the known beneficiaries if they pledged part of their remainder interest to make any known beneficiaries whole for the modest increase in distributions to Shirley (and indemnify the trustee), if any such beneficiaries were to ever actually materialize.

B. *Keybank v. Thalman,* 2016 Ohio 2832 (Ohio Court of Appeals 2016); 2018 Ohio App. LEXIS 3639 (2018). Claims that trustee breached duties by recombining trusts that had been previously divided survived summary dismissal. On remand, trial court cannot disregard court of appeals finding that the trust had been divided by the trustee.

1. Howard Couse was an attorney that authored several law textbooks. He created a trust for his children and grandchildren from the proceeds of the sales of textbooks. Thereafter, the trust income beneficiaries were his granddaughter, Jeanne Clough, and his grandson, Dr. Howard Schlitt. From 1957 until 2006, the trust was administered without incident. In 2006, Schlitt wrote to the trustee calling the income "pathetic and totally inadequate" and threatening to change trustee. Clough did not want the trust administration modified or a trustee change, and was focused on long-term asset growth.

2. In response, the trustee proposed division of the trust into Clough and Schlitt shares. The trust division was completed 2 years later, and 5 weeks after Clough's death. The trustee informed the beneficiaries (now including Clough's children) about the division, the assets were divided, and from that point forward the trusts were separately administered for all purposes

(including access to information). Several letters from the trustee confirmed the separation. The trustee informed the Clough remainder heirs that upon Schlitt's death they would receive the assets in the Clough trust, and the Schlitt remainder heirs that upon Schlitt's death they would receive the assets in the Schlitt trust.

3. Three days after Schlitt's death, the trustee informed the Clough heirs that they were preparing to distribute the Clough trust to them. The trustee informed the Schlitt heirs that they would receive the Schlitt trust assets, but they threatened to report the trustee to the FINRA and the SEC. The trustee then changed the final distribution, and informed all of the heirs that the two trusts would be combined and then re-divided before distribution, with the result being that the Clough trust heirs would receive $237,000 less. The Clough heirs objected, the trustee sued for instructions and the Clough heirs counterclaimed for damages, and the trial court summarily dismissed all of their claims and ordered equal division of the combined assets. The Clough heirs appealed.

4. On appeal, the court of appeals reversed and remanded the case back to the trial court on the following grounds:

   a. The trustee argued that the trust terms did not allow the division, which if correct would mean that the trustee induced the families to believe in a false division. This created an issue of material fact as to whether the trustee managed the trust in good faith.

   b. The UTC allows division of the trust that does not substantially impair the rights of the beneficiaries or materially adversely affect the trust purposes. Splitting the trust did not materially impair Clough or Schlitt. Both wanted to use the trust for different purposes, one wanting to benefit the remainder beneficiaries, and the other to finance his living expenses. As noted in the UTC comments, division of trusts is often beneficial and almost routine. Although splitting the trusts was not detrimental, combining them was, and the result substantially impaired the Clough heirs. Genuine material fact issues exist as to prejudice to the Clough heirs. There is a material fact issue as well concerning the trustee's argument that the trust was not actually divided, and whether the trustee breached its duty by communicating that it was and only sending statements to each family for their respective share of the trust.

   c. The $237,000 reduction of the share for the Clough heirs is adequate to satisfy the pleading of damages requirement.

5. On remand, the trial seemingly disregarded the holdings of the court of appeals, proceeded to trial (over the objections of the Clough heirs), and held that: (a) the trustee did not have the power to divide the trust under the trust terms and the trust was never actually divided into separate trusts, but rather only into sub-accounts of one trust; (b) the creation of mere sub-accounts was not a breach of trust; (c) the trustee did not breach its duties by making additional distributions to Schlitt for his "ease"; and (d) the Clough heirs failed to prove they suffered any damages from the division or the unclear correspondence sent by the trustee. The trial court ordered the Clough heirs to pall all of the trustee's attorneys' fees.

6. On another appeal, the court of appeals again reversed the trial court on the following grounds:

   a. The prior decision of the court of appeals, which was not appealed to the Ohio Supreme Court, is the law of the case, and the trial court cannot disregard the decision of the court of appeals that the trustee had actually divided the trust into separate trusts. The conclusions of the court of appeals were final and binding on the trial court. There was no room for the trial court to disagree with the decision of the court of appeals, and it was reversible error to do so.

   b. Upon division of the trust, only the Clough heirs were entitled to the assets in the Clough trust. Trial on remand was not necessary or required, and resolution of the Clough heir's claims for the assets of the Clough trust should have been perfunctory. The trustee is required to disburse the funds in the Clough trust to the Clough heirs only, and to distribute the Schlitt trust assets to the Schlitt heirs.

   c. The award of payment of the trustee's attorneys' fees is reversed, because the award was based on the trial court's erroneous disregarding of the prior decision of the court of appeals. The award of fees to the Schlitt heirs is reversed for the same reasons. The trustee was ordered to pay the appellate costs.

C. *Estate of Sukenik*, 2016 N.Y. Misc. LEXIS 2378 (2016); 75 N.Y.S.3d 422 (2018). Surrogate holds that trust and IRA beneficiary designation cannot be reformed to correct poor income tax planning. Appellate division reverses.

1. Charles Sukenik died in 2013. Under his 2004 will and revocable trust, he gave the residue of his estate and trust to The Charles and Vivian Sukenik Philanthropic Fund. In 2009, Charles signed a beneficiary designation form leaving his $3.2 million IRA to his wife Vivian. Vivian alleged that Charles's estate planning lawyer suggested leaving the IRA to charity and leaving other assets to Vivian, but that shortly thereafter Charles become too ill to make those changes.

2. Vivian asked the court to reform the trust to add a $3.2 million pecuniary bequest to her, and to reform the IRA beneficiary designation to name the charity as recipient, so that she would avoid receiving assets with a built-in income tax liability. Neither the charity nor the state attorney general opposed the relief sought.

3. Surrogate Nora Anderson rejected the petition on the following grounds: (a) there is no allegation of a drafting error or change in the law justifying the reformation; (b) decedent himself thwarted the tax efficiency of his own estate plan, and nothing in the record indicates why he did not take steps to cure the unfavorable tax consequences of his choice of IRA beneficiary (the court found allegations of his illness after receiving legal advice to "leave too much to conjecture); (c) the presumption that a testator intends to minimize taxes as a basis for reformation usually applies to drafting errors or changes in the law where there is also clear intent by the testator to secure a specific tax advantage; (d) there is no authority to justify reforming clear instruments in order to remedy the adverse tax consequences of poor estate planning; (e) nothing in the will or trust indicates an intent to minimize income taxes, and

both instruments contradict that intent by giving the fiduciaries power to distribute assets without regard to income tax basis; and (f) reforming instruments only on the presumption that one who executed testamentary instrument intends to minimize taxes would expand the reformation doctrine beyond recognition and would open the flood gates to reformation proceedings aimed at curing all kinds of inefficient tax planning.

4. On appeal, the appellate division unanimously reversed the surrogate on the law, stating as follows for the entire opinion: "The petition should have been granted. Decedent's intent to minimize taxes and provide for his wife of 39 years was apparent in the donative instruments. The Will and Trust agreements demonstrated his intent to take full advantage of all deductions and exemptions provided by law. For example, Article One, paragraph C of the Trust agreement specifically stated that the Trust funds could be transferred to the philanthropic fund only if it was a tax-exempt entity, and Article Three authorized the trustee to sell assets in order to minimize taxes payable by beneficiaries. Article Eleventh of the Will also permitted the executor to make certain elections in order to reduce taxes. Furthermore, the presumption that testators intend to take full advantage of tax deductions and exemptions, the lack of opposition, including by the State of New York, and the presumption in favor of widows, all favor petitioner's requested reformation.

XX. Spendthrift & Asset Protection Trusts

A. *Toni Trust v. Wacker*, No. 7228 (Alaska Supreme Court 2018). Alaska statute cannot deprive Montana State and federal courts of jurisdiction over fraudulent transfer action involving an Alaska self-settled asset protection trust.

1. Donald sued Mr. and Mrs. Wacker in Montana state court and they counterclaimed against Donald, his wife, his mother in law, and several trusts and businesses owned or run by Donald's family. Several default judgments were entered against Donald and his family. In 2010, before the last judgment was issued, Donald's wife and mother in law transferred land into an Alaska self-settled asset protection trust. The Wackers filed a fraudulent transfer action under Montana law in Montana state court, and the court entered default judgments against then. Before the Wackers could completely satisfy their judgments through sheriff's sales, Donald's mother in law filed for bankruptcy in Alaska and her interest in the trust became subject to the federal bankruptcy court jurisdiction. Donald, as trustee of the Alaska trust, sued the Wackers and the bankruptcy trustee in the bankruptcy court, alleging that service on the trust was defective. The bankruptcy trustee brought a fraudulent transfer action against Donald as trustee under the federal bankruptcy fraudulent transfer statute and obtained a default judgment (and the appeals were dismissed).

2. Donald then sued in Alaska state court alleging that an Alaska statute provides that only Alaska state courts have exclusive subject matter jurisdiction over fraudulent transfer actions against an Alaska self-settled assets protection trust, and therefore all of the various default judgments were issued without subject matter jurisdiction and are void. The trial court dismissed the suit and Donald appealed.

3. On appeal, the Alaska Supreme Court affirmed the dismissal of Donald's claims on the following grounds:

   a. More than a century ago, the U.S. Supreme Court held that each state may, subject to constitutional limits, determine the jurisdictional limits of its own courts and how far it will extend jurisdiction over transitory actions that arose outside their borders, and states are not constitutionally compelled to acquiesce to sister states' attempts to circumscribe their jurisdiction over such transitory actions. *St. Louis Iron Mountain Ry. Co. v. Taylor, 210 U.S. 281 (1908); Tenn. Coal, Iron & R.R. Co. v. George, 233 U.S. 354 (1914).* The Full Faith and Credit clause does not require states to go that far.

   b. The Alaska statute crosses the *Tennessee Coal* limit by purporting to grant Alaska courts exclusive jurisdiction over a transitory fraudulent action against an Alaska trust, and the statute cannot deprive Montana courts of jurisdiction over cases arising under Montana law. While Alaska's statute is not unique, and some sister states have concluded that such a statute can be effective, they rely on other types of reasoning. For example, some states have relied on principles of comity to give effect to another state's rule, but that is not a rule of law but an elective form of deference that is not mandatory or compelled. The court agreed with the reasoning in *IMO Daniel Kloiber Dynasty Trust, 98 A.3d 924 (2014)* that one state cannot unilaterally preclude a sister state from hearing claims under that sister state's own laws. The principles of *Tennessee Coal* have not changed in a century and the Alaska statute's assertion of exclusive jurisdiction does not render a fraudulent transfer judgment against an Alaska trust from a Montana court void for lack of subject matter jurisdiction.

   c. Similarly, the statute cannot deprive a federal court of jurisdiction. In *Marshall v. Marshall, 547 U.S. 293 (2006),* the U.S. Supreme Court held that state efforts to limit federal jurisdiction were invalid even though the state created the right of action giving rise to the suit. If the Alaska statute were interpreted to deny parties access to federal courts without their consent, the statute may also run afoul of the Supremacy Clause, which precludes state courts from limiting federal jurisdiction.

   d. Because the Alaska statute purports to grant Alaska courts exclusive jurisdiction over all fraudulent transfer claims against Alaska trusts, and because a federal statute grants federal courts jurisdiction over these claims, Alaska conflicts with and must yield to federal law.

B. *Olson v. Marshack,* 2018 WL 2059648 (C.D. California 2018). Bankruptcy court erred by approving settlement approving domestication of 80% of assets of Cook Islands trust.

1. Passport Management, LLC served Jana with a lawsuit. A month later, she transferred her interest in her self-settled Cook Islands trust from herself to her two minor children by gift. Jana then filed her bankruptcy petition. Jana agreed and entered into a consent order to repatriate the trust assets, but then disobeyed the bankruptcy court's order, sabotaged the repatriation by a letter to the Cook Islands trustee saying she signed the order by duress, and was sent to jail for civil contempt where she remained in custody for more than a year (she was also previously jailed for other incidents of contempt of court).

2. The trustee worked with Jana's father, as guardian for the minors, on an agreement to repatriate the money. The father agreed with the bankruptcy trustee to repatriate the money with 80% going to the bankruptcy estate and 20% going to a California trust to support the minor children. After the funds were repatriated, the bankruptcy trustee moved for approval of the compromise, and the creditor objected. The bankruptcy court approved the compromise on the grounds that 80% was better than nothing and it would be inequitable to reject the settlement after the funds were already repatriated in reliance on the settlement. At no point was a finding made that the trust assets were assets of the bankruptcy estate (i.e. through a fraudulent transfer action and finding). The creditor appealed.

3. On appeal, the federal district court reversed the approval of the compromise on the following grounds:

    a. The bankruptcy court stated that "I think somebody in the Cook Islands probably decided that they weren't going to corner the world's market of coconuts…and instead… they would create...a unique debtor's haven. Whereby the laws are tilted so heavily in favor of debtors that no matter how righteous [creditor's] claim may be, and how seemingly powerful this building with its mahogany slabs and so forth and a gold eagle up there, how fearsome that might be they can simply go 'Come and get it'. And a lot of people seem to find that protection is attractive. So much so, that they give them billions of dollars".

    b. The bankruptcy court could not approve the settlement without determining whether the Cook Islands money was part of the estate. The assets were not part of the estate at the time of the petition. While the facts present a strong case for avoidance of the transfers, the transfers were never formally avoided. Without a judgment avoiding the transfers, the funds were not part of the estate.

    c. The court erred by considering inappropriate and irrelevant factors in approving the settlement. The court did not have an equitable duty to approve the settlement because the funds had already been repatriated. The court was not bound by the expectations and reliance of the parties and should not have minimized its role. The parties cannot neutralize the court by taking actions in reliance on the settlement, where the court and the creditor were not parties to the deal or privy to the discussions. The court did not cause repatriation and had no obligation to honor it. The settlement contemplated that the court might not approve the deal and the debtor took the risk that the agreement would fall through after funds were repatriated. The debtor has done no equity here and it was erroneous for the court to be concerned with doing equity for them. Debtor has no legitimate right to hide assets in the Cook Islands and defy court orders to return the funds and it would be inequitable to allow her to profit from her actions. While ease of collection can be a factor in approving a settlement, that is only one consideration of many.

    d. A benefit to the debtor's minor children is an indirect benefit to the debtor. The concern that others may not cooperate in repatriating money from difficult to reach places is a minor concern because of the other ways a court may incentivize cooperation. Only a small number of debtors

would be willing to sit in jail for over a year, and she would have sat longer if it were this court's prerogative. The court need not be concerned for the minor beneficiaries because the claims were against the trustee and the trust and not its innocent minor beneficiaries.

C. ***In re Will of David F. King v. King,*** **2018 ore. App. LEXIS 1547 (2018).** Choice of law provision prevails over fiduciary powers clause, and spendthrift provision in Nevada trust does not preclude court from applying trustee-beneficiary's income distributions towards satisfaction of surcharge award owed to the trust.

1. Under his will, David exercised his power of appointment over a trust created by his father, and appointed the trust assets to a Nevada trust (David was a Nevada resident) that paid income only (but not principal) to his wife for life, with the remainder passing at her death to David's children from a prior relationship. The trust terms provided that "the laws of the State of Nevada shall govern all questions which may arise with respect to the interpretation of this Will or the administration of any trust established hereunder". The trust terms also granted the trustees all of the powers provided under Minnesota trust law (the drafting lawyer was in Minnesota). By 2011, David's wife, Sandra, was acting as sole trustee.

2. In 2011, David's children sued Sandra for breach of trust and sought her removal and surcharge. The trial court held that: (a) Nevada law governed the trust; (b) Sandra improperly treated certain trust receipts and undistributed earnings as income rather than principal; (c) Sandra treated the trust assets as her own and entered into poorly secured or unsecured transactions that were per se breaches of trust; (d) Sandra failed to account and generally ignored her fiduciary duties as trustee. Sandra loaned $1 million to herself to buy and remodel a home, loaned $950,000 to her son James for a home, and loaned $180,000 to a winery in which she had an interest. The court removed her as trustee, appointed a corporate trustee, surcharged Sandra $913,000, and awarded the children their attorneys' fees. Sandra appealed.

3. While the first appeal was pending, the corporate trustee petitioned for instructions on how to make trust distributions in view of the surcharge award and attorneys' fees award. The trial court held that Nevada spendthrift law prohibited the trustee from applying Sandra's income distributions towards the judgment against her. The children appealed that decision.

4. On appeal of both decisions, the Oregon Court of Appeals (applying Nevada law) affirmed the surcharge award, but reversed the trial court spendthrift ruling and held that the income distributions could be applied to satisfy the judgment, on the following grounds:

   a. David executed the will while living in Nevada and the will provided that "the laws of the State of Nevada shall govern all questions which may arise with respect to the interpretation of this Will or the administration of any trust established hereunder". A Nevada statute provides that a noncorporate trustee cannot lend funds to herself, her family members, or her business associates, and that provision of state law is mandatory and is not subject to override in the trust instrument. The trust terms also granted the trustees all of the powers provided under Minnesota trust law (the drafting lawyer was in Minnesota), but the lawyer testified that not

much thought was put into how those provisions would interplay. The court refused to apply Oregon law to the trust just because Sandra resided there and many of the trust assets were located there, because the trust terms expressed the intent that Nevada law apply. Because Nevada statutory law prohibits the loans, the loans were statutory breaches of trust regardless of the trust terms granting broad fiduciary powers.

b. The argument that the choice-of-law provision is only a gap filler is untenable and overlooks the fact that, while a settlor has considerable latitude, the trust operates within and has effect only to the extent that it complies with the trust law of some jurisdiction. The trust does not have independent legal meaning separate and apart from the law of any jurisdiction, and the law does not operate only interstitially. The trust text cannot answer any question except against the backdrop of the law of some jurisdiction. The settlor chose Nevada law unambiguously to govern the trust administration, and Nevada law prohibited the loans regardless of the fiduciary powers under the trust terms.

c. While the trust is a spendthrift trust, the trial court erred by applying Nevada's spendthrift statute to prohibit the trustee from applying Sandra's income interest in the trust to compensate the trust for the losses resulting from her breaches as trustee. Under Nevada law, a breach of the statutory loan prohibition is a breach of trust. The court may compel redress of a breach of trust using its full equitable powers, and those powers historically included the power to apply a beaching trustee-beneficiary's interest in the trust to compensate the trust and other beneficiaries for losses caused by the breach (Restatement 2nd of Trusts Section 257). That principle applied with equal force to spendthrift trusts and the Nevada Supreme Court recently indicated its adherence to that approach in *Montoya v. Ahearn, 426 P3d 599 (Nev. 2018).*

d. Although Nevada's statutory spendthrift protection is worded broadly, it is written in terms of creditors and proceedings that are external to trust affairs. Breach of trust proceedings differ in that they are internal and it is not clear that the statute is intended to apply to them. All three restatements of the law of trusts recognize that a spendthrift provision does not prevent application of the rule that a breaching trustee-beneficiary's interest can be applied to compensate other beneficiaries for losses incurred because of the breach of trust. Since at least 1941, Nevada's law of testamentary trusts has incorporated the trust common law. The Nevada legislature did not intend its spendthrift statute to prohibit surcharge of a breaching trustee-beneficiary and the Nevada Supreme Court would not apply the statute that way. If the legislature had intended that statute to abrogate well-established common law, it would have said so explicitly. Nevada's spendthrift statute does not displace the trustee's duty to treat all beneficiaries equally and does not require the trustee to direct payments to one beneficiary at the expense of the others. The Nevada statute does not prohibit the trustee from applying Sandra's interest in the trust to compensate the trust for losses that the trial court found were caused by her breaches of trust.

D. *Lvb-Ogden Mktg., LLC v. Bingham*, 2018 U.S. Dist. LEXIS 207154 (W.D. Washington 2018). Assets transferred by beneficiary to trust as repayment of trust loan are self-settled assets subject to seizure by creditors.

1. In 2007, Frances created a spendthrift trust for her daughter, Sharon. Sharon and her husband defaulted on tens of millions of dollars of loans related to the 2008 mortgage crisis. The trustee paid millions of dollars out of the trust to settle claims made by Sharon's creditors.

2. The trustee also made secured loans from the trust to Sharon totaling $2 million. Sharon defaulted on the loans, and the trustee agreed to take certain stock, an interest in a ship, household furniture and fixtures, and Sharon's wedding ring, that were put up as collateral for the trust loan, as payment in satisfaction of the loan (the "disputed assets")

3. In 2010, the plaintiff obtained a $70 million judgment against Sharon and sought to collect against the disputed assets and the trustee opposed. The court allowed the creditor to recover against the disputed assets on the following grounds:

    a. The disputed assets were placed into the trust by Sharon and are subject to seizure. Once the trustee loaned money to Sharon, the assets no longer had spendthrift protection under Washington law. The disputed assets were subject to seizure before being placed into the trust, and nothing changed with the transfer to the trust. There is no exception in the statute for transfers into trusts where consideration is exchanged.

    b. No case law supports the novel position advanced by the trustee that a debtor can protect its assets from seizure by taking out loans from a spendthrift trust and then transferring other assets back into the trust. Once assets leave the shelter of the spendthrift trust, the creditors may claim them under Washington state law.

    c. Likewise, any assets transferred into a spendthrift trust by the beneficiary are subject to seizure. The disputed assets are self-settled and entitled to seizure by creditors. The fact that consideration was exchanged is immaterial to the question of whether the assets are self-settled.

XXI. Creditor Claims & Debts

A. *In re Marriage of Larocque*, 2018 IL App (2d) 160973 (2018). Large trusts funded through complex estate planning before breakdown in marriage excluded from the marital estate on divorce.

1. John and Janet married in 1985 and John amassed substantial wealth during the marriage as an investor. Janet was a stay-at-home mother to their four children. The marriage deteriorated during the serious illness and death of their eldest child and Janet petitioned for divorce in 2014.

2. Starting around 2005, John engaged estate planning counsel and John (in part with Janet's signature on various papers and tax returns) engaged in extensive and effective estate planning, including: (a) gifts by John and Janet to irrevocable trusts; (b) grantor trust status for income tax purposes; (c) loans to the trusts (John also took some loans from the trusts but repaid them with interest and they all had written notes); (g) a GRAT program; and (h) sales to the trusts. John's counsel and the trustees of the various trusts submitted affidavits describing all of the transactions and the primary goal of minimizing

federal and state estate taxes. For the trusts created by John, Janet lost her rights as a beneficiary upon divorce, and John similarly lost rights under trusts with Janet as the settlor.

3. During the divorce proceedings, Janet argued that the trust assets should be part of the marital estate to be considered in the 50/50 property division. Janet claimed: (a) John did not involve her in the process and she did not know the details; (b) she blindly signed the documents based on John's representations; and (c) John was really engaged in "divorce planning" and not estate planning. The trial court granted summary judgment excluding the trusts from the marital estate, and Janet appealed. Janet was awarded 50% of a $21 million marital estate and $30,000 per month in permanent maintenance.

4. On appeal, the Illinois Court of Appeals affirmed the trial court on the following grounds:

   a. There was support for the finding that February 1, 2014 was the date that the marriage began its irretrievable breakdown, despite the fact that each spouse had consulted with divorce counsel earlier.

   b. John met the burden of proving that the trusts were valid and funded with donative intent by the affidavits by counsel and the trustees with extensive supporting documentation. The trusts were funded as part of a comprehensive estate plan designed to provide for an orderly passing of assets and minimize exposure to estate taxation. Janet never disputed that the trusts were valid and distinct legal entities. The trusts were irrevocable, were not illusory or colorable or tantamount to a fraud. Janet produced no expert testimony on the legitimacy of the trusts or the transfers.

   c. Janet's failure to read documents before signing them, and professing ignorance of them, is not a defense. John's representations that the documents were "just business", "nothing to worry about", "for the children", and "for tax purposes" were not palpably untrue or even misleading, and the estate planning process was put into place 6 years before Janet claimed the marriage started to break down and 9 years before she petitioned for divorce.

   d. John's counsel testified that it is not unusual to deal with one spouse for purposes of estate planning for a couple. No cases support that a trust term disinheriting a spouse incident to divorce renders a trust illusory, and the provision applied to both spouses. Janet did not demonstrate that it was unusual for John to name a friend or his brother as trustee of trusts and there was no evidence that any trustee breached fiduciary duties.

   e. The trusts were separate and distinct legal entities and there was no evidence that John lacked donative intent or that he improperly retained control over the trust assets.

   f. The court's decision did not preclude Janet from subsequently arguing at trial that, by funding the trusts, John committed dissipation or depletion of the marital estate. The court's decision does not undermine the ability of a court to set aside a transfer that is proven to be fraudulent. Janet could not argue depletion of the marital estate for transfers before

February 1, 2014. The depletion claims were unpersuasive because she signed the gift tax returns and her claims of lack of knowledge were not credible, and she failed to prove breach of fiduciary duty. The trusts were managed properly.

B. *Embassy Healthcare v. Bell,* 2018 Ohio 4912 (2018). Nursing home must file claim with estate before making a claim against decedent's spouse for payment under state necessaries statute.

1. Robert stayed at a nursing home before his death. His contract with the home made him responsible for payment. His wife, Cora, also signed the agreement as a responsible party, but only to the extent she had control over Robert's assets, and not with individual contractual liability.

2. Six months and three days after Robert's death (and three days after the expiration of the limitations period on claims against his estate), the home sent Robert's estate (care of his wife) notice of its claim for $1,678 against Robert's estate. The letter stated that Cora was not individually liable for the debt. No estate had been opened at that time, and the home did not exercise its right as creditor to open the estate and appoint an administrator.

3. The next year, the home sued Cora for payment of the debt under the Ohio necessaries statute. That statute codifies the common law doctrine (originally developed as a response to a married woman's inability to contract under coveture) and provides that "each married person must support the person's self and spouse out of the person's property or by the person's labor. If a married person is unable to do so, the spouse of the married person must assist in the support so far as the spouse is able". The necessaries statute also provides that "if a married person neglects to provide the required support, any other person may supply the spouse with necessaries and recover the reasonable value of the necessaries supplied from the married person who neglected to support the spouse, unless the spouse abandoned that person without cause".

4. The magistrate dismissed the complaint on summary judgment in favor of Cora. The trial court granted summary judgment for Cora on different grounds than the magistrate. A divided Twelfth District Court of Appeals reversed and Cora appealed.

5. On appeal, a divided Ohio Supreme Court, with one dissenting justice, reversed the court of appeals, affirmed the trial court, and dismissed the claims against Cora on the following grounds:

    a. The plain language of the necessaries statute provides that Robert as the debtor spouse retains primary liability for his unpaid debt. The home must therefore first seek satisfaction of its claim from Robert's income and assets. Each married person retains primary responsibility for supporting himself or herself from his or her own income and property. The non-debtor spouse is liable only if the debtor spouse does not have the income or assets to pay for his or her necessaries. A creditor must therefore first seek satisfaction of its claim from the assets of the spouse who incurred the debt.

b. The claim arises from an agreement with Robert that made Robert the payor, and that agreement expressly excludes making Cora personally liable for the debt. The home was required to seek recourse first against Robert's estate before seeking payment from Cora. The home's demand for payment falls squarely within the type of claims that must be presented to the decedent's estate by the statute providing that " all creditors having claims against an estate, including claims arising out of contract…shall present their claims" in accordance with the statute. Upon his death, Robert's obligation became estate obligations. The home should have presented its claim to the estate in accordance with the statute.

c. The six-month deadline to present its claims to the estate expired three days before the home presented its claim. The home could have opened an estate but did not seek appointment of an administrator before the expiration of the limitations period. If a creditor fails through indifference, delay, or lack of diligence to procure the appointment of an administrator, the law should not come to the creditor's aid. Because the home sat on its rights, its claims arising from Robert's obligations under the contract are forever barred as to all parties, including Cora.

d. The six-month limitation statute pertains to all claims against an estate, and not just to creditors that seek actual payment from an estate.

e. The home was required to timely present its claim for unpaid necessaries to the estate before it could pursue a claim individually against the surviving spouse under the necessaries statute. Because the home failed to timely present the claim or seek appointment of an administrator, Cora was entitled to summary judgment.

XXII. Spousal Rights & Claims

A. *Sveen v. Melin,* 584 U.S. ___ (2018). United States Supreme Court holds that application of Minnesota's revocation on divorce statute to life insurance policy obtained before statutory enactment does not violate the Contracts Clause.

1. Before addressing the facts of the case, the majority opinion authored by Justice Kagan opened with this: "All good trust-and-estate lawyers know that death is not the end; there remains the litigation over the estate (from the Collected Works of Ambrose Bierce). That epigram, beyond presaging this case, helps explain the statute at its center".

2. Mark and Kaye married in 1997. In 1998, Mark obtained life insurance and named his wife as primary beneficiary, with his children from a prior marriage as contingent beneficiaries. In 2002, Minnesota passed a new revocation-on-divorce statute that followed the model of the Uniform Probate Code and revoked not just testamentary bequests but also beneficiary designations to a former spouse. They divorced in 2007 and the divorce decree did not address the insurance. Mark did not make any changes to the beneficiary designations after the divorce. Mark died in 2011 and Kaye and the children made competing claims to the insurance proceeds. The trial court rejected Kaye's argument that retroactive application of the statute would violate the Contracts Clause of the United States Constitution (Article I, Section 10, Clause 1). The Eight Circuit Court of Appeals reversed, and the children appealed. The Supreme Court granted certiorari to resolve a split of judicial authority on the issue.

3. On appeal, the United States Supreme Court, with one dissenting opinion by Justice Gorsuch, reversed the Eighth Circuit and upheld the application of the statute on the following grounds:

   a. Not all laws affecting pre-existing contracts violate the Contracts Clause. The threshold issue is whether state law operated as a substantial impairment of a contractual relationship. The court considers the extent to which the law undermines the bargain, interferes with a party's reasonable expectations, and prevents the party from safeguarding or reinstating his rights. The statute odes not substantially impair pre-existing contractual arrangements.

   b. While the law, by revoking a beneficiary designation, makes a significant change, the law did not severely impair Mark's contract. The law is intended to reflect the owner's presumed intent (and the typical intent in most cases) and support, rather than impair, the contractual scheme. Laws have long made judgments about a decedent's likely intent after life changes such as marriage, birth, or divorce, and legislatures have long enacted statutes that revoked earlier made wills by operation of law. Legislative presumptions about divorce are prevalent and accurately reflect the intent of most divorcing parties. Most divorcees do not aspire to enrich their former partners. The failure to change the beneficiary designation after divorce is more likely the result of neglect rather than choice and the statute honors, not undermines, the intent of the contracting party.

   c. An insured cannot reasonably rely on a beneficiary designation remaining in place after a divorce. Divorce courts have wide discretion to divided property when a marriage ends, and that extends to life insurance. While not part of this decree, the policy could have been. The fact of any reasonable reliance cuts against providing protection under the Contracts Clause.

   d. A policyholder can reverse the effect of the statute with the stroke of a pen. The law puts in place a presumption that the owner may overthrow (or, if he wants to commit himself forever like Ulysses binding himself to the mast, he may agree in the divorce settlement to continue the spouse's beneficiary status). The statute therefore reduces to a mere paperwork requirement, and a fairly painless one. File a form and the default rule gives way. Laws that impose minimal paperwork burdens to not violate the Contracts Clause.

B. ***Blalock v. Sutphin,*** **CV-17-900084 (Alabama Supreme Court 2018).** Alabama law applies to life insurance policy obtained by Alabama domiciliary despite being formed in Tennessee, and application of Alabama's revocation on divorce statute to life insurance policy obtained before statutory enactment does not violate the state constitution.

1. In 2011, Lloyd obtained a $250,000 whole life insurance policy. The contract was formed and delivered at his workplace in Tennessee but listed his Alabama home address. He named his daughter as sole beneficiary. In 2012, Lloyd married Kimberly and changed the beneficiary designation to give 50% to her. In 2015, Alabama passed the Uniform Probate Code provision extending its revocation-on-divorce statute to include will substitutes such as life insurance and retirement plan beneficiary designations. In 2016, Lloyd and

Kimberly divorced. The life insurance was not addressed in the divorce decree and Lloyd didn't change the beneficiary designation form. Lloyd died later that year. His daughter petitioned for a judgment that she was entitled to all of the insurance proceeds and Kimberly opposed. The trial court held that the daughter was entitled to all of the insurance proceeds and Kimberly appealed.

2. On appeal, the Alabama Supreme Court affirmed the trial court on the following grounds:

   a. Kimberly' argument that Tennessee law should apply does not deprive the court of subject matter jurisdiction; it only goes to the choice of law. Alabama generally follows the *lex loci contractus* rule which would result in the application of Tennessee law. The policy does not provide for choice of law. Here, although an Alabama resident, Lloyd applied for the policy and the policy was delivered in Tennessee. However, the application of Tennessee law would violate the public policy of Alabama. Tennessee has not expanded its revocation-on-divorce statute to apply to will substitutes like life insurance. Alabama determined that the Uniform Probate Code approach reflected the better presumed intent of its domiciliaries. Lloyd lived in Alabama at all times, was divorced in Alabama, and died in Alabama. The policy listed his address in Alabama and he received correspondence about the policy in Alabama. It is therefore appropriate to apply Alabama law to determine the beneficiaries and the impact of his divorce on the policy terms.

   b. In keeping with the reasoning in U.S. Supreme Court decision in *Sveen v. Melin*, it was not unconstitutional to apply the statute to this insurance contract that was formed before the statute was enacted.

   c. The trial court did not commit clear error by finding that there was not a valid common law marriage that resuscitated the beneficiary designation in Kimberly's favor. Beneficiary designations revoked by divorce can be resuscitated by remarriage. Until January 1, 2017, common law marriage was recognized in Alabama. Lloyd and Kimberly reunited and lived together for two months before Lloyd's death. Witnesses could not tell the difference between their relationship before and after the divorce. However, the court found that they planned to be remarried in a future ceremony and Lloyd had repurchased their original wedding rings (they had been sold after the divorce). Because they intended to remarry formally, the court could find that they did not intend to be married at common law. The intent to enter into marriage a question of fact and the appellate court cannot here substitute its judgment for the trial court where the trial court decision had supporting evidence.

C. *Gordon v. Fishman*, No. 2D17-1488 (Florida 2nd District Court of Appeals 2018). Statute disinheriting spouse incident to divorce does not apply where will is signed prior to marriage.

1. Ron signed a will in 2005 that gave property to his then fiancée, Sylvia, and if she predeceased, to her children. They married two years later, divorced six years after that, and then Ron died two years after the divorce. Ron's father (through his guardian) asserted that the divorce revoked the provisions in favor of Sylvia. The trial court agreed and held that Sylvia's children should receive the property. Sylvia appealed.

2. On appeal, the court of appeals reversed on the following grounds:

   a. The statute provides that "any provision of a will executed by a *married person* that affects the spouse of that person shall become void upon the divorce of that person". The statute only applies when the marriage predates the will. Here Ron did not marry Sylvia until 15 months after he executed the will.

   b. The statute does not address a will made in contemplation of marriage. If that language is to be added to the statute, the legislature must do it. The court will hew to the statute's language and will construe the statute that extends its express terms and that abrogates legislative power.

D. *King v. Nash,* 2016 Mich. App. LEXIS 911 (2016); 2018 Mich. LEXIS 1570 (2018). Physical separation alone does not establish willful abandonment that bars intestate inheritance.

1. James and Maggie were married in 1968. They did not live together after 1976 and Maggie petitioned for spousal and child support. In 2010, they jointly sued General Motors for breach of contract, and in their complaint alleged that Maggie's life was irreplaceable for James. Maggie was also named as beneficiary of James's life insurance.

2. James died intestate, survived by six children from his first marriage and four children from his marriage to Maggie. Maggie sought the intestate rights of a surviving spouse, which the trial court allowed, finding that Maggie was not willfully absent from James for inheritance purposes. James's child from a prior marriage, Beatrice, appealed and asserted that physical separation was enough on its own to prove willful absence that eliminated inheritance rights.

3. On appeal, the court of appeals affirmed on the following grounds:

   a. The "willful absence" required to cause a loss of inheritance includes some intent - physical separation alone is not sufficient. All of the facts and circumstances, including physical separation, should be considered, and physical separation does not necessarily preclude a spouse from inheriting.

   b. This approach solves practical concerns about physical absence in other circumstances, such as: for employment; for education or family situations; to assist an elder parent; to seek medical treatment; or to avoid taking children out of schooling.

   c. While the record is sparse, there is some evidence in the record that the physical separation did not completely foreclose continued emotional intimacy in this case.

4. On further appeal, the Michigan Supreme Court, with one concurring and one dissenting justice, affirmed the court of appeals on the following grounds:

   a. The state statute, read in its statutory context and considering commonly used definitions of the words used in the statute, and other rules of statutory construction, cannot refer solely to physical absence as a basis for loss of spousal rights.

b. The term "willfully absent" cannot be defined exclusively by physical separation and there must be something more than mere physical distance. There are countless situations where spouses choose to be physically separated but do not want to interrupt or weaken their marriage, such as for work or military deployment. A committed spouse should not forfeit inheritance based on the erroneous assumption that physical distance prevented the pursuit of a loving relationship. If two married people decide to live apart but maintain an element of emotional support and contact, courts have no business second-guessing that life decision.

c. Willful absence requires consideration of the totality of the circumstances, and presents this factual question for the trial court to answer: whether a spouse's complete absence brought about a practical end to the marriage. Although an intentional physical absence is necessary to a finding of willful absence, without additional indicia of a complete absence in terms of emotional support and contact, courts should conclude that the marriage endured and allow the surviving spouse to retain spousal status.

d. The plain language of the statute does not require that an individual intend to abandon marital rights before being excluded as a surviving spouse, and the court cannot ignore this omission. The only intent that a spouse must have is to be absent, and a party seeking to establish that a spouse should be excluded does not need to show that the spouse intended to dissolve the marriage, only that the spouse intended to be absent from the decedent spouse.

E. *In re Estate of Sharpe,* 2018 N.C. App. LEXIS 326 (2018). Premarital agreement bars claim for elective share despite lack of specific elective share provision in agreement.

1. Thomas and Alma signed a premarital agreement on November 4, 2009. He was 86 at the time and she was 75. Both had been married before and had adult children from prior marriages. The marital agreement: (a) identified each other's property as separate property; (b) preserved for each of them the exclusive right to control their respective separate property and the right to dispose of it by deed, will, or otherwise; and (c) was expressly binding on their heirs, executors, successors, and assigns. The agreement did not otherwise expressly address the elective share. They married on November 21, 2009. Thereafter, each of them executed estate planning documents leaving their respective separate property to their own children, and nothing to each other. Alma's will stated she was doing so pursuant to the terms of the premarital agreement.

2. Thomas died in 2016. Alma's son, as her agent under a power of attorney, filed an elective share claim for Alma against Thomas's estate. The clerk allowed the claim, the estate appealed, and the superior court reversed the clerk and held that the elective share was barred by the marital agreement. Alma died during the appeal and her son was substituted as a party in her place as her personal representative. Alma's estate appealed.

3. On appeal, the Court of Appeals affirmed the rejection of the elective share claim on the following grounds:

a. The agreement was voluntarily executed after full disclosure.

b. The unambiguous language of the agreement plainly establishes the intent of the parties that Alma waive any rights to Thomas's separate property, that Thomas had the right to dispose of his property as if he were unmarried, and that each party "specifically waives, relinquishes, renounces, and gives up any claim that he or she may have or otherwise had or may have to the other's separate property under the laws of the state". The only logical reading of this waiver is to include the right to an elective share. The agreement also provided that it was binding on successors, and this refutes the argument that Alma intended to retain any rights in her husband's estate. Although the agreement does not expressly mention the elective share, the plain and unambiguous language cannot be read to mean they intended to waive only lifetime rights and not rights upon death.

c. Alma's estate cannot show how the court was prejudiced by taking judicial notice of the fact that Alma left her own assets to her children, and nothing to Thomas "pursuant to the premarital agreement executed by us on November 4, 2009".

F. ***Estate of Heil v. Heil,* 2018 Mo. App. LEXIS 91 (2018).** Consensual separation does not preclude a finding of spousal abandonment that bars elective share claim.

1. John and Marilyn were married in 1968. In the 1990s, John started spending much of his time at his parents' farm and then lived there full-time after he inherited the property. He refused to return to the marital home. Marilyn moved to the farm in 1999, they did not have a positive relationship but John's treatment of Marilyn was not to a level where she could no longer be reasonably expected to live with him. She returned to the marital home the next year. John did not request the move but agreed to it. She visited him infrequently (only to talk business or bring the grandchildren around) and they did not provide each other with domestic, financial, or emotional support. She did not help care for him through several illnesses, including falls, heart attacks, and Alzheimer's. When his son sough her help with care, she gave him a phone number for a caregiver. Neither took steps to terminate the marriage or separate, and neither committed adultery or marital misconduct. She made no additional efforts to pursue a marital relationship.

2. John died in 2014. His will left his entire estate to his son. His widow, Marilyn, claimed an elective share in the estate. The son objected and the trial court held that Marilyn had abandoned John and lost the right to an elective share. Marilyn appealed.

3. On appeal, the court of appeals affirmed on the following grounds:

   a. A finding of marital misconduct is not a condition of disqualifying a spouse from the right to an elective share. The court could find both a lack of marital misconduct and also abandonment that caused the loss of the elective share right.

   b. Separation alone does not cause abandonment. There was here also a showing that Marilyn intended to give up the marital relationship with no intention of resuming it.

c. The fact that separation was consensual does not preclude a finding of abandonment. While this may be relevant to the award of pendente lite temporary maintenance after spousal abandonment, this is not part of the determination with respect to the elective share. Consensual separation is a relevant fact, but is not dispositive, in determining whether a spouse has abandoned her spouse for elective share purposes. Though consensual separation may weigh against an inference that a spouse intended to completely give up on the marital relationship without cause, it does not foreclose the inference. It was possible here for the court to find that both spouses abandoned each other, rendering each disqualified from enforcing inheritance rights against the other's estate.

G. *Acosta-Santana v. Santana,* 2018 N.J. Super. Unpub. LEXIS 2667 (2018). Divorce proceedings abated upon death of one spouse.

1. Husband and wife married in 1990. In 2015, wife sued for divorce. In 2016, husband executed a will leaving his assets to their children, and then died a few months later before the divorce litigation was completed. Most of husband's assets passed to wife by title or beneficiary designation that husband did not change while the divorce was pending. Husband's executor moved to intervene in and continue the divorce proceedings, with the goal of obtaining an equitable property division award from spouse that would generate assets to pass under husband's estate plan to the children. The trial court denied interpleader and held that the divorce proceedings abated on the husband's death. The executor appealed.

2. On appeal, the appellate division affirmed on the following grounds:

   a. Divorce proceedings and equitable distribution abate when one party died before entry of a final divorce order unless (i) the facts were fully adjudicated before the death so that a decree could or should have been rendered or (ii) there are highly unusual circumstances such as fraud or unjust enrichment.

   b. There are no exceptional circumstances in this case to justify avoidance of abatement. The interpleader was not brought to protect an innocent living spouse, but rather to enrich a deceased spouse's estate to the detriment of the living spouse. While wife received a benefit by being the beneficiary of the husband's insurance policies, retirement accounts, and house, there was no argument that those benefits were unjust, and there was no allegation that wife committed fraud or misconduct to obtain those benefits. There was nothing to justify equitable relief from the general rule of abatement.

XXIII. Fiduciary Appointment & Succession

A. *Bank of America v. Evangelista,* 2018 R.I. Super. LEXIS 8 (2018). Trust provision that allows removal of corporate trustee "any time" does not require a showing of fault before removal.

1. In 1950, George Metcalf created an irrevocable trust for the benefit of his son and his grandchildren. Rhode Island Hospital Trust Company was named as initial trustee, and its corporate successor Bank of America eventually succeeded to the trusteeship under the trust terms. In 2013, the court divided

the trust into three separate trusts, one for each of the grandchildren, including a trust for the benefit of granddaughter Hannah. Two individual co-trustees served with the corporate trustee.

2. The trust terms provided that the co-trustees could remove the corporate trustee "at any time" by a signed written instrument, provided there were three trustees then serving, the trustee removal was assented to in writing by a majority of the settlor's then living adult issue, and at least one adult living issue was alive to assent to the removal. In 2017, the individual co-trustees exercised their power of removal with the written assets of a majority of the settlor's adult issue. No claims or allegations of fault against the corporate trustee were asserted.

3. Bank of America petitioned the court for instructions on the validity of the removal, and asserted that, because the trust terms did not include the language "without cause", "for any reason" or "controlled discretion" (which appeared elsewhere in the trust with respect to trust distributions), the removal would not be valid without a showing of fault.

4. The court held that the individual co-trustees validly exercised the power to remove the corporate trustee on the following grounds:

   a. The trust terms provide that the trustee could be removed "at any time". The settlor, however, imposed a series of other conditions to be satisfied before a trustee could be removed. The plain language imposes restrictions on the power to remove but does not impose any requirement of cause or fault before removal can be effectuated.

   b. The inclusion of the phrases "for any reason" and "uncontrolled discretion" elsewhere in the trust with respect to distributions, but not with respect to trustee removal, does not require a conclusion that a trustee could only be removed for cause. The settlor imposed criteria for removal and could have imposed a "for cause" requirement, but he chose not to protect the trustee from removal unless there was a showing of cause. The court will not rewrite or read nonexistent terms into the document.

   c. Injecting a cause requirement for removal of a trustee would be likely to disrupt the settlor's intent. The court dismissed the trustee's argument that allowing no-fault removal of a trustee would lead to a trustee ignoring its fiduciary responsibilities and bending to the will of the beneficiaries or co-trustees.

B. *Matter of Sinzheimer*, 2017 NY Slip Op 31379 (2017); 2018 N. Y. App. Div. LEXIS 3069 (2018). Corporate trustee acted properly when, after its removal, it refused to turn over trust assets to individual co-trustee that intended to terminate the trust, where trust terms clearly required appointment of successor corporate co-trustee.

1. Ronald Sinzheimer and his wife Marsha created an irrevocable trust in 1997. Ronald died and the trust provided for discretionary distributions for Marsha's lifetime benefit by an ascertainable standard, with the assets retained in trust for remainder beneficiaries upon her death. The co-trustees were an individual and a bank trustee. Ronald and Marsha's son Andrew and Marsha requested a

discretionary distribution to Marsha of all of the trust assets. A bank trust officer asked them to provide a tax return and budget for Marsha, which they refused to provide. Andrew's predecessor individual trustee removed the bank trustee (which was authorized under the trust terms) without appointing a successor bank, and then resigned as co-trustee and appointed Andrew as his successor. Andrew demanded the transfer of all trust assets to him, and announced his intention to distribute the assets to Marsha and terminate the trust.

2. Andrew and Marsha sued the bank trustee to compel the assets transfer, for money damages equal to the trust assets with interest, surcharge for commissioner, costs, and expenses, and $400,000 in punitive damages. The bank trustee counterclaimed for an order directing Andrew to appoint a successor bank co-trustee, or alternatively to order the transfer of assets to Andrew.

3. The surrogate denied all of Andrew and Marsha's claims against the bank, and ordered Andrew to appoint a successor corporate co-trustee, on the following grounds:

   a. The trust terms clearly and unambiguously required the appointment of a corporate co-trustee at all times after Ronald's death by providing that "[i]f after the death of Ronald, the individual Trustee removes the corporate Trustee or there is otherwise no corporate Trustee, the individual *shall appoint* another bank or trust company…to serve in its place" (emphasis added). The subsequent trust term that the settlor intended that there at all times be one individual co-trustee serving does not negate the corporate co-trustee requirement, particularly where the corporate co-trustee has the ability to appoint the individual co-trustee where one is not otherwise appointed. Nothing in the trust terms supports the view that a corporate trustee is unnecessary; and

   b. No claim for conversion is stated where the bank did not assert title to the funds, but rather temporarily withheld delivery of funds until Andrew first appointed a corporate co-trustee. The bank's position was reasonable in view of Andrew's stated intent to terminate the trust and the duties owed to the remainder beneficiaries, and the bank sought court directions just 4 months after Andrew made clear his plan not to appoint a new corporate trustee. The punitive damage claims must be dismissed for failure to support any underlying cause of action against the bank.

4. On appeal, the Appellate Division affirmed the Surrogate on the grounds that: (a) the trust terms clearly require a corporate co-trustee; (b) the decision allows the flexibility to move the court for further relief if it is actually true that no corporate trustee will accept the trusteeship; (c) retention of trust assets until a proper successor co-trustee was appointed is not conversion; and (d) no facts were proven to support a claim for punitive damages.

C. *In re Estate of Mickels,* 2018 Mo. LEXIS 2 (2018). Widow may not petition for appointment as personal representative after statutory deadline, despite state supreme court recognition of cause of action after expiration of deadline.

1. After Joseph Mickels died, his family brought a wrongful death action against his doctor who had failed to diagnose his brain tumor. The trial court granted summary judgment for the doctor because the tumor was incurable and the family could not prove that the doctor caused death. On appeal, the Missouri Supreme Court held that the missed opportunity to delay death by six months stated a negligence action that would have been actionable as a survivorship personal injury claim allowed under state statue if brought by the personal representative.

2. His widow, Ruth, then petitioned to be appointed as personal representative to bring the claim recognized by the state supreme court. By that time, Joseph had been dead for seven years and the probate statutes provided that a petition to appoint a personal representative must be filed within one year after death. The trial court denied the petition and Ruth appealed.

3. On appeal, a divided Missouri Supreme Court affirmed the dismissal of the petition on the following grounds:

   a. The decision of the state supreme court in the wrongful death litigation did not recognize a new cause of action for "deprivation of the opportunity to delay death". A survivorship personal injury action has been available under state law since 1907, and the current statute tracks the original statute almost verbatim. The court simply articulated how this missed opportunity is indeed an actionable personal injury under a century-old statute.

   b. The court has consistently rejected equitable exceptions to clear statutes under principles of legislative deference. Equity should not be used to clearly contravene the intent and language of the legislature, particularly with respect to statutory causes of action. The court cannot create an equitable exception, no matter how compelling the argument or how narrowly tailored the exception. To do so would be to usurp the lawmaking authority of the legislature. The statute is clear and the petition had to have been brought within one year of death.

   c. One dissenting justice would hold that probate division has complete and unrestricted equitable powers in probate matters, and that such power is broad enough to afford an aggrieved party relief from the rigid enforcement of the statute of limitations where this court announces that a party has a cognizable cause of action after the running of the limitations period.

D. *Matter of Hettrick*, 2018 N.Y. Misc. LEXIS 5367 (2018). Surrogate refuses to move trust situs to facilitate appointment of out of state private trust company selected by beneficiary as trustee.

1. Suzanne died in New York. Under her will, she created a supplemental needs trust for the benefit of her son Andrew, who received SSDI and Medicare benefits. She named her other children, David and Elizabeth, as trustees and they were also the presumptive remainder beneficiaries. Andrew lived in Massachusetts at the time of Suzanne's death and then later moved to Virginia. The trust terms did not address the trust situs.

2. The trust protector (Andrew's cousin) removed the trustees and appointed a Virginia private trust company as successor, contingent upon the New York surrogate entering an order releasing jurisdiction over the trust. Andrew and the trust protector petitioned the surrogate to transfer the trust situs to Virginia and the trustees objected. On cross motions for summary judgment, the surrogate refused to transfer the situs to Virginia on the following grounds:

   a. The court has authority to change trust situs if shown to have a beneficial effect, but not merely because the parties request it. The lack of a trust term prohibiting a situs change is not reason enough to authorize a change.

   b. The trust terms do not require the trustees to physically check up on the beneficiary and be nearby to do so, and Andrew has expressly rejected such visits. While Andrew claimed to want a trustee with whom he could have face-to-face contact, he is tech savvy and could use his computer and cell phone to have contact with the trustees, as he had done in the past.

   c. Andrew's apparent desire for a trustee that would never question or evaluate his distribution requests is at odds with the responsibilities of the trustee. A corporate trustee might actually be less sensitive and more stringent in evaluating his requests, and there is no suggestion that the current trustees ever breached their duties as trustee. The current trustees used the trust assets for Andrew's benefit, and there was no suggestion that they ever put their own interests as remainder beneficiaries ahead of Andrew's interests.

   d. A blanket rule prohibiting all relatives who are remainder persons from serving as trustees would violate New York's public policy of appointing relatives rather than strangers to administer a disabled person's assets.

   e. The fact that the successor trustee selected by the trust protector does not have New York trust powers, and that the intent was to apply Virginia law to the trust upon the change of trustee, militate against a transfer of jurisdiction in view of the will provisions that suggest New York law was to apply to the trust.

   f. Andrew resided outside of New York when the trust was created and the settlor was aware that Andrew's place of residence should not be a factor in the trust situs and governing law. The petitioners advanced no compelling reason to warrant transfer of the trust situs.

XXIV. Capacity, Undue Influence & Contests

A. *In re Estate of Danford,* 2018 Tex. App. LEXIS 3045 (2018). Signing of durable power of attorney on the same day of the will raises a presumption of undue influence that precludes no evidence summary judgment in favor of validity of the will.

1. Annie was unmarried and had no children. In 2010, she signed a self-proving will leaving her estate to Robert and naming him as executor. On the same day, she signed a durable general power of attorney naming Robert as agent. Robert brought two witnesses and a notary to Annie's house to witness the

documents. The witnesses described her as alert, without signs of mental confusion, looking nice, and carrying on normal conversation. However, the witnesses did not know Annie before the signing, none could verify that she knew she was signing a will, and it was not announced at the signing that the document was a will. Annie's former foster son testified that Annie began experiencing confusion as far back as 2008, she kept over 70 raccoons, a peacock, cats and other stray animals at her home, and her home was covered in animal feces and was in great disrepair. Annie frequently called 911 at all hours, distraught and confused. By 2009, she was homebound in a wheel chair.

2. Shortly thereafter, the nephews discovered the papers, asked Annie about the papers, and said that Annie got upset, denied knowledge of the will and said that Robert gave her papers and demanded that she sign them. She immediately revoked the power of attorney. There was evidence she had memory problems around that time. She signed a criminal trespass warning against Robert but rescinded it within the year.

3. Annie died in 2016. Robert applied to probate the will and the nephews opposed, asserting lack of capacity and undue influence. The trial court granted summary judgment in Robert's favor and the nephews appealed.

4. On appeal, the court of appeals reversed the summary judgment in Robert's favor on the following grounds:

   a. Robert failed to present evidence that Annie understood she was making a will. Even if his initial burden was met by the self-proving affidavit, the evidence raises genuine issues of material fact about whether Annie understood she was making a will and had the capacity to do so.

   b. A power of attorney creates an agency relationship that is fiduciary in nature as a matter of law. There was some evidence that, at the time of signing the will, Robert was in a fiduciary relationship to Annie, giving rise to a presumption of undue influence that precludes summary judgment.

B. *Estate of Luce,* 2018 Tex. App. LEXIS 9341 (2018). Will executed by quadriplegic through "blinking system" valid.

1. Michael and GayeLynne met in 1987. Both had children from prior marriages. In 1998, Michael signed a will naming his wife as executor and giving her his entire estate, and later adopted two of her adult sons. His relationship with his own twin daughters was distant. Their relationship was volatile, and separated four times over 26 years, and GayeLynne had filed for divorce twice. They separated again in June of 2015 and she filed for divorce again.

2. In October of 2015, Michael was in an ATV accident that left him a quadriplegic. When admitted to the hospital, he told the staff he was getting divorced, wanted his daughters to make his medical decisions if he was unable, and that he did not want his wife making any decisions for him. A week later he went into respiratory failure, was intubated, and became unable to speak. The entire time he was alert to person, place, and time.

3. A week later, Michael met alone with an estate planning lawyer in the ICU to discuss a new will. The lawyer determined Michael's wishes through using a blinking system to indicate "yes" or "no" to a series of leading questions

posed by the lawyer. The lawyer determined through this system that Michael wanted to revoke his prior wills and leave his estate to his daughters. The lawyer went to his office and drafted the new will. He returned to the hospital and read the new will to Michael first privately, and then in the presence of a notary and two witnesses. The notary signed the will on Michael's behalf, in the presence of the witnesses, and the witnesses signed in Michael's presence, and the will was notarized. No one else was present in the hospital room.

4. Michael died a month later. His wife offered the old will for probate, and his daughter offered the new will for probate. GayeLynne contested the new will and a jury unanimously found that the new will was validly executed, Michael had testamentary capacity, the will was not a product of undue influence, and GayeLynne did not bring her suit in good faith. The trial judge admitted the will to probate and then lost reelection shortly thereafter. The newly seated replacement judge vacated the lack of good faith finding and awarded GayeLynne her attorneys' fees from the estate. Both sides appealed.

5. On appeal, the court of appeals affirmed the validity of the will, but reversed the replacement judges' decision to vacate the jury finding that GayeLynne brought her contest in bad faith, on the following grounds:

    a. A Texas statute allows a notary to sign for a person who is physically unable to sign if directed to do so by that individual. Michael used the blinking system to confirm that he understood the execution process and that he was requesting the notary to sign for him. While the lawyer, notary, and witnesses could not remember whether one blink meant "yes" or "no", all testified that Michael made his wishes clear through the use of the blinking system. There was, therefore, evidence to support the jury's finding.

    b. The medical records showed that Michael did not suffer a head or brain injury and expressed his concerns about his wife and his divorce upon admission. The lawyer testified that Michael had full testamentary capacity. Two days after the execution, a doctor examined Michael again and confirmed that Michael was fully competent and had mental capacity at the time of the execution as well. While he was severely physically injured and could not speak due to intubation, be was alert and lucid and had full mental capacity.

    c. Testimony about Michael's relationship with his children was properly excluded as irrelevant to the issue of his capacity. While it may have been relevant to the claim of undue influence, it cannot be shown that its exclusion led to an improper judgment, in view of the fact that Michael expressed a preference for his daughters upon his hospital admission and confirmed his intent to his lawyer through the blinking system.

    d. Michael's physical distress was not the same as the mental distress that could make him susceptible to undue influence. Michael's isolation from GayeLynne and her sons prior to death is not altogether surprising given that Michael and GayeLynne were in the middle of a contested divorce at the time. And while Michael's daughter contacted the lawyer and provided some basic information to the lawyer, she was not involved in the will's preparation and execution in any way.

e. The new judge erred by vacating the jury finding that GayeLynne brought her contest in bad faith and awarding her attorneys' fees, because there was evidence to support the jury finding, and GayeLynne knew before trial Michael had told the hospital staff he was getting divorced and did not want his wife involved in any way and that the medical records confirmed he did not suffer any brain or head injuries.

XXV. Wills, Probate & Administration

A. *Guardianship & Alternatives, Inc. v. Jones,* 2018 Mich. App. LEXIS 2813 (2018). Electronic note on smart phone admitted to probate as a will.

1. Before he committed suicide at age 21, Duane left an updated handwritten journal entry saying: "My final note, my farewell is on my phone. The app should be open. If not look on Evernote". The journal provided an email address and password for Evernote.

2. On his phone, there was a typed electronic document with his full name at the bottom. The document included apologies and personal sentiments, religious comments about the afterlife, requests for funeral arrangements, and the following paragraph concerning disposition of his property (in informal lay person language): (a) gift of his stuff from his father and grandmother to his uncle; (b) gift of his car to Jody; (c) gift of his trust fund to his half-sister, and not to his mother; and (d) gift of the rest of his property 10% to the church, 50% to his half-sister, and the remaining 40% to "do whatever you want with". In another paragraph, he asked his uncle to give anything he didn't want to keep to two other people, and gave "all of his money" to his half-sister.

3. His court appointed guardian petitioned to probate the electronic document as Duane's will, his mother objected to probate and claimed to be his sole intestate heir, and the trial court admitted the electronic document to probate as Duane's will. His mother appealed.

4. On appeal, the Michigan Court of Appeals affirmed the trial court on the following grounds:

   a. By statute, a document or writing that is not executed with the requisite will formalities, and is also not holographic will, may be admitted to probate if the proponent proves by clear and convincing evidence that the decedent intended the document to be a will. No specific formalities are required under the statute.

   b. The document expresses Duane's testamentary intent and was written with his death in mind, by directing the disposition of his assets, stating his intent that his mother not receive the trust fund, and addressing funeral arrangements.

   c. Extrinsic evidence supporting probate includes the journal directing the reader to his final "farewell", and that he left the journal in his room with his phone, and then left home to commit suicide. Testimony about Duane's strained relationship with his mother supports the conclusion that he intended the document to be a will to ensure that his mother, who would otherwise be his heir, would not inherit from him.

B. ***Passarelli v. Dalpe,*** **LC No. 16-005565-DE (Unpub. Michigan Court of Appeals 2018).** Unsigned draft will not admitted to probate.

1. Alan was involved in a romantic relationship with Linda and he had two children from a prior marriage. Alan visited a lawyer to prepare his estate plan, wanted more time to consider the complex estate plan prepared for him, and signed a "stopgap" simple will leaving all of his assets to Linda if she survived. He died shortly after signing the simple will and before considering the more complex plan prepared for him.

2. After Alan's death, the same lawyer met with Linda twice to discuss the estate and also Linda's plan. He took handwritten notes that stated Linda wanted a plan like Alan's and wanted to leave all of her assets (which would almost entirely be the property inherited from Alan) to Alan's children. He prepared a rough draft will and final will for her, but it was not clear that she ever reviewed the drafts and Linda died shortly after the second meeting.

3. Alan's children petitioned the court to admit the unsigned draft to probate, which the trial court denied. On appeal, the Michigan Court of Appeals affirmed the trial court on the following grounds:

    a. By statute, a document or writing that is not executed with the requisite will formalities, and is also not holographic will, may be admitted to probate if the proponent proves by clear and convincing evidence that the decedent intended the document to be a will. No specific formalities are required under the statute.

    b. Evidence supported the trial court finding that Linda was not very savvy and would not have been clear about what happened at the meetings with the lawyer. She did not know what an estate plan was and had only a ninth-grade education.

    c. There was undisputed testimony that Linda had an argument with Alan's children after his death, said shew wouldn't sign anything, threw them out of her house, and had no further contact with them. Linda did not see the rough draft or the final draft, never reviewed the final draft with the lawyer to confirm it carried out her intent, and it was doubtful she even knew it existed.

    d. Linda was close with her and lived with her sister (who was also her intestate heir), and her sister testified that Linda did not want to leave her property to Alan's children, with whom she did not have a good relationship. Linda's sister also challenged the lawyer's account of the discussion at the two meetings and recalled that only Alan's estate was discussed and not Linda's estate plan.

    e. Alan's children failed to meet the burden of proving by clear and convincing evidence that the unsigned document was intended by Linda to be her will.

C. ***Matter of Will of E. Warren Bradway,*** **No. A-4535-16T3 (New Jersey Appellate Division 2018).** Codicil written in testator's own blood admitted to probate.

1. Warren was in a relationship with Marc from 1997 to 2004. The lived together, filed documents with the Philadelphia Commission on Human Relations

recognizing their status as life partners, and operated a bed and breakfast together. In 2001, Warren executed a formal attested will leaving his estate to Marc. Their relationship ended in 2004, Warren moved out of their shared home, and a court resolved the business dispute by ordering Marc to pay Warren $95,500 for this share of the business. Warren started a relationship with Kirsten at that time.

2. In 2006, Warren filed papers severing his life partner status with Marc. That same day he drafted a one-page handwritten codicil to his will that named Kirsten as beneficiary, directed that all references in his will to Marc be replaced with Kirsten, and directed that half of Marc's business debt to Warren be forgiven. He told Kirsten he was keeping the codicil in his file cabinet. He moved in with Kirsten and died unexpectedly in 2016. Kirsten found the will and codicil in the file cabinet that had been moved into her home when Warren moved in with her in 2011.

3. Kirsten moved to probate the will and codicil and Marc contested the codicil. The trial court approved probate of the codicil and denied Kirsten's attempt to impose sanctions on Marc for bringing frivolous litigation. The court also entered judgment without allowing Marc to call witnesses to testify that the will was not signed at Warren's death. The court of appeals affirmed the trial court on the following grounds:

   a. The DNA experts at trial agreed that the body of the codicil, excluding the signature, was written in the decedent's own blood (due to lack of a sample from Warren, they actually tested Warren's brothers and concluded that the blood was a 99.999% probability of coming from a full-sibling of the brothers).

   b. Both handwriting experts opined that the body of the codicil was written in Warren's handwriting.

   c. By statute, New Jersey allows probate of a document without a signature where there is clear and convincing evidence of an intent to make a codicil to a will. The court accepted Marc's position that the codicil was not signed and approved the codicil under this statute. Therefore, it was not error to enter judgment without allowing Marc to call witnesses that would testify that the codicil was not signed.

   d. The language of the codicil, by using the term "codicil", stating the intent to amend the will, providing a revised testamentary disposition, referring to Marc as a former partner, and forgiving part of Marc's debts, showed a clear intent to make a codicil. The fact that Warren wrote the codicil in his own blood adds support to other clear and convincing evidence that Warren intended to alter his will. Because a signature is not required under the statute relied on by the court, and the court accepted Marc's position that the codicil was not signed, the unresolved dispute about the validity of the signature does not undermine the court's decision.

D. *Estate of Ehrlich,* 427 N.J. Super.64 (2012); 2018 N.J. Super. Unpub. LEXIS 1043 (2018). Uniform Probate Code in New Jersey allows probate of unsigned copy of will. Prevailing party at trial cannot sue his attorney for attorney malpractice because the other side had the right to appeal his victory.

1. N.J.S.A.3B:3-3, is virtually identical to Section 2-503 of the Uniform Probate Code, and states: "Although a document or writing added upon a document was not executed in compliance with Section 5–502, the document or writing is treated as if it had been executed in compliance with that Section if the proponent of the document or writing establishes by clear and convincing evidence that the decedent intended the document or writing to constitute (i) the decedent's will".

2. The purpose of the statute is to avoid harmless errors in the formalities of Will execution. The majority applied the statute to save an unsigned, unwitnessed, copy of a document labeled Last Will and Testament. The opinion recites these facts:

   a. Richard Ehrlich, a trust and estates attorney who practiced in Burlington County for over fifty years, died on September 21, 2009. His only next of kin were his deceased brother's children — Todd and Jonathan Ehrlich and Pamela Venuto. The decedent had not seen or had any contact with Todd or Pamela in over twenty years. He did, however, maintain a relationship with Jonathan, who, he had told his closest friends as late as 2008, was the person to contact if he became ill or died, and to whom he would leave his estate.

   b. Jonathan learned of his uncle's death nearly two months after the passing. An extensive search for a Will followed. As a result, Jonathan located a copy of a purported Will in a drawer near the rear entrance of decedent's home, which, like his office, was full of clutter and a mess. Thereafter, on December 17, 2009, Jonathan filed a verified complaint seeking to have the document admitted to probate. His siblings, Todd and Pamela, filed an answer, objecting. The court appointed a temporary administrator, Dennis P. McInerney, Esquire, who had been previously named as Trustee of decedent's law practice, and by order of June 23, 2010, directed, among other things, an inspection of decedent's home. Pursuant to that order, on July 8, 2010, Jonathan, Todd and Pamela, along with counsel and McInerney, accessed and viewed the contents of decedent's home and law office. No other document purporting to be decedent's Will was ever located.

   c. The document proffered by Jonathan is a copy of a detailed fourteen-page document entitled "Last Will and Testament." It was typed on traditional legal paper with Richard Ehrlich's name and law office address printed in the margin of each page. The document does not contain the signature of decedent or any witnesses. It does, however, include, in decedent's own handwriting, a notation at the right-hand corner of the cover page: "Original mailed to H.W. Van Sciver, 5/20/2000[.]" The document names Harry W. Van Sciver as Executor of the purported Will and Jonathan as contingent Executor. Van Sciver was also named Trustee, along with Jonathan and Michelle Tarter as contingent Trustees. Van Sciver predeceased the decedent and the original of the document was never returned.

   d. In relevant part, the purported Will provides a specific bequest of $50,000 to Pamela and $75,000 to Todd. Twenty-five percent of the residuary estate is to pass to a trust for the benefit of a friend, Kathryn Harris, who is to receive periodic payments therefrom. Seventy-five percent of the residuary estate is to pass to Jonathan.

e. It is undisputed that the document was prepared by decedent and just before he was to undergo life-threatening surgery. On the same day this purported Will was drafted—May 20, 2000—decedent also executed a Power of Attorney and Living Will, both witnessed by the same individual, who was the Burlington County Surrogate. As with the purported Will, these other documents were typed on traditional legal paper with Richard Ehrlich's name and law office address printed in the margin of each page.

f. Jonathan is named the alternate agent to make health care decisions in the event his uncle became incapacitated and the primary agent was unavailable.

g. Years after drafting these documents, decedent acknowledged to others that he had a Will and wished to delete the bequest to his former friend, Kathryn Harris, with whom he apparently had a falling out. Despite his stated intention, decedent never effectuated any change or modification to his Will as no such document ever surfaced, even after the extensive search conducted of his home and law office after his death.

3. In applying the statute, the court concluded the document was simply a copy of the decedent's Will:

a. "Clearly, decedent's handwritten notation on its cover page evidencing that the original was sent to the executor and trustee named in that very document demonstrates an intent that the document serve as its title indicates—the "Last Will and Testament" of Richard Ehrlich. In fact, the very same day he sent the original of his Will to his executor, decedent executed a power of attorney and health care directive, both witnessed by the same individual. As the General Equity judge noted, "[e]ven if the original for some reason was not signed by him, through some oversight or negligence his dated notation that he mailed the original to his executor is clearly his written assent of his intention that the document was his Last Will and Testament.""

b. "Lest there be any doubt, in the years following the drafting of this document, and as late as 2008, decedent repeatedly orally acknowledged and confirmed the contents therein to those closest to him in life. The unrefuted proof is that decedent intended Jonathan to be the primary, if not exclusive, beneficiary of his estate, an objective the purported Will effectively accomplishes. Indeed, the evidence strongly suggests that this remained decedent's testamentary intent throughout the remainder of his life."

c. "Moreover, decedent acknowledged the existence of the Will to others to whom he expressed an intention to change one or more of the testamentary dispositions therein. As the wife of decedent's closest friend recounted: "And [Richard] has to change [the Will] because there is another person that he gave, I don't know how you say it, annuities every month ... in case he passed away, and he wants to take her off the [W]ill. And by that time Richard could barely write or sign, so I'm not surprised he didn't sign his [W]ill." Although there is no evidence whatsoever that decedent ever pursued this intention, the very fact that he admitted to such a document is compelling proof not only of its existence but of decedent's belief that it was valid and of his intention that it serve as his final testamentary disposition."

d. "Given these circumstances, we are satisfied there is clear and convincing evidence that the unexecuted document challenged by appellants was reviewed and assented to by decedent and accurately reflects his final testamentary wishes. As such, it was properly admitted to probate as his Last Will and Testament."

e. "The fact that the document is only a copy of the original sent to decedent's executor is not fatal to its admissibility to probate. Although not lightly excused, there is no requirement in Section 3 that the document sought to be admitted to probate be an original. Moreover, there is no evidence or challenge presented that the copy of the Will has in any way been altered or forged."

4. A dissent argued that this was not a harmless error case at all but rather a lost Will case: "Despite Jonathan Ehrlich's reliance upon *N.J.S.A.* 3B:3–3 in seeking to probate the unexecuted copy of the decedent's will found after his death, Jonathan does not appear to claim that the decedent actually intended that document to be his will, as required for probate under *N.J.S.A.* 3B:3–3. Instead, Jonathan's claim appears to be that the will found in the decedent's home was an unexecuted copy of an original executed will, which the decedent sent to his executor Van Sciver, and that the original was lost by Van Sciver or Van Sciver's estate after his death. For the reasons previously discussed, *N.J.S.A.* 3B:3–3 does not address such a claim. In my view, Jonathan is entitled to prevail only if he can show, in conformity with the common law authority dealing with lost wills, that the unexecuted will found in the decedent's home is a copy of an original executed will sent to Van Sciver, which was lost and not revoked by the decedent. However, because this case was presented solely under *N.J.S.A.* 3B:3–3, the trial court did not make any findings of fact regarding these issues. Indeed, the trial court concluded that the copy of the will found in the decedent's home could be admitted to probate under *N.J.S.A.* 3B:3–3 "[e]ven if the original ... was not signed by [the decedent]." Therefore, I would remand to the trial court to make such findings. I would not preclude the parties from moving to supplement the record to present additional evidence on the question whether the unexecuted copy of the will found in the decedent's home may be admitted to probate as a copy of the alleged executed original sent to Van Sciver."

5. Because there was a dissenting opinion, there was a right for the losing side to appeal to the state supreme court. Jonathan fired the counsel that prevailed below, hired new counsel, and had his new counsel settle the case to avoid protracted appellate litigation. Jonathan then sued his prior attorney for legal malpractice, alleging that his counsel should have argued that the will was a lost will, and if he had, there would not have been a dissenting opinion and he would not have had to settle with his siblings. The trial court granted summary judgment dismissing the malpractice action and Jonathan appealed. On appeal, the superior court affirmed on the following grounds:

a. The lost will theory requires the proponent of the will to overcome a rebuttable presumption that the testator revoked his will. There is nothing in the facts of the case that would have overcome the rebuttable presumption that his uncle destroyed the will. The trial court reasonably accepted expert opinion of the difficulties of proof in a lost will theory.

b. As a matter of law, a jury could not determine that one theory of the case was better than the other. Even if Jonathan had prevailed on another theory, nothing would have prevented an appeal by his siblings. He might have been presented with precisely the same quandary if a dissent was filed. That rank speculation is no different than the rank speculation he engages in by asserting he could have prevailed on a lost will theory, that his siblings would not have appealed, and if they had appealed, appellate review would have resulted in a unanimous decision. Any damages from the alleged malpractice were unforeseeable – mainly Jonathan's decision to retain new counsel, pay that attorney's fees, and settle the matter.

c. Jonathan could not have proven his cause of action before a jury and therefore summary judgment was proper.

E. *In re Estate of Starkey,* 2018 Tenn. App. LEXIS 154 (2018). Allegation that unnamed person tricked testatrix into destroying document other than will is adequate to state a challenge to a will disinheriting children in favor of charity.

1. Wanda's husband predeceased her. In 1991, she signed a will leaving her estate to her children. In 2009, she signed a new will that revoked all prior wills and left her estate to the Leukemia and Lymphoma Society of Middle Tennessee ("LLS"). Wanda died in 2013. Wanda's daughter, Drema, petitioned to probate the 1991 will and alleged that there were no later wills. When LLS petitioned to probate the 2009 will, the court revoked the letters of administration granted to Drema, and an administrator *cum testamento annexo* was appointed. The original 2009 will was placed on file with the court. Drema then contested the 2009 will, claiming to have information that Wanda tried to destroy the 2009 will, and believed that it had been destroyed in her presence, causing intestacy or resuscitation of the 1991 will. Drema then filed an amended pleading claiming that Wanda instructed an unnamed person to destroy the 2009 will, but that unnamed person destroyed another document, thereby tricking Wanda. The circuit court dismissed the contest as a matter of law and Wanda appealed.

2. On appeal, the Court of Appeals revised the dismissal of the claim as a matter of law on the following grounds:

a. As far back as 1846, the Tennessee Supreme Court has recognized that, where a testator has the apparent intention to revoke a will, an act of destruction does carry out that effect, even though the will was not literally destroyed, so long as the testator completed the act he intended to work the revocation. For example, if the testator attempts to burn the will and believes he has done so, but by the fraud of another person a different paper is burned, it will be a revocation if the testator intended it to be one and honestly believed it was.

b. The 1985 enactment of legislation codifying the means of revoking a will (which includes destruction with the intent and purpose of revocation by the testator or another person in the testator's presence and by his direction) does not abrogate the common law, because the intent to do so was not sufficiently clear. The phrase "no change of circumstances other than as described in this section revokes a will" in the statute refers only to marriage, the birth of a child, divorce, or annulment, and does not abrogate the common law rule that fraud will not defeat an attempt to revoke a will.

c. Drema alleges sufficient facts in support of her claim that would warrant relief under the common law. She alleged that Wanda, with the intent and for the purpose of revoking her 2009 will, had a document she mistakenly believed to be her 2009 will destroyed in her presence, and that the mistaken belief was due to the trickery of another.

F. *Fenstermaker v. PNC Bank*, 2018 U.S. Dist. LEXIS 49198 (Conn. 2018). Disinherited son lacks standing to challenge estate plan, compel an accounting, or bring other tort claims before father's death.

1. Scott was an experienced trial lawyer who administered his uncle's estate in 2012. He claimed that his sister, Martha, demanded that he make improper estate distributions until Scott hired counsel and threated legal action. Scott claimed that Martha's anger led her to begin taking steps to undermine Scott's relationship with their father, Lloyd, and to interfere with his expected inheritance. Soon after this family dispute, Lloyd removed Scott as executor under his will. Lloyd's health deteriorated and Martha provided his care and managed his affairs. Scott blamed Martha for his lack of communication with his father. Scott also believed his father wanted to punish him with disinheritance because Scott defended certain alleged terrorists, and in his defense of those persons and while running for the U.S. Congress, Scott was quoted as believing the 9/11 attack on the World Trade Center was "deserved" and "one of the greatest events in human history".

2. In 2016, Lloyd amended his estate plan multiple times, finally concluding with a pour over will to a revocable trust with a bank trustee that disinherited Scott's share of the $1.5 million estate and left that share to Scott's ex-wife, Linda. At some point during the estate planning process, Lloyd fell and fractured his hip and received treatment in Delaware, and had some diminished or impaired capacity. Scott was given notice pursuant to Delaware law to bring a pre-death legal challenge to the will and trust in January of 2017. However, in December of 2016, Lloyd moved from Delaware to Connecticut near his daughter, and suffered three stokes and remained hospitalized.

3. Scott sued *pro se* to invalidate his father's will and trust and to compel an accounting of his father's assets, and alleged: (a) tortious interference with expected inheritance against Martha; and (b) intentional infliction of emotional distress for $2 million against Martha and Lloyd. He alleged that the activities of his father and sister exacerbated his anxiety condition (for which he had received treatment since the 1980s), caused him to double the dosage of his mediation and be hospitalized, caused his divorce, damaged his relationship with his brother, and hindered his ability to work effectively thereby costing him income.

4. The federal court granted dismissal of all of the claims on the following grounds:

   a. Because Scott is an experienced trial lawyer, he is not entitled to have his pleadings construed liberally as an ordinary *pro se* litigant.

   b. Scott has not suffered an injury-in-fact, and his case is not ripe for adjudication, because while his father is alive he is no more than a theoretical beneficiary and has suffered no actual injury. He is not entitled to any property while his father is alive.

c. The fact that Delaware law prescribes a pre-mortem procedure to challenge a will or trust in state court does not mean that there is constitutional standing to allow such a challenge in federal court. Federal courts are courts of limited jurisdiction and state courts are courts of general jurisdiction. Even if Scott had standing, Lloyd has moved out of Delaware and it is highly doubtful that the Delaware statute would apply now that Lloyd lives in Connecticut (and Connecticut does not have a pre-death validation statute).

d. Scott cannot make First or Fourteenth Amendment constitutional claims that his father impaired his free speech rights because those amendments only apply to government actors, and there are no constitutional dimensions to a testator's or settlor's choice of beneficiaries. Equal protection does not require that all children be treated equally.

e. Scott has no right to an accounting of his father's assets during the father's lifetime. Even if Connecticut would recognize the tort of interference with an expected inheritance, Scott does not have standing to bring the claims at this time due to lack of any cognizable injury before his father's death. Scott has not plausibly alleged that one who disinherits a child, or one who convinces a parent to disinherit a child, has committed the kind of outrageous conduct that is required to sustain an intentional infliction of emotional distress claim.

f. Plaintiff may be upset at being excluded from his father's estate, but that does not transform his father's lawful conduct into a tort.

G. *Gulledge v. Sullivan,* 2018 Conn. Super. LEXIS 2604 (2018). Estate can sue for wrongful death damages for lost use of motorcycle.

1. The court held that an estate could, as part of a wrongful death claim, sue for damages for the lost use of the decedent's motorcycle on the grounds that the estate could assert any claims the decedent could have asserted had he lived.

2. The court concluded that the estate lost the use of the motorcycle for the period from October 8, 2016 through February 26, 2017 while the police were investigating the accident and deciding to charge the person that caused the accident. After that point, photographs and other secondary evidence would be permissible to prosecute the criminal case and use would be restored. At a rate of $50 per day, the court valued the claim at $7,100.

H. *Hofmann v. Estate of Hoffman,* 2018 Conn. Super LEXIUS 3195 (New Britain Superior Court 2018). Ademption of bequest by extinction is not grounds to deny probate of will.

1. Timothy died testate in 2017. Under his will, he left any motor vehicles owned at the time of his demise to his son Brian. At the time he signed the will, he owned a Mercury Mountaineer with a value of $30,000. At the time of his death, he did not own a vehicle. The court admitted the will to probate and Brian appealed the probate order, alleging only that he was not left with any bequest from his father's estate.

2. The court dismissed the suit as a matter of law on the grounds that the allegations of ademption of the bequest by extinction are not grounds for appealing the probate of a will, and because the decedent did not own a vehicle at his death, the will has been followed and there is no relief, equitable or otherwise, that can be given.

I. ***In re Estate of Abbott,* 2018 Tenn. App. LEXIS 445 (2018).** Probate of will signed by two interested witnesses allowed.

1. Joe signed his will in 2016 and the will was witnessed by his children, and was also notarized. His will left his assets equally to his children. His daughter, Marce, probated the will and qualified as executor. She then settled a claim against the U.S. Department of Veterans Affairs for $135,000. The check was made payable to the estate but addressed to the court. The court required posting of bond before the check could be distributed to the heirs, Marce tried unsuccessfully to disqualify the probate judge, and the probate court rescinded the order of probate and held that the will failed to comply with state law requirements for due execution because both witnesses were interested and other grounds. Marce appealed. The court of appeals reversed the probate court and admitted the will to probate on the following grounds:

   a. The probate court erred by rejecting probate based on the witnesses being interested because by statute no will is invalidated because it is attested by an interested witness.

   b. The will did not fail to state that the witnesses were competent because the will provided a statement by the witnesses that they are "of sound mind and proper age to witness a will".

   c. The will did not fail to state that the testator signed in the presence of two witnesses who signed in each other's presence and in the testator's presence, because the will stated that the testator signed in the presence of both witnesses who signed in each other's presence and in the testator's presence.

   d. The will is not invalid for failure to include a self-proving affidavit because that is an option under the law and not a requirement.

J. ***In re Estate of William,* 2018 Ohio App. LECXIS 1206 (2018).** Court properly rejected second disinterment of corpse.

1. William died in 2016 survived by his wife, Charlene. Pursuant to his wishes, his body was buried on December 19th on the family burial site at Arcadia Cemetery. A month later, William's sister Linda sent a letter to Charlene's attorney informing Charlene that the deed to the burial site was being changed to be in the name of a family trust and that the trust terms would prohibit Charlene from being later buried with her husband (Linda later claimed that their father's will, by which the lot passed, prohibited spousal burials, but that was not part of the letter).

2. After consulting with the funeral home and her attorney, she had William's remains disinterred in August 2017 and reburied at another cemetery where she could later be buried with him. That month Linda petitioned the court to again disinter the remains and have them reinterred at Arcadia Cemetery. The court denied the petition and Linda appealed.

3. On appeal, the court of appeals affirmed the trial court on the following grounds:

   a. Well-established public and legal policy has been that a person, once buried, should not be exhumed except for the most compelling reasons. Good cause must be shown and the evidence supported the trial court's application of the factors for the determination of lack of good cause.

   b. Charlene's relationship with William was entitled to more weight than Linda's, as there was no evidence of a strained marriage or that they were on bad marital terms at his death.

   c. William strongly desired to be buried next to Charlene.

   d. Linda's letter left no doubt that Charlene would not be buried with William. While Linda testified that she had since resolved the issue by titling the lot into a trust that allowed the burial of spouses, her letter stated that the titling in the name of the trust was the reason why Charlene could not be buried there. The court could find that Linda's professed change of heart at trial, and withdrawal of her objection to Charlene's burial at Arcadia, was disingenuous and that her objection only softened in the face of litigation. Linda's attempt to block Charlene from being buried at Arcadia weighs against disinterment.

   e. Charlene undertook a good faith effort to comply with the statutory requirements by consulting with the funeral home and acting on advice of counsel. The statutes do not require a spouse to inform anyone else about their plans to disinter the remains of a deceased spouse.

   f. Her initial consent to burial at Acadia is not a waiver of her right to object to additional disinterment to return the body there. If the consent to burial was based on the understanding that the site would be maintained so that the surviving spouse could also be buried there, and later events make it impractical to carry out that understanding, the consent to the original site may be vitiated. Linda's letter nullified Charlene's earlier consent. Charlene did not act outside the bounds of acceptable conduct.

K. ***In re Estate of Field,*** **2018 Kan. App. LEXIS 9 (2018).** Proof adequate to sustain trial court finding that codicil was a forgery.

1. Earl O. Field had no children and his wife, Nonie, died in 2009 after 70 years of marriage to Earl. In 2010, Earl signed a will that left a life estate for the family that had farmed Earl's family land in Kansas, gave a small monetary gift to his brother in law, and left the balance of his $20 million estate to Fort Hays State University (where he and Nonie graduated) to fund music and athletic scholarships. The will was prepared by his long-time attorney who had prepared all of his prior estate planning documents, and was reviewed by the college.

2. Earl met Wanda when she worked for his local bank and she later worked for his accountants. He later offered Wanda a job as his part-time bookkeeper from 2008 until his death in 2013. Earl was depressed after Nonie's death and spent more time with Wanda. She had access to his bank accounts, was listed as survivor on some of them, had access to his papers, and had the ability to sign checks on his accounts. She received hundreds of thousands of dollars from his accounts before and after his death. Earl was admitted to the

hospital on January 28, 2013 where he was admitted as a patient, and diagnosed with cancer. Three days later he was admitted to a rest home where he received hospice care. Earl died on February 19, 2013.

3. Wanda claimed that she went to his office that night and found two typewritten letters dated January 23, 2013, one to Wanda and one to Earl's attorney, purportedly signed by Earl, both of which said that half of his estate should go to Wanda and half should be divided between the attorney and the college. The letters did not have witness signatures. The next day, the attorney told her the letters did not pass property because they were not witnessed, and her own attorney said the same thing. She called her friend Kathy, and Kathy told her own husband Steve that the letters were not valid to pass property for lack of witness signatures. Five days later, Wanda visited the car dealership where Steve worked to have her car serviced, and while she was there Steve called the attorney and told him that he and Kathy had witnessed Earl sign a purported codicil, and signed it as witnesses at Steve's office on January 22nd (the day before the date of the letters), but had not told Wanda because Earl wanted it to be a surprise. Wanda had also called Kathy before and after Steve's call to the attorney. Kathy and Steve went to Wanda's house that night, and Wanda claimed that was the first she learned of a witnessed document. The next day, Wanda went to Earl's office and claimed that she found the purported signed and witnessed codicil dated January 22. Copies of that document were shredded (and lacked witness signatures) and Wanda made copies at the local bank (which did have the witness signatures).

4. Wanda attempted to probate the codicil and the college objected. After a nine-day trial with 30 witnesses and 300 exhibits, the trial court denied probate of the codicil, but awarded Wanda $1 million in attorneys' fees and costs. At the time of trial, Steve and Kathy were dead from a murder-suicide immediately after their house was searched by the FBI. They had been served with subpoenas by a grand jury. Their testimony was admitted by video depositions.

5. Both sides appealed. On appeal, the court of appeals affirmed the rejection of the codicil, but reversed the award of attorneys' fees, on the following grounds:

    a. Wanda met her burden to make a prima facie showing that the purported codicil was a valid instrument. Earl's capacity was not questioned, Steve and Kathy submitted affidavits that they had witnessed the execution and signed the codicil at Steve's office at Earl's request. The attorney testified that the signature appeared to be Earl's. Nothing on the face of the instrument raises the suspicion of a forgery, and therefore the burden of proof shifted to the contestant to show the invalidity of the document.

    b. Clear and convincing evidence supported the trial court determination that the codicil was not signed by Earl.

    c. Experts testified that: (i) the typewriter used was not the same one Earl used before he stopped typing; (ii) the second half of the January 23 letters was sharply darker than the first half, showing that a ribbon had been changed, but the purported January 22 codicil was dark throughout, suggesting it was drafted after the ribbon change, and not before it as the

dates suggest, and all the codicil was clearly typed with the same ribbon as the second half of the letters; (iii) the shredded photocopy of the codicil was identical to the final codicil but did not have witness signatures (which could not be explained if it was a photocopy); and (iv) Earl's signature was suspect because letters were retraced, the signatures on the letters and codicil were identical whereas that it impossible for people to do because of natural variations, the signatures were made with a degree of fluidity Earl did not possess, Earl always crossed the letter "F" from left to right, but here it was crossed from right to left, and the experts concluded through this and 10 other material differences from this signature and known other signatures that this was not Earl's signature.

d. The formatting was inconsistent with Earl's known historic drafting style in the punctuation, construction, salutation, margins, spacing, closing, date placement, and signature placement.

e. The court could discount Wanda's expert who only opined that Early "probably" signed the document, as that is a weak standard by expert parlance.

f. Steve and Kathy's testimony was impeached by the totality of the circumstances. They gave conflicting testimony about whether Wanda discussed the estate plan with them, service records from the dealership show that Wanda was there when Steve called the attorney to mention the codicil, and Kathy texted Wanda "good luck" before she met with the attorney. There was a reasonable inference that the grand jury subpoena left with them on the morning they died was related to this case.

g. The court could reasonably find that Wanda's testimony lacked credibility because: (i) she gave inconsistent testimony about her contact with Steve and Kathy; (ii) she claimed to have no idea that Earl intended to include her in his estate plan, but claimed that Earl had dictated to her the letter to the attorney (despite never having given dictation before); (iii) she changed her story and denied lawyers had told her the letters were not valid for want of witness signatures; (iv) she denied talking to Steve while at the car dealership; (v) the lack of witness signatures on what she claimed were shredded copies of the codicil (which were reclaimed from the shredder and reassembled by court order); (vi) there was a handwritten draft of the codicil also in the shredder in her own handwriting; (vii) she gave inconsistent testimony about the ribbon changing on the typewriter; (viii) her theory of the case was unbelievable as to the actions of an elderly and sick man who was no longer typing, and her speculation does not refute the clear picture of a forgery that was painted consistently by those who knew both Earl and Wanda; (ix) Wanda was fired from the bank for writing herself checks out of a client's custodial account; and (x) Wanda admitted stealing funds as treasurer for her class reunion.

h. Earl remained close with the family to whom he wanted to give the life estate. He was also close with the president of the college. Earl's accountant and close friends testified that he did not worry about estate tax planning because he had planned to give his assets to the college, he hated paying taxes and invested in tax-free bonds to avoid them, and that he would be "rolling over in his grave" if his assets passed to Wanda and

his estate had to pay $4 million in estate taxes. Earl's lawyer testified that Earl had always had counsel prepare his estate planning documents, and that the gift to the college had been in his documents signed in 1987, 1994, 1996, 1998, 2003, 2005, 2009, and 2010.

i. The codicil contradicted Earl's long-time estate plan and there was no evidence that Early expressed a change in attitude about the individuals he intended to benefit, that he was willing to pay estate taxes, or that he no longer wanted to be remembered through the large gift to the college. Unbeknownst to Wanda, Earl told the college president *after* the date of the alleged codicil that his attorney had his will and that he was leaving more money, and not less, to the college.

j. The trial court erred by awarding Wanda attorneys' fees because the evidence does not support a finding that Wanda acted in good faith and with just cause.

L. *Andelson v. Neptune Mgmt. Corp.,* 2018 Cal. App. Unpub. LEXIS 42 (2018). Funeral company did not commit actionable error by following instructions from agent under power of attorney that were different than instructions under will.

1. In November 2008, Arvin entered into an agreement for pre-arranged funeral services. The agreement provided that the company would provide cremation services or arrange for the services if death happened outside the company's service area. In the instructions for disposition of the ashes, Arvin instructed that his ashes be disposed of by burial at sea three miles off the coast of Los Angeles County. Arvin told his son about the arrangements and that he did not want a memorial service when he died. In 2010, he gave his son a copy of this will which left his estate to his son (and specifically excluded his brother, Robert, as a beneficiary), named his son as executor, and named his son to handle arrangements for disposition of the ashes. Neither Arvin nor his son gave a copy of the will to the funeral home.

2. In July of 2012, Arvin signed an Advance Health Care Directive and Power of Attorney for health care, naming his brother, Robert, as his agent, and authorizing Robert to direct the disposition of his remains. Arvin entered hospice care the next month and asked the hospice to communicate with Robert first. In September of 2012, a hospice worker sent the son a copy of the directive, but Robert was unaware of the document. Arvin died that month. The hospice provided the funeral company with a copy of the directive. No one gave the funeral company a copy of Arvin's will. The next day, the funeral company contacted Robert and informed him of the directive. The company obtained a death certificate and obtained a permit to dispose of the remains off the coast of Los Angeles County. The son emailed the will to Robert and instructed him not to make any decisions about Arvin or his estate. The son called the funeral home, but an employee said that they would only deal with Robert. When the son stated he was the executor and that there was a will, the employee hung up on him. The son did not contact the company again. Less than 20 minutes after the call, Robert emailed the son, informed the son he was aware of his call to the company, and stated that anything related to the ashes must be arranged through Robert, Robert was already making arrangements to recover the ashes, that Robert's wishes would be respected, and that Robert was arranging a proper memorial as Arvin had instructed him.

3. Arvin was cremated on October 1, 2012. The death certificate states that remains were disposed of that day off the coast of Los Angeles County. In actuality, the company released the remains to Robert on October 9, 2012 for scattering off the coast of Los Angeles County. Robert discussed a change with the company and the company obtained a new permit to dispose of the remains off the coast of Orange County. A few weeks later, Robert had a memorial service that the son did not attend because he felt it was against Arvin's wishes. He then learned that the ashes were displayed at the service. Robert then scattered the remains off the coast of Orange County. The son became upset, developed anxiety and sleep problems, and began avoiding social interaction.

4. The son sued the funeral companies (Arvin died outside the original company's territory and pursuant to the contract the company arranged services by another provider) for breach of contract, fraud, negligence, intentional violation of various statutes, and breach of fiduciary duty. He sought $5 million in actual damages, $5 million in punitive damages, and statutory double and triple damages. The trial court granted summary judgment in favor of the companies and the son appealed.

5. On appeal, the court of appeals affirmed on the following grounds:

   a. The Uniform Health-Care Decisions Act permits an adult with capacity to execute a power of attorney for health care. By statute, a decedent may direct in writing the disposition of his remains. Unless the power of attorney for health care directs otherwise, an agent may make decisions that may be effective after the principal's death including directing the disposition of remains.

   b. A person who provides written authorization for cremation represents the truthfulness of his authorization and is personally liable for damage resulting from his breach of warranty. A crematory is not liable for disposition of remains pursuant to that authorization unless it has actual notice that the representation is untrue.

   c. Upon the principal's death, the agent under a power of attorney for health care may direct the disposition of the remains, unless the power of attorney specifies otherwise. Arvin expressly granted Robert the right to control disposition of the remains. Arvin did not revoke the power of attorney. Even though he signed forms in hospice, where he did not check the box saying he had a power of attorney, that alone was not enough to evidence an intent to revoke his power of attorney. Even if those forms could be a revocation, the forms did not address burial arrangements and would not have revoked that part of the power of attorney. The fact that hospice sent the power of attorney to the company indicates that hospice did not view the forms as revoking the power of attorney.

   d. A decedent's last written directions concerning the disposition of his remains are to be carried out at his death. The power of attorney was signed after the will and therefore contained Arvin's last written directions concerning his remains and controlled over the conflicting provisions of his will and pre-need arrangements. It is not legally correct that a will also contains the final instructions concerning the remains.

e. Because the power of attorney authorized Robert to have control, the company committed no misconduct in arranging with Robert for their disposition. Robert's lack of awareness of the power of attorney did not negate its validity. The son did nothing to assert that his authority trumped Robert's or stop the company from giving the remains to Robert during the two-week period from Arvin's death to the delivery of the remains to Robert. The company was fully justified in releasing the ashes to Robert based on the power of attorney and Robert's representations. The company was bound to follow the power of attorney as Arvin's last written directions and therefore was not contractually bound to follow the pre-need agreement.

f. While the death certificate included inaccurate information about the place of disposition, the company was not aware at the time it was prepared that Robert would scatter the ashes off of Orange County rather than Los Angeles County. Because the power of attorney was signed after the forms with the company, it was not unusual that Robert's name would be added to the forms later, and there was no proof that the company created false documents to give Robert authority. Robert's authority was granted by Arvin under the power of attorney and not through the company's internal forms.

g. Because the company followed Robert's directions and acted in accordance with the power of attorney and applicable law, the company did not show disrespect to Arvin's remains. There is no evidence that the company misrepresented or concealed any material facts upon which the son relied to his detriment.

XXVI. Construction & Conditions

A. *In re Craig Living Trust,* 2018 N.H. LEXIS 163 (New Hampshire Supreme Court 2018). Trust code provisions applying rules of will construction to trusts do not incorporate pretermitted heirs statute into trusts.

1. Teresa died in 2016. Her son Michael predeceased her leaving two surviving children. Her other son Sebastian survived. Her 2012 will and revocable trust agreement did not mention Michael's children, and left all assets to Sebastian. The will (but not the revocable trust) provided that Teresa, except as otherwise expressly provided, made no provisions for her descendants intentionally and not as the result of any accident, mistake, or inadvertence.

2. Michael's children petitioned to be included as heirs, alleging that the pretermitted heir statute should be applied to the trust agreement as a result of the Uniform Trust Code provision that "the rules of construction that apply in this state to the interpretation of and disposition of property by will also apply as appropriate to the interpretation of the terms of a trust and the disposition of the trust property". While the suit was pending, the legislature amended the pretermitted heir statute to expressly state it did not apply to any trust. The issue was certified to the New Hampshire Supreme Court, which rejected the claim on the following grounds:

a. The pretermitted heir statute refers only to the "testator", the "will", and the devisees and legatees under a will, and does not refer to the settlor or the trust. In 2001, the New Hampshire Supreme Court declined to apply the statute to a trust absent an express legislative intent to do so (consistent with cases from other jurisdictions).

b. The adoption of the UTC in 2004, and its provision that "the rules of construction that apply in this state to the interpretation of and disposition of property by will also apply as appropriate to the interpretation of the terms of a trust and the disposition of the trust property", does not cause the pretermitted heir statute to be applied to a trust. The pretermitted heir statute is not a rule of construction, it is a rule of law - it does not merely provide guidance relative to construction and interpretation which the decision maker is free to accept or reject based on the circumstances. Rather, the statute states a conclusive rule that a child or descendant of a deceased child, that is not mentioned in a will and not included as a devisee or legatee will, is still a taker under the will unless there is evidence in the will itself that the omission is intentional. The court will not conclude that the legislature intended to abrogate the 2001 decision of the New Hampshire Supreme Court because it never stated such an intention, and is presumed to be aware of the common law.

XXVII. Issue, Beneficiaries, Paternity & Adoption

A. *Simms v. Estate of Blake,* 2018 Ky. App. LEXIS 132 (2018). Payment of court-ordered child support is not enough to avoid disinheritance of father from son's estate under Mandy Jo's Law due to willful abandonment.

1. Melanie and Bobby were never married and never cohabitated. They had a son, Brandon, in 1989 while Bobby was married to another woman. No father was listed on the birth certificate and Bobby did not take any steps to establish paternity or obtain visitation rights. Bobby provided minimal support and rarely saw or communicated with his son. When Brandon was 7, Melanie petitioned for and was ordered monthly child support of $281 from Bobby. The next year, Melanie and Brandon moved an hour away, after which Bobby only saw Brandon twice before his death (the last time when Brandon was 9 years old). In 2000, Melanie married Derek who acted in all respects as Brandon's father. Bobby claimed that Melanie asked him to stay away from Brandon, and he complied because he felt Derek was a good influence on Brandon.

2. Brandon died in a car accident in 2014, intestate, unmarried, and without descendants. At Melanie's request, Bobby did not attend the funeral. Derek and Melanie successfully sought appointment as administrators and falsely listed Derek as Brandon's father. Bobby was not notified at that time but, the next day Bobby's counsel contacted the estate counsel (who also brought a wrongful death action). The lawyers remained in contact while the wrongful death action was pursued. The total value of Brandon's estate was $12,500 and the wrongful death recovery (after payment of the one-third commission) was $100,000.

3. Bobby sued to assert a right to 50% of the estate and wrongful death proceeds, alleged that Melanie swore a false affidavit to allow her to settle the wrongful death claims and exclude Bobby, and brought claims for breach of duty, negligence, and fraud. He sought compensatory and punitive damages. The circuit court found that Bobby had abandoned the care and maintenance of his son and was foreclosed by Mandy Jo's Law from receiving a distribution from Brandon's estate or any wrongful death proceeds. Bobby appealed.

4. On appeal, a divided court of appeals affirmed (over one dissenting opinion) on the following grounds:

   a. Mandy Jo's Law provides that a parent who willfully abandons the care and maintenance of a child shall not have right to intestate inheritance or wrongful death proceeds, unless (i) care and maintenance is resumed at least one year before death or (ii) the parent was deprived of custody under a court order and complied with all court orders for support payments.

   b. Melanie made the initial error of failing to list Bobby on the probate papers, but the court cannot ignore the fact that Bobby received notice immediately after the appointment, did not object for several months, only took action after the Mandy Jo Law was raised as an issue, and by that time the court could not take any action to remedy the notice deficiency.

   c. The estate has the burden of proof of the application of Mandy Jo's Law. The law does not expressly state the standard of proof. As a matter of first impression in Kentucky, a preponderance of the evidence standard is appropriate because the case is a civil case and only money is at issue between the parties. The claims are not similar to a termination of parental rights claim where a higher standard is justified. The preponderance standard is consistent with North Carolina which has a similar law. No constitutional rights are at issue and the state is not involved, and the default civil standard of proof is appropriately applied to Mandy Jo's Law.

   d. It was proper for Melanie's personal counsel, and not the estate, to present proof supporting the application of Mandy Jo's Law because the estate is not the beneficiary of wrongful death proceeds (they are paid directly to the heirs even though the estate has standing to sue), and a state statute allows intestate heirs to bring and pursue claims.

   e. The lack of an order granting Bobby custody or visitation rights does not preclude application of the law. A court can restrict visitation rights, and if done, Mandy Jo's Law cannot be applied to prevent inheritance so long as the parent has paid court ordered support. This does not mean, however, that a parent has no obligation to provide love and support until a court enters an order – that obligation arises on birth, and while a court order is required to remove it, it is not necessary to create it. Bobby could have established paternity at any time and sought visitation but he did not do so. He took no action to assert his parental rights. The fact that he did not exercise his constitutional rights to visit his son did not relieve him of his parental obligation of care, and he cannot rely on the absence of an order he voluntarily chose not to request to escape Mandy Jo's Law.

f. The determination of abandonment is not based on a single factor, it is based on the total circumstances, including displays of affection and financial support. The mere payment of court-ordered child support is not dispositive. The words "care and maintenance" must be combined to define the parental responsibilities. A parent cannot avoid the law by abandoning the "care" while just paying the "maintenance". Bobby had no role in his child's life other than paying court-ordered support. There were 6,570 days between Brandon's birth and his 18th birthday, and Bobby could only recall seeing Brandon on a few of those days, and he was content to have Derek serve as the parent.

g. Melanie's request that Bobby not visit with Brandon does not give rise to estoppel that precludes Melanie from asserting Mandy Jo's Law, because she did not make a material misrepresentation.

h. One dissenting justice would bar Melanie from recovering under the doctrine of unclean hands as a result of her false statement on the probate papers.

B. *Hall v. Hall,* 2018 W. Va. LEXIS 345 (2018). Divided West Virginia Supreme Court holds that child may not inherit from biological parent who dies intestate after his or her parental rights to the child have been either voluntarily relinquished or involuntarily terminated.

1. Michael abused his daughter, Michaelin, and the Department of Health and Human Services filed a complaint against him. He voluntarily relinquished his parental rights, a court order terminated them as well, he was sentenced to a lengthy prison term for abusing his daughter, and his wife divorced him. He died in 2011, intestate, unmarried, and without issue other than Michaelin, but survived by his parents. Michaelin petitioned for the right to inherit the entire estate, Michael's parents objected, and the trial court awarded summary judgment in favor of the parents. Michaelin appealed.

2. On appeal, a divided West Virginia Supreme Court affirmed the trial court on the grounds that:

a. The Child Welfare Act, and the court, recognize that while termination may completely sever a parent's rights, certain of the child's rights persist, such as the right to continuing support. For example, a parent cannot voluntarily relinquish parental rights to avoid the child's right to support from a parent. Several states have adopted legislation to extend this principle to the right of inheritance through intestacy, but West Virginia has not done so.

b. Because Michaelin is seeking the right to inherit through intestacy, the Child Welfare Act is not controlling. The term descendant in the intestacy statute is defined with reference to the definition of "child and parent" contained elsewhere in the code – and both definitions, child and parent, must be met in order to inherit. The term child is not defined in the intestacy statutes. The term parent, however, is defined to include "any person entitled to take, or who would be entitled to take if the child died without a will, as a parent under this code by intestate succession from a child whose relationship is in question". A parent whose rights have been terminated does not meet this definition, because termination of parental rights terminated all rights of the parent and such a parent could not inherit the instate estate of the child.

c. A child may not inherit through intestacy from a biological parent who dies intestate after his or her parental rights to the child have been either voluntarily relinquished or involuntarily terminated. Any change in this law must be enacted by the legislature.

d. Two dissenting justices would hold that, while Michael's rights were terminated, Michaelin's rights were not terminated and remain intact, and remarked that the majority's disturbing decision piles even more hardship on a child whose life was already severely damaged by parental abuse and neglect. The court noted that the state provision was drawn from the Uniform Probate Code and that the majority was deviating from its understood meaning.

XXVIII. Disclaimers & Powers

A. *Estate of John O'Connor*, 2018 Cal. App. LEXIS 774 (2018). Will language is adequate to make specific reference to power of attorney and validly exercise the power, without naming the instrument creating the power.

1. Arthur and Hildis created a joint revocable trust agreement that was funded with an interest in a limited partnership that owned an apartment complex in San Diego. Arthur also created an insurance trust. Their planning (after various amendments) resulted, in part, in the creation of trusts for their son John. Under one trust, the trustees were required to make $1,000 monthly payments to John, and John had a testamentary general power of appointment. Under the other, the trustees had discretion to make distributions to John, but John did not have a power of appointment. The trust provision granting John the power of appointment provided for the distribution over the trust assets "as he shall appoint by a will specifically referring to and exercising this general testamentary power of appointment". The power was a general power only by allowing him to appoint to the creditors of his estate (otherwise he was required to appoint among the settlors' descendants other than himself). In default of the exercise of the power, and because he died without issue, the trust assets would pass to trusts for his siblings.

2. John died in 2014 survived by his wife but no descendants. Under his will dated two weeks before his death, he provided as follows: "I exercise any Power of Appointment which I may have over that portion of the trust or trusts established by my parents for my benefit or any other trusts for which I have Power of Appointment I exercise in favor of my brother Kevin O'Connor". His lawyer had drafted another will that referred to the instruments creating the power more specifically, but he did not sign that version of the will due to his final illness.

3. Kevin petitioned to probate the will and validate the exercise of the power of appointment in his favor. The other siblings objected and argued that the exercise of the power was invalid for failure to specifically reference the instrument creating the power. The trial court held that the exercise of the power was valid, and the siblings appealed. On appeal, the court of appeals affirmed the trial court on the following grounds:

   a. Under the California Powers of Appointment Act, a power can only be exercised by complying with any requirements about the manner, time, and conditions of the exercise specified in the creating instrument. If the

creating instrument directs that a power be exercised by specific reference to the power of the instrument creating the power, the exercise of the power must have the required reference. A required reference in the creating instrument precludes the use of form wills with blanket exercises of powers. A court cannot excuse compliance with a donor's specific reference requirement and the exercise of a power must reflect manifestation of the powerholder's intent to exercise the power.

b. John's will complied with the specific reference requirement of the trust, even though it did not name the instrument that created the trust. The trust terms did not require John to make specific reference to the trust instrument creating the power. The trust merely required reference to the power itself, and the court rejected outright the argument that John was required to identify the creating trust by name when the settlors did not impose this requirement. To hold otherwise would fail to recognize a distinction between a required reference to the instrument creating a power and a reference to the power itself, which is a distinction expressly made in the governing statute.

c. The trust does not define what amounts to a "specific reference" to the power. The objective is to ensure that the donee consciously exercised a particular power. The will supports an inference that John consciously and deliberately exercised the power granted by the trust terms. The will recites the existence of the power, the trust, and the donors. Because of these specific references, the will cannot be reasonably read as a blanket exercise of the power that presents a risk of John inadvertently or unintentionally exercising the power. The fact that John's exercise could apply to multiple trusts, where as a result of amendments by Arthur there was only one trust over which John had a power, does not require a different result.

d. John's attorney's testimony did not support an inference that the exercise of the power was a mistake or boilerplate. John exercised the power in favor of a permissible recipient, and the trust did not limit his ability to exercise in favor of his brother, and there is no legal reason not to give effect to his exercise.

B. *In re Trust FBO Samuel Frances DuPont,* C.A. No. 12904-MG (Delaware Chancery Court 2018; Master's Report). Divorce property agreement incorporated into a court order, in which husband agrees to exercise his limited power of appointment in favor of the children from the marriage, is not binding on a Delaware trust.

1. Ernest DuPont created a trust for the benefit of his son, Sam, in 1936. The trust terms gave Sam a testamentary limited power of appointment over the trust assets, with the assets not appointed passing to Sam's issue, *per stirpes*. The trust included a spendthrift clause.

2. Sam had three children from his first marriage to Helen DuPont. They divorced in 1962, and the trust did not participate in the divorce proceedings. A Nevada court approved the property settlement agreement in which Sam agreed to exercise his limited power of appointment over the trust assets in favor of their three children, and incorporated the report into its final order. That same

day, Sam executed a will exercising the power in the manner agreed. Also that same day, Sam married Jan Jeffries. He then adopted her children from a prior marriage. They remained married until Jan's death in 2010.

3. Sam desired to exercise his power of appointment so that trust assets could be used to preserve the family farm where he lived with Jan, and to benefit Jan's descendants, and did not want the assets to pass to the duPont children from his first marriage who were extremely wealthy by inheriting through their mother. Sam approached the individual co-trustee, who was also Sam's personal estate planning lawyer, about preparing a new will. On the lawyer's advice, Sam obtained a legal opinion from another attorney that the settlement agreement was not enforceable against the trust (but that his duPont children might have a claim against his estate if he breached the settlement agreement).

4. In March of 2015, Sam executed a will that exercised the power of appointment in favor of Jan's granddaughter in a trust that also allowed the use of trust assets to maintain Sam's family farm. His three duPont children were listed only as remote contingent beneficiaries. Sam died 5 months later.

5. After Sam's death, the trustees petitioned the court for instructions about the validity of the divorce settlement agreement and Sam's exercise of the power of appointment. Jan's granddaughter and the duPont children asserted competing claims to the funds, and all parties moved for judgment on the pleadings.

6. The Master issued a final report finding that the settlement agreement incorporated into the Nevada divorce decree did not bind the trust, or represent a partial release of Sam's power of appointment, and it was not appropriate to impose a constructive trust over the assets, on the following grounds:

   a. A contract to exercise a testamentary power of appoint is not valid in Delaware (as was also held in the 2016 case of *Estate of Tigani*). The donor of a testamentary power of appointment, or any power that is not presently exercisable, intends that the selection of the appointees be made in light of future circumstances, and the donor requires the donee to "wait and see" and account for later facts before exercising the power. Contracting away that power defeats the donor's intent by eliminating the ability to change the appointment any time before death, and in Delaware the donor's intent controls.

   b. A contract to exercise a testamentary power of appointment also involves property interests to which the donee has no claim, and therefore cannot dispose of during lifetime. The trust property remained the donors, and Sam had no property interest he could bargain away. Sam's exercise of the power of appointment in the settlement agreement was legally ineffective because the property was not his to encumber. Accordingly, Sam's exercise of the power under his will controls.

   c. Sam, however, breached the settlement agreement and the duPont children could seek restitution from Sam or his estate. However, they failed to bring a claim against the estate within the statute of limitations.

d. The Nevada order is not entitled to full, faith, and credit, and *res judicata* and collateral estoppel do not apply, because under the law of Nevada as the rendering state and similarly under Delaware law: (i) the trustee and the trust were not parties or in privity with the parties to the divorce action; (ii) the Nevada court did not have jurisdiction over the trust, trustees, and contingent beneficiaries; (iii) Sam was not in privity with the trust and their interests were not aligned at that time; and (iv) the settlor's intent was in direct conflict with the settlement agreement.

e. This suit was not a collateral attack on the Nevada judgment. The trust is not barred by laches or unclean hands from challenging the validity of the settlement agreement due to the 50 year delay in raising the issue, because: (i) nothing that could have been done earlier could affect the primacy of the donor's intent and the agreement was invalid under longstanding Delaware law; (ii) the defenses of laches and unclean hands were not asserted in the responsive pleadings and were waived; and (iii) it would be premature for the trustee to file this petition before Sam's death because the exercise of the power of appointment did not take effect until that time.

f. The settlement agreement was not a partial release of Sam's power of appointment because the agreement on its plain language was clearly a contract to appoint and not a release, and the plain language makes it impossible to view it as a release.

g. The conduct of the trustee (who was also Sam's personal estate planning lawyer) was not inequitable such that it would cause a different result by imposition of a constructive trust because: (i) while Sam breached the settlement agreement, that is a claim against Sam and his property and does not give rise to claim against the trust or the trust property; (ii) the trustee was not required to share the information he learned about Sam's estate planning, in the capacity as his planning counsel, with the trust beneficiaries; (ii) even if he could share that information, Sam could have changed his plan at any time and it is not reasonable to expect that the beneficiaries would be notified any time Sam changed his estate plan; and (iii) he did not violate his duty of impartiality because any information he shared with Sam's granddaughter was done in his capacity as counsel, and not as trustee, and was done at Sam's direction.

h. The trustee did not breach his duties and his attorneys' fees should be paid from the trust. Because all parties had reasonable positions and the suit resolved ambiguities that facilitated trust administration, the fees of all other parties should also be paid out of the trust.

C. *Matter of Bruce,* 2017 NY Slip Op 30967(U)(2017); 2018 N.Y. App. Div. LEXIS 3871 (2018). Trial court applies rules of construction to cure flagrant fraud on a power of appointment. Appellate division affirms.

1. Ellen created two trusts for the benefit of Louise, one under agreement and one under will. The trust terms gave Louise a testamentary limited power to appoint the trust assets to anyone other than herself, her estate, or the creditors of either, and in default of appointment the trust assets passed to Ellen's issue. Under her will, Louise gave her estate to a foundation to be created in her name, and exercised her limited powers of appointment "to my Executor, to be added to my residuary estate".

2. Ellen's heirs challenged the validity of the exercise (as an invalid fraud on the power), and the surrogate granted summary judgment that the exercise of the power was valid on the following grounds:

   a. The exercise of the power must be read in the context of the trust as a whole, and "must not be taken literally unless the daughter's intention or purpose is to be sacrificed in a process by which the court doffs its common sense".

   b. It is untenable to argue that a donee of a power would take the trouble to purport to exercise it in a manner that she knew would be a nullity – this is a simple question of whether the daughter intended to say that she appointed the remainders to her estate despite her knowledge that her saying so had to be useless.

   c. This mandates construction of the exercise to distribute the assets to the "executor" not as agent for the daughter's estate, but as agent for the foundation that her will commissioned him to establish. The direction to "add" the assets to the residuary estate can "plausibly" be recognized as a maladroit way of directing the executor to give the remainders directly to the entity designated as the residuary legatee, as supplements to the benefits it were to receive as estate beneficiary.

   d. This is an instance wherein a literal fulfillment of the language found would lead to a setting at naught of dispositions which, beyond any reasonable doubt, we know were intended by the donee of the power.

3. On appeal, the appellate division affirmed the surrogate's decision as carrying out the decedent's intent as gleaned from a sympathetic reading of the will as an entirety and in view of all of the circumstances.

XXIX. Insurance

A. *Whisenant v. McKamie,* 2018 Ark. App. 87 (2018). In Arkansas, a will can change the beneficiary of a life insurance policy.

1. Sam and Kindell were married in 2010. Sam's brother took him to see an insurance agent and Sam purchased life insurance in 2012. His brother gave him money for the payment of the premiums. Sam and Kindell divorced in 2014 (and without having children). Sam asked the agent to change the beneficiary of the policy to be his father and filled out the form, but the agent never sent the form to the company headquarters. Sam, however, signed a new will in 2015 that gave his father "any proceeds from any life insurance", stated his intent that his ex-wife not receive the proceeds, and that he intended his will to prevail over any beneficiary designations made in favor of Kindell. He also made specific reference to the policy "purchased by" his brother, although the policy showed Sam as the purchaser and the evidence was that the brother provided Sam with money around the time of the purchase.

2. Sam died in 2016, the insurance company interpleaded the proceeds, and the estate and Kindell made competing claims to the funds. The trial court granted summary judgment in favor of the estate and Kindell appealed. On appeal, the court of appeals affirmed on the following grounds:

a. The general rule is that an insurance beneficiary is to be changed in the manner provided in the policy and attempted changes by will are ineffectual. However, since 1937 by case law, Arkansas allows a will to change the beneficiary of a life insurance policy if the will sufficiently identifies the policy and states an intent to change the beneficiary.

b. Kindell admitted that Sam intended to change the beneficiary of the policy.

c. Sam adequately identified the policy by stating it was on his life, that it named Kindell as beneficiary, and that it was purchased on his brother, because it was not disputed that Sam only obtained one policy on his life, and he intended to change the beneficiary of any policy. There is no allegation that Sam could have been referring to another policy.

B. *Feola v. Morello,* No. 340008 (Mich. App. Unpub. 2018). Claims that trustee of ILIT should have stopped paying insurance premiums earlier dismissed as based on speculation.

1. In the mid-90s, Jeannine created an ILIT that was implemented by her attorney as independent trustee. The beneficiaries were her nieces and nephews, and her niece Feola served as family trustee. The annual premium payments on the $500,000 were $15,000. In 2014, the trust funds were in danger of depletion and Palazzo and the trustee decided to cash out the insurance policy for a cash value of $36,000. Jeannine died unexpectedly a few days after cashing out the policy.

2. Feola filed an objection to the trustee's accounting, alleged that the trustee failed to properly monitor the funds, and alleged that the failure to provide progress reports and other information to the beneficiaries (such as the cost and risks of the policy) for 18 years led to a loss for the beneficiaries. She did not object to the creation of the ILIT. She admitted that Jeannine and the trustee made the decision to cancel the policy after considering other options, but argued that the trustee put them into a position of needing to cancel the policy because the trust had fallen into bad financial shape. The trustee moved for summary dismissal which the trial court granted on the grounds that the claims were based on pure speculation. Feola appealed.

3. On appeal, the court of appeals affirmed the summary dismissal of the claims on the following grounds:

   a. Even assuming the trustee should have provided more information to the beneficiaries, there is insufficient evidence about what would have been done differently had he done so. Feola admitted it was speculation that the beneficiaries would have had the settlor stop paying policy premiums. While an accountant called by Feola said "obvious modifications" could have been made to the policy, he did not provide any specifics and admitted his conclusions were based on speculation. He later stated that the trustee should have renegotiated the premiums or looked for a better deal with another carrier, but provided no specifics about whether such actions would have been successful. Their testimony did not rise above the level of speculations.

b. The estate planning lawyer called by Feola testified that the trustee deprived the beneficiaries of the opportunity to take corrective action to protect their interests, such as exploring with their aunt other options for investing that $15,000 annual premium. She also averred that the beneficiaries would not have allowed their aunt to continue to pay the premiums. However, she did not state when the trust assets became devalued such that premiums were no longer "worth it", and suggested that damages be awarded for all premiums paid for the policy even though Jeannine willingly paid the premiums when initially establishing the trust. She also provided no basis for her testimony that the beneficiaries would have not allowed the aunt to pay premiums, and no evidence that they could stop her from doing. She admitted that it was merely speculation that the policy would have been cancelled if the family had received updates from the trustee about the financial status of the trust assets.

c. While the timing of events was unfortunate, Feola failed to provide evidence how the ultimate circumstances would have differed even if the trustee had been more proactive in obtaining and distributing information about the trust.

C. *Jo Ann Howard & Associates v. Cassity,* 2017 U.S. App. LEXUS 15621 (8th Cir. 2017); 2018 U.S. Dist. LEXIS 197542 (2018). Trustee of preneed funeral insurance trusts owes duties to funeral homes and consumers who have standing to sue, and claims against the trustee arise under trust law, are tried to the court and not a jury, and the damage measure is determined by trust law. Claims for aiding and abetting a fraud are rejected as not having been recognized under Missouri law. On remand following appeal, the trial court largely rejected attempts to narrow the court's discretion to award damages through summary judgment motions.

1. The Cassity family owned National Prearranged Services, Inc. (NPS), a Missouri-based company that engaged in a nationwide fraud scheme involving selling of preneed funeral insurance contracts. The Cassity family also owned two Texas insurance companies. The preneed contracts required the current payment of money (at a fixed price) in consideration for later provided funeral services at the time of death, at the funeral home of the purchaser's choosing. NPS sold the contracts, and under state law was allowed to keep 20% of the proceeds and was required to place 80% in a trust with a corporate trustee (the trust terms were largely dictated by state law). The trustee was to invest the funds, but where the assets exceeded $250,000, NPS was allowed to appoint an independent qualified investment advisor. After a funeral, the funeral home would certify it provided services, NPS would pay the home the amount in the contract plus a "growth" payment to adjust for inflation, and then NPS was entitled to a trust distribution equal to all deposits made with respect to that contract purchaser.

2. A bank became trustee of the NPS trusts in 1998. At that time, NPS had already appointed Wulf Bates & Murphy (Wulf) as investment advisor, and Wulf remained as advisor for the duration of the bank's trusteeship. Wulf used the trust assets to purchase life insurance on the lives of NPS's preneed consumers so that when one died (and NPS would have to pay for funeral services), the life insurance companies also owned by the Cassity family would pay life insurance proceeds into the NPS trusts. The bank was acquired

by a larger national bank that did not want to become trustee of the NPS trusts, so the trusteeship was assigned to another bank that assumed duties in 2004. At the time the national bank acquired the trustee bank, the trusts held $122.9 million in deposits and $159.8 million in insurance coverage. In 2009, yet another large national bank acquired the prior national bank, and the acquiring national bank's liability in this case was derived solely from its acquisition of the prior national bank that had acquired the liability of the original bank trustee.

3. In 2007, insurance regulators discovered that NPS had engaged in a massive national fraud for serval years in which: (a) the insurance company issued loans to NPS without trustee approval and despite the fact that loans should only have been issued to the trusts, depleting the trust assets; (b) NPS manipulated the payment amounts on policy applications allowing it to retain most of the money that should have been sent to the trust (i.e. where a consumer paid $1500, NPS changed the amount to $5, send $5 in, and keep the balance). As a result of the fraud, a Texas court placed NPS and the insurance companies into receivership, which triggered coverage by the state guaranty associations that made sure the obligations to consumers to pay funeral expenses were met. The entities agreed to a liquidation plan as well.

4. In 2009, parties on behalf of NPS (in receivership), the funeral homes, and consumers sued the final acquiring national bank for the alleged breaches by the original bank trustee, alleging negligence, breach of duties as trustee, aiding and abetting fraud, allowing the fraudulent loans, failure to account and keep accurate trust records, allowing NPS to manipulate trust assets and siphon millions of dollars from the trusts, and aiding and abetting the breaches of duty by Wulf and fraud by NPS.

5. The bank moved to strike the jury demand, asserted that all claims should be brought only under trust law, and claimed that only NPS was a trust beneficiary allowed to bring claims (and had waived those claims by giving consent). The district court rejected all of the bank's positions (other than dismissing the aiding abetting claims as not being recognized under Missouri law) and allowed the case to proceed to a jury trial. The jury awarded the plaintiffs $355.5 million in compensatory damages and $35.55 million in punitive damages. The bank's post-trial motions were rejected and the district court entered judgment on the jury verdict. Both sides appealed.

6. On appeal, the 8th Circuit Court of appeals affirmed in part, reversed in part, and remanded the case on the following grounds:

    a. The trust beneficiaries are NPS, consumers in Missouri, and the funeral homes that were to provide services to those consumers under the preneed contracts, because: (i) a beneficiary is a person who benefits from a trust, is intended to benefit from the trust, or who has a right or expectancy in a trust; (ii) under the statutory scheme, trust principal was distributed only to NPS, but the whole purpose of the trusts was to ensure funding for funeral services, 80% of the contract sales were placed in the trusts to guarantee that money would be available to pay for funerals, and funeral homes would likely not agree to perform services without a guarantee of funds for payment; (iii) if NPS failed to make any payments, the consumers and funeral homes were entitled to a trust

distribution in an amount equal to all deposits made for the preneed contract, making the consumers and funeral homes more than mere "incidental beneficiaries"; (iv) if NPS were both settlor and sole beneficiary, NPS could unilaterally compel trust termination contrary to the trust purposes; and (v) any defense that the trustee's actions were authorized by a beneficiary does not apply to the consumers and funeral homes, and was properly rejected by the district court.

b. The bank cannot escape liability because of the involvement of an investment advisor because: (i) the statutes also provide that control of investments shall not be divested from the trustee and investments must not be beyond the authority of a reasonable prudent trustee to invest in; and (ii) the bank could not be relieved of all investment responsibility because that would not give effect to the statutory requirements, and a trustee has a duty to ensure the trust assets are prudently invested, regardless whether the trustee is investing or monitoring the investment decisions of the investment advisor, and the trustee is only relieved of liability where Wulf invested the assets in the manner of a prudent trustee.

c. The claims against the trustee were trust law claims, and should have been tried to the court rather than to a jury. There is an exception for a claim of indebtedness where a trustee has a duty to pay money or property immediately and without conditions to a beneficiary and fails to do so, but that does not apply here, and a breach of trust claim does not become an indebtedness claim merely because the trust has since terminated. Prior cases that allow jury trials arising from "deeds of trust" are irrelevant because a deed of trust is a mortgage and not an actual trust.

d. The claims against the trustee for aiding and abetting fraud and breaches of duty were properly dismissed because Missouri has not yet clearly recognized those causes of action, and the federal courts of appeals are cautious in expanding state-law theories of liability. Here, the plaintiffs are attempting to use this new theory of liability to circumvent the damages limitations of trust law as applied to the same conduct, and the court will not recognize the new cause of action in that context.

7. On remand the district court resolved competing motions for summary judgment as follows:

a. The court rejected the bank's assertion that it is shielded from liability if the investment advisor invested in investments that were within the authority granted under the trust agreement. The court held that the bank's position was an overbroad interpretation of the 8th Circuit decision and would completely eviscerate the trustee's duties to ensure prudent investments were made. Simply ensuring the types of investments are within the authority granted in the trust agreement is not enough to relieve the trustee of liability, although the trustee is not required to check every single investment made by the advisor. The court declined to determine on summary judgment whether the advisor was independent because of a dispute over material facts.

b. The awarding of prejudgment interest is within the equitable discretion of the court and the court denied summary judgment on the issue.

c. Because the evidence related to breaches of trust was in dispute, the court declined to award summary judgment on the issue of the availability of damages for losses to the trust or disgorgement of profits, but noted that while those remedies may be mutually exclusive when applied to a single incident of breach, where multiple breaches are proven the court would have discretion to apply different remedies to each proven incident of breach.

d. The court may be permitted to order disgorgement of profits as a remedy for breach, whether or not improper use or disposition of trust assets occurred in connection with the breach. Restatement (Second) of Trusts Section 205 does not define "profits". The alleged premium paid to shareholders for their bank stock when sold to another bank (over the value that would have been paid if the liabilities were known at the time of sale) is not a "profit" to the bank because corporations are distinct form their shareholders, there have been no allegations to support piercing the corporate veil, and therefore the stock price premium paid to the shareholders is not recoverable in this action.

XXX. Torts, Slayers, & Bad Actors

A. *Archer v. Anderson,* 2018 Tex. LEXIS 611 (2018). Texas Supreme Court refused to recognize tort of intentional interference with inheritance.

1. Jack Archer executed a 1991 will that left his $7.5 million estate to his brother, other than gifts of $90,000 to 12 Christian charities. In 1998, after a stroke, his capacity sharply declined. Shortly thereafter, Jack's longtime friend (who was an attorney) prepared and had Jack sign documents naming him as Jack's agent, even though the medical records showed significant delusion and confusion on the date they were signed. The agent then tried to compel Jack to sell his ranch and Jack objected. The agent then hired attorneys to draft new estate planning documents for Jack (the planning lawyers never met with Jack and took their instructions only from the agent). The brother filed guardianship proceedings for Jack, Jack's new lawyers consented to the appointment of temporary guardians (and stated that new estate planning would need to wait due to incapacity), the agent fired the lawyers from the guardianship action and hired new counsel that withdrew from the guardianship, and the agent had Jack sign new estate planning documents that disinherited the brother and left the entire estate to the charities.

2. The brother refiled the guardianship action and the court appointed a guardian over the agent's objection. The brother contested the new estate planning documents while Jack was still alive and settled the case with the charities by agreeing that the new documents would not be respected or probated and that the charities would receive only Jack's coin collection with a value of $600,000. The brother then sued the agent on Jack's behalf for breach of duty, intentional infliction of emotional distress, and legal malpractice. The brother also successfully sued others on Jack's behalf and settled those claims for hundreds of thousands of dollars.

3. The agent died in 2006 and Jack died a month later. The brother received the bequest under the 1991 will. In 2007, the brother sued the agent's estate for intentional interference with inheritance to try to recover the $600,000 they

paid to settle claims with the charities and their $3 million in attorneys' fees in the litigation. The jury found in the brother's favor but awarded only $2 million in damages. The trial court entered judgment on the verdict and added back an additional $600,000 in damages. Both sides appealed.

4. On appeal, a divided Texas Supreme Court reversed and held that Texas would not recognize the tort of intentional interference with inheritance on the following grounds:

   a. The Texas Supreme Court has never recognized the tort, and the lower courts should not recognize it in the first instance. There is a split in the courts of appeals as to whether the cause of action exists under Texas law. Existing remedies are not inadequate merely because they do not provide the relief a tort would. The fundamental difficulty with the tort is that it claims for the judiciary the authority to supplant or augment probate law and settled remedies and principles whenever they are perceived to be unfair. The waste of public and private resources should be avoided by answering the unresolved question and holding that the tort is not recognized in Texas.

   b. The probate law protects a donor's freedom of testation. The tort gives the beneficiary his own right that he does not otherwise have. That right may or may not protect the donor's right of testation. A beneficiary's interests and motives and those of his donor may be consistent, but they may also conflict. Family relationships and feelings change. An expectancy is powerful motivation to ignore reality and misperceive a donor's true intent. A prospective beneficiary has no right to fairness, he gets only what the donor chooses to give, fairly or unfairly. Probate law protects that choice. Tort law is ill-suited to posthumous reconstruction of a decedent's intent. A donor may not wish to disclose his true intentions during life and risk offending family and friends. Probate law has special doctrines and procedures to derive the true intent. These carefully developed doctrines take into account the context of nuanced family dynamics and customs that are often inaccessible to outsiders. The evidentiary rules and procedures in probate law strike a balance between honoring a testator's actions and addressing situations where actions were wrongfully taken. These provisions were enacted by the legislature and should be respected. It is not prudent for the court to recognize a new tort simply because the probate procedures sometimes present hardships or even bar a recovery. A new tort should only be available where the court lacks the power to provide redress. But limits on the probate court's power are among the limits and procedures of probate law with which the tort is not meant to interfere. Given probate law's extensive and thorough provisions to protect freedom of testation, the lack of further remedies must be viewed not as legislative oversight but legislative choice.

c. The argument that the tort is a necessary gap-filler is not compelling. The laws of probate and restitution thoroughly govern inheritance and provide remedies for unfairness, such as through imposition of a constructive trust. Restitution law is itself a gap-filler that is sensitive to the rules of procedure, standards of proof, and limitations periods of probate law, such that it cannot be used to circumvent probate procedures. Suits on established torts, such as fraud, conversion, theft, and breach of duty, and also suits for declaratory judgment, may also be available. The court is not persuaded that all of these causes of action are inadequate in providing remedies.

d. The fact that a plaintiff estate may not recover attorneys' fees under probate law (and that the fees diminish the interest of the heirs) does not require recognizing a new tort. The rule that the costs of a good faith contest are paid by the estate is established by probate law. While good policy arguments might be made that the rule punishes the innocent and does not deter wrongdoing, this does not make the probate law inadequate or allow courts to circumvent legislative policy. If standing is not allowed under probate law (despite its notable breadth), or relief is lacking, the reason is legislative choice and probate proceedings should not be retried in a tort action. The limits of restitution simply recognize that not every wrong can be remedied.

e. In settling the probate action, the brother chose not to seek attorneys' fees against the charities and to pay the charities' attorneys' fees. The law also provided the brother with multiple causes of action against the agent. The brother's desire for a probate process that differs from the one created by the legislature on the issue of attorneys' fees does not justify creating a new tort.

f. The tort is invoked in a great many cases and the bench, the bar, and the public deserve a straight and clear answer. The court is concerned about elder financial abuse, but the state's extensive probate laws and legislative improvements to guardianship law to redress abuse are the right path to address that concern, and not a judicial expansion of tort law. Any expansion of tort law in this respect should be left to the legislature. Tort law should not provide a remedy that disregards the limits of statutory probate law. The tort of intentional interference with inheritance is not recognized in Texas and the decision of the courts of appeals to the contrary are overruled.

B. *Mulvey v. Stephens,* 2018 Fla. App. LEXIS 9093 (2018). Absence of wrongful conduct precludes claim for tortious interference with expectancy.

1. While married to his first wife, Jack created a revocable trust to hold property in St. Lucie County that the family called the "ranch". After his first wife died, Jack married Thelma. They did not combine their finances. Jack tried unsuccessfully to sell the ranch, sometimes with the help of his daughter Sheila. Eventually, Jack pulled the ranch out of the revocable trust and sold it to his friends for a $500,000 note. In 2010, Jack signed a new will that revoked his 2005 pour-over will (that would leave property to a trust that benefitted his children) and left all of his residuary assets outright to Thelma.

2. Jack died in 2011, Sheila contested the new will on the grounds of lack of capacity and undue influence, and the court held that the will was valid and

that there was no evidence of mental impairment. Sheila then sued Thelma alleging tortious interference with expectancy. The trial jury found in Sheila's favor and awarded her damages in the amount of $60,000. Thelma appealed.

3. On appeal, the court of appeals reversed and held that the trial court should have granted Thelma's motion for judgment notwithstanding the verdict on the following grounds:

   a. Sheila admitted that there was no direct evidence of intentional interference. Merely changing a document such as a will or trust is insufficient because there must be a showing of improper actions by the alleged tortfeasor. Here there was no evidence of an independent tort.

   b. There was no evidence that Thelma interfered with Jack's property. Jack removed the ranch from the trust and placed it in his and his wife's names as a way of paying her back for large loans she had made to him. There was also no evidence that Thelma lied to Jack. Even if she said that Jack's children hoped he died so they could inherit and complained about the care she provided him when he needed extraordinary assistance, those statement came after he had already removed the ranch from the trust and sold it. There was also no clear evidence that Thelma interfered with his relationship with his son who was in prison.

C. *McKay v. Thomas,* 2018 Ohio App. LEXIS 4469 (2018). Tearing up draft pour-over will is not sufficient to support claim for intentional interference with expectancy.

1. William and Clara were married in 1991. In 2010, William executed a will and revocable trust that left his land and tangibles to Clara outright, and established a trust for her benefit with the balance of the assets (over which Clara had a withdrawal right). In 2014, William discussed a new will and revocable trust with his counsel. That month, the lawyer brought a draft new will to William at the hospital, but due to quarantine he was not allowed to see him. He asked the nurse to give the draft will to him. He had not yet drafted the new trust. Clara reviewed the draft will and destroyed it, stating it contained factual inaccuracies. William died the next month and Clara probated the 2010 will, transferred the assets to the 2010 revocable trust for her benefit, and pursuant to the trust terms withdrew the trust assets.

2. The disappointed heirs (William's great niece, great-great nephew, and great-great niece) sued Clara for intentional interference with expectancy (and additional claims they conceded were derivative to this claim). Clara moved for summary dismissal which the trial court granted. The disappointed heirs appealed. On appeal, the court of appeals affirmed on the following grounds:

   a. Ohio does recognize the tort of intentional interference with expectancy.

   b. The will that Clara destroyed was a pour-over will to a new revocable trust that had not yet been drafted by counsel. There was no allegation that Clara interfered with the drafting, review, or execution of a new revocable trust. It was conceded that the new trust was never drafted. Any suggestion of a new oral trust by William failed because of the requirement that trusts receiving a pour-over bequest be in writing and executed simultaneously with or prior to the will with the pour-over clause.

c. Because the residue could not be poured-over to the new trust, if the will had been signed the residue would descend to Williams's next of kin by intestacy, and Clara was the intestate next of kin. Because even if the will had been signed the assets would have passed to Clara, it cannot be proven to a reasonable degree of certainty that the expectancy of inheritance would have been realized but for Clara's interference.

XXXI. Third Party Liability

A. *Cortese v. Sherwood,* 2018 Cal. App. LEXIS 746 (2018). Third-party claim against attorney for aiding a trustee in a breach of trust must comply with pre-filing requirements for conspiracy claims against attorneys.

1. Over their 23-year marriage, Francesca and Robert acquired significant wealth in excess of $2 billion. Their long-time attorney handled all of their legal matters including estate planning. The attorney drafted Francesca's will that left her $2 million estate to her daughter from a prior relationship, Christina.

2. Christina claimed that, after mother's death in 1997, she did not challenge the modest size of her mother's estate because Robert and the attorney assured her that she would be wealthy when she inherited through Robert's estate plan. Christina alleged that Robert said he intended to include her equally as a child in his estate plan, and leave her a golf course in Marbella, Spain. When the value of her mother's estate (then in a marital trust for Robert) dropped from $31 million to $16 million, she claimed she was induced not to act on her concerns about Robert's management of the trust by the promises of future inheritance by Robert and the attorney. In 2008, Robert and the attorney proposed commuting the trust, Christina had questions about the relatively modest value of the trust as part of the overall marital wealth. She alleged she was induced not to assert the issue by the repeated promises of a large future inheritance.

3. Robert died in 2016, and the trustees of Robert's trust (one of whom was the attorney) informed Christina that she was not a beneficiary of Robert's estate.

4. Christina sued the attorney for breach of fiduciary duty as trustee of Robert's trust, for third party liability for breach of trust. The attorney demurred to the claim for third party liability for Robert's breach of trust because the claim did not comply with the statutory pre-filing requirements for conspiracy claims against attorneys. The trial court rejected the demurrer and the attorney appealed.

5. On appeal, the court of appeals reversed and ordered the trial court to sustain the demurrer to the third-party claim on the following grounds:

   a. By statute, a party must establish a reasonable probability of prevailing before pursuing a cause of action against an attorney for a civil conspiracy with his client arising from any attempt to contest or compromise a claim or dispute. That section does not apply where the attorney had an independent legal duty to the plaintiff or the attorney's acts go beyond the performance of a professional duty to serve the client and involve a conspiracy to violate a legal duty in furtherance of the attorney's financial

gain. The statute was enacted to combat the use of frivolous conspiracy claims brought as a tactical ploy to disrupt the attorney-client relationship. The exceptions to the statute mirror prior case law.

b. The second cause of action are based on the allegations that the attorney conspired with Robert to attempt to contest or compromise a claim or dispute. She claimed that the attorney induced her not to challenge Robert's actions as executor and trustee of his wife's estate and trust, by representing she would receive a large inheritance from Robert's estate. The court cannot conceive how the attorney could have participated in Robert's alleged breaches of fiduciary duty without an implied agreement to do so. If the allegations are taken as trustee, there must have been an agreement between Robert and the attorney to effectuate a common plan or design. While state law recognizes a cause of action for participation in a breach of trust, the tort is dependent on the trustee's breach of duty. While there may be a third-party cause of action that does not involve a claim of conspiracy, this is not the case here. Here the allegations imply an agreement between Robert and his attorney, and the claims are that the attorney participated in and assisted Robert in his breaches.

c. The pre-filing requirements apply to conduct that arises from an attempt to contest or compromise a claim or dispute. The dispute did not need to mature into actual litigation for the pre-filing requirement to apply.

d. The statutory exceptions do not apply because: (i) there is no allegation that the attorney represented Christina, he represented only Robert, the client here was Robert as fiduciary alone and not the beneficiaries; (ii) there is no allegation that the attorney's statements to Christina were false when made in 1997 and 2009, and Robert could have changed his estate planning documents after that time, and therefore there is not a sufficient allegation of fraud; (iii) there is not allegation of conduct by the attorney that was beyond his work for his client and, as Robert's attorney, the attorney had no duty to protect Christina or advocate for her benefit; (iv) there is no allegation that the attorney was negligent in providing advice to Christina; (v) the allegations were that the attorney was following his client's instructions; (vi) there is no duty by the attorney to ensure that Robert kept his promises to Christina; (vii) there is no allegation that the attorney personally gained from the actions; (viii) allegations that the attorney was paid for legal work are not adequate; and (ix) allegations that the attorney's son was employed by one of Robert's companies are not enough because the alleged wrongful conduct occurred after the son was employed and therefore the attorney's conduct could not have been motivated by a desire to obtain a benefit for his son.

South Carolina Bar

Continuing Legal Education Division

The Year in Review: An Estate Planning Perspective of Recent Tax Developments

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The Year in Review: An Estate Planner's Perspective on Recent Tax Developments

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AN ESTATE PLANNER'S PERSPECTIVE ON RECENT TAX DEVELOPMENTS: THE YEAR IN REVIEW

By

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I. INTRODUCTION

The past year has witnessed substantial changes in the estate, gift and generation-skipping transfer (GST) taxes and in the income tax laws relating to estate planning.

This outline summarizes the legislation, regulations, revenue rulings and procedures, regular decisions of the Tax Court, the Claims Court and the courts of appeals, as well as selected district court and Tax Court memorandum decisions, private rulings, notices, announcements and other Service and Treasury documents from the past year.[2] This outline includes those developments reported publicly from June 1, 2018 through June 28, 2019.

The tax developments in this outline are divided into 5 categories: Income Taxes, Estate Taxes, Gift Taxes, Generation-Skipping Transfer Taxes, and Special Valuation Rules.

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[1] The author thanks Probate Practice Reporter for permission to use material published in that journal. Subscriptions to Probate Practice Reporter, of which this author is the tax editor, may be obtained at http://www.probatepracticereporter.com/Subscribe.asp.

[2] Private letter rulings (PLRs) and technical advice memoranda (TAMs) are not legal precedents. IRC § 6110(k)(3). They may, however, show how the Service might address a similar case, and they have been cited and discussed by several courts. See, *e.g., Wolpaw v. Comm'r*, 747 F.3d 787 (6th Cir. 1995), *rev'g* T.C. Memo. 1993-322 (taxpayers can rely on 20-year old PLR, absent definitive regulations); *Xerox Corp. v. United States*, 656 F.2d 659 (Ct. Cl. 1981) (stating that PLRs are useful in ascertaining the scope of the doctrine adopted by the Service and demonstrating its continued and consistent application by the Service); *Estate of Blackford v. Comm'r*, 77 T.C. 1246 (1982) (noting that the Service litigation position was contrary to a prior PLR); *Hardy v. Comm'r*, T.C. Memo. 2017-17 (during litigation, IRS released a TAM presenting the same issues as this case, and the court ordered supplemental briefs, and in its opinion, the court stated that "[a]lthough the technical advice memorandum is not precedential [footnote citing Sec. 6110(k)(3)], it shows that the Hardys' grouping was not clearly inappropriate"); *Fanning v. United States*, 568 F.Supp. 823 (E.D. Wash. 1983) (noting that a distinction between the facts of the instant case and those of prior cases had been cited in a TAM, and that TAMs are often relied upon by the courts).

All references to "IRC" or to "Code" are to the Internal Revenue Code of 1986, as amended to date, unless otherwise specifically indicated. References to "Regs" are to the regulations of the Treasury Department, unless otherwise specifically indicated.

Each category is arranged by Internal Revenue Code section, except that a few consolidated discussions examine the developments relating to family partnerships and LLCs, grantor trusts, charitable remainder trusts, and various procedural rules.

There is also an additional section, "Selected Attachments," that includes discussions of certain cases that affect tax planning indirectly, sample forms illustrating some of the planning techniques discussed in this outline, and other related items, such as relevant portions of the IRS "no-rulings" list and the Treasury/IRS Priority Guidance.

II. INCOME TAXES

A. IRC § 1. Income Tax Rates

1. Income Tax Rates Adjusted for Inflation. Rev. Proc. 2018-57, 2018-49 I.R.B. 827 (Dec. 3, 2018)

The 2019 income tax rates for trusts and estates under Section 1(e) are as follows:

Income	Rate
Not over $2,600	10%
Over $2,600 but not over $9,300	$260 + 24% on excess over $2,600
Over $9,300 but not over $12,750	$1,868 + 35% on excess over $9,300
Over $12,700	$3,075.50 plus 35% on excess over $12,750

The kiddie tax applies to net unearned income over $1,100, and a parent can elect to include in gross income up to $11,000 of a child's income in 2019. IRC § 1(g)(4)(A). See also discussion of proposed Tax Technical and Clerical Corrections Act, below.

2. Proposed Tax Technical and Clerical Corrections Act would Modify 2017 Changes in the Kiddie Tax. See Staff of the Joint Committee on Taxation, 115th Cong., 2d Sess., *Technical Explanation of the House Ways and Means Committee Chairman's Discussion Draft of the "Tax Technical and Clerical Corrections Act"* p. 2-3 (Jan. 2, 2019) (Committee Print)

Before the end of his tenure as chairman of the House Committee on Ways and Means, Representative Kevin Brady (R-Tex.) presented to the committee a discussion draft of the "Technical and Clerical Corrections Act," which would correct perceived technical flaws in the TCJA. Pub. L. 115-97, 115th Cong., 1st Sess. (Dec. 22, 2017), 131 Stat. 2054.[3] This bill would make the following changes in the kiddie tax:

- It would eliminate the election to allow a child's unearned income to be included on the parent's return;

- It would remove the requirement that the parent provide to a child the taxpayer identification number of the parent and that the child include the number on the child's tax return;

- It would modify the definition of net unearned income to take into account the Section 199A deduction (the 20% deduction for qualified business income), to take into account the child's standard deduction only once, and to treat none of the child's unearned income as earned income;

- It would apply the trust and estate rate schedule for kiddie tax purposes only to the portion of the child's taxable income attributable to net unearned income and apply the rate schedule otherwise applicable to the child applies to the portion of the taxable income not attributable to net unearned income; and

- It would tax a child's net capital gain at trust rates only to the extent the gain does not exceed the child's net unearned income, and tax any net capital gain in excess of that amount at the child's rates.

Note. The discussion draft has somewhat less significance because Representative Brady is no longer the chairman of the Committee on Ways and Means, but this bill focuses on purely technical corrections, most of

[3] The Senate Parliamentarian required that the short title of "The Tax Cuts and Jobs Act" be deleted from the final act, because it had no revenue effect and, as the bill was being passed under the budget reconciliation procedures (avoiding the Senate filibuster rules), it had to contain only revenue-related provisions. The technical name of the bill is "An Act To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." It seems most often referred to still as the Tax Cuts and Jobs Act or TCJA. So be it.

which should be noncontroversial in the new Congress. Expect these changes to make their way into some future tax bill.

3. Joint Committee on Taxation's Blue Book Raises Questions about 2017 Change in Kiddie Tax. Staff of the Joint Committee on Taxation, 115th Cong., 2d Sess. *General Explanation of Public Law 115-97*, p. 7-8, note 18 (Dec. 21, 2018) (Committee Print)

The Joint Committee on Taxation's Blue Book on the TCJA notes a particular drafting problem with the recent changes in the kiddie tax. The Joint Committee stated that a technical correction may be necessary for the kiddie tax to reflect fully the intent that the net unearned income (both ordinary income and net capital gain) of a child to whom the kiddie tax applies should be taxed according to the tax table applicable to trusts, while the earned taxable income of a child is taxed according to the tax table applicable to the child (normally the table applicable to unmarried individuals). The Blue Book states that, as enacted, the total amount taxed at a given rate should not exceed the amount that would be taxed at that rate in the case of an individual to whom the kiddie tax does not apply. The Blue Book illustrates the problem with two examples:

> *Example 1.—Assume a child to whom the ''kiddie tax'' applies is a dependent of another taxpayer and has interest income of $8,000 and no other income for taxable year 2018. The child is allowed a standard deduction of $1,050 (section 63(c)(5)(A) limits the basic standard deduction in the case of certain dependents to the greater of, for 2018, (i) $1,050 or (ii) the sum of $350 and the child's earned income) and thus the child's taxable income is $6,950. The child's net unearned income is $8,000 less $2,100 (section 1(g)(4)(A) provides for a reduction in the amount of net unearned income by twice the basic standard deduction, which for 2018 is $1,050, if the child does not itemize deductions), which is $5,900. The child's earned taxable income is $1,050 ($6,950 less $5,900). The tax on the net unearned income of $5,900 may be calculated by computing the tax on a trust with that amount of taxable income. The tax is $255 plus 24 percent of the excess over $2,550, which is $1,059 ($255 plus $804). Next, the tax brackets for unmarried taxpayers are reduced by any net unearned income taxed at that same rate. $2,550 of unearned income is taxed at 10 percent, so the top of the 10-percent bracket is reduced to $6,975 ($9,525 less $2,550). $3,350 of unearned income is taxed at 24 percent, so the top of the 24-percent bracket is reduced to $154,150 ($157,500 less $3,350). No changes are made to the top of*

the 12-, 22-, 32-, and 35-percent brackets. The tax on $1,050 of earned taxable income is subject to this revised rate schedule. Thus, the tax on this income is $105 ($1,050 at 10 percent). The child's total tax liability is $1,164 ($1,059 plus $105). Note that in this example, a portion of the child's income is subject to tax under a rate schedule other than the estates and trusts rate schedule, notwithstanding that the taxpayer has only unearned income. This is a result of reducing unearned income by two standard deductions to arrive at net unearned income.

Example 2.—Assume a child to whom the "kiddie tax" applies is a dependent of another taxpayer and has interest income of $18,000 and wages of $18,000 for the taxable year 2018. The child is allowed a standard deduction of $12,000 (which is less than the sum of $18,000 plus $350) and thus the child's taxable income is $24,000. The child's net unearned income is $15,900 ($18,000 less $2,100). The child's earned taxable income is $8,100 ($24,000 less $15,900). The tax on the net unearned income of $15,900 may be calculated by computing the tax on a trust with that amount of taxable income. The tax is $3,011.50 plus 37 percent of the excess over $12,500, which is $4,269.50 ($3,011.50 plus $1,258). Next, the tax brackets for unmarried taxpayers are reduced by any net unearned income taxed at that same rate. $2,550 of net un- earned income is taxed at 10 percent, so the top of the 10-percent bracket is reduced to $6,975 ($9,525 less $2,550). $6,600 of net unearned income is taxed at 24 percent, so the top of the 24-percent bracket is reduced to $150,900 ($157,500 less $6,600). $3,400 of net unearned income is taxed at 35 percent, so the top of the 35-percent bracket is reduced to $496,600 ($500,000 less $3,400). No changes are made to the endpoints of the 12-, 22-, or 32-percent brackets. The tax on $8,100 of earned taxable income is subject to this revised rate schedule. Thus the tax on this income is $832.50 ($6,975 at 10 percent and $1,125 at 12 percent). The child's total tax liability is $5,102 ($4,269.50 plus $832.50)

Note. The odd result of taxing part of a child's unearned income at the rate schedule used for earned income clearly demands a technical correction, but moreover, these examples show that the TCJA's goal of simplifying the computation of the kiddie tax not been attained.

B. IRC § 61. Gross Income (Including Split Dollar Life Insurance Arrangements)

1. Split-Dollar Arrangement Not Taxable as Compensation Income; Rather It is an S Corporation Distribution of Property. *Machacek v. Comm'r*, 906 F.3d 429, 2018 WL 4939080 (6th Cir. Oct. 12, 2018), *rev'g and rem'g* T.C. Memo. 2016-55

John J. Machacek Jr. was an employee of an S corporation in which he and his wife, Marianne, were the only shareholders. The company's employee benefits plan provided John with life insurance under a split-dollar arrangement under which the company paid a $100,000 premium. The company deducted the premium payment. The IRS claimed that the payment was taxable as compensation to the taxpayer. The Tax Court held that the compensatory nature of the agreement caused the economic benefit of the company's premium payment to be taxable as a individual compensation.

The Sixth Circuit (Judge White) reversed and remanded, relying on Reg. § 1.301-1(q)(1)(i), which states that a corporation's provision of economic benefits "to its shareholder pursuant to a split-dollar life insurance arrangement . . . is treated as a distribution of property." The Tax Court had not addressed this regulation, but the Sixth Circuit found it dispositive. The IRS argued that the regulation applies to both compensatory and shareholder arrangements, and that it should not define which characterization applies. The Sixth Circuit held that the regulation "renders irrelevant whether [the taxpayer] received the economic benefits through a compensatory or shareholder split-dollar arrangement," and noted that the IRS had been unable to explain why there should be a distinction between compensatory and shareholder arrangements under the regulation. The court stated that its interpretation was supported by the fact that the split dollar regulations state that the tax treatment of the economic benefits depends on the "relationship between the owner and the non-owner" and that the regulations did not state that the tax treatment depends upon the nature of the split-dollar arrangement — compensatory or shareholder.

2. What Really Constitutes a Split-Dollar Life Insurance Arrangement under the Regulations? *De Los Santos v. Comm'r*, T.C. Memo. 2018-155 (Sept. 18, 2018)

Dr. Ruben de los Santos was the sole shareholder of an S-corporation that employed him as a physician and employed his wife as the office manager. There were four other employees. The corporation contributed $1.8 million to an employee welfare benefit plan established by Legacy Benefit Plans, LLC (LBP), which bought through its Legacy Benefit Trust (the Plan Trust) a $12.5 million life insurance policy insuring the lives of the de los Santoses. The plan was structured as multiple-employer welfare benefit plan under

Section 419A(f)(6), and LBP was the sponsor and administrator. The corporation elected to participate by adopting a welfare benefit plan pursuant to the terms of a master plan. LBP offered living benefits, including disability benefits, and death benefits payable on the death of a covered employee, to that person's spouse or designated beneficiary. Participating employers selected the types of benefits to be provided to their employees. No employee could withdraw from, borrow against, or surrender his or her interest in LBP. A covered employee designated the beneficiary or beneficiaries who would receive death benefits to which that employee was entitled. LBP determined the amount of the employer contributions through a rate chart, which took into account common risk factors such as age, gender, number of covered dependents, and benefit terms. Employees did not contribute to LBP. Employer contributions were irrevocable and were inaccessible by the participating employer and its creditors. The Plan Trust assets could be used only to fund benefits for participating employees and their beneficiaries or defraying expenses of plan administration. LBP and the Plan Trust never received any IRS recognition of the Plan Trust as tax-exempt under Section 501(a). In 2010, the plan was merged into the Legacy Employee Flex Benefit Plan (the Legacy/Flex Plan). The IRS assessed a deficiency against the de los Santoses based on their having received economic benefits from their participation in the plan.

The Tax Court (Judge Lauber) granted the government summary judgment that the arrangement did not involve a genuine multi-employer plan, but rather was taxable as a compensatory split-dollar life insurance arrangement. Thus, the policy owner had to include in gross income the value of the economic benefits conferred on it each year. The court explained that a split-dollar life insurance arrangement is usually an arrangement (other than group-term life insurance) between an owner of a life insurance contract and a non-owner of the contract if, among other things, one party is entitled to recover from the insurance proceeds "all or any portion" of the premiums previously paid. Reg. § 1.61-22(b)(1)(ii). This was not the case with the Legacy/Flex Plan, but it was still a split-dollar arrangement under the regulations, which state that, even if the general definition does not apply, an arrangement is a split-dollar life insurance arrangement if: (a) the arrangement is entered into "in connection with the performance of services" and not as "part of a group-term life insurance plan described in section 79." Reg. § 1.61-22(b)(2)(ii)(A); (b) the employer or other service recipient pays, "directly or indirectly, all or any portion of the premiums" on the policy. Reg. § 1.61-22(b)(2)(ii)(B); and (c) the beneficiary of the death benefit is "designated by the employee or service provider" or must be a person "whom the employee or service provider would reasonably be expected to designate as the beneficiary." Reg. § 1.61-22(b)(2)(ii)(C)(1). The regulations attribute ownership of a policy in a compensatory arrangement to the employer or other service recipient if the owner is (among other things) a welfare benefit fund under Section 419(e)(1). Reg. § 1.61-

22(c)(1)(iii)(C). For purposes of applying the split-dollar regulations, therefore, the S-corporation was the owner of the policy and the taxpayers were the non-owners. Reg. § 1.61-22(c)(1) and (2). The parties agreed that the Legacy/Flex Plan would fall under the economic benefit rules, if it were taxed as a split-dollar life insurance arrangement. Thus, the owner would be treated as providing current economic benefits to the non-owner. Reg. § 1.61-22(d)(1). Under the economic benefit regime, the non-owner of the life insurance contract (the taxpayers) "must take into account the full value of all economic benefits . . ., reduced by the consideration paid * * * by the non-owner to the owner for those economic benefits." Reg. § 1.61-22(d)(1). The taxpayers paid no consideration to the corporation for the benefits they received under the Legacy/Flex Plan, so the question was the value of the economic benefits provided to them. The regulations state that this is the sum of (a) the "cost of current life insurance protection provided to the non-owner" and (b) "[t]he amount of policy cash value to which the non-owner has current access . . . (to the extent that such amount was not actually taken into account for a prior taxable year)." Reg. § 1.61-22(d)(2). The parties agreed that the cost of the current insurance protection was $178 for 2011 and $213 for 2012, but they disagreed on the second component. A non-owner "has current access to that portion of the policy cash value" to which he or she "has a current or future right" if specified conditions are met. Reg. § 1.61-22(d)(2)(4)(ii)(A). A non-owner who cannot extract cash from the policy currently is still treated as having "current access" to that portion of the policy cash value if he or she has a future right if such portion "is inaccessible to the owner" of the policy (i.e., the employer) or is "inaccessible to the owner's general creditors." Reg. § 1.61-22(d)(2)(4)(ii)(B). The taxpayers had such a "future right" to the Policy cash value in this case because they had the right to designate who would receive death benefits, and because, once the employer made contributions to the Plan Trust, those contributions were irrevocable and were inaccessible to the employer and its creditors. Thus, although the taxpayers could not withdraw funds from the policy or the Legacy/Flex Plan in the years in question, the cash value, in its entirety, was "inaccessible to the owner" (i.e., the S Corp.) and was "inaccessible to the owner's general creditors." Reg. § 1.61-22(d)(4)(ii)(B).

Note. *De los Santos* has significant implications for estate planners. First, it identifies an arrangement that is being marketed to business owners with the promise of tax results quite different from those that appear likely to apply. The formation of what appears to be a multi-employer welfare benefit plan has been the basis for a number of arrangements that have failed to achieve their desired tax results, and practitioners and their clients should avoid most of these structures. Second, *De los Santos* provides a careful and detailed review of the split-dollar regulations. Without this case and its predecessor, *Our Country Home Enters, Inc. v. Comm'r*, 145 T.C. 1 (2015) it would be easy to overlook the application of the split-dollar rules to a transaction in which the non-owner was not directly entitled to recover its

premium contributions. This case may be the poster child for the breadth of the split-dollar regulations.

C. IRC § 101. Income Tax Treatment of Life Insurance Death Benefits

Notice and Proposed Regulations Explain and Expand on Income Taxation and Reporting of Reportable Policy Sales. REG-10308-18 (March 25, 2019)

Treasury and the IRS proposed regulations on Section 6050Y, regarding "reportable policy sales," "reportable death benefits," and the 2017 changes in the transfer for value rules. REG-103083-18 (March 25, 2019). These proposed regulations provide numerous definitions and greatly expand the available guidance on the reporting requirements under Section 6050Y and the effect of a reportable policy sale on the income taxation of life insurance death benefits. The key provisions of the proposed regulations include the following:

a) Income Taxation of Life Insurance Death Benefits

The TCJA provides that the recipient of death benefits under a policy that was the subject of a reportable policy sale cannot take advantage of the statutory exceptions to the transfer-for-value rule, for transfers (1) in which the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract or (2) made to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. IRC § 101(a)(3). The proposed regulations state that: (a) any transfer of an interest in a life insurance contract for cash or other consideration reducible to a money value is a transfer for valuable consideration. Prop. Reg. § 1.101-1(f)(5); (b) to the extent that a transfer of an interest in a life insurance contract is not for value, even if it is a reportable policy sale, the death benefits excludible from gross income are limited to the proceeds attributable to the gratuitously transferred interest that would have been excludable by the transferor had there been no transfer, plus any premiums and other amounts subsequently paid by the transferee. Prop. Reg. § 1.101-1(b)(ii)(B)(2)(i); (c) if only part of an interest in a life insurance contract is transferred, the death benefit exclusion from gross income that would have been available to the transferor, but for the transfer, is ratably apportioned among the several parts. Prop. Reg. § 1.101-1(b)(ii)(B)(2)(ii); (d) if multiple parts of an interest are transferred, the transfer of each part is treated as a separate transaction. Prop. Reg. § 1.101-1(b)(ii)(B)(2)(ii); (e) a transfer of an interest in a life insurance contract that is in part a sale and in part a gratuitous transfer, is treated

as two separate transactions for purposes of determining the amount of the proceeds attributable to the interest that is excludable from gross income. Prop. Reg. § 1.101-1(b)(ii)(B)(2)(iii). The portion that is treated as a gift preserves the full income tax exclusion for its death benefits; the other portion does not; (f) in determining the consideration paid by the transferee for the transfer of an interest in a life insurance contract and premiums and other amounts subsequently paid by the transferee with respect to that interest, the amounts paid by the transferee are reduced, but not below zero, by amounts received by the transferee under the life insurance contract that are not received as an annuity, to the extent excludable from gross income under Section 72(e). Prop. Reg. § 1.101-1(b)(ii)(B)(3).

- **Definition of Reportable Policy Sale.** The proposed regulations state that persons who acquire shares in a C corporation that holds an interest in a life insurance contract will not be considered to have an indirect interest in the contract, unless the C corporation primarily owns life insurance contracts (or interests therein). The proposed regulations state that the term "other entity" does not include a C corporation (as defined in Section 1361(a)(2)), unless more than 50% of the gross value of its assets consists of life insurance contracts, immediately before the indirect acquisition. Prop. Reg. §1.101-1(f)(3)(ii).

- **Definition of Substantial Relationships**. The proposed regulations provide definitions of a "substantial family relationship," "substantial business relationship," or "substantial financial relationship". Prop. Reg. § 1.101-1(d)(1). The proposed regulations state that a "substantial family relationship" means the relationship between an individual and any family member of the individual. A family member, for this purpose, is very broadly defined. Prop. Reg. § 1.101-1(f)(3). A substantial family relationship also exists between an individual and his or her former spouse with regard to a transfer of an interest in a life insurance contract to (or in trust for the benefit of) that former spouse incident to divorce. Prop. Reg. § 1.101-1(d)(1).

  The proposed regulations state that a substantial business relationship exists in two situations. First, a substantial business relationship exists if the insured is a key person (see Section 264) of, or materially participates (see Section 469) in, an active trade or business as an owner, em-

ployee, or contractor, and at least 80% of that trade or business is owned (directly or indirectly, through one or more partnerships, trusts, or other entities) by the acquirer or its beneficial owners. Second, a substantial business relationship exists if the acquirer acquires an active trade or business and the interest in the life insurance contract either as part of that acquisition or from a person owning significant property leased to the acquired trade or business or life insurance policies held to facilitate the succession of the ownership of the business, if certain requirements are met. Prop. Reg. § 1.101-1(d)(2).

The proposed regulations describe three situations in which a substantial financial relationship exists between the insured and the acquirer. First, a substantial financial relationship exists if the acquirer (directly or indirectly, through one or more partnerships, trusts, or other entities of which it is a beneficial owner) has, or its beneficial owners have, a common investment (other than the interest in the life insurance contract) with the insured and a buy-out of the insured's interest in the common investment by the co-investor(s) after the insured's death is reasonably foreseeable. This covers the use of most life insurance used to fund a buy-sell agreement. Prop. Reg. § 1.101-1(d)(3)(i). Second, a substantial financial relationship exists if the acquirer maintains the life insurance contract on the life of the insured to provide funds to purchase assets or satisfy liabilities following the death of the insured. This covers the use of some types of key person life insurance. Prop. Reg. § 1.101-1(d)(3)(ii). Third, a substantial financial relationship exists if the acquirer is a charity described in Sections 170(c), 2055(a), and 2522(a) that previously received financial support in a substantial amount or significant volunteer support from the insured. Prop. Reg. § 1.101-1(d)(3)(iii).

- **Definition of Transfer of an Interest in a Life Insurance Contract.** A transfer of an interest in a life insurance policy does not, however, include: (a) the revocable designation of a beneficiary of the policy proceeds (unless and until that designation becomes irrevocable other than by reason of the insured's death); (b) pledging or assigning a policy as collateral security; or (c) issuance of a life insurance contract to a policyholder, other than in a policy exchange under Section 1035. Prop. Reg. § 1.101-1(e)(2).

- **Reportable Policy Sale Specific Exceptions.** The proposed regulations provide several specific exceptions from the definition of reportable policy sale. First, the transfer of an interest in a life insurance contract between entities with the same beneficial owners is not a reportable policy sale if the ownership interest of each beneficial owner in each entity does not vary by more than a 20% ownership interest. Prop. Reg. §§ 1.101-1(c)(2)(i) and 1.101-1(g)(10). Also, a transfer between corporations that are members of an affiliated group (See Section 1504(a)) that files a consolidated tax return for the taxable year in which the transfer occurs is not a reportable policy sale. Prop. Reg. § 1.101-1(c)(2)(ii).

b) **Returns and Statements for Reportable Policy Sales**

The Code requires that every person who acquires a life insurance contract or interest in a life insurance contract in a reportable policy sale during must make a return for the taxable year in which such sale occurred, "at such time and in such manner as the Secretary shall prescribe." IRC § 6050Y(a)(1). This return must include (a) the name, address, and TIN of such person; (b) the name, address, and TIN of each recipient of payment in the reportable policy sale; (c) the date of such sale, (d) the name of the 6050Y(a) issuer of the life insurance contract sold and the policy number of such contract, and (e) the amount of each payment. The proposed regulations provide definitions for "reportable policy sale payment," and "reportable policy sale payment recipient."

c) **The Reportable Policy Sale Information Return**

Section 6050Y(a)(1)(E) requires that the acquirer file a return that reports the "amount of each payment." The proposed regulations require more specifically that the return provide "the aggregate amount of reportable policy sale payments made, or to be made, to the seller or other reportable policy sale payment recipient to which the return relates with respect to the reportable policy sale." Prop. Reg. § 1.6050Y-2(a)(5). The proposed regulations also state that the acquirer's return must include "any other information that is required by the form or its instructions." Prop. Reg. § 1.6050Y-2(a)(6). Presumably, this information will change from time-to-time as the IRS perceives changes in its information needs. The proposed regulations allow for unified reporting by the acquirers in a series of prearranged transfers of any interest in a life insurance contract. Prop. Reg. §§ 1.6050Y-2(b) and 1.6050Y-2(d)(3). A series of pre-

arranged transfers of an interest in a life insurance contract may include transfers in which one or more persons serve as intermediaries and such intermediaries may acquire title or possession of an interest in a life insurance contract for state law purposes as nominee on behalf of another person or persons. These rules respond to comments received on Notice 2018-41 which suggested that a rule allowing unified reporting be adopted with respect to acquirers in a series of prearranged transfers.

The written statement to reportable policy sale payment recipients and 6050Y(a) issuers need not include information with respect to any other reportable policy sale payment recipient. Prop. Reg. § 1.6050Y-2(d)(1)(i). Each reportable policy sale payment recipient receives information only on his or her own payment. The reportable policy sale information return must be filed with the IRS Center designated on the form and instructions, on or before February 28 (March 31 if filed electronically) of the year after the calendar year in which the reportable policy sale occurs. Prop. Reg. § 1.6050Y-2(c). The reportable policy sale statements that must be provided to recipients are due on or before February 15 of the year following the calendar year in which the reportable policy sale occurred. Prop. Reg. § 1.6050Y-2(d)(1).

d) **Returns and Statements of Seller's Basis in Life Insurance Contracts**

The Code requires that issuers of life insurance contracts who receive a written statement furnished by an acquirer of a reportable policy sale (a "reportable policy sale statement" or "RPSS") or a notice of a transfer to a foreign person, must itself file a return reporting: (a) the name, address, and TIN of the seller who transfers any interest in the contract in such sale; (b) the investment in the contract with respect to the seller; and (c) the policy number of the contract. IRC § 6050Y(b)(1). The Code also requires every issuer who must file such a return to furnish each person whose name is required to be set forth in the return a written statement showing (a) the name, address, and phone number of the information contact of the person required to make the return; and (b) the information required to be shown on the return with respect to each seller whose name is required to be set forth in the return. IRC § 6050Y(b)(2). The proposed regulations state that an RPSS need not be furnished to the 6050Y(a) issuer by an acquirer who acquires an interest in a life insurance contract in an indirect acquisition. Prop. Reg. § 1.6050Y-2(d)(2)(i)(B). The proposed regulations State that the meaning of "issuer" depends on the context in which the term is used. In general, "issuer" means, on any date, with respect to any

interest in a life insurance contract, any person that bears any part of the risk with respect to the life insurance contract on that date and any person responsible on that date for administering the contract, including collecting premiums and paying death benefits. Prop. Reg. § 1.6050Y-1(a)(8)(i).

e) Furnishing a Return and Statement of Seller's Basis

A 6050Y(a) issuer that receives a RPSS from an acquirer becomes a 6050Y(b) issuer and must both file an information return respecting the seller's basis and furnish a written statement to the seller in a reportable policy sale. IRC § 6050Y(b). The proposed regulations provide that acquirers must furnish the 6050Y(a) issuer with a RPSS with respect to each reportable policy sale payment recipient that is also a seller. Prop. Reg. § 1.6050Y-2(d)(2)(i)(A). An acquirer acquiring an interest in a life insurance contract in an indirect acquisition, however, is not required to furnish a RPSS to the issuer. Prop. Reg. § 1.6050Y-2(d)(2)(i)(B). The proposed regulations echo the Code that acquirers need not set forth the amount of any reportable policy sale payment in a RPSS furnished to a 6050Y(a) issuer. Prop. Reg. § 1.6050Y-2(d)(2)(i)(A). Because sellers may need the information in the written statements furnished by 6050Y(b) issuers in order to determine their taxable income, an acquirer must furnish a RPSS to the 6050Y(a) issuer not later than the later of (1) 20 days after the reportable policy sale, or (2) 5 days after the end of the applicable state law rescission period. Prop. Reg. § 1.6050Y-2(d)(2)(ii). In no event can this be later than January 15 of the year following the calendar year in which the reportable policy sale occurred. Prop. Reg. § 1.6050Y-2(d)(2)(ii). The 6050Y(b) issue must generally furnish any written statement required by Section 6050Y(b)(2) to the seller no later than February 15 of the year following the calendar year in which the reportable policy sale occurs. Prop. Reg. § 1.6050Y-3(d)(2).

Acquirers must furnish a RPSS to the 6050Y(a) issuer by January 15 of the year following the calendar year in which the reportable policy sale occurred, if not earlier, and a 6050Y(b) issuer generally must furnish any written statement required to be provided to a seller no later than February 15 of the year following the calendar year in which the reportable policy sale or transfer to a foreign person occurs. Prop. Reg. §§ 1.6050Y-2(d)(2)(ii), 1.6050Y-3(d)(2). The proposed regulations reflect comments received on Notice 2018-41 that suggested that issuers be required to furnish written statements under section 6050Y(b)(2) to the seller no later than February 15 of the year following the calendar year in which the reportable policy sale occurs, noting that this is currently the due date for

Section 6045 broker returns and consolidated statements, and brokers also rely on third party information (e.g., dividend reclassifications). Prop. Reg. § 1.6050Y-3(d)(2). A 6050Y(b) issuer must correct returns of the seller's basis under Section 6050Y(b)(1) and written statements furnished under Section 6050Y(b)(2) within 15 days of the issuer's receipt of notice of the rescission of the related reportable policy sale or transfer to a foreign person. Prop. Reg. §1.6050Y-3(e).

f) **Returns and Statements for Reportable Death Benefits**

Amounts paid by reason of the death of an insured under a life insurance contract that was transferred in a reportable policy sale are called reportable death benefits. IRC § 6050Y(d)(4); Prop. Reg. § 1.6050Y-4(a). Section 6050Y(c) requires each person who makes a payment of reportable death benefits during any taxable year file a report with the IRS (at such time and in such manner as the Secretary shall prescribe), including: (a) the name, address, and TIN of the person making the payment; (b) the name, address, and TIN of each recipient of such payment; (c) the date of each such payment; (d) the gross amount of each such payment; and (e) each person's estimate of the investment in the contract (as defined in Section 72(e)(6)) with respect to the buyer. IRC § 6050Y(c)(1). The proposed regulations add a requirement that this return include "[a]ny other information that is required by the form or its instructions." Prop. Reg. § 1.6050Y-4(a)(6). A person who is required to file a return with respect to reportable death benefits must also provide each person whose name is set forth in that return with a notice that includes (a) the name, address, and phone number of the contact information of the person required to make the return; and (b) the information required to be shown on the return with respect to each recipient of a payment whose name is required to be included on the return. IRC § 6050Y(c)(2). The contact information must provide direct access to a person who can answer questions about the statement. Prop. Reg. §1.6050Y-4(c)(1). A person who has filed an information return regarding reportable death benefits must file a corrected return within 15 days the receipt of notice of the rescission of the buyer's reportable policy sale. Any person that has furnished a written statement regarding a reportable death benefit must furnish the recipient of that statement with a corrected statement within 15 calendar days of the receipt of notice of the rescission of the buyer's reportable sale. Prop. Reg. § 1.6050Y-4(d). The proposed regulations define "reportable death benefits," "payor," "reportable death benefits payment recipient," "investment in the contract," and "esti-

mated investment in the contract." Generally, returns regarding reportable death benefits must be filed on or before February 28 (March 31 if filed electronically) of the year after the calendar year in which the death benefits are paid. Prop. Reg. § 1.6050Y-4(b).

The proposed regulations provide two situations in which a payor is not required to file an information return regarding reportable death benefits. First, a payor is not required to file this information return if the payor obtains documentation upon which it may rely to treat a reportable death benefits payment recipient as a foreign beneficial owner of the benefits. A payor may also obtain from a partnership or trust that is a reportable death benefits recipient, in addition to documentation establishing the entity's foreign status, written certification from the entity that no beneficial owner of any portion of the reportable death benefits is a United States person. Prop. Reg. § 1.6050Y-4(e)(1). Second, a payor is not required to file this information return if the buyer obtained the life insurance contract (or interest) in a reportable policy sale to which the exception to reporting described in Prop. Reg. § 1.6050Y-3(f)(2) applies. This exception applies where a 6050Y(b) issuer received only a notice of transfer to a foreign person and was not required to treat the transfer as reportable for purposes of section 6050Y(b).

g) Application Dates

The proposed regulations relating to the income taxation of life insurance death benefits related to reportable policy sales generally apply to transfers of life insurance contracts or interests therein made after the date the final regulations are published in the Federal Register. The rules regarding returns and statements under Section 6050Y apply to reportable policy sales made and reportable death benefits paid after December 31, 2017. For reportable policy sales and payments of reportable death benefits occurring after December 31, 2017, and before the date final regulations are published in the Federal Register, the following transition rules are provided. First, with respect to reportable policy sales occurring after December 31, 2017, and before the date final regulations are published in the Federal Register, statements required to be furnished to issuers under section 6050Y(a)(2) must be furnished by the later of the applicable deadline set forth in final regulations or 60 days after the date final regulations are published in the Federal Register. Second, with respect to reportable policy sales occurring after December 31, 2017, and before the date final regulations are published in the Federal Register, returns for reportable policy sales and returns for basis in life insurance contracts (Sections 6050Y(a)(1) and 6050Y(b)(1)), and statements required to be furnished to payment recipients and

sellers following such returns, must be filed or furnished by the later of the applicable deadline set forth in final regulations or 90 days after the date final regulations are published in the Federal Register. Third, with respect to payments of reportable death benefits paid after December 31, 2017, and before the date final regulations are published in the Federal Register, returns and statements respecting reportable death benefits (Section 6050Y(c)) must be filed or furnished by the later of the applicable deadline set forth in final regulations or 90 days after the date final regulations are published in the Federal Register.

Note. One especially interesting feature of the regulations is that they discuss in some detail what actions after the original transfer for value can restore the policy proceeds to full exemption from income tax. Prop. Reg. § 1.101-1(f)(5), Exs. 1 and 2, state that a gift of a life insurance policy back to where the original transaction was not a reportable policy sale, does not cleanse the transfer of its "for value" status. On the other hand, Prop. Reg. § 1.101-1(f)(5), Ex. 3 states state that a sale of a life insurance policy for full fair market value back to an original transferor who has a substantial financial, personal, or business relationship with the insured, where the original transaction was not a reportable policy sale, does cleanse the transfer of its "for value" status. This is an odd result and it is unclear what the basis for this distinction may be, but it is clear from the proposed regulations that this is the new rule on cleansing transfers for value of policies where the original transfer was not a reportable policy sale.

Prop. Reg. § 1.101-1(f)(5), Exs. 5 and 6 state that a retransfer of a life insurance policy back to an original transferor who has a substantial financial, personal, or business relationship with the insured, from a transferee who has no such relationship with the insured, does not cleanse the transfer of its "for value" status, if the original transfer was a reportable policy sale. This result occurs whether or not the retransfer is a gift or a sale for full fair market value. This is an important distinction in the transfer for value rules applicable to a transfer that was a reportable policy sale and a transfer that was not a reportable policy sale.

D. IRC §§ 170, 642, 4940-4947. Charitable Gifts and Distributions

1. Senate Bill Would Permit IRA Qualified Charitable Distributions to Donor Advised Funds. S. 1475, 116th Cong., 1st Sess. (May 15, 2019)

The Charities Helping Americans Regularly Throughout the Year (CHARITY) Act of 2019, introduced by Senator John Thune (R-S.D.), would make several changes in the charitable contribution rules, including:

a) Donor Advised Funds

The bill would allow qualified charitable distributions from an IRA to a donor advised fund, with respect to distributions made after December 31, 2018, and modify the reporting requirements for donor advised funds, with respect to returns for taxable years beginning after December 31, 2019.

b) Private Foundation Investment Income Tax

The bill would reduce the excise tax on investment income of a private foundation under Section 4940, from two percent to one percent, for taxable years beginning after the date of enactment.

c) Mileage Tax Deduction

The bill would require the Treasury Department to adopt regulations that align the simplified standard mileage tax deduction rate, which applies to the use of personal vehicles for volunteer charitable services, with the mileage rate that applies for medical and moving purposes, with respect to miles traveled after the date of enactment.

d) E-Filing

The bill would require tax-exempt organizations to e-file their annual returns, for taxable years after the date of enactment.

The bill has three co-sponsors, including two Democrats and one Republican.

2. Proposed Tax Technical and Clerical Corrections Act would Modify 2017 Changes in the 60% Deduction for Cash Contributions to Public Charities. See Staff of the Joint Committee on Taxation, 115th Cong., 2d Sess., *Technical Explanation of the House Ways and Means Committee Chairman's Discussion Draft of the "Tax Technical and Clerical Corrections Act"* p. 5 (Jan. 2, 2019) (Committee Print)

Before the end of his tenure as chairman of the House Committee on Ways and Means, Representative Kevin Brady (R-Tex.) presented to the committee a discussion draft of the "Technical and Clerical Corrections Act," which would correct perceived technical flaws in the TCJA. This discussion draft bill would make the following changes to the new 60% income tax deduction for contributions of cash to public charities: (a) better coordinate the new 60% limit applicable to cash contributions to public charities and the 50% limit applicable to non-cash contributions, reducing the 60%

limit by the amount of certain non-cash contributions, and not reducing the 50% limit by the amount of cash contributions allowed under the 60% limit; and (b) make a related conforming change to the 30% limit applicable to certain charitable contributions to organizations that are not public charities.

Note. The discussion draft has somewhat less significance because Representative Brady is now no longer the chairman of the Committee on Ways and Means, but this bill focuses on purely technical corrections, most of which should be noncontroversial in the new Congress. Expect these changes to make their way into some future tax bill.

3. Joint Committee on Taxation's Blue Book Answers and Raises Questions About New 60 Percent Limitation on the Deduction of Cash Gifts to Public Charities. Staff of the Joint Committee on Taxation, 115th Cong., 2d Sess. *General Explanation of Public Law 115-97,* p. 51 and note 53 (Dec. 21, 2018) (Committee Print)

The Joint Committee's Blue Book clarifies that the new 60% of contribution base limitation for contributions of cash to public charities does not require that the entire 60% be contributed in cash. The Blue Book states that the statute was intended to apply both to donors whose contributions are made entirely in cash and to those whose contributions are a mixture of cash and property. In the latter case, the previous 50% limitation will apply to the extent that the contribution is not cash, and the 60% limitation will apply only to the cash portion of the contribution. The Blue Book illustrates this with an example:

> *For example, assume an individual with a contribution base of $100,000 for taxable year 2018 makes two contributions to public charities: unappreciated property with a fair market value of $50,000 and $10,000 in cash. The individual makes no other charitable contributions in 2018 and has no charitable contribution carryforwards from a prior year. The cash contribution limit under new section 170(b)(1)(G) is determined after accounting for noncash contributions. Thus, the $50,000 contribution of unappreciated property is accounted for first, using up the individual's entire 50- percent contribution limit under section 170(b)(1)(A) (50 percent of the individual's $100,000 contribution base), and leaving $10,000 in allowable cash contributions under the 60-percent limit ($60,000 (60 percent of $100,000) reduced by the $50,000 in noncash contributions allowed under section 170(b)(1)(A)).*

The Joint Committee also states in a footnote that a technical correction may be needed to reflect this intent, and that without the technical correction,

"some might interpret the provision as requiring that the 50% limit for non-cash contributions under section 170(b)(1)(A) be applied after (and reduced by) the amount of cash contributions allowed under the 60% limit of section 170(b)(1)(G)."

4. Effect of a State or Local Income Tax Credit on the Federal Charitable Income Tax Deduction and the SALT Cap Workaround. T.D. 9864, 84 Fed. Reg. 27513 (June 13, 2019); Notice 2019-12, 2019-27 I.R.B. ___ (June 13, 2019); 2019-REG-112176-18, 83 Fed. Reg. 43563-01 (Aug. 27, 2018)

The Treasury and IRS have issued final regulations on the effect on a donor's federal income tax charitable deduction of a state or local tax credit for a charitable contribution. The final regulations largely follow the proposed regulations, with a few notable exceptions. Generally, the regulations prevent the use of charitable contributions to certain charities as a means of avoiding the $10,000 annual limitation on the deductibility of state and local taxes. Several states grant a dollar-for-dollar state income tax credit for all or part of the taxpayer's contributions to certain charities. This could, in theory, allow taxpayers to replace the nondeductible portion of state and local tax payments with fully deductible charitable gifts. The regulations prevent this technique by reducing the federal charitable income tax deduction by the amount of any state tax credit allowed or expected to be allowed for such contributions; they treat the state credit as a *quid pro quo* for the charitable gift. Reg. §§ 1.170A-1(h)(3)(i) and 1.642(c)-3(g)(1). In addition:

- The final regulations clarify that a state or local income tax deduction that does not exceed the amount of the charitable gift or the fair market value of the contributed property does not reduce the federal income tax deduction. Reg. § 1.170A-1(h)(3)(ii)(A). A taxpayer must, however, reduce its federal income tax charitable contribution deduction to the extent that it receives or expects to receive state or local tax deductions that exceed either the amount of the charitable contribution or the value of the property transferred to the charity. Reg. § 1.170A-1(h)(3)(ii)(B);

- The final regulations clarify that the fact that the state or local income tax credit is provided by someone other than the donee of the gift does not change the fact that it is provided "in consideration" for the gift. Reg. § 1.170A-1(h)(3)(iii);

- The final regulations, like the proposed regulations, provide a *de minimis* rule for state credits that do not exceed 15% of the value of the contributed property or the amount of the contribution. The final

regs add, however, that the 15% exception applies only if the sum of the taxpayer's state and local income tax credits received or expected to be received, does not exceed 15% of the gift to the charity. Reg. § 1.170A-1(h)(3)(vi);

- The final regulations, like the proposed regulations, provide comparable rules under Section 642(c) with respect to contributions by a trust or estate. Reg. § 1.642(c)-3(g);

- The final regulations, like the proposed regulations, apply to amounts paid or property contributed after August 27, 2018 (the date the proposed regulations were published in the Federal Register). Reg. §§ 1.170A-1(h)(3)(viii) and 1.642(c)-3(g)(2). Treasury and the IRS denied the request by some commentators for either a delayed or phased-in effective date, finding that the August 27, 2018 date provides "maximum certainty." The final regulations, like the proposed regulations, apply to both new and to preexisting state tax credit programs, including several long-standing scholarship granting programs and state and local hospital funding programs;

- The Treasury declined to make an exception for conservation easement tax credits, agreeing that they are finding that they are a favored charitable vehicle, but that the usual rules of charitable tax deductions still apply. They did say that they would consider for future guidance the question of whether basis should be given in credits that are treated as a *quid pro quo*, for use when those credits are sold to other taxpayers; and

- In response to concerns that the proposed regs would result in an overall decline in charitable giving, Notice 2019-12 states that an individual who itemizes deductions and makes a charitable payment in return for a state or local tax credit may treat the portion of that payment that is or will be disallowed under the final regulations as a charitable contribution deduction instead as a payment of state or local tax for purposes of Section 164. Thus, if the taxpayer has not used all of his or her $10,000 SALT cap, the charitable contribution that is creditable for state or local income tax purposes may still be deducted as state and local taxes.

5. Final Regulations Clarify Rules for Substantiation and Reporting Cash and Noncash Charitable Contributions. T.D. 9836, 83 Fed. Reg. 36417 (July 30, 2018)

The final regulations implement and expand on changes in the income tax treatment of charitable gifts made by section 883 of the American Jobs Creation Act of 2004, Pub. L. 108-357, 108th Cong., 2d Sess. (2004), 118 Stat. 1418, 1631, and sections 1216, 1217, and 1219 of the Pension Protection Act of 2006, Pub. L. 109-280, 109th Cong., 2d Sess. (2006), 120 Stat. 780, 1079-83. The specific provisions of these regulations include:

- The regulations require that a donor maintains as a record of any cash, check, or other monetary gift (1) a bank record, or (2) a written communication from the donee. The regulations require that the record show the name of the donee organization, the date of the contribution, and the amount of the contribution. Reg. § 1.170A-15(a)(1). These requirements are an addition to the requirement that a donor who claims a deduction for a charitable contribution of $250 or more must receive a contemporaneous written acknowledgement. Reg. § 1.170A-15(a)(2). A single document that is acquired on or before the earlier of the date of the original income tax return for the year in which the contribution is made or the due date of such return, may be used for both sets of recordkeeping requirements. Reg. §§ 1.170A-15(a)(3), -15(c); 83 Fed. Reg. at 36418 – 36419.

  Note. Some commenters asked whether a blank pledge card provided by a donee organization but filled out by the donor constitutes adequate substantiation for a contribution of cash to a distributing organization. The preamble to the final regulations notes that a blank pledge card provided by the done that does not itself show the information required under Section 170(f)(17), is not sufficient to substantiate a cash, check, or other monetary gift. 83 Fed. Reg. at 36418. Obviously, a blank pledge card provided by the done that does show the information required under Section 170(f)(17) is sufficient to substantiate a cash, check, or other monetary gift.

- The substantiation requirements for gifts of under $250 do not apply to unreimbursed expenses of less than $250. Reg. § 1.170A-15(e). For the requirements for unreimbursed expenses of $250 or more, see Reg. § 1.170A-13(f)(10).

- The cash gift substantiation requirements with respect to gifts made by a partnership or S corporation are applied by treating the entity as the donor. Reg. § 1.170A-15(f).

- The cash gift substantiation requirements with respect to gifts under $250 do not apply to a transfer to a charitable remainder trust or a grantor charitable lead trust, but they do apply to a transfer to a pooled income fund. Reg. § 1.170A-15(g). The requirement of a contemporaneous written acknowledgement with respect to a gift of $250 or more, however, does apply to gifts to a charitable remainder trust or grantor charitable lead trust.

- A donor who deducts a noncash contribution of less than $250 is required only to obtain a receipt from the donee or to keep reliable records showing the name and address of the donee, the date of the contribution, a description of the property in sufficient detail under the circumstances for a person who is not generally familiar with the type of property to ascertain that the described property is the contributed property, and in the case of securities, the name of the issuer, the type of security, and whether the securities are publicly-traded. Reg. § 1.170A-16(a)(1).

- A donor who claims a noncash contribution deduction of at least $250 but not more than $500 must obtain a contemporaneous written acknowledgment. Reg. § 1.170A-16(b). A donor who claims a noncash contribution deduction of more than $500 but not more than $5,000, must both obtain a contemporaneous written acknowledgment and file a completed Form 8283 (Section A), "Noncash Charitable Contributions," with the return on which the deduction is claimed. Reg. § 1.170A-16(c).

- A donor who claims a noncash contribution deduction of more than $5,000 must obtain a contemporaneous written acknowledgment and a qualified appraisal and must also complete and file an appraisal summary Section A of Form 8283 with the return on which the deduction is claimed. Reg. § 1.170A-16(d)(1). If the gift is one of publicly-traded securities, certain intellectual property, a qualified vehicle, or certain inventory, the donor need not obtain a qualified appraisal and must complete Section B of Form 8283, rather than Section A. Reg. § 1.170A-16(d)(2).

- A donor who claims a noncash contribution deduction of more than $500,000 must obtain a contemporaneous written acknowledgment and a qualified appraisal, complete and file Section B of Form 8283, and file a copy of the qualified appraisal with the return for the taxable year in which the contribution is made. Reg. § 1.170A-16(e).

□ The requirements for substantiation that must be submitted with a return also apply to the return for any carryover year under Section 170(d). Reg. § 1.170A-16(f)(3).

Note. The final regs do not include a standard for determining whether the taxpayer has reasonable cause for not providing a qualified appraisal, because the Tax Court, in *Crimi v. Comm'r*, T.C. Memo. 2013-51, held that this determination was "inherently a fact-intensive one, and facts and circumstances must be judged on a case-by-case basis." T.C. Memo. 2013-51 at *99.

The preamble to the final regulations states that a Form 8283 cannot satisfy the requirement for a contemporaneous written acknowledgment under Section 170(f)(8). The contemporaneous written acknowledgment must be provided by the donee organization and contain certain required information, and the only portions of the appraisal summary that is signed by the donee organization does not contain the required information.

The preamble also states that the government needs to have the appraisal attached to each return reflecting a contribution in excess of $500,000, and that this need outweighs the burden on taxpayers to supply it. 83 Fed. Reg. at 36419.

□ The regulations define Aqualified appraisal@ as an appraisal document prepared by a qualified appraiser in accordance with generally accepted appraisal standards, (the substance and principles of the Uniform Standards of Professional Appraisal Practice). Reg. § 1.170A-17(a)(2). They also provide that a Aqualified appraiser@ is an individual with verifiable education and experience in valuing the relevant type of property. Someone has verifiable education and experience who has successfully completed professional or college-level course work in valuing the relevant type of property and has two or more years of experience in valuing that type of property. The regulations require a statement in the appraisal of the appraiser's specified education and experience in valuing the relevant type of property. The appraiser must also complete course work in valuing the category of property that is customary in the appraisal field for an appraiser to value. Reg. § 1.170A-17(b).

Note. The regulations provide that the new education and experience requirements apply only to contributions made on or after January 1, 2019. Reg. § 1.170A-17(c).

□ A "qualified appraisal" must be conducted by a qualified appraiser in accordance with generally accepted appraisal standards, which were defined in the proposed regulations as the "substance and principles of the Uniform Standards of Professional Appraisal Practice

[USPAP], as developed by the Appraisal Standards Board of the Appraisal Foundation." Reg. § 1.170A-17(a)(2).

6. Conservation (Including Façade) Easements Raise Numerous Problems. *PBBM-Rose Hill, Ltd. v. Comm'r*, 900 F.3d 193, 2018 WL 3853450 (5th Cir. Aug. 14, 2018); *Pine Mountain Preserve, LLP v. Comm'r*, 151 T.C. ___ (No. 14) (Dec. 27, 2018); *Harbor Lofts Associates v. Comm'r*, 151 T.C. ___ (No. 3) (Aug. 27, 2018); *Pine Mountain Preserve, LLP v. Comm'r*, T.C. Memo. 2018-214 (Dec. 27, 2018); *Champions Retreat Golf Founders, LLC v. Comm'r*, T.C. Memo. 2018-146 (Sept. 10, 2018); *Wendell Falls Development LLC v. Comm'r*, T.C. Memo. 2018-45, *reconsideration denied*, T.C. Memo. 2018-193 (Nov. 20, 2018); *United States v. Zak*, No. 1:18-cv-05774 (N.D. Ga. Dec. 18, 2018), https://www.justice.gov/opa/press-release/file/1121451/download

a) *PBBM-Rose Hill, Ltd*. Contribution that Served Conservation Purposes Was Not Perpetual because Amount Due to Charity in Case of Changed Circumstances Reduced by Value of Improvements

PBBM-Rose Hill, Ltd., the taxpayer, gave a conservation easement over 234 acres of property (the "Conservation Area") to the North American Land Trust ("NALT"). The Conservation Area was a golf course, but not the course maintenance areas or the club house. The easement deed granted NALT the deed restrictions "in perpetuity" and to accomplish the "Conservation Purposes," which were: (a) preserving the Conservation Area for outdoor recreation by, or the education of, the general public; (b) preserving the Conservation Area as a relatively natural habitat of fish, wildlife, or plants or similar ecosystem; (c) preserving the Conservation Area as open space which provides scenic enjoyment to the general public and yields a significant public benefit; and (d) preserving the Conservation Area as open space which, if preserved, will advance a clearly delineated Federal, State or local governmental conservation policy and will yield a significant public benefit. The taxpayer deducted $15.1 million for the easement gift, but the IRS denied the deduction. After a five-day trial, the tax court gave a bench order that the easement was not granted exclusively for conservation purposes and denied the deduction. The court also held that the easement was worth only $100,000 and that the taxpayer was subject to a gross valuation misstatement penalty.

The Fifth Circuit (Judge King) affirmed the holding of the Tax Court. The court held that the contribution did protect the conservation purpose of preserving land for outdoor recreation by the general public, as provided in Section 170(h)(4)(A)(i), but that it

was not deductible because it did not do so in perpetuity. The IRS agreed that the land was preserved for outdoor recreation but claimed that it did not afford the general public "substantial and regular use," as required by Reg. § 1.170A-14(d)(2)(ii). The deed was ambiguous on this point. The Tax Court relied on the fact that the purchasing property owners' association restricted public access over part of the property. The Fifth Circuit held that whether the public had access must be based on the facts on the date of the conveyance of the easement, unless the donor knew or should have known at the time of the donation that the public would be denied access. Reg. § 1.170A-14(d)(5)(iv)(C). The court found no such knowledge and, despite the ambiguity and construing the deed in light of the donor's intent, the court found that the public was intended to have the required substantial access. The court then held that the deed did not create a perpetual easement. Reg. § 1.170A-14(g)(6)(i) requires that if a later change in conditions makes continued use of the property for conservation purposes impossible or impractical, if the proceeds of any subsequent sale or exchange must be used by the donee in a manner consistent with the conservation purpose. In particular, Reg. § 1.170A-14(g)(6)(ii) requires that the restriction "gives rise to a property right ... with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time.... [T]hat proportionate value of the donee's property rights shall remain constant.... [When the unexpected change occurs, the donee] must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction...." The court agreed with the IRS that the "proportionate value" in the regulations means a fraction equal to the value of the conservation easement at the time of the gift, divided by the value of the property as a whole at that time. See also *Kaufman v. Shulman*, 687 F.3d 21, 26 (1st Cir. 2012); and *Carroll v. Comm'r*, 146 T.C. 196, 212 (2016). The court also held that the easement provisions did not satisfy this requirement, because the amount due to NALT on a sale or exchange would be reduced by the value of the purchase price attributable to any improvements to the property. The court held that the regulations do not permit this adjustment. The court also affirmed the Tax Court's determination that the easement was worth only $100,000, finding that the court correctly took into account testimony from experts that the property could not likely have been developed by the donor, in light of local development restrictions. Thus, the substantial overvaluation penalty under Section 6662 was also sustained.

b) ***Pine Mountain Preserve, LLP*. Right to Change Areas Subject to Reduced Restrictions Disqualifies Gift for $29 Million Deduction**

Over several years and through several transactions, Pine Mountain Preserve, LLP (PMP) acquired 6,224 acres of land about 20 miles southeast of Birmingham, Alabama. In separate transactions in 2005, 2006, and 2007, PMP contributed to North American Land Trust (NALT), a qualified charitable organization, easements covering portions of the property. Each easement defined a conservation area that was to be restricted in perpetuity from commercial and residential development, but with a carve-out in the 2005 and 2006 easements (but not the 2007 easement) for reserved "building areas," within which PMP could construct a single-family residence. The 2005 easement carve-out permitted PMP (with NALT's consent) to move the building areas from their initially designated locations to any other location within the conservation area, and reserved to PMP the rights to construct, within the conservation area, other facilities appurtenant to residential development, such as barns, riding stables, scenic overlooks, and boat storage buildings, some of which could include additional living quarters. The boundary modification was permitted only if (a) the modification of the boundary would not, in NALT's reasonable judgment, directly or indirectly result in any material adverse effect on any of the "conservation purposes" of the easement; (b)the acreage of the building areas could not be increased; and (c) the modification must be set forth in a recorded, written, amendment to the easement deed signed by the owner of the land in the portion of conservation area that is subject to the boundary modification and NALT. The 2006 easement did not specify the location of the building areas, except to state that these locations must be "approved in advance" by NALT. PMP claimed approximately $33 million in charitable contribution deductions for the three easement gifts, of which $4 million was the 2007 gift. PMP included an appraisal prepared by an independent professional appraiser with each tax return. The IRS denied the deductions, finding that the gifts were not qualified real property interests under Section 170(h)(1)(A) and were not made "exclusively for conservation purposes."

The Tax court (Judge Lauber, with agreement by Judges Foley, Gale, Thornton, Marvel, Gustafson, Kerrigan, Buch, Nega, Pugh and Ashford), in a reviewed decision with one judge dissenting, held that the 2005 and 2006 contributions were not deductible, because neither easement identified any property that could, in no event, become unencumbered and used for residential development.

Also, neither the 2005 nor the 2006 easement constituted "a restriction (granted in perpetuity) on the use which may be made of the real property" under Section 170(h)(2)(C), or a "qualified real property interest." The court followed *Belk v. Comm'r*, 140 T.C. 1 (2013), *supplemented by*, T.C. Memo. 2013-154, *aff'd*, 774 F.3d 221 (4th Cir. 2014), which denied a deduction where a developer donated to a land trust a conservation easement over a golf course, which was surrounded by a single-family residential development. The Belk easement permitted the parties by mutual agreement "to change what property is subject to the * * * easement" as long as the developer substituted, and subjected to the easement, a contiguous plot of land of equal or greater size, value, and ecological quality." The Fourth Circuit in Belk noted that "the section 170(h)(5) requirement that the conservation purpose be protected in perpetuity is separate and distinct from the section 170(h)(2)(C) requirement that there be real property subject to a use restriction in perpetuity."). The Tax Court refused to follow *BC Ranch II, L.P. v. Comm'r*, 867 F.3d 547 (5th Cir. 2017), *vac'g & rem'g Bosque Canyon Ranch, L.P. v. Comm'r*, T.C. Memo. 2015-130, which involved conservation easements donated to NALT on terms similar to those in Pine Mountain Preserve, LLP. In *Bosque Canyon*, the developer retained rights resembling those reserved by PMP, including the right, by mutual agreement with NALT, to change the location of homesite parcels within the conservation area that could be developed, subject to the proviso that any such change could not, in NALT's reasonable judgment, "directly or indirectly result in any material adverse effect on any of the Conservation Purposes," and that "[t]he area of each homesite parcel * * * [could] not be increased." In *Bosque Canyon*, the easement only permitted the developer to change the location of the homestead sites within the conservation area, while leaving the perimeter of the conservation area unchanged. The Fifth Circuit found these terms materially different from those in *Belk* and allowed the deduction. PMP urged that its easements were more like those in *Bosque Canyon* than those in *Belk*, but the Tax Court disagreed. The court noted that this decision would be appealable to the Eleventh Circuit, so that neither the Fourth nor the Fifth Circuit holdings were binding on the Tax Court. *Golsen v. Comm'r*, 54 T.C. 742, 756-757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). The court agreed with the Fourth Circuit and disagreed with the majority opinion in the Fifth Circuit, and stated that the facts of this case were too close to those in *Belk* to produce a different result. The court permitted a deduction for the 2007 contribution, however, noting that that easement designated no "Building Areas" and permitted no residential construction anywhere within the 2007 Conservation

Area. The 2007 easement also reserved to PMP no rights to construct scenic overlooks, barns, riding stables, boat storage buildings, piers, or other structures appurtenant to residential development. The court did, however, leave to a separate memorandum decision (see below) a determination of the value of the 2007 easement, separate and apart from the values of the 2005 and 2006 easements.

Judge Morrison dissented. He would have permitted a $27,904,500 deduction for the 2005 easement, but none for the 2006 easement. He would also permit a deduction for the 2007 easement, in an amount to be determined in a separate opinion. The dissent disagreed with the majority and contended that a careful reading of the easement deeds shows that they do not permit a change to the external boundaries of the conservation area; they only permit a change in the location of the 10 acres of building areas within the fixed external boundary of the conservation area. The dissent also contended that permitting construction within the 10 acre building area did not prevent the property, including the building area, from being a qualified real property interest; rather, it merely reduced the significance of the restrictions imposed on the 10 acre portion of the interest. There were still restrictions, but they were less stringent. The majority disagreed, noting that "the dissent does not cite a single operative restriction that would actually be imposed by the easement." The dissent also distinguished the easement restrictions in *Bosque Canyon* from those in this case. In *Bosque Canyon*, the dissent argued, the right to change the boundaries of the "Homesite" parcels caused the easements to fail the perpetual-use-restriction test. The 2005 and 2006 Pine Mountain easements, however, define the building areas and those areas are governed by the restrictions in the deeds. The 2005 easement and the 2006 easement each impose 18 specific restrictions, but only some of these are lifted with respect to the building area. In *Bosque Canyon*, all restrictions were lifted for the Homesite areas. The dissent also argued that the 2005 easement and the 2007 easement did not permit any uses inconsistent with its conservation purposes, but that the 2006 easement did permit uses inconsistent with its conservation purposes. The dissent noted that easements can reserve the right of landowners to construct buildings and to use the land for various other purposes and still be considered contributions exclusively for conservation purposes. Citing *Glass v. Comm'r*, 124 T.C. at 269, 271, 283 (conservation easement permitted construction of overlook decks, patios, boat houses); *Butler v. Comm'r*, T.C. Memo. 2012-72 (conservation easement on 393.33 acres of land reserved the right to partition property into 11 smaller tracts averaging 36 acres, each of which would include a 2-acre building site on which a home and a garage could be constructed); Reg. § 1.170A-14(f), Ex. (4) (donation of an easement on

900 acres was deductible where easement permitted landowner to build four houses on each of five 9-acre clusters, the sites must be approved by the entity to which the easement was donated, and the donor and the donee have already identified sites where development would not impair scenic view). Certain reserved rights, however, can subvert the conservation purposes. Citing *Turner v. Comm'r*, 126 T.C. 299, 313-314 (2006) (right to construct 62 houses on 15 acres with no limitations on the building areas). The dissent concluded that the most significant right reserved in the 2005 easement is the ability of the landowner to build 10 "single family dwellings," each of which could be built only on a designated building area, the size and location set forth by the easement deed, clustered together along the shore of a small man-made lake. At trial, the taxpayer produced testimony of a biologist employed by NALT, who explained that NALT had made a complete inventory of plant and animal life on the property, and that the lake and the 10 building areas around the lake were of limited value as a natural habitat. Therefore, the biologist opined that the construction of 10 houses would not affect the conservation value of the easement. Thus, the dissent found that the right to construct the 10 houses was not inconsistent with protecting a relatively natural habitat. The 2006 easement sought primarily to protect ridgelines that provide scenic vistas. The most significant right reserved by the 2006 easement deed to the owner of the land is the right to build a house in each of 6 building areas, which is inconsistent with the specified conservation purposes, as the 2006 easement deed does not identify the locations of the building areas. The location of each building area must be approved by NALT and then only if, in NALT's judgment, the building area does not directly or indirectly result in any material adverse effect on any of the conservation purposes of the easement or the features of the conservation area having ecological or scenic significance. The dissent contended that the right to build 6 houses is inconsistent with the conservation purposes of preserving a relatively natural habitat and protecting open space for the scenic enjoyment of the general public, with "only a vague hope that NALT will exercise its veto over boundary areas that would undermine the conservation purposes."

Note. In *Pine Mountain Preserve, LLP v. Comm'r*, T.C. Memo. 2018-214 (Dec. 27, 2018), Judge Morrison held that the value of the 2006 easements was $4,779,500, as opposed to the $4,100,000 reported on the taxpayer's income tax return, and the $9,110,000 suggested by the taxpayer's appraisal expert at trial. The court held that the opinion of the taxpayer's expert about the value of the 2007 easement failed to account fully for the beneficial effects of the easement on the unencumbered portions of the PMP property,

which affects the "after" portion of the "before-and-after" measurement of the value of an easement.

c) *Harbor Lofts Associates*. Long-Term Lessee Cannot Deduct Façade Easement Contribution

Harbor Lofts Associates is the lessee under a long-term lease on two historic buildings in Lynn, Massachusetts. The owner and lessor is the Economic Development & Industrial Corporation of Lynn (Economic Development Corp.). The lease requires that Harbor Lofts pay all insurance and utility costs and permits it to use the buildings "for multi-family residential uses and such uses as may be incidental there to, and for no other purpose or purposes whatsoever without the prior written consent of" the Economic Development Corp. Harbor Lofts also has a right of first refusal to buy the buildings and is entitled to a portion of the proceeds if the land is taken under eminent domain. In 2009, Harbor Lofts and the Economic Development Corp. granted a façade easement over the buildings to Essex National Heritage Commission, Inc. (Heritage Commission), a qualified charity. On the same day as the easement was granted, Harbor Lofts and the Economic Development Corp. extended the lease term and revised the rent schedule. Harbor Lofts deducted $4,457,515 for the easement contribution, and the IRS denied the deduction and assessed, in the alternative, either an accuracy-related penalty of 40% for a gross valuation misstatement under Section 6662(b)(3), (e), and (h) or a 20% penalty under Section 6662(a).

The Tax Court (Judge Buch) granted the government's motion for summary judgment, finding that Harbor Lofts was not entitled to any deduction for its contribution, because it did not own the fee simple title to the underlying property. Harbor Lofts argued that fee ownership of is not expressly required by Section 170(h), and that in any event, it is the equitable owner of the building for tax purposes. The court disagreed, finding that a long-term lessee does not hold a fee interest in the subject property and cannot contribute a conservation easement that would be perpetual under Section 170(h). Furthermore, no deduction is allowed the lessee merely for joining the lessor in contributing the conservation easement.

d) *Champions Retreat Golf Founders, LLC.* Conservation Easement Denied for Failure to Serve Proper Environmental Purpose

Champions Retreat Golf Founders LLC owned an interest in a golf club in Augusta, Georgia. In 2010, Champions contributed to the North American Land Trust (NALT), a charitable organization, an

easement over 348.51 acres (the easement area) of the land on which the golf course was situated. The easement restricted the ways that Champions can use the easement area, the types of structures it can maintain there, and various environmental practices, but it allowed Champions to build structures with an aggregate of up to 10,000 square feet and to shift around greens, fairways, and other golf features. Champions claimed a $10,427,435 charitable contribution deduction. The IRS denied the deduction both for lack of a proper conservation purpose and because the value of the easement was zero.

The Tax Court (Judge Pugh) denied the deduction because she found that the easement did not serve a proper conservation purpose. Champions argued that the easement area provides a habitat for several species of conservation concern, namely, birds, the southern fox squirrel, and the denseflower knotweed. The court agreed that "rare, endangered, or threatened" was not limited to species listed under the Endangered Species Act of 1973 (16 U.S.C. § 1533), but after considering expert testimony, concluded that there was not a sufficient presence of rare, endangered, or threatened species in the easement area to satisfy the conservation purpose requirement. In particular, the court noted that the taxpayer presented evidence of only one rare, endangered, or threatened species with a habitat on the easement area -- denseflower knotweed -- and that species only inhabited a small fraction of the easement area. The court also disagreed with the taxpayer that the easement area was a "relatively natural habitat" because it contributed to the ecological viability of Sumter National Forest, across the Savannah River. The court basically agreed with one expert that the golf course was not a relatively natural habitat, and that the resemblance of the area between fairways to open pine woodlands or savannas was insufficient to meet the requirements of the Code. Furthermore, any such consistency was overcome by the fact that the golf course was sustained using chemical fertilizers, pesticides, and fungicides, which did not enhance the ecological viability of the adjacent property. The court also held that the easement did not meet the conservation purpose as a preserved open space, because it was not actually open to the public, either physically or with respect to views. Finally, the court stated that a preserved open space can further "a specific, identified conservation project." Reg. § 1.170A-14(d)(4)(iii)(A). In this case, however, the Georgia statute that the taxpayer cited did not relate to an "identified conservation project," but rather a more general conservation purpose.

e) *Wendell Falls Development, LLC.* Deduction Lost Because Contribution was Precondition for Approval of Development

The taxpayer, Wendell Falls Development, LLC, owned 1,280 acres of unimproved land near the town of Wendell, North Carolina, which it wished to subdivide and develop. The taxpayer proposed that the town permit it to subdivide the acreage into a master-planned community with residential areas, commercial spaces, an elementary school, and a public park, and that it be allowed to sell the residential lots to homebuilders and the commercial lots to commercial builders. The taxpayer stated that it would contribute 125 acres of lakeshore property to the Smokey Mountain National Land Trust for use as a public park. The taxpayer entered into a contract to sell the acreage to the town for over $3 million, subject to the charitable easement. The easement created by the taxpayer and the Smokey Mountain National Land Trust permitted building of the following structures on the 125 acres: (1) an environmental education center, (2) an overnight lodge, (3) one or more recreational day-use facilities, (4) sports fields, (5) an elevated wooden walkway, and (6) related maintenance facilities. The taxpayer reported a charitable gift of $1,798,000 for the conservation easement, based on an appraisal valuing the easement at $4,818,000. The IRS denied the deductions.

The Tax Court (Judge Morrison) held for the government and denied the deduction, though it imposed no penalties. The court noted that the taxpayer expected a substantial benefit from the contribution of the easement, through the approval of the master-planned community. Therefore, it could not deduct the contribution. Also, the court held that the easement had no value, because the plan accepted by the town established that the best use of the 125 acres was as parkland in the midst of a master-planned community, and the easement did not prevent the use of the property for that purpose. The court declined to impose a negligence, substantial understatement of tax, or substantial valuation misstatement penalty. The court also rejected any penalties, finding that the taxpayer took reasonable steps to determine the deductibility of these contributions, including hiring two independent appraisers.

On a motion for reconsideration, the court denied a motion for reconsideration, finding that there were neither unusual circumstances nor substantial error. *Estate of Quick v. Comm'r*, 110 T.C. 440, 441 (1998). First, the court held that its original opinion did not invalidate the fifth sentence of Reg. § 1.170A-14(h)(3)(i), which states that the deduction for the gift of a conservation easement (granted after January 14, 1986), must be reduced to the extent that the contribution increases the value of any other property owned by

the donor or a related person, the amount of the deduction. The court stated that its original opinion did not hold that any enhancement to the value of other property held by the donor results in a total disallowance, but rather that the value of the easement was zero because the highest and best use of the 125 acres subject to the easement was as parkland and the easement did not prevent the land from being put to its best use. Second, the court held that its original opinion did not invalidate the sixth sentence of Reg. § 1.170A-14(h)(3)(i), which denies a deduction for a contribution of a conservation easement if the donor or a related party receives (or is reasonably expected to receive) "financial or economic benefits that are greater than those that will inure to the general public from the transfer," or the seventh sentence of that regulation, which suggests that a deduction is not precluded if the expected benefit to the donor of the easement is demonstrably less than the amount of the transfer. The court explained that this analysis requires a comparison of the expected benefit to the donor and the amount of the transfer, and in its original opinion it had held that the donor made the gift "with the expectation of receiving a substantial benefit." T.C. Memo. 2018-45, at *13. The court had originally found and did not now deny that the value of the benefit to the donor was greater than the value of the easement to the public. Thus, the original opinion was consistent with the sixth and seventh sentences of the regulation. Third, the court reasserted its view that the highest and best use of the 125 acres was parkland, and that, therefore, its continued use as parkland did not result in a diminution in value.

f) *United States v. Zak*. Justice Department Tries to Shut Down Syndicated Conservation Easements

The U.S. Department of Justice filed suit against a network of tax advisers, attorneys, appraisers, and syndicators who have attempted to syndicate conservation easement contributions. The complaint alleges that EcoVest Capital Inc. Nancy Zak (founder of Forever Forests LLC and a former officer of EcoVest), and an appraiser, Claud Clark III, together promoted and sold ownership interests in a conservation easement syndication that was "nothing more than a thinly veiled sale of grossly overvalued federal tax deductions under the guise of investing in a partnership." The government alleges that the defendants never planned to engage in any ongoing business activity and that the only return on investment would be the tax deductions from the easement contribution. The government asserts that these deductions were artificially increased by inflated appraisals provided by Clark and others, and that in the past ten years, the de-

fendants have sold at least 96 conservation easement syndicates resulting in over $2 billion in charitable contribution tax deduction claims. The government is asking the court for: (a) an order enjoining the defendants permanently from organizing, promoting, and selling conservation easement syndication schemes and preparing tax returns or any supporting documents claiming a deduction for a qualified charitable contribution; and (b) an order requiring the defendants to disgorge the gross receipts received as a result of the schemes. Not surprisingly, the defendants contend that this is overreaching by the Justice Department based on gross misrepresentations of the facts.

Note 1. In Notice 2017-10, 2017-4 IRB 544, the IRS identified conservation easement syndications as a listed transaction requiring disclosure. The transaction is described as one which: (a) purports to give investors charitable contribution deductions significantly greater than the amount invested; (b) involves investments investors in a partnership or other pass-through entity that owns or acquires real property; (c) may include additional tiers of pass-through entities; (d) syndicates ownership interests in the pass-through entity or in one or more of the tiers of pass-through entities; (e) uses promotional materials suggesting to prospective investors that an investor may be entitled to a share of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment; (f) obtains what purports to be a qualified appraisal that greatly inflates the value of the conservation easement based on unreasonable conclusions about the development potential of the property; (g) contributes a conservation easement encumbering the property to a tax-exempt entity. The promotions state that investors who held their direct or indirect interests in the pass-through entity for one year or less may rely on the pass-through entity's holding period in the underlying real property to treat the donated conservation easement as long-term capital gain property under Section 170(e)(1). The IRS stated that it intends to challenge the purported tax benefits from this transaction based on the overvaluation of the conservation easement, and possibly also based on the partnership anti-abuse rule, economic substance, or other rules or doctrines. The IRS also noted that the charitable donee will not be treated as a party to or participant in the transaction.

Note 2. See also S. 170, 116th Cong., 1st Sess. (Jan. 16, 2019), the Charitable Conservation Easement Program Integrity Act of 2019, introduced by Senators Steve Daines (R-Mont.) and Debbie Stabenow (D-Mich.), would impose a limit on a partner's deduction for a partnership's qualified conservation contributions. The limit would be 2.5 times the partner's basis in the partnership interest and would apply for the first three years of the partnership. There would

be an exception for family limited partnerships. The bill would apply to contributions made in taxable years ending after December 23, 2016. The bill states that no inference is intended as the appropriate treatment of contributions made in taxable years ending on or before such date or as to any activity not described in Section 170(h)(7), as added by this bill.

7. Charitable Contribution of Appreciated Stock May Present Deductibility and Assignment of Income Problems. *Chrem v. Comm'r*, T.C. Memo. 2018-164 (Sept. 27, 2018)

Marc Chrem and his wife and several others owned the stock of a company that they planned to sell to a related corporation for $4,500 per share. After the shareholders had agreed to tender about 87% of the shares, the taxpayers contributed some of their shares to a charitable organization. The taxpayers obtained an appraisal for purposes of their ESOP and used this for their charitable deduction purposes. The IRS denied the charitable deduction because it said that the appraisal was not a qualified appraisal and taxed the donors on the gain as an anticipatory assignment of income. At trial, both parties moved for summary judgment.

The Tax Court (Judge Lauber) denied both motions, finding that there existed material disputes of fact. With respect to the anticipatory assignment of income, the court explained that one question was whether the acquisition was a mere expectation or a virtual certainty, and another was whether the donee charity was obligated or could be compelled to complete the sale. Rev. Rul. 78-197, 1978-1 C.B. 83 (1978); *Rauenhorst v. Comm'r*, 119 T.C. 157, 166 (2002). The existence of an "understanding" among the parties, or the fact that transactions occur simultaneously or according to prearranged steps, may be relevant in answering that question. *Blake v. Comm'r*, 697 F.2d 473, 480 (2d Cir. 1982), *aff'g* T.C. Memo. 1981-579; *Ferguson v. Comm'r*, 108 T.C. 244 (1997), *aff'd*, 174 F.3d 997 (9th Cir. 1999). The court stated that the fact that the acquired and acquiring corporation were related by common management, had interests that were aligned, and desired that the stock acquisition be completed, suggested that the acquisition was virtually certain to occur. It was unclear, however, whether the taxpayers had the ability to sway the charity's actions and compel the sale, and the significance of the charity's fiduciary duties to maximize the contribution; if it tendered its shares, it would immediately receive $4,050,000 in cash; otherwise, it would be left with a 13% minority interest in a closely-held corporation. These issues required trial. With respect to whether the appraisal and appraisal summary met the regulations' reporting requirements, the court noted that those requirements may be substantially, rather than literally, complied with. *Bond v Comm'r*, 100 T.C. 32 (1993); *Hewitt v. Comm'r*, 109 T.C. 258, 265, n.10 (1997), *aff'd without pub'd op.*, 166 F.3d 332 (4th Cir. 1998). Also, Section 170(f)(11)(A)(ii)(II) excuses

failure to satisfy the reporting requirements discussed above if the failure "is due to reasonable cause and not to willful neglect." The IRS asserted that, while the appraiser was a qualified appraiser, the appraisal was not a qualified appraisal and the appraisal itself was not attached to the return, as required by Section 170(f)(11)(D) with respect to gifts valued at more than $500,000. The appraisal was not addressed to the taxpayers, did not include the date of the contribution, and did not state that it was prepared for income tax purposes. Reg. § 1.170A-13(c)(3)(ii). Instead, it stated that it was intended solely for the use of the ESOP trustee, and that it "d[id] not take into consideration any tax consequences related to [the company's] selling shareholders." Also, the appraisal did not value the specific blocks of stock being contributed, but instead valued the entire corporation without a minority discount. The taxpayers argued that the acquiring corporation was offering to by 100% of the shares for $4,500 per share, so that no minority discount was appropriate. They argued that, under these facts, they had complied substantially wit the appraisal reporting requirements. Alternatively, if they did not strictly or substantially comply with the reporting requirements, they argued that their failure was due to reasonable cause and not to willful neglect. IRC § 170(f)(11)(A)(ii)(II). The taxpayers noted that their 2012 returns were prepared by an experienced CPA whom they supplied with the Empire report and all relevant information about the stock acquisition, and that she did not direct any of petitioners to include a copy of the report with their returns. The court held that there was a triable issue of fact regarding the substantial compliance and reasonable cause issues.

8. Substantial Charitable Deductions Lost for Failure to Include Basis Information in Donor's Appraisal Summary. *Blau v. Comm'r*, 924F.3d 1261, 2019 WL 2236815 (D.C. Cir. May 24, 2019), *aff'g sub nom. RERI Holdings, LLC I v. Comm'r*, 149 T.C. 1 (2017); *Belair Woods, LLC v. Comm'r*, T.C. Memo. 2018-159 (Sept. 20, 2018)

a) *Blau*. $33 Million Deduction Lost Because of Omission of Basis Information; Value of Remainder Interest is Based on All Relevant Facts and Circumstances

RERI Holdings, an LLC taxed as a partnership, bought for $2.95 million a remainder interest in a Hawthorne, California building that was rented to AT&T for use as a web hosting facility. Hawthorne Holdings, LLC owned all of the membership interests in RS Hawthorne, LLC, which owned the fee interest in the real estate. AT&T had a fifteen and one-half-year triple net lease, with three five-year renewal options. The remainder interest would become possessory in seventeen years. The agreement creating the remainder interest included extensive covenants designed to preserve the value of the property. The agreement, however, made immediate possession the

sole remedy for breach of those covenants; other damages were precluded. Seventeen months after buying the remainder interest, RERI assigned it to the University of Michigan, and claimed a $33 million income tax deduction. An appraisal prepared for RERI valued the fee at $55 million, based on the projected rents, and valued the remainder interest at $33 million, based on the Section 7520 actuarial tables. The taxpayer's appraisal summary left blank the space for "Donor's cost or other adjusted basis." The IRS denied the entire deduction.

The Tax Court (Judge Halpern) held for the government, that the omission of basis information from the Form 8283 was material and caused the contribution not to have been properly substantiated under Reg. § 1.170A-13(c)(4)(ii)(E). The doctrine of substantial compliance applies to some of the substantiation requirements, but it requires that all material information be provided. *Bond v. Comm'r*, 100 T.C. 32, 40-41 (1993). The disclosure of cost or other basis was material, because a large disparity between basis and fair market value would alert the IRS to a potential overvaluation. Thus, there was no substantial compliance. The taxpayers' experts at trial valued the property based on its cash flow, and the remainder interest actuarially. The court held that the limitation on remedies in the original agreement did not adequately protect the remainder holder and it was not appropriate to value the remainder interest under the standard actuarial tables. Reg. § 1.7520-3(b)(2)(iii). The remainder must be valued based on all relevant facts and circumstances. Reg. § 1.7520-3(b)(1)(iii). On that basis, the remainder interest was worth $3,462,886 on the date of the gift. As the claimed valuation was more than 400% of the actual value, a 40% gross valuation misstatement penalty was imposed under Section 6662(e)(1)(A), 6662(h)(2). The penalties were not avoided because RERI did not make a good faith investigation of the value of the remainder interest, and thus did not have reasonable cause for, or act in good faith with respect to its claim of a charitable contribution deduction. I.R.C. § 6662(c)(2)(B).

The Court of Appeals for the D.C. Circuit (Senior Judge Ginsburg) affirmed. The court noted that the information gathering function for charitable contributions was set out in the Deficit Reduction Act of 1984, which directed the Treasury to increase the stringency of its requirements for verification. Pub. L. No. 983-69, § 155(a)(1), 98 Stat. 494, 691. Specifically, the 1984 law instructed the Secretary to promulgate regulations that require a taxpayer claiming a deduction for a noncash charitable contribution, among other things, "to include on such return such additional information (including the cost basis and acquisition date of the contributed property) as the Secretary may prescribe in such regulations." Reg.

§ 1.170A-13(c)(4)(ii)(E) specifies that an appraisal summary must include "[t]he cost or other basis of the property." The court stated:

> *Though the Congress left it to the discretion of the Secretary of the Treasury to impose additional reporting requirements, the Congress specifically identified the basis and the date of acquisition as the bare minimum that a taxpayer must provide. We should be very reluctant to set to naught what the Congress deemed essential.*

2019 WL 2236815 at *5. The court then refused to rule that the doctrine of substantial compliance does not apply to the substantiation requirements, holding that it was unnecessary to do so, because the taxpayer had not substantially complied with the regulations; omission of basis is a material failing. The taxpayer argued that omitting basis should result in the IRS presuming basis to be zero, which would raise the same red flag as would reporting a low basis. The court rejected this argument, finding that Treasury already addresses this issue by providing that a donor can substitute an explanatory statement if it is unable to provide basis information. Reg. § 1.170A-13(c)(4)(iv)(C)(1). Here, the taxpayer neither lacked information about its basis nor had any other excuse for its failure to report its basis. The court also affirmed the Tax Court's analysis with respect to the valuation of the remainder interest and the imposition of the 40% overvaluation penalty.

b) *Belair Woods, LL.* Summary Judgment Denying $4,778,000 Deduction Because Taxpayer Failed to Include Basis Information in Appraisal Summary; Taxpayer May Avoid 20% Penalty by Demonstrating Reasonable Cause at Trial

Belair Woods, LLC owned 145.15 acres of a 1,490-acre tract of woodland in Effingham County, Georgia. An affiliate of the manager of Belair owned the rest of the tract. Belair contributed a conservation easement over 141.15 acres of the tract to the Georgia Land Trust (GLT). The subject property excluded a pair of two-acre "homesites" designated for residential development. Belair timely filed its tax return claiming a deduction of $4,778,000 (or $33,707 per acre) for the easement. Belair included with the return a copy of an appraisal that relied on the "before and after" method to value the easement and Form 8283, the appraisal summary, executed by the appraiser and the charity. A company that helps taxpayers implement charitable easement contributions, Forever Forests, prepared the Form 8283. Forever Forests was informed by its attorneys that

"[i]t should not be necessary to include the basis information * * * if you attach an explanation to Form 8283 providing a reasonable cause for why it is not included." In the relevant boxes on the Form 8283, Belair wrote "see attached" and appended a two-page letter, that stated, with respect to "cost or adjusted basis":

> *A declaration of the taxpayer's basis in the property is not included in * * * the attached Form 8283 because of the fact that the basis of the property is not taken into consideration when computing the amount of the deduction. Furthermore, the taxpayer has a holding period in the property in excess of 12 months and the property further qualifies as "capital gain property."*

T.C. Memo. 2018-159 at *8. The IRS disallowed the entire deduction because of the absence of basis information in the appraisal summary. It also assessed a 40% "gross valuation misstatement" penalty under Section 6662(a) and (h) and, in the alternative, a 20% accuracy-related penalty under Section 6662(a).

The Tax Court (Judge Lauber) granted the government summary judgment that the taxpayer failed to file a proper appraisal summary, and that the summary filed did not substantially comply with the requirements of the regulations. It also found a material fact question whether there was reasonable cause for the failure to include basis information. The regulations require a donor who seeks to deduct a contribution of property valued at more than $5,000 to "[a]ttach a fully completed appraisal summary" to the tax return, and that the summary must include certain information on the basis of the property. Reg. § 1.170A-13(c)(4)(ii)(E). Belair did not do so, stating only that the IRS did not need the information in this case. The court also held that Belair did not substantially comply with the appraisal summary requirement, because basis information is an integral component. Substantial compliance requires that the taxpayer provide most of the information required and that omissions are not material; the basis information is essential to enable the IRS to identify overvaluations. See *RERI Holdings I, LLC v. Comm'r*, 149 T.C. 1 (2017). Belair acquired the land in question by contribution from a related party, that had bought it for $2,605 an acre; the Belair appraisal valued the property at $33,707 an acre. However, Section 170(f)(11)(A)(ii)(II) created a defense for failure to comply with the regulatory reporting requirements by a showing of "reasonable cause" and a lack of "willful neglect." The taxpayer contends that it relied on advice from Forever Forests, which relied

on an outside law firm. This issue the court stated, had to be decided at trial.

9. Charitable Deductions Denied for Lack of Adequate Substantiation. *Grainger v. Comm'r*, T.C. Memo. 2018-117 (July 30, 2018); *Archer v. Comm'r*, T.C. Memo. 2018-111 (July 16, 2018); *Ayissi-Etoh v. Comm'r*, T.C. Memo. 2018-107 (July 9, 2018)

a) *Grainger*. A Private Tax-Shelter via Talbots Fails

Estelle Grainger bought clothes at Talbots at deep-discount end-of-season sales, using frequent-shopper points to obtain even greater discounts. She then promptly gave the clothes to charity and deducted the amounts that the store said were the normal list prices before any discounts. The taxpayer substantiated her contributions with receipts from Talbots, marked-down price tags of purchased items, and receipts from Goodwill. On the Goodwill receipts, a Goodwill employee marked the date and location of the donation, the general types of items donated (e.g., clothing), and his signature. The taxpayer also supplied a spreadsheet she had prepared. The taxpayer deducted $34,401 in charitable gifts; the IRS disallowed all but $6,117 – the amount of cash she had paid for the clothing.

The Tax Court (Judge Lauber) agreed with the IRS, noting that where similar items of contributed property are valued in excess of $5,000, the taxpayer must substantiate the value of the property with a qualified appraisal. IRC §170(f)(11)(C). The taxpayer must then also attach to her return a fully completed "appraisal summary" on Form 8283. *Costello v. Comm'r*, T.C. Memo. 2015-87; Reg. §1.170A-13(c)(2)(i)(B). The taxpayer in this case made contributions of similar items that together produced a deduction in excess of $5,000, but she obtained no qualified appraisal and submitted no appraisal summary. Furthermore, the Forms 8283 that the taxpayer submitted were not executed by an official of the donee, as required. The taxpayer also failed to secure a valid contemporaneous written acknowledgement, as required by Section 170(f)(8)(B), and the receipts from Goodwill merely stated that she donated clothing; they did not indicate what specific items of clothing she donated or the number of items she donated on any particular visit. For these items, the taxpayer failed to maintain reliable written records that include the name and address of the donee, the date and location of the contribution, and a description of the property "in detail reasonable under the circumstances." Reg. § 1.170A-13(b)(2)(ii)(A) - 1.170A-13(b)(2)(ii)(C).

Note. The court also noted that, even if Estelle had met the substantiation requirements, she did not employ a legitimate method

for establishing fair market value. The fair market value for this purpose "is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Reg. §1.170A-1(c)(2); *United States v. Cartwright*, 411 U.S. 546, 551 (1973). The fair market value of an item is not the price at which a hopeful retailer initially lists that item for sale, but rather the price at which it is actually sold. No buyer with knowledge of the relevant facts would have paid for these items a price higher than the price Talbots was then charging. Also, the court noted that even if the fair market value were the higher figure, the deduction would have been limited to cost basis, because the items were not held long enough to produce a long-term capital gain if sold or exchanged.

b) *Archer.* Inadequate Records Cost Taxpayer His Deductions

Over two taxable years, Darrell Archer reported cash charitable gifts of $10,800 and noncash gifts of $6,399. He did not produce canceled checks or receipts for the cash contributions. For noncash contributions in one year, he produced forms provided by the recipient that he filled out himself, on which he estimated values but did not describe any donated property other than as "bags/boxes" and "large household item(s)".

The Tax Court (Judge Cohen) noted that for cash contributions a taxpayer must retain canceled checks, receipts from the donee organizations showing the dates and amounts of the contributions, or other reliable written records showing the names of the donees, dates, and amounts of the contributions. Reg. § 1.170A-13(a)(1). For each noncash contribution, the taxpayer must maintain a receipt from the donee, unless doing so is impractical, and the receipt must show: (1) the name of the donee; (2) the date and location of the gift; and (3) a description of the property in detail reasonably sufficient under the circumstances. Reg. §1.170A-13(a)(2). A taxpayer who lacks a donee receipt must maintain reliable written records showing the same items, along with the fair market value of the property at the time the contribution was made and the method used to determine the fair market value. Reg. §1.170A-13(a)(2)(ii); *Van Dusen v. Comm'r*, 136 T.C. 515, 532 (2011). Also, no deduction is allowed for "any contribution of clothing or a household item" unless such property is "in good used condition or better." IRC § 170(f)(16)(A). In this case, the taxpayer had no such records and lost the deductions.

c) *Ayissi-Etoh*. Self-Created Spreadsheet is Inadequate Substantiation

Magloire Ayissi-Etoh and Katrina Sharpe, a married couple, made 2011-2012 contributions to their church, Goodwill, and their private foundation, American Management & Consulting Foundation, Inc. (AMC Foundation). The foundation was not recognized by the IRS as a tax-exempt charitable organization until 2016, and then with a November 23, 2015 effective date. In the years in question, the taxpayers deducted over $76,000 in cash gifts and $23,000 in non-cash gifts, all of which deductions the IRS denied.

The Tax Court (Judge Lauber) denied the deductions, finding that the taxpayers' gifts to the Foundation were made to a non-qualified donee and that they had entirely failed to substantiate those gifts. The taxpayers' only records for the gifts to the foundation were "receipts" that the husband signed in his capacity as chairman of the foundation; they presented no checks, bank records, or contemporary written receipts. See IRC § 170(f)(8)(B). The court denied the deduction for the claimed weekly cash contributions to the couple's church, which were substantiated only by a self-created spreadsheet which the court found unreliable to substantiate the contributions. Reg. § 1.170A-13(a)(2)(i). The court also denied the deductions for contributions of $14,000 worth of clothing and electronic equipment to Goodwill, finding that the taxpayers' only support for these gifts was a self-prepared spreadsheet and a Goodwill "valuation guide." The taxpayer's Forms 8283 were not signed by any Goodwill official, the taxpayers had no receipt, contemporary written acknowledgement or other donee-provided document recognizing the gifts. The purported contributions included three dozen suits valued at up to $600 apiece, three dozen pairs of basketball shoes valued up to $280 apiece, a dozen winter jackets, and 15 pairs of jeans. The court characterized this listing as "implausible on [its] face."

10. No Deduction for Allowing Charity to "Deconstruct" Residence and Salvage Components, because Donor Did Not Obtain a Qualified Appraisal. *Mann v. United States*, 2019 WL 399902, 123 A.F.T.R. 2d 2019-599 (D. Md. Jan. 31, 2019) (Slip copy)

Linda and Lawrence Mann owned a house that they decide was not suitable for them. Linda, in whose name the house was titled, gave it to Second Chance, a public charity that employs disadvantaged persons to deconstruct properties, salvaging of building materials, fixtures, and furniture, and then selling the salvaged items. Second Chance does not perform actual demolition, though deconstruction sometimes destroys part of a subject property.

In one document, Linda conveyed to Second Chance all of her rights, title, and interest in "the improvements, building and fixtures located on the Premises" In a second document, Linda conveyed to Second Chance various furniture and other personal property associated with the house. The Manns also agreed to give $20,000 in cash to Second Chance, to cover the costs of deconstruction, though they ultimately only gave $10,000 in one year and $1,500 in the next. The taxpayers obtained two appraisals of the house and one of the personal property. House Appraisal A valued the entire house at $675,000 and stated that moving it to another site would produce the greatest profit. House Appraisal B valued the house at $313,353, assuming that the taxpayers conveyed the rights in the structure to Second Chance to be used for training purposes and that any salvaged building materials would later be sold by Second Chance. The personal property appraisal listed some of the items of furniture and home decoration, individually valued and photographed, and attributed to them a total value of $24,206, based on the cost of the items if new, less labor and other costs, and depreciating the resulting "materials costs" by 42% to reflect that the items had an expected lifespan of 60 years and were approximately 25 years old. The appraiser calculated the new cost value of the 40 items at $372,000. Ultimately, Second Chance was unable to extract as much salvage material from the house as they had hoped, though they kept no manifest or record of exactly what materials were salvaged. Second Chance incurred approximately $13,144 in expenses in deconstructing the house. The taxpayers claimed deducted $675,000 for their gift of the house, $24,206 for their gift of the personal property, and $11,500 for the cash donations. The IRS denied all of the deductions.

The U.S. District Court for Maryland (Judge Chuang) held for the government, allowing summary judgment denying the taxpayers' a refund based on their deduction of the noncash contributions, and allowing the refund based on the cash payments. The court explained that the taxpayers gave the charity only a partial interest that did not meet the requirements of Section 170(f)(3). The court noted that, under Maryland law, ownership of improvements to land follows title to the land, and one can convey title to the improvements separate from the underlying land only by a recorded deed or similar instrument; no instrument was recorded in this case. Thus, the taxpayers' donation was comparable to granting the charity a license to access and use the house for salvage and training purposes. See *Patel v. Comm'r*, 138 T.C. 395, 411 (2012) (under Virginia law, a donation of a house but not the underlying land to a fire department to be burned as a training exercise was "a mere license to use the property"). It was not a contribution of an undivided interest in property nor was it a gift in any other permissible form under Section 170(f)(3). The court also denied the deduction because the appraisals used by the taxpayers were not qualified appraisals. The valuation methodology used in House Appraisal A was in-

valid because it did not take into consideration the condition on the conveyance that would reduce the value of the donation. House Appraisal B used a methodology that was inconsistent with the condition that Second Chance would not merely dismantle all the building materials and sell them at market value, but also use the process for "training individuals for reintroduction into the local community." House Appraisal B concluded that the donation of the house was similar to donating a structure to the local fire department for use in a fire training exercise, except that in this case, Second Chance's program prevented any materials from being salvaged. House Appraisal B incorrectly based the valuation on the resale value of all building materials and overstated the value of the contribution. The correct way to value the contribution would have been to take the resale value of the specific building materials and contents that Second Chance actually removed to its warehouse. The court also found that the taxpayers had abandoned their claim for the personal property, but that even if they had maintained it, the personal property appraisal: (a) did not provide the specific basis and documentation for valuing all of the 40 items of household furniture at $372,000 and instead included fair-market comparators for only a few items; and (b) included a flawed conclusion as to the donation value of the personal property by not adhering to its own avowed methodology, which requires both the deduction of certain costs and then depreciation by 42%, rather than merely depreciating the items haphazardly. Thus, it was not a qualified appraisal. The court allowed the taxpayers to deduct their cash payments to Second Chance, noting that Second Chance's deconstruction services did not reduce the cost to the taxpayers of the house demolition and the taxpayers received no discernible benefit from their $11,500 in payments. See *Scheidelman v. Comm'r*, 682 F.3d 189 (2d Cir. 2012) (homeowner could deduct cash gift of 10% of the value of a contributed façade easement, made to cover administrative costs).

11. Updated Guidance for Contributors to Tax-Exempt Organizations. Rev. Proc. 2018-32, 2018-23 I.R.B. 739 (June 4, 2018)

The IRS updated its rules respecting when grantors and contributors may rely on the IRS identification of a donee organization for purposes of deducting contributions to the organization, and when they may rely on the listing of an organization in the IRS searchable database of those organizations that are eligible to receive tax-deductible contributions. The new procedure, which is effective May 16, 2018, states that donors may safely rely on the information in the various IRS searchable databases of tax-exempt organizations, unless the IRS has revoked the organization's qualification to receive deductible contributions and (1) the donor knows of the revocation, (2) the donor was aware that the revocation was imminent, or (3) the donor was in part responsible for or aware of the activities or deficiencies

that result in the loss of qualification. The procedure also provides safe harbors for determining when a grant or contribution may cause the grantor or contributor to be responsible for, or aware of, an act that results in an organization's loss of public charity classification, and for determining that a grant or contribution is an "unusual grant." It also incorporates changes made in the transition from using Publication 78, "Cumulative List of Organizations Described in Section 170(c)," to a searchable IRS database of eligible organizations, and regulation changes that eliminated the advance ruling process and changed the computation period for determining public support for certain organizations.

12. Stock Contributed to Private Foundation is Qualified Appreciated Stock, Despite SEC Restrictions. PLR 201848005 (Nov. 30, 2018)

Taxpayer's sole member LLC contributed shares of the stock of Corporation to a private nonoperating private foundation. Corporation's shares are listed and regularly traded on a national securities exchange registered with the SEC under the Securities Act of 1934 and could be sold on without restriction under an exception from SEC Rule 144. Corporation's insider trading policies, however, require Taxpayer and Taxpayer's LLC to conduct purchases and sales of Corporation's shares pursuant to a SEC Rule 10b5-1 written trading plans.

The IRS stated that Section 170(e)(1)(B)(ii), which reduces the amount of the deduction of corporate shares other than "qualified appreciated stock" to a nonoperating private foundation by the portion of the value that would have been long-term capital gain had it been sold, instead of contributed, did not apply, because the stock of Corporation was qualified appreciated stock. The IRS explained that neither the exemption to the registration requirement, nor an SEC Rule 10b5-1 written trading plan, nor the SEC Rule 144(e) volume restrictions subject the contributed shares to a restriction that materially affects their value or prevents the shares from being freely traded.

E. IRC § 262. Personal, Living, and Family Expenses

Second Circuit Denies Individual Retirement Benefit Recipient Deduction for Estate Expenses. *Harrell v. Comm'r*, 765 Fed. Appx. 501, 2019 WL 1178736, 123 A.F.T.R. 2d 2019-505 (2d Cir. March 13, 2019), *aff'g in part and rem'g in part* T.C. Memo. 2017-76

Ingrid Harrell received $28,937 in gross distributions from the New York City Employees' Retirement System (NYCERS) as the beneficiary of her father, who was a participant in NYCERS. NYCERS is a defined benefit plan consisting of both employer and voluntary and mandatory employee contributions. During the years in

question, Ingrid paid and deducted various expenses related to her father's death and the administration of his estate, including funeral expenses and professional fees. Ingrid and her husband also reported the full annuity distributions of $28,937 from NYCERS on their income tax returns, but asserted that $16,245 of each distribution was excludable from gross income.

The Tax Court held that Ingrid and her husband could not deduct the estate expenses they paid and that they had miscalculated the decedent's investment in the contract that would permit a tax-free recovery of his contributions from the annuity paid to Ingrid. The Tax Court also held that no evidence was presented that proved that the decedent made after-tax contributions that could have been recovered tax-free from the annuity. Finally, the court held that the taxpayers could not deduct any net operating loss carryforward with respect to the disputed funeral and estate administration expenses, because they are nondeductible personal or family expenses, which are not allowable in computing a net operating loss.

The Second Circuit (Judges Jacobs, Raggi, and Lynch, by summary order) affirmed the Tax Court on all issues. It held that the taxpayers were not entitled to deduct funeral and estate expenses from their income. The taxpayers argued that this deduction can be taken from the annuity, which they contended was an estate asset from which they can claim the expenses as an estate tax deduction. Funeral and estate expenses are "personal, living, or family expenses," however, which are not deductible without specific statutory authority. See IRC § 262; *Beck v. Comm'r*, T.C. Memo. 2001-270. The court noted that the taxpayers did not identify any provision permitting such a deduction, nor have they identified a basis for their assertion that they can claim estate tax deductions on an income tax return. In addition, the Second Circuit held that the taxpayers produced no evidence that the decedent's contributions included any after-tax contributions.

F. IRC §§ 401-409A. Retirement Plan Benefits

1. Pending Legislation to Change the Contribution and Distribution Rules for Various Defined Contribution Plans (Including IRAs). H.R. 1994, 116th Cong., 1st Sess. (March 29, 2019); H. Rpt. 116-65, 116th Cong., 1st Sess. (May 16, 2019); Passed House of Representatives (May 23, 2019); Unanimous Consent in Senate failed (May 25, 2019); S. 972, 116th Cong., 1st Sess. (April 1, 2019); S. 1431, 116th Cong., 1st Sess. (May 13, 2019);

a) SECURE Act

Rep. Richard Neal (D-Mass.), chairman of the House Committee on Ways and Means, introduced H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019." This bill expands some of the rules on retirement plan benefits to

facilitate the accumulation of private retirement savings. Among the provisions of this bill are the following:

- The bill would eliminate the prohibition on contributions to a regular IRA by persons who have reached 70 ½ by the end of the year. This rule would apply to contributions made for taxable years beginning after December 31, 2019.

- The bill would permit withdrawal of up to $5,000 per individual from a qualified plan or IRA free of the 10% early withdrawal penalty tax, for "qualified birth or adoption" distributions, and permit most recontributions of such withdrawals to eligible retirement plans or IRAs. A qualified birth or adoption distribution is one made during the one-year period beginning on the date on which a child is born or legally adopted. No more than $5,000. This rule would apply to distributions made after December 31, 2019.

- The bill would raise from 70½ to 72 years the age on which the required beginning date for required minimum distributions is based. This rule would be effective for distributions required to be made after December 31, 2019, for employees and IRA owners who attain age 70½ after December 31, 2019. Present law would continue for employees and IRA owners who reach 70 ½ before January 1, 2020.

- The bill would provide that distributions to a designated beneficiary after the participant's death, unless the designated beneficiary is an "eligible designated beneficiary" as defined in the bill, must be distributed by the end of the 10th year following the year of the employee's or IRA owner's death.

  - Distributions may be taken over life or life expectancy of an eligible designated beneficiary beginning in the year following the year of death. Eligible designated beneficiaries include (a) the surviving spouse, (b) a disabled or chronically ill individual, (c) any individual who is not more than 10 years younger than the employee (or IRA owner), or (d) a minor child of the employee (or IRA owner). In the case of a child who has not reached the age of majority. Calculation of the required minimum distribution for a minor child is only allowed for 10 years

beginning with the year the child reaches the age of majority.

- The 10-year rule also would apply after the death of an eligible designated beneficiary or after a child reaches the age of majority.

- The 5-year withdrawal rule would continue to apply if there is no designated beneficiary, as where the payments are made to the decedent's estate or to a charity.

- This rule would apply to required minimum distributions with respect to employees (or IRA owners) with a date of death after December 31, 2019.

- In the case of an employee (or IRA owner) who dies before the effective date, if the designated beneficiary dies on or after the effective date, the 10-year withdrawal rule applies to any beneficiary of the designated beneficiary as though the designated beneficiary were an eligible beneficiary. For this purpose, the effective date is the date of death of the employee (or IRA owner) used to determine when the proposal applies to the plan (or IRA), for example, before January 1, 2020, under the general effective date.

Note. Possibly the most important feature of this bill is that it would allow all designated beneficiaries to withdraw retirement plan balances over 10 years, rather than the present 5 years, while permitting surviving spouses, minor children, disabled children, and beneficiaries who are not more than 10 years younger than the decedent, to continue to be paid over their life expectancies. Inherited IRA payouts are also limited to 10 years. This could be expensive for children both of whose parents die prematurely, because the children will be left to withdraw the inherited IRA over a relatively-short 10-year period.

The changes in the required minimum distribution rules apply only to "individuals" who are designated beneficiaries. The bill does not state how these changes would apply to distributions made to trusts, but it seems likely that pass-through trusts will still be ignored and treated as if the distribution were made to the individual beneficiary. Unfortunately, this result will not be certain until the IRS or Congress provides some clarification.

The reference to minor children may not be limited to the standard age of majority. The regulations state that, with respect to payments under a defined benefit plan or an annuity contract, references to a minor may include children until as much as age 26, if the child has not completed a specified course of education. Regs. § 1.401(a)(9)-6 Q&A-15.

The problem in the Senate was due to an amendment in the House that deleted a provision that would have allowed up to $10,000 in distributions per beneficiary from Section 529 plans to pay for home-schooling expenses. Senator Ted Cruz (R-Texas) objected to the elimination of this exclusion. It is unclear whether Senate Majority Leader Mitch McConnell (R-Tenn.) will allow the bill to be debated in full after it failed to obtain unanimous consent.

b) Retirement Enhancement and Savings Act of 2019

Senator Chuck Grassley (R-Iowa) and Senator Ron Wyden (D-Ore.), the chairman and ranking minority member of the Senate Finance Committee, introduced S. 972, "The Retirement Enhancement and Savings Act of 2019 (RESA)." They key provisions of this bill include:

- The bill would repeal the prohibition on contributions to a traditional IRA by an individual who has attained age 70½. This change would apply to contributions made for taxable years beginning after December 31, 2019.

- The bill would modify the required minimum distribution rules with respect to defined contribution plans and IRA accounts upon the death of the account owner. The account balance would be required to be distributed by the end of the fifth calendar year following the year of the employee's or IRA owner's death, except with respect to distributions to a surviving spouse, a minor child, a disabled or chronically-ill individual, or an individual who is not more than 10 years younger than the employee or IRA owner. These persons could continue to withdraw benefits over their life expectancy.

- An exception to the current 5-year distribution rule would also be provided for each beneficiary to the extent that the balance of the account they receive from the deceased employee or IRA owner does not exceed $400,000, valued as of the date of death.

c) Retirement Security and Savings Act of 2019.

Senators Rob Portman (R-Ohio) and Ben Cardin (D-Md) introduced S. 1431, the Retirement Security and Savings Act of 2019, which would make the following changes in the laws regarding retirement plan distributions:

- The bill would permit permitting nonspousal beneficiaries to roll over retirement plan benefits.

- The bill would increase the required beginning date for mandatory distributions from age 70 ½ to age 72, for calendar years 2023 – 2029, and to age 75 for calendar years after 2029.

- The bill would create an exception from the mandatory distribution rules where the plan assets do not exceed $100,000, adjusted for inflation after July 1, 2019.

- The bill would reduce the excise tax on excess contributions and the excise tax on failure to take a required minimum distribution, where the taxpayer promptly corrects the failure after receiving notice from the IRS.

2. Spouse May Roll-Over Decedent's IRA Made Payable to Trust for Spouse's Exclusive Benefit with Spouse as Trustee. PLR 201923002 (June 7, 2019)

Decedent was married to Taxpayer until his death, at which time both Decedent and Taxpayer were over 70 ½ years old. Trust was the beneficiary of Decedent's IRA. Taxpayer is the sole trustee and beneficiary of Trust which gives Taxpayer the right to withdraw its net income and/or its principal. Taxpayer has the right to modify, amend, or revoke Trust at any time and has the sole authority and discretion to distribute the Decedent's IRA proceeds to herself at any time. Taxpayer intends to roll the amounts paid to her from Decedent's IRA to an IRA in her own name.

The IRS stated that, because Taxpayer is entitled to the proceeds of Decedent's IRA as the sole beneficiary of Trust during her life, Taxpayer is effectively the individual for whose benefit the account is maintained for purposes of the roll-over rules. If Taxpayer receives a distribution of the proceeds of Decedent's IRA, she may roll over the distribution into one or more IRAs established and maintained in her name. Therefore: (a) Decedent's IRA will not be treated as an inherited IRA with respect to Taxpayer; (b) Taxpayer may roll over distributions from Decedent's IRA to one or

more IRAs established and maintained in her own name, as long as the rollovers occur no later than the 60th day after the proceeds are received; and (c) Taxpayer will not be required to include in gross income for federal tax purposes, for the year in which a distribution from Decedent's IRA is made, any portion of the proceeds distributed from Decedent's IRA which are timely rolled over to one or more IRAs set up and maintained in Taxpayer's name.

3. What Constitutes a Valid Conduit Trust for Decedent's IRA. PLR 201902023 (Jan. 11, 2019)

D's IRA was payable to D's revocable trust, which created Subtrust specifically to hold any retirement plan benefits, including a traditional IRA. The Trust and Subtrust were both valid under applicable state law. D died after D's required beginning date and after distributions under the IRA had begun. The Trust and Subtrust became irrevocable upon D's death. D, in the IRA adoption agreement, named the Trust as the designated beneficiary and before October 31 of the year immediately following the year of D's death, the Trustee delivered the Trust document for the Trust and Subtrust to the IRA custodian. The Trust document provided that all property held by the Subtrust will be held, administered, and distributed for the benefit of Surviving Spouse, who shall be the sole beneficiary of the Subtrust, and that all retirement benefits distributed to the Trustee, including required minimum distributions, must be paid directly to the Surviving Spouse upon receipt by the Trustee. The instrument also stated that the Trustee shall serve as a conduit only and that, upon Surviving Spouse's death, any remaining assets of the Subtrust shall be divided equally between and distributed to D's children or their descendants. D was older than Surviving Spouse.

The IRS ruled privately that the Trust and Subtrust created a conduit trust under Reg. § 1.401(a)(9)-4, Q&A-5, and Surviving Spouse will be treated as the actual designated beneficiary of the IRA for purposes of determining the applicable distribution period under Section 401(a)(9). The IRS noted that (a) the Trust was valid and irrevocable and that the required documentation has been provided, in accordance with Reg. § 1.401(a)(9)-4, Q&A-5(b)(1), (2), and (4); (b) the Trust document identifies Surviving Spouse as the sole beneficiary of the Subtrust, in accordance with Reg. § 1.401(a)(9)-4, Q&A-5(b)(3); (c) the Trust document requires the Trustee to pay Surviving Spouse any and all funds in the Subtrust withdrawn by the Trustee, including required minimum distributions under Section 401(a)(9); and (d) the Trust provides that there can be no accumulation on behalf of any other beneficiary. The IRS also ruled that the applicable distribution period for the distribution calendar year containing D's death is the longer of (i) the remaining life expectancy of Surviving Spouse determined in accordance with Reg. § 1.401(a)(9)-5, Q&A- 5(c)(2), and (ii) the remaining

life expectancy of D determined in accordance with Reg. § 1.401(a)(9)-5, Q&A-5(c)(3). Because Surviving Spouse's life expectancy is longer than D's, the applicable distribution period for D's IRA is based on the life expectancy of Surviving Spouse.

4. Disclaimers Enable Rollover of IRA Paid to Decedent's Estate. PLR 201901005 (Jan. 4, 2019)

D was married to Spouse until D's death, at which time D was over 70 ½ years old. D was survived by Spouse, D's son, Son, and two grandchildren, Grandchild A and Grandchild B. Trust was the sole beneficiary of D's IRA. Within nine months after D's death, Trustee, Son, Grandchild A, and Grandchild B disclaimed any and all of their interests in IRA. The disclaimers were all qualified disclaimers under Section 2518. As a result of the disclaimers, because there was no contingent beneficiary of the IRA, Spouse became entitled to the IRA as the sole beneficiary of D's estate. Spouse wished to roll over the IRA into an IRA in her own name.

The IRS stated that (a) Spouse will be treated as having acquired the IRA directly from D, and not from his estate or Trust; (b) Spouse is eligible to roll over the IRA to one or more IRAs established and maintained in her own name, as long as the rollover occurs no later than 60 days after the day the proceeds of D's IRA are distributed; and (c) Spouse will not be required to include in her gross income for federal income tax purposes for the calendar year in which the distribution and rollover occur the amount distributed from IRA and timely rolled over into Spouse's IRAs.

G. IRC §§ 641-663. Fiduciary Income Taxation

1. Proposed Regs Address Gap in TCJA's Small Business Trust Rules. REG-117062-18, 84 Fed. Reg. 16415-01 (April 17, 2019)

Treasury and the IRS have proposed regulations to assure that S corporation income remains subject to U.S. income tax when a nonresident alien is the deemed owner of an ESBT that is also a grantor trust. The TCJA provided that a nonresident alien could be a potential current beneficiary of an ESBT, without jeopardizing the S election. When a grantor trust makes an ESBT election, the deemed owner of the trust (the grantor or beneficiary holding a Section 678 withdrawal power) is treated as a potential current beneficiary.

The proposed regs modify the allocation rules under Reg. § 1.641(c)-1 that divide income between the S portion and non-S portion of an ESBT, to require that the S-corporation income of the ESBT that would otherwise be allocated to an NRA deemed owner under the grantor trust

rules must be included in the S portion of the trust income, so that it is taxable to a U.S. person (the ESBT itself). This rule would apply to all ESBTs after December 31, 2017.

2. Final and Proposed Regulations on 20% Pass-Through Deduction Under Section 199A Include Multiple Trust Anti-Abuse Rule. REG-107892-18, 83 Fed. Reg. 40884 (Aug. 16, 2018); T.D. 2952-01, 84 Fed. Reg. 2952-01 (Feb. 8, 2019); and REG-134652-18, 84 Fed. Reg. 3015-01 (Feb. 8, 2019)

Section 199A, added by the TCJA, provides a deduction of up to 20% of income from a domestic business operated as a proprietorship or through a partnership, S corporation, trust, or estate. The deduction is available to taxpayers whose taxable income does not exceed a statutorily threshold amount (for 2019, $160,700 for a single individual and $321,400 married filing jointly) and phased-out for those with taxable income over the threshold but not over $50,000 more than the threshold for a single taxpayer or $100,000 over the threshold for a married taxpayer filing jointly. The Section 199A deduction may also be limited based on (1) the type of trade or business engaged in by the taxpayer, (2) the amount of the taxpayer's W-2 wages with respect to the trade or business, and/or (3) the unadjusted basis immediately after acquisition of qualified property held for use in the trade or business (UBIA of qualified property). The business of an employee or an owner of a Specified Service Trade or Business (SSTB) (including law, health, accounting, consulting, financial services or certain other service businesses) is technically not a Qualified Trade or Business, but income from such businesses can sometimes qualify for a Section 199A deduction. Once the threshold is reached, the Section 199A deduction is not based exclusively on qualified business income (QBI), but upon a W-2 Wage Test or a W-2 Wage and UBIA test. The deduction in such cases is limited to 20% based upon the greater of (a) 50% of the W-2 wages and (b) the sum of 25% of the W-2 wages and 2.5% of depreciable tangible assets (including real estate). Section 199A also allows individuals and some trusts and estates to deduct up to 20% of their combined qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income, including such income earned through passthrough entities. This part of the Section 199A deduction is not limited by W-2 wages or UBIA of qualified property.

The Treasury and the IRS have issued final and proposed regulations under Sections 199A and 643(f). These regulations address several issues affecting the use and taxation of trusts and estates.

a) Generally

A trust or estate computes its Section 199A deduction based on the QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income allocated to the entity. An individual beneficiary's Section 199A takes into account any of these types of income allocated to him or her by the trust or estate, as though these items had been allocated from an RPE. Reg. § 1.199A-6(d)(1).

- A grantor or other person who is treated as owning all or part of a trust under the grantor trust rules (Sections 671 through 679) computes the Section 199A deduction as if that person directly held the interests owned by the trust and directly conducted the activities of the trust with respect to those interests. Reg. § 1.199A-6(d)(2).

- A trust's or estate's QBI must be computed by allocating qualified items of Section 199A(c)(3) deductions in accordance with the classification of those deductions as directly attributable or not directly attributable to specific items of income, in the same manner as these deductions are taken into account in computing the entity's distributable net income (DNI) under Reg. § 1.652(b)-3. See Reg. § 1.199A-6(d)(3)(i).

- The QBI (including any amounts that less than zero, as calculated at the trust or estate level), W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of a trust or estate are allocated to the beneficiaries and the trust or estate based on the relative shares of the trust's or estate's DNI allocated to each for fiduciary income tax purposes.

- Determining and allocating DNI takes into account the separate share rule of Section 663(c), but without regard to Section 199A. A trust or estate with no DNI for the taxable year is allocated all of the QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income. Reg. § 1.199A-6(d)(3)(i). New proposed regulations provide, however, that a trust with substantially separate and independent shares for multiple beneficiaries under Section 663(c) will not treat the separate shares as separate trusts for purposes of applying the Section 199A threshold amount;

the trust will be treated as a single entity for purposes of determining whether its taxable income exceeds the threshold amount. Prop. Reg. § 1.199A-6(d)(3)(iii).

- A beneficiary who receives a distribution of DNI from a separate share that includes Section 199A items, applies its own threshold amount to the Section 199A computation under the final regulations. Reg. § 1.199A-6(d).

- The final regulations also provide that depletion and depreciation deductions under Section 642(e) and amortization deductions under Section 642(f) that otherwise are properly included in the computation of QBI, will be included in the QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code. Reg. § 1.199A-6(d)(3)(i).

b) The Anti-Abuse Rule

As in the proposed regulations, the final regulations adopt an anti-abuse rule stating that a trust formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under Section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of Section 199A. See also Regulations Section 1.643(f)-1, discussed below. Reg. § 1.199A-6(d)(3)(vii). This anti-abuse rule applies to taxable years ending after December 22, 2017, rather than the date on which the final regulations appear in the Federal Register.

The preamble to the final regulations clarifies that the anti-abuse rule is designed to thwart the creation of even one single trust with a principal purpose of using more than one threshold amount. If the creation of such a single trust violates the rule, the trust will be aggregated with the grantor or other trusts from which it was funded for purposes of determining the threshold amount for calculating the deduction under Section 199A. 84 Fed. Reg. at 2979.

Note. Some have taken to referring to trusts that are not respected under the anti-abuse rule as "[Rodney] Dangerfield Trusts." It seems a reasonable sobriquet.

c) The General Multiple Trust Rule of Section 643(f)

The final regulations include final regulations under Section 643(f), which for most fiduciary income tax purposes, treats multiple trusts

as a single trust if: (1) they have substantially the same grantors and primary beneficiaries and (2) a principal purpose of the trusts is income tax avoidance. Section 643(f) was added to the Code in 1984, and practitioners have waited over 30 years for these regulations. See Pub. L. 98–369, div. A, title I, § 82(a), 98th Cong., 2d Sess. (July 18, 1984), 98 Stat. 598. Unfortunately, the final regulations merely state that:

> "*For purposes of subchapter J of chapter 1 of subtitle A of Title 26 of the United States Code, two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax. For purposes of applying this rule, spouses will be treated as one person.*"

Reg. §1.643(f)-1(a).

- The final regulations differ from the 2018 proposed regulations in several material ways. The final regulations removed the definition of "principal purpose" and the examples that had been included in the 2018 proposed regulations. The Treasury and the IRS stated in the preamble to the final regulations that they are "taking under advisement" whether and how future guidance should address such questions as the meaning of "principal purpose" and "substantially identical grantors and beneficiaries" and examples for each of these terms. Nevertheless, their position remains that the determination of whether an arrangement involving multiple trusts is subject to treatment under Section 643(f) may be made on the basis of the statute and the guidance provided regarding that provision in the legislative history of Section 643(f), in the case of any arrangement involving multiple trusts entered into or modified before the effective date of these final regulations. 84 Fed. Reg. at 2980.

- The multiple trust rules apply to taxable years beginning on or after August 16, 2018 (the date of the publication of the proposed regulations in the Federal Register). Reg. § 1.643(f)-1(b). The reference in the proposed regulations to the date on which a trust is created or added to are deleted

in the final regulations. The multiple trust regulations under Section 643(f) do not sunset in 2026, when Section 199A is scheduled to end.

d) Electing Small Business Trusts (ESBTS)

An electing small business trust (ESBT) is clearly entitled to the deduction under Section 199A. The S portion of the trust takes into account the QBI and other items from any S corporation whose shares are owned by the trust. The grantor portion of the trust takes into account the QBI and other items from any assets treated as owned by a grantor or another person (owned portion) of the trust under Sections 671 through 679. The non-S portion of the trust takes into account any QBI and other items from any other entities or assets owned by the ESBT. For purposes of determining whether the taxable income of an ESBT exceeds the Section 199A threshold amount, the S portion and the non-S portion are treated as a single trust. See Reg. § 1.641(c)-1.

One commenter supported the 2018 proposed regulation's view on an ESBT's eligibility for the deduction, while another stated that the S portion and non-S portion should each have its own threshold. The Treasury Department and the IRS disagreed, noting that although an ESBT has separate portions, it is one trust. Therefore, in order to provide clarity, the final regulations state that the S and non-S portions of an ESBT are treated as a single trust for purposes of determining the threshold amount. Reg. § 1.199A-6(d)(vi); see also preamble, 84 Fed. Reg. at 2979.

e) Charitable Remainder Trusts

In the 2018 proposed regulations, the Treasury and the IRS requested comments with respect to whether taxable recipients of annuity and unitrust interests in charitable remainder trusts and taxable beneficiaries of other split-interest trusts may be eligible for the Section 199A deduction where the entity's income otherwise qualifies. The government asked that for comments on how amounts that may give rise to the Section 199A deduction would be identified and reported in the various classes of income of the trusts received by such recipients and how the excise tax under Section 664(c) would apply to such amounts. 84 Fed. Reg. at 2979.

- The 2019 proposed regulations state that, because a charitable remainder trust is not subject to income tax, and because the excise tax imposed by Section 664(c) is not imposed under chapter 1 of the Code, the trust does not have or need to

calculate a Section 199A deduction and the Section 199A threshold amount does not apply to the trust. A taxable recipient of a unitrust or annuity amount, however, must determine and apply the recipient's own threshold amount, taking into account any annuity or unitrust amounts received from the trust.

- A taxable recipient of a unitrust or annuity amount from a trust may take into account QBI, qualified REIT dividends, or qualified PTP income for purposes of determining the recipient's Section 199A deduction to the extent that the unitrust or annuity amount distributed to such recipient consists of such Section 199A under the tier system applicable to charitable remainder trusts. Prop. Reg. § 1.199A-6(d)(3)(v).

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- To the extent that a trust is treated as distributing QBI, qualified REIT dividends, or qualified PTP income to more than one unitrust or annuity recipient in the taxable year, the distribution will be treated as made to the recipients proportionately, based on their respective shares of the total of these items distributed for that year. The trust allocates and reports any W-2 wages or UBIA of qualified property to the taxable recipient of the annuity or unitrust interest based on each recipient's share of the trust's total QBI (whether or not distributed) for that taxable year. If 10% of the QBI of a charitable remainder trust were distributed to the recipient and 90% of the QBI were retained by the trust, 10% of the W-2 wages and UBIA of qualified property is allocated and reported to the recipient and 90% of the W-2 wages and UBIA of qualified property would be treated as retained by the trust. Prop. Reg. § 1.199A-6(d)(3)(v).

- Any W-2 wages retained by a charitable remainder trust will not carry over to subsequent taxable years for Section 199A purposes. Any QBI, qualified REIT dividends, or qualified PTP income of the trust that is unrelated business taxable income is subject to excise tax and that tax must be allocated to the corpus of the trust under Regulations Section 1.664-1(c). Prop. Reg. § 1.199A-6(d)(3)(v).

f) Other Split-Interest Trusts

The August 2018 proposed regulations requested comments on whether any special rules were necessary with respect to other split-

interest trusts, such as non-grantor charitable lead trusts or pooled income funds. Despite one contrary comment, the preamble to the proposed regulations states that the Treasury Department and the IRS concluded that no special rules for other split-interest trusts are necessary, because such trusts are taxable under the general fiduciary income tax rules of subchapter J, other than the grantor trust rules. Such trusts would, therefore, determine their treatment under Section 199A under the final regulations applicable to non-grantor trusts, described above. Reg. § 1.199A-6(d)(3).

g) Effective Date

The proposed regulations rulemaking generally are proposed to apply to taxable years ending after the date of publication of the final regulations in the Federal Register, but taxpayers may rely on the proposed regulations until the date final regulations are published.

Note. The application of Section 199A to estates and non-grantor trusts under the final and newly proposed regulations is complicated. Practitioners must be careful in planning the estates of clients whose taxable income is below the threshold amount or whose family members have taxable income below the threshold amount. It may not be up to the estate planner to determine that the client or family member qualifies for the Section 199A deduction, but care must be taken so that estate planning techniques do not impede the availability of this deduction.

3. IRS Will Clarify New Rules on Estate and Trust Miscellaneous Itemized Deductions. Notice 2018-61, 2018-31 I.R.B. 278 (July 30, 2018)

The TCJA eliminates the deduction for miscellaneous itemized deductions that would otherwise have been subject to the 2% floor under Section 67. This applies to taxable years beginning after December 31, 2017, and before January 1, 2026. TCJA § 11045. In this notice, Treasury and the IRS announced that it would promulgate regulations to clarify the operation of these changes to trusts and estates. The Notice states that the IRS will apply a narrow reading to this provision of the new law, much to the relief of many practitioners. The IRS noted that some commentators have suggested that Section 67(g) might be read as eliminating the ability of estates and non-grantor trusts to deduct any expenses described in Section 67(e)(1), whether or not of the type customarily and commonly incurred by individuals. Apparently, the IRS and Treasury do not agree. For taxable years after 2017 and before 2026, the IRS and Treasury believe that new Section 67(g) merely denies the deductibility of miscellaneous itemized deductions under

section 67(a) does not affect the deductibility of those miscellaneous itemized deductions that would have been subject to the 2% floor before the addition of Section 67(g).

Treasury and the IRS also stated that they would appreciate comments on whether the final-year deductions should be characterized as miscellaneous itemized deductions only to the extent that they would have been subject to the 2% limitation prior to the new law. Doing so would seemingly permit the beneficiary to deduct that portion of the final-year expenses that would previously have been deductible without regard to the 2% floor, if the trust or estate had not terminated.

H. IRC § 664. Charitable Remainder Trusts

Provisions of Charitable Remainder Unitrust to Divide Unitrust Amount between Charitable and Noncharitable Beneficiaries Do Not Disqualify Trust. PLR 201845014 (Nov. 9, 2018)

D proposed forming CRUT 1 and CRUT 2, each of which should be a qualified charitable remainder unitrust. CRUT 1 directs that the trustee distribute to X, during X's lifetime a specified fraction of the full unitrust amount and "such additional portion of the unitrust amount, if any, as the independent trustee determines is necessary to ensure the total portion of the unitrust amount distributed to X in each taxable year shall not be de minimis under the facts and circumstances." The balance of the full unitrust amount shall be distributed to "one or more of X and one or more charitable organizations" selected by the independent trustee. X, however, may designate the members of the charitable class of organizations within which the trustee shall select. There is always required to be at least one independent trustee. The provisions of CRUT 2 are identical to those of CRUT 1, except that there are two measuring lives for the unitrust interest in CRUT 2 – X and X's spouse, subject to X's right to revoke the spouse's surviving unitrust interest.

The IRS stated that (1) the independent trustee's power to allocate a portion of the unitrust amount of CRUT 1 and CRUT 2 between noncharitable and charitable beneficiaries will not prevent each trust from being a qualified CRUT; (2) the power of X and X's spouse to remove and replace one independent trustee with another independent trustee who is not related or subordinate to X or X's spouse will not prevent either trust from being a qualified CRUT; (3) X's power to designate the charitable class of both CRUTs will not prevent either from being a qualified CRUT; (4) X's testamentary power to revoke by a provision in his will all interests of X's spouse in the survivor unitrust will not prevent CRUT 2 from being a qualified CRUT, but it will render X's gift to X's spouse incomplete until X dies without exercising that power; (5) X's power to designate the charitable class will prevent completion of the gift of the net unitrust amount during X's lifetime until such power lapses; and (6) if X's spouse survives X and if X does not revoke the

survivor's unitrust interest, the entire value of CRUT 2 will be includible in X's gross estate, and will qualify for the estate tax marital and charitable deductions.

I. IRC §§ 671-679. Grantor Trusts

1. Transfers to Directed Trust Shift Income without a Taxable Gift – Transfers Are Incomplete Gifts and Trust May Not Be a Grantor Trust. PLRs 201925005 – 201925010 (June 21, 2019); 201908002 – 201908007 (Feb. 22, 2019); 201852014 (Dec. 28, 2018); 201852009 (Dec. 28, 2018); 201850001 – 201850006 (Dec. 14, 2018); 201848002 (Nov. 30, 2018); 201848009 (Nov. 30, 2018); 201838002 – 201838007 (Sept. 21, 2018); 201832005 - 201832009 (Aug. 10, 2018)

Grantor created an irrevocable trust for the grantor's own benefit and that of certain other family members. During Grantor's lifetime, the trustee must distribute net income and principal to Grantor and the other beneficiaries as directed by the distribution committee and/or Grantor, as follows: (a) at any time, the trustee, pursuant to the direction of a majority of the distribution committee, with Grantor's written consent, must distribute to Grantor or the beneficiaries such net income or principal as directed by the distribution committee; (b) at any time, the trustee, as directed by all of the distribution committee members, other than Grantor, must distribute to Grantor or the beneficiaries such net income or principal as directed by the unanimous distribution committee; and (c) at any time, Grantor, in a nonfiduciary capacity, may distribute to any one or more of the beneficiaries such amounts of the principal (including the whole thereof) as Grantor deems advisable to provide for their health, maintenance, support, and education. The initial distribution committee is Grantor, her children (through guardians acting on until their majority), and her stepchildren. The distribution committee must always have at least two members other than Grantor.

The IRS stated that, as long as there is a distribution committee, the trust is not a grantor trust (absent application of Section 675, on which the IRS declined to rule), contributions of property to the trust are not a completed gift by Grantor, distributions of property by the distribution committee from the trust to Grantor will not be a completed gift by any member of the distribution committee, and distributions of property by the distribution committee from the trust to any beneficiary, other than Grantor, will not be a completed gift subject to federal gift tax, by any member of the distribution committee, other than Grantor. The IRS evaluated grantor trust status by considering the powers of the distribution committee under Section 674. It declined to rule about grantor trust status under Section 675, because the application of those rules depends upon the actual administration of the trust.

Note 1. The IRS also found that there was no completed gift by grantor because grantor had a right to veto distributions of income or principal to other persons during her lifetime, and a testamentary power to appoint the remainder among grantor's descendants. Reg. § 25.2511-2(e). For more on this technique for avoiding state income taxes on trust income, see also Akhavan, *DINGing State Income Taxes in Artwork Transactions*, 153 Tr. & Est. 31 (June 2014); Blattmachr & Lipkind, *Fundamentals of DING Type Trusts: No Gift Not a Grantor Trust*, 26 Prob. Pract. Rptr. 1 (April 2014); Pulsifer and Flubacher, *Eliminate a Trust's State Income Tax*, 145 Tr. & Est. 30 (May 2006); Schaller, *Reduce State Tax with DINGs, NINGs, WINGs, and Other ThINGs*, 41 Est. Plan. 23 (April 2014); Schoenblum & Schoenblum, *Avoiding State Income Tax with the Right Kinds of Trusts*, 41 Est. Plan. 19 (May 2014); Steiner, *The Accidentally Perfect Non-Grantor Trust*, 144 Tr. & Est. 28 (Sept. 2005).

Note 2. Several of these rulings, including PLRs 201850001 – 201850006, and 201852018, also noted that the community property held by the trust was entitled to a basis adjustment at the first spouse's death under Section 1014(b)(6). The IRS noted that:

> *"Trust provides that all transferred property to Trust is community property or is being transmuted into community property. Moreover, any and all property transferred to Trust prior to the death of the Predeceased Grantor is and shall retain its character as community property."*

This may be relevant in evaluating the use of community property trusts created in a community property state by grantors who do not live in a community property state, though the rulings do not address this issue directly. See, *e.g.*, Alas. Stat. §§ 34.77.010 to 34.77.995; S.D. Cent. Code §§ 55-17-1 to 55-17-14; and Tenn. Code §§ 35-17-101 to 35-17-108. See also Asher, Blattmachr & Zaritsky, *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 Real Prop. Prob. & Tr. J. 615 (Winter 1999); Shaftel & Greer, *Alaska Enacts an Optional Community Property System Which Can Be Elected by Both Residents and Nonresidents*, SD 36 ALI-ABA 1, 12–13 (1999); Singleton, *Yes, Virginia, Tax Loopholes Still Exist: An Examination of the Tennessee Community Property Trust Act of 2010*, 42 U. Mem. L. Rev. 369 (Winter 2011); Ware, *Section 1014(b)(6) and the Boundaries of Community Property*, 5 Nev. L.J. 704 (Spring 2005).

2. Grantor Cannot Compel Trustee to Reimburse Grantor for Income Taxes on Grantor Trust. *Millstein v. Millstein*, 2018 WL 3005347, 2018 Ohio 2295 (Oh. App. 8th Dist. June 14, 2018) (Slip copy)

Norman Millstein created two irrevocable trusts for the benefit of his children, with his son Kevan as the sole trustee of both trusts. Both trusts were grantor trusts for federal income tax purposes. In 2010, Norman asked Kevan to reimburse him for the rather substantial (over $6 million) income taxes Norman had to pay on the trusts. Kevan declined but reached an agreement whereby the assets of a third, unrelated trust were used to defray Norman's personal income tax liabilities. In 2013, however, Kevan informed his dad that the third trust no longer had liquid assets available to defray his income tax liabilities resulting from the trusts, and that Norman would have to make other arrangements. Norman sued to demand that Kevan provide an "equitable reimbursement of income taxes" from the two trusts. The trial court granted Kevan's motion to dismiss and Norman appealed.

The Court of Appeals (Administrative Judge Gallagher) affirmed the decision of the trial judge. The court explained state law (Ohio) permits modification of a court to achieve the settlor's tax objectives, but only on the petition of the trustee or a beneficiary – not on the request or demand of the grantor. The grantor can bring a suit to modify or terminate a trust only with the consent of the beneficiaries. Ohio Rev. Code §§ 5804.10 and 5804.11. The existence of specific legislative remedies precluded the use of equitable principles in contravention of those remedies. Citing *Lorain Cty. Bd. of Commrs. v. United States Fire Ins. Co.*, 81 Ohio App.3d 263, 269-270, 610 N.E.2d 1061 (9th Dist.1992); *Patterson v. Lamson*, 45 Ohio St. 77, 90-91, 12 N.E. 531 (1887); *Seven Hills v. Cleveland*, 1 Ohio App.3d 84, 95, 439 N.E.2d 895 (8th Dist.1980).

Note. It is common for a grantor to grow weary of paying the income taxes on a grantor trust whose income is held for or paid to others, particularly if the amount of that income grows beyond what had been expected, or if the beneficiaries cease to occupy the same warm place in the grantor's heart. In Rev. Rul. 2004-64, 2004-2 C.B. 7, however, the IRS stated, in part, that the grantor's gross estate will include the value of the assets of a grantor trust if the trust requires that the trustee pay the income taxes due on the trust's income or reimburse the grantor for their payment. The IRS stated that the trustee, in such a case, will be discharging the grantor's legal obligations. Authorizing the trustee to reimburse the grantor may, furthermore, also cause the trust assets to be included in the grantor's gross estate under Section 2036(a) if the grantor's creditors could force the trustee to exercise the power to the maximum extent that the trustee is authorized. See, e.g., Rev. Rul. 76-103, 1976-1 C.B. 293; *Outwin v. Comm'r*, 76 T.C. 153 (1981), *acq*. 1982-1 C.B. 2; *Paolozzi v. Comm'r*, 23 T.C. 182 (1954), *acq*. 1962-1 C.B. 4. Even if the grantor's creditors were unable to

exercise this power under applicable state law, the trust assets could be includible in the grantor's gross estate if either: (a) there exists an arrangement between the trustee and the grantor by which the former will reimburse the grantor's taxes; or (b) the grantor has the power to remove the existing trustee and appoint himself or herself as trustee. See also Beaman, *Estate Tax Consequences of Revenue Ruling 2004-64: Silence in Grantor Trusts Is Anything but Golden,* 54 Drake L. Rev. 929 (Summer 2006); Gans, Heilborn & Blattmachr, *Some Good News About Grantor Trusts: Rev. Rul. 2004-64,* 31 Est. Plan. 467 (Oct. 2004). Several states have enacted statutes clarifying that the grantor's creditors cannot compel the trustee to exercise its authority to reimburse the grantor for the income taxes on a grantor trust. See, *e.g.*, Ariz. Rev. Stat. § 14-10505(2)(a); 12 Del. Code § 3536(c)(1); Fla. Sta. § 736.0505(c); Iowa Code § 633A.2304(3); N.H. Rev. Stat. § 564-B:5-505(a)(2)(B); N.Y. EPTL § 7-3.1(d); N.C. Gen. Stat. § 36C-5-505(a)(2a); 20 Pa. Consol. Stat. § 7745(2); S.D. Cod. Laws § 55-1-36; Tex. Property Code § 112.035(d). Thus, had the Ohio Court of Appeals granted the grantor's motion, a serious question would have been raised whether all grantor trusts in that state should be included in the grantor's gross estate. Furthermore, as Ohio has adopted the Uniform Trust Code, the same question would have been raised respecting grantor trusts in other states with similar trust rules.

J. IRC § 691. Income in Respect of a Decedent

No Deduction for Estate Taxes on Items of IRD without Proof that Asset was Included in Decedent's Gross Estate. *Schermer v. Comm'r*, T.C. Memo. 2019-28 (April 4, 2019)

Jill Schermer's husband died. He was the beneficiary of his father's two IRAs and a tax deferred annuity. Jill's father-in-law had died three years earlier. The IRA and annuity were included in the father-in-law's gross estate and $156,789 in estate taxes was paid on them. Jill's husband named her as the beneficiary of the annuity and IRAs after his death. Jill received over $225,000 in distributions from the annuity and two IRAs and included them in her gross income. She sought to deduct the father-in-law's estate taxes on these benefits.

The Tax Court (Judge Kerrigan) held that Jill was not entitled to any deduction for the estate taxes imposed on her father-in-law's estate, because the accounts passed to her from her husband's estate and there was no evidence that they were included in her husband's gross estate.

K. IRC § 1022. Basis Adjustment for Property in the Estate of a 2010 Decedent

Late Election Allowed to Allocate Basis Among Assets for Estate of 2010 Decedent that Was Subject to Carryover Basis Rules. PLRs 201842004 (Oct. 19, 2018); 201845012 (Nov. 9, 2018)

- **PLR 201842004.** D died in 2010 and D's spouse, S, was named executor. S hired Attorney to prepare the appropriate tax filings, and Attorney failed to prepare a timely Form 8939 before the filing deadline. Thus, S failed to allocate the $1,300,000 basis adjustment under Section 1022 among D's assets.

  The IRS allowed a late election to allocate basis under Section 1022. The IRS applied Reg. § 301.9100-3, finding that (a) the taxpayer acted reasonably and in good faith; and (b) granting relief will not prejudice the interests of the government. The IRS explained that, under Reg. § 301.9100-3(b)(1)(v) deems a taxpayer to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, as was the case here.

- **PLR 201845012.** D died in 2010 and Son was named executor. Son retained CPA to prepare the necessary tax filings for the estate. CPA failed to prepare the Form 8939 before the filing deadline of January 17, 2012. Thus, Son failed to make a Section 1022 Election for D's estate.

  The IRS allowed a late election to allocate basis under Section 1022. The IRS applied Reg. § 301.9100-3, finding that (a) the taxpayer acted reasonably and in good faith; and (b) granting relief will not prejudice the interests of the government. The IRS explained that, under Reg. § 301.9100-3(b)(1)(v) deems a taxpayer to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, as was the case here.

L. IRC §§ 1361-1379. Subchapter S Corporations

1. Regulations Close Gap in TCJA's Small Business Trust Rules for Nonresident Alien Potential Current Beneficiaries. Reg. § 1.641(c)-1; T.D. 9868, 84 Fed. Reg. 28215 (June 18, 2019); REG-117062-18, 84 Fed. Reg. 16415-01 (April 17, 2019)

The TCJA provided that a nonresident alien could be a potential current beneficiary of an ESBT, without jeopardizing the S election. When a grantor trust makes an ESBT election, the deemed owner of the trust (the grantor or beneficiary holding a Section 678 withdrawal power) is treated as a potential current beneficiary. Treasury and the IRS issued proposed regulations to assure that S corporation income remains subject to U.S. income

tax when a nonresident alien is the deemed owner of an ESBT that is also a grantor trust. Treasury received no comments and then finalized these regulations without changes.

The regulations modify the allocation rules under Reg. § 1.641(c)-1 that divide income between the S portion and non-S portion of an ESBT, to require that the S-corporation income of the ESBT that would otherwise be allocated to an NRA deemed owner under the grantor trust rules must be included in the S portion of the trust income, so that it is taxable to a U.S. person (the ESBT itself). This rule applies to all ESBTs after June 18, 2019 (the date on which the final regulations were published in the Federal Register).

2. Shareholders' Agreement Creates Second Class of Stock for S Corporation. PLR 201919005 (May 10, 2019)

X is an S corporation with both voting and nonvoting common stock. X has three shareholders, A, B, and C, and they entered into a Shareholders' Agreement providing that: (1) if a shareholder's voting stock is sold, a corresponding percentage of his or her non-voting stock must be cancelled, and if that the remaining shareholders have other than equal ownership of the remaining shares of non-voting stock, those shareholders are entitled to distributable earnings *pro rata* in accordance with the shares of non-voting stock; and (2) in the event of a sale of X, C will receive more of the payments than A and B. Later, the Shareholders' Agreement was amended to remove these two provisions. No shares of X were sold between the date of the agreement and the date of the amendment.

The IRS stated that the Shareholders' Agreement created a second class of stock prohibited by Section 1361(b)(1)(D), and inadvertently terminated X's S election. The IRS explained that a corporation generally is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds, ignoring differences in voting rights. Reg. § 1.1361-1(l)(1). Determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds takes into account binding agreements, such as the buy-sell agreement in this case, except for commercial contractual agreements, such as a lease, employment agreement, or loan agreement, that does not have as a principal purpose the circumvention the one class of stock requirement. Reg. § 1.1361-1(l)(2)(i). In this case, the Shareholders' Agreement created a second class of stock by creating different distribution rights. Under Section 1362(f), however, if: (1) an S election was ineffective because of a failure to meet the fundamental requirements of Section 1361(b) or to obtain shareholder consents, or was terminated; (2) the circumstances resulting in the ineffectiveness or termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the ineffectiveness or termination, steps were

taken or consents obtained so that the corporation now meets the requirements of an S corporation; and (4) the corporation and each person who was a shareholder of the corporation agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the ineffectiveness or termination, the corporation will be treated as an S corporation during the period specified by the Secretary. Thus, while the Shareholders' Agreement caused the S election to terminate, the termination was inadvertent and the corporation remains an S corporation because of the remedial provisions of Section 1362(f).

M. IRC § 1400Z-2. Special Rules for Capital Gains Invested in Opportunity Zones

Proposed Opportunity Zone Regulations Include Trust and Estate Provisions. REG-120186-18 (April 17, 2019)

Treasury and the IRS proposed regulations regarding Opportunity Zones and investments in Qualified Opportunity Funds (QOF), the gains on which are deferred if reinvested in other QOFs, or, if earlier, until December 31, 2026. Investments in QOFs held for at least 5 years are eligible for a 10% reduction in the deferred capital gain; investments held for 7 years are eligible for a 15% reduction; and investments maintained for at least 10 years get a full step-up in basis. These proposed regulations include the following provisions relating to the use of trusts and estates to hold interests in such investments.

a) Gifts

A gift of an investment in a QOF would trigger the deferred gain, whether made to a charitable or noncharitable donee, with an exception for transfers to a grantor trust deemed owned by the transferor. Prop. Reg. § 1.1400Z2(b)-1(c)(3).

b) Grantor Trust Status

A grantor trust that holds an interest in a QOF that ceases to be a grantor trust, other than on account of the grantor's death, will recognized the deferred gain. Prop. Reg. § 1.1400Z2(b)-1(c)(5).

c) Death of QOF Owner

- The death of the owner of a QOF does not trigger recognition of the deferred gain, whether the interest passes by intestacy,

survivorship to a joint owner, or the provisions of the deceased owner's will or revocable trust; nor does the distribution of the interest to a beneficiary of the estate or revocable trust. Prop. Reg. §§ 1.1400Z2(b)-1(c)(4), 1.1400Z2(b)-1(c)(5).

- The distribution of an interest in a QOF by an estate to a trust that was a grantor trust before the grantor's death, or from that trust to a beneficiary, also will not trigger recognition of the deferred gain. Prop. Reg. § 1.1400Z2(b)-1(c)(4).

- An interest in a QOF held at the owner's death is treated as an item of income in respect of a decedent. Therefore, gain is recognized on (A) a sale, exchange, or other disposition by the deceased taxpayer's estate or trust, other than a distribution to a beneficiary; (B) Any disposition by the legatee, heir, or beneficiary who received the qualifying investment by reason of the taxpayer's death; and (C) Any disposition by the surviving joint owner or other recipient who received the qualifying investment by operation of law on the taxpayer's death. Prop. Reg. § 1.1400Z2(b)-1(c)(4)(ii).

d) Carryover Basis

The 5-, 7-, and 10-year holding periods in a QOF interest carryover to the recipient who receives the interest at the owner's death or by a gift to a grantor trust. Prop. Reg. § 1.1400Z2(b)-1(d)(1)(iv).

Note. The treatment of a gift as triggering the deferred gain is odd, because the statute specifically provides that "deferred capital gain "shall be included in income in the taxable year which includes the earlier of – (A) the date on which such investment is *sold or exchanged*, or (B) December 31, 2026." (emphasis added). It is hard to determine how a gift is a sale or exchange.

In its comment letter, ACTEC recommended allowing the heir to continue to defer the gain under Section 691, but the Treasury and IRS did not address this issue. One also hopes that the final regulations will clarify that the safe harbor applies to such pre-death transactions with grantor trusts as sales and swaps.

N. Income Tax Procedures

1. Filing State Probate Claim Tolls the Statute of Limitations for Collecting Income Taxes from Decedent's Estate. *United States v. Estate of Chicorel*, 907 F.3d 896, 2018 WL 5289703 (6th Cir. Oct. 25, 2018), *aff'g* 2017 WL 4325488 (E.D. Mich. 2017), *indic. ruling*, 2018 WL 460070, 121 A.F.T.R. 2d 2018-530 (E.D. Mich. 2018) (Slip copy)

Albert Chicorel, the decedent, died owing the United States $140,903 in income taxes. The government filed a proof of claim in the decedent's probate proceedings, but after receiving no money for more than seven years, it brought suit in the District Court to collect the tax. Albert's estate argued that the statute of limitations on suits for refund under Section 6502(a), which allows the government to collect an assessed tax by levy or court proceeding "only if the levy is made or the proceeding begun. . . within 10 years after the assessment of the tax." The U.S. District Court for the Eastern District of Michigan granted the government summary judgment that the filing of a claim in probate was the beginning of the collection action.

The Sixth Circuit (Judge McKeague) affirmed. The court held that filing a proof of claim in a probate proceeding is a proceeding in court for purposes of Section 6502(a), and that once that was filed, the further action to collect the tax could be brought at any time. The court stated that, while what constitutes a court proceeding is a federal tax issue, it turns on how state law treats the proof of claim. *United States v. Silverman*, 621 F.2d 961, 964 (9th Cir. 1980); *United States v. Saxe*, 261 F.2d 316, 319 (1st Cir. 1958). Under Michigan law, a proof of claim has significant legal consequences for the creditor and the estate, and thus qualifies as a proceeding in court under Section 6502(a). The Michigan probate code actually states that "[f]or purposes of a statute of limitations, the proper presentation of a claim ... is equivalent to commencement of a proceeding on the claim." Mich. Comp. Laws § 700.3802(3). Furthermore, a properly presented proof of claim necessarily requires the estate to provide notice that the claim is not allowed, otherwise the claim is deemed automatically allowed. Mich. Comp. Laws § 700.3806(2). When the United States filed a claim against the probate estate and the estate did not reply within the required four-month period, the government could file proof of its claim within three years after the date of death, which it did. Once the government has filed a proceeding within the ten-year period, it can bring an action to collect at any time, even after the ten-year period has expired. *United States v. Weintraub*, 613 F.2d 612, 620–21 (6th Cir. 1979).

2. FBAR Penalties Repeatedly Sustained; $100,000 Cap Repeatedly Rejected. *United States v. Schoenfeld*, 2019 WL 2603341 (M.D. Fla. June 25, 2019); *United States v. Park*, 2019 WL 2248544 (N.D. Ill. May 24, 2019); *United States v. Garrity*, 2019 WL 1004584 (D.Conn. Feb. 28, 2019) (Slip copy), *app. filed* (2d Cir. April 25, 2019); *United States v. Horowitz*, 361 F.Supp. 3d 511, 2019 WL 265107 (D. Md. Jan. 18, 2019), *app. filed* (4th Cir. March 15, 2019); *Kimble v. United States,* 141 Fed. Cl. 373, 2018 WL 6816546, 122 A.F.T.R. 2d 1028-7109 (Ct. Fed. Cl. Dec. 27, 2018*), app. filed,* (Fed. Cir. Feb. 26, 2019); *Norman v. United States*, 138 Fed. Cl. 189, 2018 WL 3629293, 122 A.F.T.R. 2d 2018-5334 (Fed. Cl. July 31, 2018), *app. filed,* (Fed. Cir. Sept. 21, 2018)

In *Garrity*, a jury found that the deceased, Paul G. Garrity, Sr., had willfully failed to file an FBAR report and that the penalty was equal to 50% of the balance in the decedent's bank account for the year of the failure-to-file -- $936,691. 31 U.S.C. § 5314, 5321(a)(5). The representatives of the decedent's estate moved to reduce the penalty to $100,000, or alternatively, to "an amount that is proportional to the harm caused by the failure to file the FBAR, as required under the Eighth Amendment" to the U.S. Constitution.

The District Court for Connecticut (Judge Shea) denied the motion and sustained the larger penalty. The defendants argued that the Treasury regulations capped the maximum civil penalty at $100,000. 31 C.F.R. § 1010.820(g). The court explained that the FBAR rules were initially enacted in 1970, as part of the Bank Secrecy Act. Pub. L. No. 91-508, 91st Cong., 2d Sess. (1970), 84 Stat. 1114. These rules were amended in 1986, however, to permit the Treasury to assess civil monetary penalties for willful violations of the reporting requirements. Money Laundering Control Act of 1986, Pub. L. No. 99-570, 99th Cong., 2d Sess. (1986), 100 Stat. 3207. The statute provided for civil penalties equal to the greater of $25,000 or the account balance, but not over $100,000. Treasury then promulgated its regulations imposing this $100,000 limitation. In 2004, however, Congress amended the civil penalties for willfully failing to file an FBAR, increasing the penalty to the greater of $100,000 or 50% of the balance of the account at the time of the violation. 31 U.S.C. § 5321(a)(5)(C). American Jobs Creation Act of 2004, Pub L. No. 108-357, § 821, 108th Cong., 2d Sess. (2004), 118 Stat. 1418, 1586. Treasury never promulgated new regulations to reflect the new limitations. The Defendants argued that the 2004 amendment established a ceiling on civil penalties, but that by retaining the old regulation, the Secretary established a *lower* ceiling, thereby limiting its own authority. The court rejected this argument, finding it inconsistent with the effective date of the 2004 amendment (the date of enactment). Treasury lacked the power to override a clear legislative directive to raise the maximum willful FBAR penalty. The taxpayers noted that, in *California Bankers Ass'n v. Shultz*, 416 U.S. 21, 26 (1974), the Supreme Court noted that

the Bank Secrecy Act's civil penalties attached only upon violation of regulations promulgated by the Treasury, but the court explained that this statement related only to the reporting requirement, and not the size of the penalties. The court also rejected the argument that the penalty was excessive under the Eighth Amendment to the U.S. Constitution, finding that (a) the civil FBAR penalty must be evaluated independently of other penalties imposed on the taxpayer under the foreign trust rules; and (b) the fine was not excessive, considering the essence of the crime and its relation to other criminal activity, whether the defendant fits into the class of persons for whom the statute was principally designed, the maximum sentence and fine that could have been imposed, and the nature of the harm caused by the defendant's conduct. *United States v. Bajakajian*, 524 U.S. 321 (1998); *United States v. Castello*, 611 F.3d 116, 120 (2d Cir. 2010).

Note. See same analysis and holding on similar facts in *United States v. Horowitz*, *Kimble v. United States*, *Norman v. United States*, *United States v. Park*, and *United States v. Schoenfeld*. Two other courts, however, took the opposite position. *United States v. Wahdan*, 325 F. Supp. 3d 1136, 122 A.F.T.R.2d 2018-5208 (D. Colo. 2018); *United States v. Colliot*, 2018 WL 2271381, 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 2018) (Slip copy). As the court in *Schoenfeld* opined, "the Court finds the analysis of these courts [*United States v. Garrity, United States v. Horowitz, Kimble v. United States*, and *Norman v. United States)*,more persuasive than that applied in *Wahdan* and *Colliot*, because although "Congress did not establish specific reporting requirements in the BSA, leaving that to the Secretary, it *did* establish, in § 5321, specific parameters for civil penalties, providing what the maximum penalty for willful violations 'shall' be." Citing *Park*, 2019 WL 2248544, at *8. Obviously, a variety of appellate opinions will be forthcoming on this issue, which should either be dispositive or lead to a request for certiorari.

3. Tax Court Acknowledges Validity of Foreign Asset Protection Trust that, On Creation, Held Only A Relatively-Small Part of Grantor's Assets; Trust Assets Are Not Disposable by Grantor for Purposes of Offer in Compromise. *Campbell v. Comm'r*, T.C. Memo. 2019-4 (Feb. 4, 2019)

John F. Campbell, the taxpayer, created a 99-year irrevocable trust in and under the laws of Nevis, West Indies, in anticipation of his family's relocation to St. Thomas in the U.S. Virgin Islands. The taxpayer and his family are all beneficiaries, but the taxpayer has never received any benefit from the trust and he testified that he anticipates receiving no benefit. The taxpayer funded the trust with $5 million, leaving him a net worth of $20 million. The trustee is a Nevis trust company and the trust protector was an individual. The trust instrument gives the taxpayer no control over the trustee with respect either to distributions or investments. The taxpayer can request, but not insist upon, a change in the trustee. The taxpayer made

several investments that lost money and left him responsible for personal loan guarantees. The IRS assessed a $1,135,192 deficiency and a $113,519 accuracy-related penalty. The taxpayer submitted an Offer in Compromise, which the IRS rejected because it included in the taxpayer's assets, for this purpose, the assets of the Nevis trust. The taxpayer disagreed and filed suit, claiming that the IRS determination was an abuse of its authority.

The Tax Court (Judge Kerrigan) held for the taxpayer. The court admitted that an abuse of discretion exists when an IRS determination is arbitrary, capricious, or without sound basis in fact or law. *Murphy v. Comm'r*, 125 T.C. 301, 320 (2005), *aff'd*, 469 F.3d 27 (1st Cir. 2006). For determining whether a taxpayer's realizable assets will cover a tax liability, the IRS can Take dissipated assets into account if it can be shown that the taxpayer has sold, transferred, encumbered or otherwise disposed of the assets in an attempt to avoid the tax liability. Rev. Proc. 2003-71, § 4.02(2), 2003-2 C.B. 517; IRM pt. 5.8.5.18(1) (Mar. 23, 2018). The taxpayer's net worth exceeded $19 million in 2006, but by 2010 he had $ 3.5 million of negative equity in his investments. The trust assets can be taken into account only if the trust held them as transferee, nominee, or alter ego. The trust document gives the taxpayer no control over the trustee and he cannot force the trustee to make distributions or investments. Under applicable state law (which relies on federal principles on this issue), because the taxpayer was not rendered insolvent by the creation and funding of the trust and there was no evidence that he had any actual control over the trustee, the trust assets could not be taken into account for purposes of the offer in compromise.

Note. Compare result and analysis in *In re Rensin v. Rensin*, 2019 WL 2004000 (SD Fl., Bankr. May 3, 2019), where Joseph K. Rensin was sued by the Federal Trade Commission based on fraudulent sales by his wholly-owned corporation. More than 15 years before the bankruptcy suit was filed and 7 years before the dispute with the FTC, Joseph established a $9 million Cook Islands spendthrift trust of which he was the primary beneficiary and a Cook Islands corporation was the trustee. Joseph retained no power to control the trustee or trust protector, but he did retain a testamentary power of appointment over the remainder. The following year, a district court entered judgment against Joseph's corporation in favor of the FTC, but not against Joseph. The Second Circuit reversed the district court and suggested that suit should be filed against both Joseph and the corporation, and that damages should be set at about $14 million. The next month, Joseph moved to Florida from Maryland, where he had long resided. The trustee invested the trust funds in a deferred variable annuity and a fixed annuity, both issued by a Cayman Islands company. The district court entered a new judgment in favor of the FTC against Joseph and his company in the amount of $13.4 million, plus post-judgment interest. Joseph made a demand on the trustee to pay the FTC judgment. The trustee sought direction from the Supreme Court of Belize, which ordered the trustee not to comply with any court order to turn over trust assets other than an order

from the Supreme Court of Belize. Joseph filed a voluntary petition in bankruptcy and claimed that the trust assets were not available to him The district court held Joseph in contempt, found that he has assets that could be used to satisfy the FTC judgment, and directed Joseph to meet with the FTC to negotiate a payment plan, which the district court suggested may include the use of his Florida property and annuity payments. Joseph claimed that the trust assets, and particularly the annuities, were exempt from the bankruptcy trustee's claims under Florida law.

The District Court (Bankruptcy Judge Kimball) held that under Florida law, the choice of law provided in a contract is binding unless it offends Florida public policy. *See. Floating Docks v. Auto-Owners Ins. Co*., 82 So. 3d 73, 80 (Fla. 2012); *Mazzoni Farms, Inc. v. E.I. DuPont De Nemours & Co*., 761 So. 2d 306, 311 (Fla. 2000). Florida law strongly disfavors self-settled spendthrift trusts. *Menotte v. Brown (In re Brown)*, 303 F.3d 1261, 1266 (11th Cir. 2002) (citing cases). Florida courts will not enforce a spendthrift trust designed to permit a person to place his or her assets beyond the arms of creditors. *See* Fla. Stat. § 736.0107. Under the Florida Uniform Trust Code, "[w]hether or not the terms of a trust contain a spendthrift provision ...With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit." Fla. Stat. § 736.0505(1)(b). As the trustee has discretion to distribute the entire income and principal to Joseph, his creditors are placed in the same position as if the trust had not been created.

4. With Modest Power Comes Modest Responsibility -- Government Cannot Collect Taxes from Special Administrator of Estate. *United States v. O'Brien*, 2018 WL 6305232, 122 A.F.T.R. 2d 2018-6810 (D. Md. Dec. 3, 2018) (Slip copy)

Louis Pate died in 2012 and his estate was opened with Willie Mae Pate Roary as personal representative. Willie Mae was removed by the court in 2013, and Timothy O'Brien was named special administrator. The special administrator filed suit in state court to permit him to pay $7,243.69 in federal income taxes and $4,666.41 of state income taxes, and the court granted the order. The court also deemed the estate insolvent and ordered it closed. No successor personal representative was appointed. The United States brought suit against Timothy, as special administrator, and against Diane V. Marshall, as Representative of the decedent's estate, contending that they owed $229,974 for the decedent's unpaid income taxes, interest, and penalties. Timothy moved to dismiss, claiming that he was not a proper party.

The U.S. District Court for the District of Maryland held for the special administrator and granted the motion to dismiss. The court explained that Maryland law provides for the appointment of a special administrator when needed "to protect property prior to the appointment and qualification of a personal representative or upon the termination of appointment of a

personal representative and prior to the appointment of a successor personal representative." Md. Code Ann., Est. & Tr. § 6-401(a). The special administrator fills in when there is no personal representative for an estate. Md. Code Ann., Est. & Tr. § 6-401(a). In this capacity, the special administrator's duties are limited to collecting, managing, and preserving property and account to the personal representative, and performing any unperformed duties required of a personal representative concerning the preparation and filing of inventories, accounts and notices of filing accounts, and proposed payments of fees and commissions. Md. Code Ann., Est. & Tr. § 6-403. The special administrator has only those powers to do whatever is. "necessary to collect, manage, and preserve property" and any "other powers designated from time to time by court order." Md. Code Ann., Est. & Tr. § 6-403. State law does not give the special administrator the powers normally granted a personal representative, such as the power to sue or defend the estate against suit. The United States noted that state law did not specifically state that a special administrator cannot participate in litigation. The court noted that Maryland's highest court has observed that "the powers of a Special Administrator are limited to preserving and maintaining estate property, unless those powers are expanded by court order" (citing *Green v. Nassif*, 934 A.2d 22, 25 n.4 (Md. 2007)), but that it has not considered the precise scope of those powers. In the absence of guidance from the highest court of Maryland, the court examined the decisions of Maryland's intermediate courts of appeals. In this regard, the court noted that *Banashak v. Wittstadt*, 893 A.2d 1236 (Md. Ct. Spec. App. 2006) held that a special administrator could not recover attorney's fees incurred defending his position as special administrator, when there was no court order authorizing him to engage in litigation. The *Banashak* court noted that a special administrator replaces the personal representative when an estate transitions a relatively litigation-free administrative probate to a more combative judicial probate and that the statute did not accidentally forget to grant certain powers to the special administrators. It concluded that the special administrator did not have an inherent power to sue or to be sued and may do so only if the court issues an order granting such authority. The District Court found this opinion compelling and not inconsistent with the views expressed by the highest court in the state. Therefore, the court concluded, because Timothy was appointed as special administrator, as opposed to personal representative, even if his role as special administrator had not terminated when the United States filed suit, he had no power to sue or defend suit and was not a proper party to the government's claim.

Note. The United States also asked the court to grant Timothy authority to defend the estate in this particular litigation, which it contended could be done under Section 7402(a), which states that he district courts, in tax matters, may render "such other orders and processes, and . . . render such judgments and decrees as may be necessary or appropriate for the en-

forcement of the internal revenue laws." As the government had not included this request in its complaint or its amended complaint, but only in its Opposition, the court declined to consider the request. The court did, however, note that:

> *the United States has not identified any case law that demonstrates that the Court's authority to issue orders "as may be necessary or appropriate for the enforcement of the internal revenue laws" would permit it, in this instance, to grant O'Brien authority to defend this litigation. Certainly, the United States argues that "the probate court no longer has jurisdiction over this matter" because more than eighteen months have passed since Pate's death. Pl.'s Opp'n 8. But, the United States has not alleged or even argued that it could not have attempted to collect these taxes while the Estate was in probate. Therefore, it does not appear necessary or appropriate for the Court to direct O'Brien to act on the Estate's behalf, that is, for the Court to perform a function typically performed by a state court, when the state court may no longer have that authority. The United States' request to grant O'Brien "authority to defend the estate in this litigation" pursuant to 26 U.S.C. § 7402(a) is denied.*

5. Taxpayer's Irrevocable Trust May Be Liable for His Taxes as Nominee or Alter Ego. *United States v. Hovnanian*, 2019 WL 1233082 (D.N.J. March 18, 2019) (Slip copy)

The father of the taxpayer, Shant Hovnanian, created an irrevocable trust for the benefit of Shant's children, (the VSHPHH Trust) and transferred to it a parcel of rental real estate. Initially, Shant and Nina were co-trustees, but Nina later became the sole trustee. Shant also created a separate irrevocable trust for his children (the Pachava Trust), to which his mother transferred another parcel of real estate. Shant now owed $16.2 million in income tax, penalties, and interest. The government sued the trustee of the two trusts to recover the amount Shant owed from the trust assets, but the trustee moved to dismiss the trusts from the suit, because they, rather than Shant, owned the assets and they were not liable for his tax obligations.

The U.S. District Court for New Jersey (Judge Thompson) refused to dismiss the trusts as defendants at an early stage in the proceedings, because the government may yet be able to establish that Shant, rather than the trustee, is the true owner of the trust property. The court noted that with respect to the VSHPHH Trust, Shant pays individually both the municipal taxes and utility bills, and he receives rental income indirectly, with checks given to his father and redeposited in an account in the name of one of Shant's businesses. With respect to the Pachava Trust, Shant receives his

mail at the address of the trust's property and he pays its municipal taxes and utility bills directly from bank accounts under his control. The court stated that, if the trusts were Shant's nominees or alter egos, the tax liens could be attached to the trust assets. 26 U.S.C. § 7403(a), (c); *United States v. Patras*, 909 F. Supp. 2d 400, 410 (D.N.J. 2012), aff'd, 544 F. Appx 137, 140-141 (3d Cir. 2013) (citing *G. M. Leasing Corp. v. United States*, 429 U.S. 338, 351 (1977)). To determine whether a trust is a taxpayer's nominee under applicable state law (New Jersey), the court held that it must examine:

> *(1) whether the nominee paid adequate consideration for the property; (2) whether the property was placed in the nominee's name in anticipation of a suit or other liabilities while the taxpayer continued to control ... the property; (3) the relationship between the taxpayer and the nominee; (4) the failure to record the conveyance; (5) whether the property remained in the taxpayer's possession; and (6) the taxpayer's continued enjoyment of the benefits of the property.*

United States v. Patras, 544 F. App'x 140 at 141–42 (3d Cir. 2013). With respect to the both trusts, the court explained that, taking the plaintiff's allegations as true for purposes of this motion, there were several factors that pointed to the trusts being nominees or alter egos, including the facts that the property was transferred without consideration and, although the trust property never belonged to the taxpayer, it was transferred to the trusts after his tax liabilities arose and "was an attempt to avoid encumbering the property with the federal tax liens." Some factors tended to favor the taxpayer, including the fact that he never owned the trust assets nor transferred them to the trust, though he was the grantor of the Pachava trust. Most importantly, however, the court noted that the taxpayer receives rental income from one of the trust properties and pays taxes and expenses for one or both of the trust properties. The court concluded that, taking the government's allegations as true for purposes of a motion to dismiss, there is a reasonable basis to believe that the trusts are alter egos or nominees of the taxpayer.

O. State Income Taxes

State Cannot Tax on Undistributed Trust Income Based Solely on Residence of Beneficiaries. *N.C. Dept. of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, ___ U.S. ___, 2019 WL 2552488 (S.Ct. June 21, 2019)

Joseph Lee Rice III formed an irrevocable New York family trust for the benefit of his children. The trust was created under New York law with a New York resident as trustee. The trustee had "absolute discretion" to distribute Trust income and

principal to and among the beneficiaries. Three years later, his daughter, Kimberley Rice Kaestner, moved to North Carolina. The trustee later divided the Trust into three separate subtrusts, one of which, the Kimberley Rice Kaestner 1992 Family Trust (the Trust), was held for the benefit of Kimberley and her three children. North Carolina tried to tax the Trust's income under a statute that permitted it to tax any trust income that "is for the benefit of" a state resident. N.C. Gen. Stat. § 105–160.2. The state assessed over $1.3 million in tax for 2005 through 2008, during which time Kimberley had no right to, and did not receive, any Trust distributions. The Trust also had no physical presence within the state, made no direct investments in the state, and held no real property in the state. The trustee paid the tax under protest and then sued the taxing authority in state court, arguing that the tax as applied to the Trust violates the Fourteenth Amendment's Due Process Clause. The state courts agreed, holding that the beneficiaries' in-state residence was too tenuous a link between the state and the Kimberley Trust to support the tax. See *Kimberley Rice Kaestner 1992 Family Trust v. N.C. Dept. of Revenue*, 814 S.E.2d 43 (N.C. 2018).

The U.S. Supreme Court, in a unanimous opinion (Justice Sotomayor) affirmed held that the presence of in-state beneficiaries alone does not empower a state to tax undistributed trust income over which the beneficiaries have no right to demand distribution and which they might never receive. The Court explained that the Due Process Clause of the 14th Amendment permits states to impose only taxes that are in "fiscal relation to protection, opportunities and benefits given by the state." *Wisconsin* v. *J. C. Penney Co.*, 311 U. S. 435 (1940). There must be a reasonable minimum connection between the state and the person, property or transaction it seeks to tax. With respect to an income tax, the income that the state taxes must "be rationally related to values connected with the taxing State," *Quill Corp.* v. *North Dakota*, 504 U. S. 298, 306 (1992). For a trust beneficiary, the Constitution requires the Court to focus on the extent of the in-state beneficiary's right to control, possess, enjoy, or receive trust income or assets. *Safe Deposit & Trust Co. of Baltimore* v. *Virginia*, 280 U. S. 83 (1929); *Brooke* v. *Norfolk*, 277 U.S. 27 (1928); and *Maguire* v. *Trefry*, 253 U.S. 12 (1920); *Curry* v. *McCanless*, 307 U.S. 357 (1939). The Court held that the residence of the beneficiaries alone cannot supply the minimum connection needed to sustain the state's income tax, because the beneficiaries did not receive any income from the Trust during the years in question, they had no right to demand Trust income or otherwise control, possess, or enjoy the Trust assets in the tax years at issue, and they could not count on necessarily receiving any specific amount of income from the Trust in the future.

Note 1. Justice Alito (with Chief Justice Roberts and Justice Gorsuch) filed a concurring opinion, noting that they agreed that North Carolina had too tenuous a connection with the trust income to permit it to tax that income. The concurring justices, however, stressed that the opinion is limited to the facts before the court. The opinion discussed the specific terms of this trust, and a different result could occur for beneficiaries who have a different relationship with the trust. This could be an issue in a state such as California, which taxes resident beneficiaries on income of a trust as long as their interests in the trust are not contingent.

Note 2. The Trust provided for termination when Kimberley reached 40 years of age. After the tax years in question, on consultation with the grantor, and notice to, but no consent from Kimberley or the other beneficiaries, the trustee decanted the trust into a new trust that would not terminate when she reached 40 years of age. The Court specifically noted that the trustee could decant again to further postpone any distributions, rendering the beneficiaries' interests in the trust income especially uncertain. This decanting was not expressly authorized by the Trust instrument but was under applicable state law. See N.Y. Est., Powers & Trusts Law Ann. § 10–6.6(b).

III. ESTATE TAXES

A. IRC § 2001. Estate Tax Repeal or Reform

The Estate Tax Repeal and Reform Movement Continues. H.R. 25, 116th Cong., 1st Sess. (Jan. 3, 2019); H.R. 218, 116th Cir. 1st Sess. (Jan. 3, 2019); H.R. 521, 116th Cong, 1st Sess. (Jan. 11, 2019); H.R. 1737, 116th Cir. 1st Sess. (March 13, 2019); S. 176, 116th Cong., 1st Sess. (Jan. 17, 2019); S. 215, 116th Cong, 1st Sess. (Jan. 24, 2019); S. 309, 116th Cong., 1st Sess. (Jan. 31, 2019); S. 787, 116th Cong., 2d Sess. (March 13, 2019)

No matter how high the estate, gift, and GST tax exemptions may be, there remains a significant number of legislators for whom the estate tax (and sometimes the GST and gift taxes) will always be unacceptable. Thus, the estate tax repeal movement survives these increased exemptions. There also remain a significant number of legislators who would like to see the estate, gift, and GST tax exemptions dropped, rates raised, and planning curtailed.

a) H.R. 25. Fair Tax Act

On January 3, 2019, Representative Rob Woodall (R-Ga.) introduced H.R. 25, the Fair Tax Act, which would replace the income, estate, gift, and GST taxes (along with chapter 14), with a national sales and consumption tax. The repeal of the income tax would render the basis issues irrelevant. This bill has 29 co-sponsors, all of whom are Republicans. The bill would authorize no funding for the operations of the Internal Revenue Service after fiscal year 2023, and the national sales tax would terminate if the Sixteenth Amendment to the Constitution (authorizing an income tax) is not repealed within seven years after the enactment of this bill. If enacted, this bill would take effect on January 1, 2021.

b) H.R. 218. Death Tax Repeal Act

On January 3, 2019, Rep. Jason Smith (R-Mo.) introduced H.R. 218, the Death Tax Repeal Act, which would repeal the estate and GST taxes. The bill would retain a 35% gift tax with a $10 million exemption, indexed for inflation. The bill has 55 co-sponsors, including 2 Democrats. If enacted, this bill would apply to estates and transfers on or after the date of enactment.

c) H.R. 521. Permanently Repeal the Estate Tax Act of 2019

On January 11, 2019, Representative Robert E. Latta (R-Ohio) introduced H.R. 521, the "Permanently Repeal the Estate Tax Act of

2019," which would repeal the estate tax, but not the gift tax, the GST tax, the special valuation rules of chapter 14 or the date-of-death value basis under Section 1014. The bill has 8 co-sponsors, all of whom are Republicans, and it was referred to the House Committee on Ways and Means. If enacted, the bill would apply to estates of decedents dying after December 31, 2018.

d) S. 176. Estate Tax Rate Reduction Act

On January 17, 2019, Senator Tom Cotton (R-Ark.) introduced a bill to reduce the estate, gift, and GST tax rates to a flat rate of 20%. The bill has 3 co-sponsors, all of whom are Republicans. If enacted, the bill would apply to transfers after December 31, 2019.

e) S. 215. Death Tax Repeal Act

On January 23, 2019, Senator John Thune (R-S.D.), introduced a bill to repeal the estate and GST taxes. The bill would retain the gift tax with an inflation-adjusted $10,000,000 exemption and a 35% marginal rate (applicable to transfers over $500,000). The bill has 30 co-sponsors, all of whom are Republicans. If enacted, the bill would apply to estates and transfers on or after the date of enactment.

f) S. 309. For the 99.8 Percent Act

On January 31, 2019, Sen. Bernie Sanders (I-Vt.) introduced a bill which would:

- reduce the estate, gift, and GST exemptions to $3.5 million with respect to estates of individuals dying after, to gifts after, and to transfers after December 31, 2019;

- raise the top estate and gift tax rates to 45% on transfers of $3.5 million to $10 million, 50% on transfers of over $10 million and not over $50 million, 55% on transfers of over $50 million and not over $1 billion, and 77% on transfers of more than $1 billion, with respect to estates of individuals dying after and gifts made after December 31, 2019;

- raise the GST tax rate to 77% with respect to transfers after December 31, 2019;

- increase from $750,000 to $3,000,000 the maximum amount that an estate can be reduced by special use valuation under

Section 2032A for farm and closely-held business real estate, with respect to estates of individuals dying after December 31, 2019;

- increase from $500,000 to $2,000,000 the estate tax deduction under Section 2031(c) for land subject to certain conservation easements, and permit a reduction of up to 60% of the gross estate, rather than 40%, with respect to estates of individuals dying after and to gifts after December 31, 2019;

- require that the donee use a basis in contributed property that does not exceed the value on which a gift tax has been imposed and apply the consistent basis rule for property acquired from a decedent to require reporting within 30 days of the date on which the estate tax return is required to be filed, rather than 30 days after the date of death, with respect to transfers the returns for which are due after the date of enactment;

- eliminate valuation discounts for nonbusiness assets held by an entity and eliminate control discounts where the transferor, the transferee, and members of the family of the transferor and transferee control the business, with respect to transfers after the date of enactment;

- require that a GRAT have a 10-year or greater term, and a remainder interest with a value not less than the greater of 25% of the fair market value of the property in the trust or $500,000 (but not more than the fair market value of the trust property), with respect to transfers after the date of enactment;

- require that assets of a grantor trust be deemed to be included in the deemed owner's gross estate for estate tax purposes, less the amount of any taxable gifts deemed made by the owner to the trust, with respect to trusts created after and additions to and sales, exchanges or similar comparable transactions made to trusts after the date of enactment;

- eliminate the GST exemption for transfers to a trust whose termination date is 50 years or greater from the date of its creation, with respect to transfers after the date of enactment (a trust created before the date of the enactment would be deemed to be a qualifying trust for a period of 50 years after the date of the enactment); and

- limit the total gift tax annual exclusion for all transfers made in trust or through a passthrough entity or subject to a prohibition on sale or liquidation, made in a calendar year to twice the annual exclusion, with respect to transfers after the date of enactment.

This bill has only one co-sponsor, Sen. Kirsten E. Gillibrand (D-N.Y.).

g) S. 787 and H.R. 1737. The American Housing and Economic Mobility Act of 2019

On March 13, 2019, Sen. Elizabeth Warren (D-Mass.) introduced S. 787, the "American Housing and Economic Mobility Act of 2019," the tax provisions of which would dramatically alter the estate, gift, and GST taxes, to increase the rate of tax on large estates, reduce the estate, gift, and GST tax exemptions, and eliminate or curtail many popular estate tax planning techniques. A companion bill was introduced in the House by Rep. Cedric L. Richmond (D-La.), H.R. 1737, These bills would:

- reduce the estate, gift, and GST exemption to $3.5 million (there is no clear effective date for this change);

- raise the estate and gift tax rate to 55% for transfers of $3.5 million to $13 million, 60% for transfers of over $13 million and not over $93 million, 65% for transfers of over $93 million and not over $1 billion (there is no clear effective date for this change);

- impose a 10% surtax on transfers of more than $1 billion (there is no clear effective date for this change);

- raise the GST tax to 65% (there is no clear effective date for this change);

- require that a GRAT created after the date of enactment have a 10-year or greater term;

- deem assets of a grantor trust to be included in the deemed owner's gross estate for estate tax purposes (less the amount of any taxable gifts deemed made by the owner to the trust) and deem distributions from a grantor trust to someone other

than the grantor to be taxable gifts, with respect to trusts created after, additions to trusts made after, and to sales, exchanges or similar comparable transactions made to a grantor trust after the date of enactment;

- eliminate the GST exemption for transfers to trusts the termination date of which is 50 years or more from the date of its creation, with respect to transfers after the date of enactment (any trust created before the date of the enactment would be deemed to be a qualifying trust for a period of 50 years after the date of the enactment); and

- limit the total gift tax annual exclusion for all transfers made in trust or through a passthrough entity or subject to a prohibition on sale or liquidation, made in a calendar year to twice the annual exclusion, with respect to gifts after the date of enactment.

The Senate bill has two co-sponsors, both of whom are democrats. The House bill has 14 co-sponsors, all of whom are democrats.

Note. The Sanders and Warren bills are extreme examples of estate tax reform and would, if enacted, dramatically change the way in which estate tax planning was currently implemented. It seems unlikely that such legislation would pass Congress unless the Democrats obtained 60 Senate seats and the White House in 2020, because Republicans will strongly oppose such an increase in the wealth transfer taxes. Nonetheless, practitioners may use the possibility of such legislation to encourage clients to take advantage of various estate planning techniques sooner, rather than later. Such dramatic changes may be remote possibilities, but they should not be ignored entirely.

B. IRC § 2010. Unified Credit & Portability

1. Proposed Regulations Would Eliminate Clawback of Increased Basic Exclusion Amount with Respect to Taxable Gifts Made Before January 1, 2026. 83 Fed. Reg. 59343 (Nov. 23, 2018)

The Treasury and IRS proposed regulations addressing the problem of clawback. Treasury and the IRS, apparently influenced by several comments received from the public, perceived four situations in which there could be a serious problem of clawback. The proposed regulations address three of

these by analysis in the preamble, and the fourth by an actual change in the language of the regulations.

a) Situation 1. Taxable Gift and Gift Tax Payment Before 2018; Additional Gifts After 2017 and Before 2026

Donor makes taxable gifts and pays a gift tax before 2018, and then makes additional taxable gifts after 2017 and before 2026. The question raised is whether some of the increased basic exclusion amount that should be available with respect to the 2018-2025 taxable transfers must first be allocated to the pre-2018 transfers on which gift tax has actually been paid. If so, this would recapture some of the benefits of the prior increased basic exclusion amount.

The IRS deems there to be no real clawback problem where a donor who makes taxable gifts in 2018 – 2025 has made pre-2018 gifts on which a gift tax was actually paid. The IRS explained that the gift tax is calculated in seven steps:

Step 1. One determines a tentative gift tax (the tax before application of the unified credit) on the sum of all taxable gifts, including both the gifts made in the current taxable year and those made in prior years. See IRC § 2502(a)(1).

Step 2. One determines a tentative tax on the taxable gifts made before the current taxable year. IRC § 2502(a)(2).

Step 3. One subtracts the result in Step 2 from the result in Step 1, to produce a net tentative gift tax on the current year's taxable gifts. IRC § 2502(a).

Step 4. Fourth, one determines the credit equal to the applicable credit amount (defined in Section 2010(c)). This is the tentative tax on the applicable exclusion amount determined as if the donor had died on the last day of the current calendar year. The applicable exclusion amount is the sum of the basic exclusion amount as in effect for the year in which the gift was made, any DSUE amount as of the date of the gift (See Reg. § 25.2505-2), and any restored exclusion amount as of the date of the gift as computed pursuant to Notice 2017-15, 2017-6 I.R.B. 783. IRC § 2505(a)(1).

Step 5. One must calculate the sum of the amounts allowable as a credit to offset the gift tax on gifts made in all preceding calendar periods, computing the tentative tax at the tax rates in effect for the current period, using the applicable exclusion amount for the prior period, but not exceeding the tentative tax on the gifts actually made during the prior period. IRC § 2505(a)(2), and flush language at the end of IRC § 2505(a).

Step 6. Sixth, the total credit allowable for prior periods determined in Step 5 must be subtracted from the credit for the current period in Step 4. IRC § 2505(a).

Step 7. One subtracts the credit amount in Step 6 from the net tentative gift tax in Step 3. IRC § 2505(a).

The IRS explained that there is no clawback problem in Situation 1, because of the calculations in Steps 3 through Step 6. Step 3 subtracts the tentative tax on all gifts from prior periods from the tentative tax on the cumulative gifts (including the current year and prior periods). The full amount of the gift tax liability on the pre-2018 gifts is thus subtracted from the tax on the current year gifts, whether that tax was sheltered by the basic exclusion amount or satisfied by a gift tax payment. Steps 4 through 6 then reduce the basic exclusion amount for the current year by the basic exclusion amount for the prior years to the extent applied to the gifts made in those periods. The increased basic exclusion amount was not available in the years before 2018, so the gift tax determination appropriately reduces the increased basic exclusion amount only by the basic exclusion amount allowable against prior period gifts. There is, therefore, no loss in the benefit afforded by the prior gift tax payments.

b) Situation 2. Taxable Gifts Before 2018; Death After 2017 and Before 2026

Donor makes taxable gifts and pays a gift tax before 2018, and then dies after 2017 and before 2026. The question raised is whether some of the increased basic exclusion amount that should be available with respect to the deceased donor's estate tax must first be allocated to the pre-2018 transfers on which gift tax has actually been paid. If so, this would recapture some of the benefits of the prior increased basic exclusion amount.

The IRS deems there to be no real clawback problem where a donor who dies after December 31, 2017 and before January 1, 2026, has made pre-2018 gifts on which a gift tax was actually paid. The IRS explained that the estate tax is calculated in five steps:

Step 1. One determines a tentative tax (the tax unreduced by the unified credit) on the sum of the taxable estate and the post-1976 taxable gifts not included in the gross estate. IRC § 2001(b)(1).

Step 2. One determines the gift tax payable, which is the hypothetical gift tax that would have been imposed on all prior post-1976 taxable gifts, whether or not included in the gross estate, reduced (but not to below zero), by the credit amounts allowable in the years of the gifts. The credit amount allowable for each year during which a gift was made is the tentative tax, computed using the tax rates in effect at the decedent's death, on the applicable exclusion amount for that year, but not more than the tentative tax on the gifts made in that year. IRC §§ 2001(b)(2), 2001(g), 2505(c).

Step 3. The gift tax in Step 2 is subtracted from the tentative tax in Step 1, producing a net tentative estate tax. IRC § 2001(b).

Step 4. One determines the credit equivalent of the applicable exclusion amount as in effect on the date of death (but not more than the net tentative estate tax). IRC §§ 2010(a), 2010(c), 2010(d).

Step 5. One subtracts the credit amount in Step 4 from the net tentative estate tax, to produce the estate tax due. IRC § 2010(a).

The Preamble to the proposed regulations explains that Step 3 requires that the hypothetical gift tax on the decedent's post-1976 taxable gifts be subtracted from the tentative tax on the sum of the taxable estate and adjusted taxable gifts. The post-1976 taxable gifts include the pre-2018 gifts on which gift tax was paid. Thus, the full amount of the gift tax liability on the pre-2018 gifts is removed from the estate tax computation, regardless of whether that liability was sheltered from gift tax by the basic exclusion amount or satisfied by a gift tax payment.

Step 4 then subtracts the amount of the basic exclusion amount for the year of the decedent's death from the net tentative estate tax. The only time that the increased basic exclusion amount enters into the computation of the estate tax is when the credit on the basic exclusion amount for the year of the decedent's death is netted against the tentative estate tax, which in turn already has been reduced by the hypothetical gift tax on the full amount of all post-1976 taxable gifts (whether or not gift tax was paid). Thus, the increased basic exclusion amount is not reduced by any part of the prior taxable gifts and is fully available to the decedent's estate.

c) Situation 3. Taxable Gifts Made After 2017 and Before 2026; Taxable Gifts After 2025

Donor makes taxable gifts above $5 million (adjusted for inflation) after 2017 and before 2026, utilizes all or part of the increased basic exclusion amount, and then makes taxable gifts after 2025. The question raised is whether the gift tax on the 2018-2025 taxable gifts determined in computing the tax on the post-2025 taxable gifts, takes into account the increased basic exclusion amount at the time of the 2018-2025 gifts or the reduced basic exclusion amount at the time of the post-2025 gifts. If so, this would recapture some of the benefits of the prior increased basic exclusion amount.

The IRS deems there to be no real clawback problem where a donor makes a gift tax payment on a taxable gift made after 2025 is inflated by a theoretical gift tax on a gift made during 2018 - 2025 period that was sheltered from gift tax by the increased basic exclusion amount. Again, the IRS explained that Step 3 of the gift tax computation subtracts the tentative tax on all gifts from prior periods

from the tentative tax on the cumulative gifts (including the current year and prior periods). The gift tax from prior periods includes the gift tax attributable to the gifts made during the 2018 - 2025. Thus, the full amount of the gift tax liability on the gifts made in 2018 - 2025 is removed from the computation, without regard to whether they were sheltered from tax by the increased basic exclusion amount or satisfied by a gift tax payment. Even if the sum of the credits allowable for prior periods exceeds the basic exclusion amount after 2025, the tax on the current gift cannot exceed the tentative tax on that gift and thus will not be unduly inflated.

d) Situation 4. Taxable Gifts Made After 2017 and Before 2026; Death After 2025

Donor makes taxable gifts above $5 million (adjusted for inflation) after 2017 and before 2026 and utilizes all or part of the increased basic exclusion amount, and then dies after 2025. The question raised is whether the deceased donor's post-1976 adjusted taxable gifts, for purposes of calculating the estate tax, the gift tax on the 2018-2025 gifts takes into account the increased basic exclusion amount. If so, this would recapture some of the benefits of the prior increased basic exclusion amount.

Situation 4 is the only situation in which the Treasury and IRS deemed it necessary to change the existing regulations. This situation involves a gift made during 2018 – 2025 that takes advantage of the increased basic exclusion amount, made by a donor who dies after 2025. In this case, the Code requires that the estate tax be computed in a manner that could retroactively eliminate the benefit of the increased basic exclusion amount.

This problem results from the way in which Steps 2 and 4 of the estate tax determination take into account different amounts of basic exclusion amount. Step 2 determines the credit against gift taxes payable on post-1976 taxable gifts based on the basic exclusion amount allowable on the dates of the gifts but determined using date of death tax rates. Step 3 subtracts gift tax payable from the tentative tax on the sum of the taxable estate and the adjusted taxable gifts. Step 4 determines a credit to apply against the net tentative estate based on the basic exclusion amount as in effect on the date of death. The estate tax is increased by any difference between the credit amount in Step 4 and any greater amount that was allowable for the decedent's post-1976 taxable gifts at Step 2.

The IRS illustrated this with two examples. In the first example, A makes an $11 million gift in 2018, using up her $10 million basic exclusion amount and paying tax on the additional $1 mil-

lion. A dies after 2025, when the basic exclusion amount has returned to $5 million. Donor has a $4 million taxable estate. Section 2001(b) would impose a $3.6 million estate tax, based on a $9 million estate that reflects the sum of the $4 million estate and 2018 gifts that would not have been sheltered from tax by basic exclusion amount at A's death. This effectively imposes an estate tax on that part of the 2018 gift that was sheltered from tax by the increased basic exclusion amount allowable when the gift was made.

In the second example, Donor has no taxable estate at her death, but her estate is still liable for a $2 million estate tax on the 2018 gifts that would not have been sheltered from tax by the basic exclusion amount at her death.

Treasury and the IRS propose an amendment to Reg. § 20.2010-1(c) to change the credit used in Step 4 of the estate tax calculation. The proposal applies only if the total of the amounts allowable as a credit (based solely on the basic exclusion amount) in computing the gift tax payable on a decedent's post-1976 gifts, exceeds the credit allowable in computing the estate tax (also based solely on the basic exclusion amount), in each case by applying the tax rates in effect at the decedent's death. In this situation, the portion of the credit allowable in computing the estate tax on the decedent's taxable estate that is attributable to the basic exclusion amount is the sum of the amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts. The amount allowable as a credit in computing gift tax payable for any year, furthermore, may not exceed the tentative tax on the gifts made during that year, and the amount allowable as a credit in computing the estate tax may not exceed the net tentative tax on the taxable estate. Therefore, Step 4 of the estate tax calculation would require the use of a credit equal to the tentative tax on the applicable exclusion amount as in effect on the date of death, if the basic exclusion amount included in that applicable exclusion amount is the larger of (i) the basic exclusion amount as in effect on the date of the decedent's death under Section 2010(c)(3), or (ii) the total amount of the basic exclusion amount allowable in determining Step 2 of the estate tax computation (that is, the gift tax payable).

For example, in 2019, A, who was never married, made $9 million in cumulative post-1976 taxable gifts, all of which were sheltered from gift tax by A's $10 million basic exclusion amount. A dies after 2025, when the basic exclusion amount has been reduced to $5 million. The total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million basic exclusion amount) exceeds the credit based on the $5 million basic exclusion amount applicable on the date of A's

death. The credit to be applied for purposes of computing the estate tax on A's estate shall be based on a basic exclusion amount of $9 million used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by A.

e) Effective Date

The amendment to Regulations Section 20.2010-1 is proposed to be effective on and after the date of publication of a Treasury decision adopting these rules as final regulations in the Federal Register.

Note. The proposed regulations are helpful. One unfortunate point, however, is that a donor who makes $5 million in taxable gifts between 2018 and 2025, will face 2026 with no basic exclusion amount. The gifts will have been deemed to have utilized the old $5 million basic exclusion amount before they utilize the increased basic exclusion amount.

This is not addressed directly in the proposed regulations, but it appears to flow from the descriptions in the Preamble of the calculation of the gift and estate taxes. In Step 6, the total credit allowable for prior periods (using the credits that existed at the time of the gift, but the current gift tax rates) are subtracted from the current credit. In such a calculation, the $5 million in basic exclusion amount utilized by the donor during the period of increased basic exclusion amount is subtracted from the then-current $5 million basic exclusion amount.

The same result would occur with respect to the estate tax calculation for a donor who makes $5 million in taxable gifts between 2018 and 2025, and then dies after 2025. The new rules calculate the basic exclusion amount available to such a deceased donor using a total amount of allowable credits with respect to the lifetime post-1976 taxable gifts based on the greater of the credit used to computing the gift tax payable on the donor's lifetime post-1976 taxable gifts (based on the $5 million basic exclusion amount used against post-1976 lifetime taxable gifts), or a credit based on the $5 million basic exclusion amount applicable on the date of death. Thus, the estate tax would be determined based on $5 million of lifetime taxable gifts the tax on which would be determined assuming a $5 million basic exclusion amount. There would be no basic exclusion amount remaining for the assets passing at the decedent's death.

Second, the proposed regulations do not address the question of portability of the increased basic exclusion amount. If Spouse-1 dies between 2018 and 2025, leaving a DSUEA based on a $10 million basic exclusion amount, is the surviving spouse's increased applicable exclusion amount somehow reduced when the basic exclusion amount drops to $5 million in 2026? A logical answer is that the reduction in the basic exclusion amount in 2026 does not alter an extant DSUEA, because (a) Section 2010(c)(4) limits the DSUEA based on the basic exclusion amount of the

last deceased spouse from whom the surviving spouse takes the DSUE amount, and (b) the only DSUEA adjustments permitted by the regulations are for lifetime or testamentary transfers, or the marriage and survivorship of another spouse by the spouse holding the DSUEA. For a contrary viewpoint, however, see "Jones & Thompson on the Disappearing DSUEA," LISI Estate Planning Newsletter #2708 (March 14, 2019) at http://www.leimbergservices.com.

Third, there is some question about how inflation adjustments will be taken into account. A donor who uses up all of his or her basic exclusion amount in 2018 would still have inflation adjustments regenerating basic exclusion amount throughout the period before January 1, 2026. These increases would appear to be eliminated by the reduction in the basic exclusion amount back to $5 million. One may avoid this problem by making gifts each year throughout the 2018 - 2025 period to utilize each year the inflation adjustment to the basic exclusion amount.

Fourth, the regulations do not address how the 2026 drop in the basic exclusion amount will affect trusts to which the increased GST exemption has been allocated during the 2018 – 2025 period. The increase in the basic exclusion amount automatically increased the GST exemption. Reg. § 26.2642-4 provides that an inclusion ratio, once established by the allocation of GST exemption, is altered by additional transfers to the same fund or by the inclusion of assets in the gross estate of an individual, but this regulation does not state that the list is exclusive. Still, the most logical interpretation of the change in the size of the GST exemption on January 1, 2026, is that the exemption available for future allocation is reduced, but that inclusion ratios already established should not be altered.

2. Applicable Exclusion Amount adjusted for inflation. Rev. Proc. 2018-57, § 3.41, 2018-49 I.R.B. 827 (Dec. 3, 2018)

The IRS announced that the applicable exclusion amount for 2019 is $11,400,000. The unified credit equivalent to this applicable exclusion amount is $2,240,000.

3. Executor Can Make Portability Election for Estate Under the Filing Threshold. PLRs 201923014 (June 7, 2019); 201923001 (June 7, 2019); 201921008 (May 24, 2019); 201902027 (Jan. 11, 2019); 201852018 (Dec 28, 2018); 201852016 (Dec. 28, 2018); 201850015 (Dec. 14, 2018)

In each ruling, D died survived by Spouse. The Form 706 for D's estate was due on Date 2, but the estate did not file a timely return to make the portability election. The estate discovered its failure to elect portability after the due date for making the election. The value of D's gross estate is less than the basic exclusion amount in the year of D's death, including taxable gifts made during his lifetime. The IRS noted that Reg. § 20.2010-2

states that an estate that elects portability will be considered, for estate tax purposes to be required to file a return under Section 6018(a), so that the due date of the return required to elect portability is 9 months after the decedent's date of death or the last day of the period covered by an extension (if an extension of time for filing has been obtained). Reg. § 301.9100-1(c) provides that the IRS may grant a reasonable extension of time to make a regulatory election, if the taxpayer provides evidence to establish to the satisfaction of the IRS that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government. A request for relief under Reg. § 301.9100-3 will be granted when the taxpayer establishes to the satisfaction of the IRS that the taxpayer (a) acted reasonably and in good faith, and (b) that granting relief will not prejudice the interests of the government. Reg. § 301.9100-3(b)(1)(v) provides that a taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer and the tax professional failed to make, or advise the taxpayer to make, the election.

Note. For portability elections, the IRS appears not to require that the executor have relied on a professional who made an error, though it is useful to note where this has occurred. In most rulings, the executor merely states that they did not file the return on time and that the return was below the filing threshold. It is unclear how long the IRS will remain so lenient.

Also, these rulings do not permit a late portability election when the estate is over the filing threshold, even if no estate tax was owed due to the marital, charitable, or other deductions. Section 9100 relief will not currently be allowed in such cases.

Rev. Proc. 2017-34, 2017-26 I.R.B. 1282 (June 26, 2017) permits taxpayers to file a late estate tax return to elect portability, if:

- the personal representative files a complete and properly prepared estate tax return (Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return), by the second annual anniversary of the decedent's death;

- the executor states at the top of the form that the return is "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)";

- the decedent was survived by a spouse;

- the decedent died after December 31, 2010;

- the decedent was a citizen or resident of the United States on the date of death;

- the executor is not otherwise required to file an estate tax return because the gross estate is less than the filing threshold under Section 6018(a); and

- the executor did not file a timely estate tax return.

This new procedure cannot be used for estates that are above the filing threshold, even if no tax was due because of the marital or charitable deduction. An executor who fails to file under this procedure within the first two years after the date of death can still request relief by filing a private letter ruling request.

C. IRC §§ 2031, 2032, 2032A, 2033 and 7520. Valuation

1. Old Masters Artwork Substantially Undervalued. *Estate of Kollsman v. Comm'r*, ___ Fed.Appx. ___, 2019 WL 2564084 (9th Cir. June 21, 2019), aff'g T.C. Memo. 2017-40

Eva Franzen Kollsman died owning two 17th-century Old Master paintings – "Village Kermesse, Dance Around the Maypole" (Maypole) by Pieter Brueghel the Younger, and "Orpheus Charming the Animals" (Orpheus) by Jan Brueghel the Elder or Jan Brueghel the Younger or a Brueghel studio. A vice president of Sotheby's (and cochairman of Sotheby's Old Master Paintings Worldwide) saw the paintings during a visit to decedent's residence and not long before the decedent's death, proposed terms by which Sotheby's would auction the two paintings. The Sotheby's expert provided a pre-sale estimate of $500,000 for Maypole and $100,000 for Orpheus, "based on firsthand inspection of the property." The executor had the paintings cleaned and put in new frames by a leading art restorer, who stated that Orpheus had a slight bow along the bottom and possibly the top as well, that both paintings had heavy dirt, that one painting had discolored varnish, but that cleaning should be "relatively safe." Sotheby's sold Maypole for a hammer price of $2.1 million (total price of $2,434,500), against a presale estimate of $1,500,000 to $2 million. On the estate tax return, the estate valued Maypole at $500,000 and Orpheus at $100,000. The IRS asserted that the fair market values of both paintings were their hammer prices -- $2,100,000 and $500,000 and assessed a substantial undervaluation penalty.

The Tax Court (Judge Gale) rejected the use of the informal appraisal by the Sotheby's expert as a basis for estate tax valuation and relied, instead, on the expert appraisal proffered by the IRS. The court valued the paintings at the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Reg. § 20.2031-1(b); *United States v. Cartwright*, 411 U.S. 546, 551 (1973). The

court rejected the report of the Sotheby's expert, and relied instead on that of the IRS expert, a Ph.D. and art historian with extensive art appraisal experience. The Sotheby's appraisal cited no comparable sales and acknowledged that the dirtiness of the paintings made it difficult to know "for certain [the] inherent value." It attributed the substantial difference between the actual sales price of Maypole and the appraised value to the improved condition produced by the cleaning and an increased market demand from a large influx of Russian buyers of Old Masters, and it identified three problems with Orpheus, including the uncertain attribution, weaknesses in the "composition, such that some of the animal figures are barely visible and others appear disjointed from their surroundings," and the dirtiness of that painting. The court rejected the Sotheby's valuation, because (a) Sotheby's wanted to sell the paintings and might, therefore, be inclined to provide a tax-favorable low appraisal; (b) Sotheby's overstated the dirtiness of the paintings and the risks involved in cleaning them, in light of both the testimony of the IRS expert that cleaning was reasonably safe and the fact that the cleaning was actually done using only the mildest cleaners; and (c) the Sotheby's appraisal included no comparables. The court stated that the price for which Maypole was actually sold was relevant, even though the sale occurred after the date of death. *Ithaca Tr. Co. v. United States*, 279 U.S. 151 (1929); *First Nat'l Bank of Kenosha v. United States*, 763 F.2d 891, 894 (7th Cir. 1985); *Estate of Jung v. Comm'r*, 101 T.C. 412, 431-432 (1993); *Estate of Newberger v. Comm'r*, T.C. Memo. 2015-246, at *6. The court allowed a five percent discount against each painting for the risk of cleaning, a ten percent discount for Orpheus for the fact that it was bowed, and a 25% discount for Orpheus for the questions about its attribution.

The Ninth Circuit affirmed in an unsigned memorandum opinion. Specifically, the court noted that: (i) a hypothetical willing buyer would recognize that cleaning the paintings was a low-risk and well-advised undertaking; (ii) the Tax Court correctly relied on the appraisal to determine the value of the Maypole, rather than the actual sales price; (iii) no evidence was produced to prove a recent spike in the value of Old Masters, and evidence provided to negate that claim; and (iv) the Tax Court properly rejected an appraisal that included no comparables.

2. No Additional Discount for Assignee Interest in Family Limited Partnership. *Estate of Streightoff v. Comm'r*, T.C. Memo. 2018-178 (Oct. 24, 2018)

Elizabeth Streightoff, as attorney-in-fact for her father, Frank D. Streightoff, formed a limited partnership with an LLC as the general partner. The partnership held almost entirely marketable securities and cash. Elizabeth was the sole manager of the LLC, and Frank, his children, and a former daughter-in-law were the limited partners. Frank held an 88.999% limited partnership interest. The partnership would end on the removal of

the general partner, which could be authorized by the vote of 75% of the limited partnership interests. The partnership agreement provided that a transfer of partnership interests creates an assignee, rather than a partner, unless approved by the general partner and the agreement of the transferee to abide by the partnership agreement. Elizabeth transferred Frank's limited partnership interests to his revocable trust. Frank's estate claimed a 37.2% combined discount for lack of marketability and lack of control, viewing the revocable trust's interest as an assignee interest.

The Tax Court (Judge Kerrigan) agreed with the IRS appraiser that the discount should be only 18% for lack of marketability. The court noted that the partners never had meetings or took votes, and that there was no significant difference between status as an assignee and status as a limited partner. The court also held that the transferee revocable trust was actually a limited partner, because the donor's document of assignment constituted his approval of the status of the revocable trust as a limited partner, and the trust's agreement to abide by the partnership agreement.

3. Section 2032A Limitation Adjusted for Inflation. Rev. Proc. 2018-57, § 3.42, 2018-49 I.R.B. 827 (Dec. 3, 2018)

An estate can reduce the estate tax value of qualifying real property used in a farm or business and valued under Section 2032A, by up $1,160,000 for estates of decedents dying in 2019.

D. IRC §§ 2036-2038. Retained Life Estate or Power to Alter Beneficial Enjoyment

1. Tax Court Pours Cold Water on Intergenerational Split-Dollar Life Insurance Arrangements, Relying on Sections 2036(a) and 2703. *Estate of Cahill v. Comm'r*, T.C. Memo. 2018-84 (June 18, 2018)

Richard F. Cahill was the grantor of a revocable trust, of which his son, Patrick, was the trustee. Patrick was also Richard's attorney-in-fact, and the executor of his estate. When Richard was already 90 years old and unable to manage his own affairs, Patrick created an irrevocable trust (the MB Trust) on Richard's behalf. Patrick's cousin, William Cahill, was named as trustee and Patrick and his issue were the primary beneficiaries. The MB Trust and the revocable trust then entered into three split-dollar agreements with respect to three whole life policies in the aggregate face amount of just under $80 million. One policy insured Patrick's life and the other two insured the life of his wife, Shannon. The MB Trust borrowed $10 million from Northern Trust, N.A., and used these funds to pay the premiums on all three policies in a single lump sum. Richard was personally liable for the loan through an agreement signed by Patrick, as his attorney-in-fact. The

MB Trust could not sell, assign, transfer, borrow against, surrender, or cancel a policy without the consent of revocable trust. Each split-dollar agreement could be terminated during the insured's life by written agreement between the two trusts. On termination, the revocable trust had the following termination rights: (1) the MB Trust could retain the policy, in which case the revocable trust would receive the greater of premiums paid or cash surrender value with respect to the related policy, or (2) the MB Trust could transfer the policy to Northern Trust in full or partial satisfaction of Richard's liability to Northern Trust. When an insured died, the revocable trust had the death benefit right to the greatest of: (a) the remaining balance on the loan, (b) the total premiums paid by revocable trust with respect to the policy to which the loan related, and (c) the policy's cash surrender value immediately before the insured's death. The MB Trust would retain any excess of the death benefit over the amount paid to the revocable trust. Richard reported $7,575 in gifts to the MB Trust, as determined under the economic benefit regime of the split-dollar regulations. When Richard died, the cash surrender value of the three policies was $9,611,624 but his estate contended that termination of the split-dollar arrangements was unlikely because it required the consent of the MB Trust, so the value of Richard's interests in the split-dollar agreements was only $183,700. This value was so low because the insureds, Patrick and Shannon Cahill, had long life expectancies. The parties agreed that, for income and gift tax purposes, the agreements between the trusts were split-dollar life insurance arrangements under the regulations, and that they were taxable under the economic benefit regime. See *Estate of Morrissette v. Comm'r,* 146 T.C. 171 (2016) and Reg. § 1.61-22(c)(1)(ii) (if the only economic benefit provided to the donee under a split-dollar arrangement is current life insurance protection, then the donor is deemed to own the insurance contract, regardless of formal policy ownership, and the economic benefit regime applies). IRS issued a notice of deficiency claiming that Richard's rights in the split-dollar agreements were worth the $9,611,624 cash surrender value, based on the application of Sections 2036 and 2038, and Section 2703. The IRS also assessed penalties for negligence or disregard of rules and regulations under Section 6662(a) and 6662(b)(1), and for either gross or substantial valuation misstatements under Section 6662(h), or Section 6662(b)(3)).

The Tax Court (Judge Thornton) denied the estate a partial summary judgment that none of these three Code sections could apply to the split-dollar arrangement. The court held that:

- the cash values of the policies were includible in Richard's gross estate under Sections 2036, as a lifetime transfer over which he had retained right to receive income from the transferred property, or as a right Aeither alone or in conjunction with any person@, to designate the persons who shall possess or enjoy the property or income from the property), or under Section 2038, as subject to Richard's

power, exercisable by him alone or Ain conjunction with any other person@, to alter, amend, revoke, or terminate the enjoyment of the transferred property. Citing *Estate of Bongard v. Comm'r*, 124 T.C. 95 (2005); and *Estate of Powell v. Comm'r*, 148 T.C. 392 (2017);

- the transfer of the $10 million to the MB Trust was not a Abona fide sale for an adequate and full consideration in money or money's worth,@ because there was no clear legitimate and significant non-tax reason for the transfer, and the value of what Richard received was far less than the amount transferred;

- the value of the restrictions on termination should be ignored under Section 2703, because it was not clear that the agreement was not part of a bona fide business arrangement, not a device to transfer the property to family members for less than full and adequate consideration, and comparable to similar arrangements entered into by persons in an arms' length transaction;

- there was no double-counting of the difference between the $10 million that Richard paid for the policies and the $183,700 that he received in return, even if the economic value of the insurance coverage after Richard's death was further gifts, because those gifts would be made by the persons who succeed to his interests in the agreements; and

- the mere application of the economic benefit regime under the split-dollar regulations does not alter the estate tax treatment of the agreement, because those regulations state that they do not apply for estate tax purposes.

Note. The parties have settled Cahill, apparently by including the entire cash surrender value of the policies in the decedent's gross estate. This result means that there was little or no estate tax benefit from the intergenerational split dollar arrangement.

After *Cahill*, the Tax Court also issued an order in *Estate of Morrissette* refusing to grant a partial summary judgment to the estate. *Estate of Morrissette v. Comm'r*, https://www.ustaxcourt.gov/InternetOrders/Document_Viewer.aspx?IndexSearchableOrdersID=264423 (June 21, 2018). The court refused to hold that Section 2703 could not apply in determining the estate tax value of the decedent's interest in the split-dollar arrangements, for the same reasons given by the court in *Estate of Cahill*. The court did not address Sections 2036 or 2038 because of a procedural issue, but it did refer to *Estate of Cahill*.

Not every intergenerational split-dollar life insurance arrangement needs to contain all of the features that the court found so disquieting in

Estate of Cahill, however. *Estate of Cahill* distinctly involved bad facts. Those who want to distinguish their transactions from that in *Estate of Cahill* should consider the following points.

a) A Competent Donor

It is common for the courts to attack under Sections 2036 and 2038 transactions that are implemented on behalf of an incapacitated individual by someone acting under a durable power of attorney, as was the case in *Estate of Cahill*. See, *e.g.*, *Estate of Strangi v. Comm'r*, T.C. Memo. 2003-149, *on rem'd from Gulig v. Comm'r*, 293 F.3d 279 (5th Cir. 2002), *aff'g in part, rev'g in part Estate of Strangi v. Comm'r*, 115 T.C. 478 (2000). It is better for the donor to be entirely competent and to act for himself or herself.

b) An Independent Business Purpose

The agreement in *Estate of Cahill* appears to have had no significant non-tax business purpose. The existence of such a purpose is essential if one argues that Sections 2036 or 2038 do not apply because there has been a *bona fide* sale or exchange. The transactions in *Estate of Morrissette*, on the other hand, were part of an attempt to fund buy-sell agreements to transfer the ownership of a family business to members of a lower generation. A legitimate and significant non-tax purpose also will help overcome the operation of Section 2703 by showing that the transaction is a bona fide business arrangement and not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth. IRC §§ 2703(b)(1), 2703(b)(2). One would, of course, still have to establish that the terms of the agreement are comparable to similar arrangements entered into by persons in an arms' length transaction. IRC § 2703(b)(3).

c) An Independent Trustee

The decedent’s arguments in *Estate of Cahill* were weaker because the transaction was negotiated between the trustee of the revocable trust (the decedent’s son and attorney-in-fact) and his cousin (the trustee of the MB Trust). The transaction would have had far more credibility were the trustees independent and unrelated to each other. Obviously, this increases the cost of the transaction, but it is a small price to pay to give the arrangement a far more bona fide appearance.

d) No Third-Party Debt

The use of a third-party loan to pay the life insurance premiums is not inherently inappropriate or disqualifying, but it is likely that the lender required that the decedent have the right to terminate the agreement, at a minimum with the consent of the trustee of the MB Trust. Thus, it is better if the premiums are paid from assets already held by the expected decedent.

e) Allow Only the ILIT to Terminate Split-Dollar Arrangement

The Tax Court's analysis in *Estate of Cahill* turns almost entirely on the fact that the split-dollar agreement gave the decedent the power, exercisable in conjunction with the trustee of the MB Trust, to terminate the agreement and thereby obtain the cash surrender value. This was the power that the court held was taxable under Section 2036 or 2038, and the power, without the requirement of consent of the trustee, that would be valued under Section 2703. An intergenerational split-dollar agreement would be far less susceptible to challenge under *Estate of Cahill* if only gave the trustee of the irrevocable trust the unilateral right to terminate the agreement without the consent of the older generation party (the person funding the premiums). The agreement can specify how the cash values will be dispensed in such a case. This is not a power held by the older generation party, and so the fact that it is held by the trustee should be irrelevant under Sections 2036, 2038, or 2703.

f) Just Use a Note

Intergenerational split-dollar typically relies on the economic benefit regime, because it produces relatively small taxable gifts from the person paying the premiums to the irrevocable trust that holds the policies. Such gifts are based on the value of one-year's life insurance protection. Were the transaction structured under the loan regime, either the borrower would need to make annual payments of interest at the applicable federal rate year or imputed interest would be deemed to be a taxable gift from the older generation party (the lender) to the borrower. This is certainly a larger taxable gift than would typically occur under the economic benefit regime, but it may not justify the choice of structure, in light of the analysis in *Estate of Cahill*.

The Tax Court in *Estate of Cahill* acknowledged that Section 2703 does not apply to an ordinary promissory note, and then took great pains to distinguish a split-dollar arrangement from a promissory note. The court stated:

> *"The estate's analogy between these split-dollar agreements and promissory notes is without merit. A note is generally a bargained-for agreement between two parties in which one party lends a sum of money and the other party agrees to repay that sum with interest over a period of time. On the undisputed facts before us, it seems clear that MB Trust did not bargain for these split-dollar agreements (it provided nothing to fund these arrangements), nor did MB Trust agree to repay with interest the money provided by decedent."*

T.C. Memo. 2018-84 at *24. Thus, were the transaction structured as a loan by the older-generation party to the irrevocable trust, Section 2703 should not be an issue.

Additionally, while the unpaid interest on a loan might be a larger taxable gift than that deemed to occur under the economic benefit regime, intergenerational split-dollar arrangements tend to be made by older generation parties who are quite advanced in years, and it is possible that there would not be many years of such gifts before the older generation party died. There would, of course, be additional such gifts after the older generation lender's death, from the persons who inherit the promissory note to the irrevocable trust, unless interest is actually paid by the trust, perhaps from borrowings against the policy.

Were the promissory note left to the irrevocable trust, it would be merged out of existence and there would be no further gifts. Such a bequest, however, could be viewed as a prearranged agreement that the note would not actually be repaid. In such a case, the debt could be deemed not to be a valid indebtedness and the original loan could be treated as a single large taxable gift.

2. GRAT Includable in Gross Estate of Grantor Who Dies During Annuity Term. *Badgley v United States*, 2018 WL 2267566, 121 A.F.T.R. 2d 2018-1816 (N.D. Cal. 2018) (Slip copy), *app. filed* (9th Cir. June 7, 2018)

In 1998, Patricia Yoder created a GRAT, which she funded with her interests in a family partnership and some other real estate. The GRAT paid Patricia a 12.5% annuity for 15 years. At the end of the annuity term, the partnership interest would pass to Patricia's two living daughters. The GRAT also provided for payment of the annuity to Patricia's revocable trust if she died before the expiration of the annuity term. Patricia continued to participate in the partnership business even after transferring her interest to the GRAT. Patricia died three months before the end of the 15th year of the

GRAT. Shortly before her death, the GRAT prepaid the rest of the annuity. The executor of Patricia's estate, her daughter Pamela, reported the GRAT assets as part of Patricia's gross estate. The estate then filed a claim for refund, arguing that the full value of the GRAT assets should not be included in Patricia's gross estate. The IRS disallowed the refund claim and the estate filed suit.

The U.S. District Court for the Northern District of California (Judge Gilliam) granted the government summary judgment denying the refund claim. The court rejected the estate arguments that Section 2036(a)(1) did not apply to the GRAT and that the regulations under Section 2036 were overly broad to the extent that they applied to the GRAT. The estate noted, on the first point, that there was neither statutory nor judicial authority expressly equating a fixed-term annuity with possession, enjoyment or right to income. The estate argued that income and a fixed annuity payment are different, because the former fluctuates while the latter does not, that Patricia could not receive income in excess of the annuity, and the annuity could have been satisfied from principal, rather than income. The court noted that the Supreme Court, in *Helvering v. Hallock*, 309 U.S. 106 (1940), adopted a substance-over-form approach to determining what constitutes possession, enjoyment, or a right to income. The Court in *Hallock* concluded that a grantor's reservation of any interest, however remote, was sufficient to bring the conveyance within the Code's "possession or enjoyment" language. The court also rejected the argument that Reg. § 20.2036-1(c)(2)(i), which requires that transferred GRAT property be included in a decedent's gross estate under Section 2036 where the decedent retains an annuity interest and dies before the expiration of the GRAT term, was overbroad and invalid. The court applied the deference required by *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984), finding that Section 2036 does not expressly address whether annuity payments constitute some possession, enjoyment, or right to income from the transferred property, but that the regulation is reasonable, and valid, having been based on both the legislative history of Section 2036 and the Supreme Court's decision in *Hallock*.

E. IRC § 2041. Powers of Appointment

Reformation to Correct Scrivener's Errors, Modify and Clarify Trust Converts Apparent General Power of Appointment to Limited Power of Appointment. PLR 201920003 (May 17, 2019)

Grantor created three irrevocable trusts, Trusts A, B, and C, for the benefit of his grandchildren by his three children, Son 1, Son 2, and Daughter. Trust A is for the benefit of Son 1's children (Grandchild A, B, and C); Trust B is for the benefit of Son 2's children (Grandchild D and E); Trust C is for the benefit of Daughter's

children (Grandchild F and G). The trust was created after September 25, 1985. Son 1 is trustee of Trusts A and C, and Son 2 is trustee of Trust B. Each trust provides: (a) the trust property is divided into equal parts for each grandchild; (b) the trustee may distribute income and principal to or for the benefit of the grandchild in such amounts, at such times and in such manner as the trustee in its sole discretion deems advisable health, education (including college and professional education), welfare, and support in reasonable comfort and to permit the grandchild to enter into or engage in a business or profession in which the trustee believes the grandchild has reasonable prospects of success; (c) each grandchild has a broad testamentary power to appoint his or her trust; (d) each grandchild has a 30-day Crummey power. Grantor died and left part of his estate to each of the trusts. Spouse continued to make gifts to each trust until Spouse's later death. After Grantor's death, the trustees realized that the powers of appointment could be general, whereas they were intended to have limited the class of appointees to family members. Court, on petition of the trustees, reformed the three trusts to include the necessary limiting language to qualify each power of appointment as a limited power of appointment, expressly prohibiting the appointment of trust assets to a grandchild, his or her estate, his or her creditors, or the creditors of his or her estate. Grantor's accountant and attorney affirmed that the trusts were supposed to be GST exempt, and that the powers of appointment were supposed to be limited, rather than general. Court later amended its order to clarify that the trusts end on the death of each grandchild, and the terminating distributions are outright and *per stirpes*. Court also amended its orders to limit the Crummey powers to the greater of $5,000 or five percent of the value of the assets out of which the power could be satisfied.

The IRS stated that (i) the judicial reformation and modification of the trusts will not cause their corpus to be included in the gross estate of Spouse for federal estate tax purposes; (ii) as reformed, the trusts do not give the grandchildren general powers of appointment for estate and gift tax purposes; (iii) the reformations do not constitute the exercise or release of any general powers of appointment for gift tax purposes; and (iv) the trusts are skip persons for GST tax purposes (See IRC § 2613(a)(2)) and the deemed allocation rules allocate Grantor's and Spouse's GST exemption to their gifts and bequests to the trusts. The IRS stated that the relevant trust instruments, affidavits, and representations strongly indicated that Grantor and Spouse did not intend for the grandchildren to have powers of appointment, and that the reformation was supported by clear and convincing evidence of scrivener's errors.

F. IRC § 2042. Proceeds of Life Insurance

Reformation of Irrevocable Life Insurance Trust Avoids Estate Taxation of Proceeds in Estate of Insured Trustee/Beneficiary. PLRs 201919002 (May 10, 2019) and 201919003 (May 10, 2019)

Settlor established Trust, an irrevocable trust for the benefit of Child 1 and Child 1's descendants, naming Child 1 as trustee. Child 1 has not made and will not make any contributions to Trust. Among the terms of Trust, the instrument provides that: (a) Trustee can own and acquire and maintain life insurance on the life of Child 1 and any person in which Trust or its beneficiaries may have an insurable interest; (b) Trustee is vested with all incidents of ownership in all life insurance policies owned by Trust; (c) Trustee can use all or any part of the net income or corpus of Trust to pay all or any part of any premiums or other charges due on any insurance policies held in trust, but premium payments on policies insuring Settlor's life may be made only from corpus; (d) the Trustee may distribute such income and corpus as Trustee deems appropriate for the health, support, maintenance and education of Child 1 and Child 1's descendants; (e) Child 1 has a testamentary special power to appoint Trust's assets to and among Child 1's descendants; (f) Child 1 can name one or more Co-Trustees, sole Trustees, or successor Trustees, and remove and replace any Co-Trustee or sole Trustee; and (g) a Special Co-Trustee shall be appointed if a trust governed under this agreement owns or otherwise possesses any incidents of ownership over any life insurance policies on the life of the primary Trustee within the meaning of Section 2042. Trustee wishes to buy a life insurance policy on the joint lives of Child 1 and Spouse, but because Child 1 holds a limited power of appointment over the trust, and is the Trustee, there is concern that the proceeds would be includible in Child 1's gross estate for federal estate tax purposes. Before buying the policy, Court, on petition by Child 1 as Trustee, and pursuant to an applicable state statute, reformed the Trust (i) to remove Child 1's testamentary special power of appointment over any life insurance policy on Child 1's life or the proceeds of such policy; (ii) to add an Insurance Trustee, who will have sole authority over any insurance policies on the life of Child 1 bought by Trust; and (iii) to require that premium payments on life insurance policies on Child 1 must be paid out of Trust corpus. Child 2 is appointed the Insurance Trustee and given all of the incidents of ownership with respect to the policy insuring the life of Child 1, except that Child 1 cannot appoint a person related to or subordinate to Child 1 as successor Insurance Trustee.

The IRS stated that, because of the reformation, Child 1 would not possess any incidents of ownership over any life insurance policy on Child 1's life (or that of Child 1 and Spouse) held by Trust, and that the proceeds of any such policy will not be includible in Child 1's gross estate under Section 2042(2). The IRS discussed Rev. Rul. 84-179, 1984-2 C.B. 195, in which a decedent bought an insurance policy on his life and transferred all incidents of ownership to his spouse, who predeceased the decedent and left the policy to a trust for the benefit of the couple's

child, naming the decedent as trustee. In that ruling, the IRS, based on the legislative history of Section 2042(2), stated that a decedent will not be considered to possess incidents of ownership in the insurance policy for estate tax purposes, if the decedent did not furnish consideration for maintaining the policy and could not exercise the powers for the decedent's personal benefit. The IRS explained that, in the present case, before the trust was reformed, Child 1 would, as trustee, hold all incidents of ownership over the policy insuring the lives of Child 1 and Spouse, and would also hold a testamentary power of appointment over the policy, which itself is an incident of ownership. The reformation transferred the Trustee's incidents of ownership over any life insurance policy on Child 1's life to an Insurance Trustee. Child 1 retains a beneficial interest in Trust, subject to an ascertainable standard relating to health, education, support, or maintenance. Thus, Child 1's fiduciary and beneficial powers were eliminated before the policy on Child 1's life was acquired. Accordingly, Child 1 neither has nor will have any incidents of ownership over any life insurance policy on Child 1's life acquired by Trust, as reformed, and the proceeds of such policies will not be included in Child 1's gross estate under Section 2042(2).

Note. One interesting facet of this ruling is that it appears to apply the principles of Rev. Rul. 95-58, 1995-2 C.B. 191, to the estate taxation of life insurance proceeds under Section 2042. Rev. Rul. 95-58 changed the position of the IRS from that espoused in Rev. Rul. 79-353, 1979-2 C.B. 325, in which the IRS stated that the value of property transferred in trust was includible in the decedent-grantor's gross estate under Section 2036(a)(2) or Section 2038(a)(1) when the grantor retained the power to remove the corporate trustee and appoint another corporate trustee in its place. That ruling was rejected by the Tax Court in *Estate of Wall v. Comm'r*, 101 T.C. 300 (1993), and by the Eighth Circuit in *Estate of Vak v. Comm'r*, 973 F.2d 1409 (8th Cir. 1992), *rev'g* T.C. Memo. 1991-503. Those courts held that the trustee's powers are not imputed to the grantor merely because the grantor could fire the trustee and appoint someone else. In those cases, there were no restrictions on who the grantor could appoint as replacement—other than that the grantor could not appoint himself or herself. In Rev. Rul. 95-58, the IRS responded by ruling that a grantor would not be imputed with the trustee's powers under Sections 2036 or 2038, if the grantor had the unrestricted right to remove a then-serving trustee and appoint a replacement, as long as the replacement was not related or subordinate to the grantor, under the standard set in Section 672(c).

Practitioners had long wondered whether the IRS might take a different position with respect to the imputation of incidents of ownership held by a trustee whom the grantor could remove and replace than it had with respect to powers under Sections 2036 and 2038. While PLRs 201919002 and 201919003 are not precedents, they are a logical extension of Rev. Rul. 95-58, particularly in light of the IRS recognition that the legislative history of Section 2042 indicates an intent that that section be interpreted in a manner similar to the way that Sections 2036 and 2038 are interpreted. See, e.g., Rev. Rul. 2011-28, 2011-2 C.B. 830; and Rev. Rul. 84-179, 1984-2 C.B. 195; both citing S. Rep. No. 83-1622, 83rd Cong., 2d Sess. 124 (1954). See also *Skifter v. Comm'r*, 468 F.2d 699, 701 (2d Cir. 1972).

G. IRC § 2055. Charitable Deduction

Estate's Charitable Deduction Reduced by Post-Death Events Orchestrated by Fiduciaries. *Estate of Dieringer v. Comm'r*, 917 F.3d 1135, 19 Cal. Daily Op. Serv. 2249, 2019 WL 1119598 (9th Cir. March 12, 2019), *aff'g* 146 T.C. 117 (2016)

At her death, Victoria Dieringer owned most of the voting and nonvoting stock of DPI, a real property management corporation. The decedent established a revocable trust and a private charitable foundation. One of her sons was sole trustee of both the trust and the foundation, and three of her sons were directors of DPI. The decedent left her residuary estate to the revocable trust, which in turn left $600,000 in specific charitable bequests, modest gifts to family members, and the residue of her estate to the foundation. An independent professional appraisal obtained for estate tax purposes valued the DPI stock at over $14 million, with the voting stock valued at $1,824 per share (with no discounts), and the nonvoting stock at $1,733 per share (after a 5% discount for lack of voting power). Seven months after the decedent's death, the company elected S corporation treatment. The trustee then agreed for the company to redeem the decedent's shares from the trust, in part to enable the foundation to avoid the excise taxes on excess business holdings and failing to pay required minimum distributions. The redemption agreement priced the voting shares at $779 per share and the nonvoting shares at $742 per share, based on an earlier appraisal, but the parties expected the prices to be reconciled according to the fair market value of the shares as determined by an updated appraisal. The updated appraisal, by the same appraiser who had valued the stock for estate tax return purposes, valued the voting shares at $916 per share (reflecting discounts of 15% for lack of control and 35% for lack of marketability) and the nonvoting shares at $870 per share (reflecting the same discounts as the voting stock, plus an additional 5% for lack of voting power at board meetings). DPI and the trust modified the redemption agreement, so that DPI would redeem all of the voting shares but only part of the nonvoting shares. The reduction in the number of redeemed shares was needed to ensure that DPI could afford the redemption transaction. Pursuant to the redemption agreement and the updated appraisal, DPI signed a short-term promissory note for $2,250,000 and long-term promissory note for $2,968,462, both payable to the trust. The promissory notes and remaining nonvoting DPI shares were then distributed to the foundation. At the same time as the redemption, the company sold additional shares of voting and nonvoting stock to the decedent's three sons, to provide the corporation with cash with which to pay off the promissory notes. The prices corresponded with those used in the redemption agreement. The net effect of the additional stock sales and the redemptions was that, instead of the foundation owning a majority of the voting stock and a majority of the nonvoting stock, the foundation received none of the voting stock

and only a minority of the nonvoting stock. The IRS assessed an estate tax deficiency based on lowering the charitable deduction to the value of the notes and the shares under the second appraisal and imposed an accuracy-related penalty under Section 6662(a) for an underpayment attributable to negligence or disregard of rules or regulations.

The Tax Court (Judge Kerrigan) first held that the estate could not use the date-of-death fair market value of the DPI shares to determine the charitable deduction, because the actions of the decedent's sons in redeeming the shares for promissory notes at a reduced value lacked a valid business reason. DPI's board's decision to redeem the shares to avoid the foundation excise taxes were valid business reasons for the redemption, but not for a reduced valuation for the stock. The court noted that the estate tax value of assets is usually used to measure a charitable deduction, but that the deduction must ultimately reflect the amount passing to the charity. For example, the court noted that if a trustee has the power to divert property to a noncharitable purpose, the charitable deduction is reduced by the amount that the trustee could so divert, whether or not the trustee actually does divert the assets away from the charity. Regs. § 20.2055-2(b)(1). The question must be what the charity has a right to receive, rather than what it actually receives. The estate argued that the charitable deduction should not be affected by post-death events, but the court disagreed. The court noted that the law clearly allowed consideration of post-death events if they reduced the value of the amount passing to charity, citing *Ahmanson Foundation v. United States*, 674 F.2d 761, 767 (9th Cir. 1981). The Tax Court acknowledged that there had been valid business reasons for the redemption and stock subscriptions, but that those events did not require a reduction in the value (and, therefore, the price) of the stock. The decline in per share value was primarily due to the specific instruction given to the appraiser to value decedent's majority interest as a minority interest with a substantial discount. The appraiser had largely ignored valuation discounts in determining the value of the stock in the gross estate but took them into account in determining the price to be paid for the stock by the company.

The Ninth Circuit (Judge Paez) affirmed, based principally on its reading of *Ahmanson Foundation*. The court noted that post-death events are generally ignored in determining the value of the gross estate, but that they are relevant for determining the amount of the deduction for distributions to charity, because the estate should not be allowed to deduct more than the charity receives. In *Ahmanson Foundation*, a decedent's instruments left voting shares in a corporation to family members and nonvoting shares to a charitable foundation. The Ninth Circuit held that the gross estate was determined taking into account the fact that the decedent owned control of the corporation through the voting shares, but that the amount of the charitable deduction for the nonvoting shares had to be discounted for those shares' lack of voting power. Thus, the value of the nonvoting shares included in the gross estate was higher than the amount of the deduction for their bequest to charity.

Note. The fiduciaries and corporate officers in *Dieringer* were justified in converting the C corporation to an S corporation, to make it easier for the foundation to manage the shares and to provide it a steadier source of income. They were wrong, however, to understate the purchase price of the stock in order to shift to the children part of what was to pass to the foundation. This artificial reduction in the value of the shares passing to the foundation caused the courts to insist on a reduced estate tax charitable deduction.

The Tax Court and the Ninth Circuit, however, erred in their analysis. First, both courts treated the decedent as having created an environment in which this type of value shifting could occur by leaving the estate to a revocable trust, naming her son as trustee and as executor of the estate, as trustee of the foundation, and as president, director, and majority shareholder of the corporation. Unquestionably, putting a great deal of authority in the decedent's son created a temptation to rearrange the dispositions in a manner favoring the family and disfavoring the foundation, but fiduciary obligations existed to protect against the son's yielding to that temptation. One may fault the decedent for not fully appreciating the degree to which her son was deficient in moral resolve, but that is not the same thing as arranging the transaction to produce an unjust result and should not justify the reduction in the charitable deduction.

Second, the charity did, in fact, receive assets with a value equal to that of the stock as included in the gross estate. The foundation received cash and promissory notes, which were worth much less than the gross estate value of the stock, but it also received a claim against the son for breach of his fiduciary duty to be fair to all of the beneficiaries – the family and the foundation. Thus, there should have been no reduction in the estate tax charitable deduction.

Third, the court stretched *Ahmanson Foundation* to justify reducing the estate tax charitable deduction in this case. The facts of Ahmanson Foundation were quite different, because there was in that case no claim created for damages. A more correct analysis would have been to allow the full charitable deduction. The foundation trustees could have been subject to substantial excise taxes for self-dealing if they did not enforce the damage claim.

The *Dieringer* situation is distinguishable from a simple decline in the value of property left to a charity or surviving spouse during the estate or trust administration due to mere market fluctuations. Both the Tax Court and the Ninth Circuit expressly noted that the valuation change was not the result of market conditions, but rather of fiduciary machinations, and generally, the Service appears not to reduce estate tax charitable or marital deductions just because estate or trust assets drop in value between the date of death (or alternate valuation date) and the date or dates of distributions.

See also Fox, Blattmachr & Gans, "Ninth Circuit Affirms *Dieringer v. Com'r*; Post-Death Redemption of Stock Bequeathed to Private Foundation Reduces Estate Tax Charitable Deduction; A Flawed Result Because Taxpayer Apparently Sparred Section 4941 Self-Dealing Penalty," LISI Charitable Planning Newsletter #281 (April 23, 2019) at http://www.leimbergservices.com.

H. IRC § 2056. Marital Deduction

1. Right of Recovery Under Section 2207B Avoids Reduced Marital Deduction for Estate Taxes (and Interest) on Lifetime Nonmarital Gifts Included in Gross Estate Under Section 2036(a). *Estate of Turner v. Comm'r*, 151 T.C. ___ (No. 10) (Nov. 20, 2018)

Clyde W. Turner, Sr. and his wife, Jewell, each transferred $4,333,671 in cash, certificates of deposit, and publicly-traded securities, to Turner & Co., a family limited partnership they had created. Each donor received a 0.5% general partnership interests and a 49.5% limited partnership interest. The donors retained adequate assets outside of the partnership to support themselves comfortably. Over a two-day period less than five weeks before the decedent's death, he and his wife gave limited partnership interests to their children, a trust for one of their children, and their grandchildren by a deceased child. The Service argued that the undiscounted value of 50% of the partnership assets should be included in the decedent's gross estate.

In *Estate of Turner v. Comm'r*, T.C. Memo. 2011-209 (*Turner 1*), the Tax Court held that the gifts to the partnership were transfers with a retained right to beneficial enjoyment, and that the transferred assets were includible in the decedent's gross estate.

In *Estate of Turner v. Comm'r,* 138 T.C. 306 (2012) *(Turner 2*), the Tax Court held that the decedent's estate was not entitled to the marital deduction with respect to the value of the partnership assets included in the decedent's gross estate under Section 2036, because the property was the subject of lifetime gifts and did not pass to widow.

After *Turner 2*, The government filed computations and amended computations for entry of decision pursuant to Tax Court Rule 155, but the taxpayer objected regarding (a) whether the estate must reduce the marital deduction by the amounts of the Federal estate and State death taxes owed that the government claims must be paid from estate assets passing to the widow; and (b) whether the estate may increase the marital deduction by post-death income that was not included in the gross estate but was generated by marital deduction property.

The Tax Court (Judge Marvel) held that the decedent's estate was not required to reduce the marital deduction by the amounts of the Federal estate and State death taxes it owes. The court noted that decedent's will showed his intent to leave assets to the widow undiminished by any estate, inheritance, succession, death, or similar taxes and having a value "equal to the maximum marital deduction." A residuary nonmarital trust was supposed to be created for the benefit of the decedent's children and grandchildren, but because the entire unified credit was exhausted on the Section 2036 assets, that trust was not created. The Tax Court held for the estate, noting that the estate taxes due were all attributable to the value of property

included in the gross estate under Section 2036. While the will did not address estate tax apportionment, the court noted that the executor has the right under Section 2207B to recover from the persons who received the Section 2036 property during the decedent's lifetime, an amount equal to the Federal estate and State death taxes plus interest attributable to those transfers. Furthermore, the executor must, because of his duty to carry out the terms of the will, exercise the right of recovery in order to prevent the marital deduction property from bearing the decedent's estate's tax burden contrary to his intent. Thus, the widow does not actually bear the estate taxes and her share of the estate passes free of the estate taxes. The court also held that decedent's estate could not increase the marital deduction by the amount of post-death income generated by the marital deduction property. The estate argued that post-death income should be allocated to the marital share and increase the marital deduction, relying on Reg. § 20.2056(b)-4(d)(1)(iii). The court disagreed, noting that the post-death income interest is not a deductible interest under the regulation because it was not included in the gross estate. Furthermore, the regulation in question (the *Hubert* regs) relates to which estate administrative expenses are chargeable properly against the marital deduction, and not whether income earned during the administration augments the marital deduction. The court held that it does not.

Note 1. *Turner 3* should apply to most situations in which an estate plan includes a reduce-to-zero marital deduction formula and assets are returned to the gross estate under Section 2036 (transfers with a reserved right to receive or control beneficial enjoyment), 2041 (property subject to a decedent's general power of appointment; see Section 2207), or 2044 (QTIP property; see Section 2207B). The court noted that the decedent's will in *Turner 3* did not address the payment of estate taxes, which most wills would do, but the court still found that it manifested the decedent's "intention that the marital deduction not be reduced or diminished by the estate's tax liabilities." Most well-drafted reduce-to-zero estate plans do address estate and other death taxes, and charge them away from the marital share, to the extent possible. Furthermore, many such instruments expressly state the testator's or grantor's desire to obtain the lowest possible estate tax at the first spouse's death, consistent with lowering taxes at the surviving spouse's death. Therefore, there seem to be no unusual features of the documents or state law in Turner 3 which would limit its operation in other states and with other documents. It is, however, interesting to note that the tax laws include tax recovery provisions for assets includible in a decedent's gross estate under Section 2036, 2041, or 2044, but not assets includible only under Section 2035 (transfers within three years of death), 2037 (transfers taking effect on death), 2038 (transfers with a power to alter, amend, revoke or terminate), or 2039 (certain annuities). Therefore, while *Turner 3* is helpful, therefore, it is no substitute for careful drafting of a tax apportionment clause and for provisions in the documents for transactions that might raise

issues under Sections 2035, 2037, 2038, or 2039, providing for the contribution from those transferees to the payment of the deceased transferor's estate taxes.

Note 2. Judge Marvel stated that the marital deduction should not be reduced for federal or state death taxes, but Section 2207B applies only to the federal estate tax. Unless a similar provision exists under applicable state law (or there is no applicable state death tax), the marital deduction should be reduced to the extent of the state death taxes paid from the marital share.

Note 3. A case involving the widow's estate is pending in the Tax Court. If the executor cannot actually recover a reimbursement under Section 2207B, expect the IRS to increase the widow's adjusted taxable gifts and collect additional estate tax from her estate.

2. Consequences of Division and Gift of QTIP Income Interest. PLR 201834011 (Aug. 24, 2018)

Decedent's revocable trust created a QTIP Marital Trust for the lifetime benefit of Spouse, and then to be distributed to Charitable Trust, established under the same revocable trust. The trust also states that, if Spouse disclaims any or all of the Marital Trust, the disclaimed property will be added to Charitable Trust. State Court, on the petition of Spouse and the trustee of Marital Trust, approved the division of Marital Trust into separate identical Trusts 1 and 2. Trust 1 will be funded with cash and property having a net fair market value on the date of division equal in value to $x. Trust 2 will be funded with the rest of Marital Trust. The division of Marital Trust will be done on a non-pro rata basis as authorized under Statute 2. Spouse will assign her income interest in Trust 1 to Charitable Trust.

The IRS stated that: (a) the non-pro rata division of Marital Trust would not cause Marital Trust, Trust 1, Trust 2 or any beneficiary of these three trusts to recognize ordinary income or loss, or capital gain or loss, under Sections 61 or 1001; (b) the division of Marital Trust would not disqualify either as a QTIP for estate tax purposes; (c) Spouse will be treated as having made a gift of her qualifying income interest in Trust 1 under Section 2511 and as having made a gift of the remainder interest in Trust 1 under Section 2519, both of which gifts qualify for the gift tax charitable deduction; (d) the disclaimed assets of Trust 1 are not deemed to have been transferred under Section 2519 and will not be included in Spouse's gross estate under Section 2044(a); (e) Spouse's assignment of her income interest and discretionary principal interest in Trust 1 will not cause any property in Trust 2 to be deemed a gift by Spouse under Section 2519; and (f) Spouse's renunciation of her income and discretionary principal interests will not cause her interest in Trust 2 to be valued at zero under Section 2702.

I. Estate Tax Procedures

1. IRS Timely Filed Claims for Fiduciaries' and Beneficiaries' Personal Liability for Unpaid Estate Taxes. *United States v. Johnson*, 920 F.3d 639, 2019 WL 1414049 (10th Cir. March 29, 2019), *rev'g* 2018 WL 327245, 121 A.F.T.R.2d 2018-341 (D. Utah. Jan. 8, 2018) (Slip copy), *supplementing* 224 F.Supp.3d 1220 (C.D. Utah 2016)

The decedent's revocable trust held the stock of a company that had a Nevada gaming license. Two of her children Mary Carol S. Johnson and James W. Smith were successor trustees and personal representatives of her estate. The residue of the estate passed to the trust. The trust made pre-residuary gifts, directed the payment of debts, expenses, and taxes, and left the balance to four family limited partnerships, one for the family of each of the decedent's children. Although the assessed estate taxes remained unpaid, the trustees distributed the stock to the beneficiaries, because of Nevada restrictions on casino ownership by a trust. The trustees and the beneficiaries executed a Distribution Agreement in which the beneficiaries acknowledged that the distribution was their total rights in the trust, and that they would become responsible for a proportionate share of the estate tax liabilities. The decedent's estate tax return showed a federal estate tax liability of approximately $6.6 million, of which $4 million was paid with the return. The estate elected to pay the estate taxes on the Hotel interest in installments under Section 6166. Mary Carol furnished documents for a special lien under Section 6324A, to relieve the fiduciaries of personal liability for the deferred estate taxes. The company went bankrupt and was liquidated, with all proceeds going to its creditors. The IRS assessed the outstanding estate taxes against the fiduciaries.

The U.S. District Court (Judge Waddoups) held that (a) the trustees had no personal liability for the unpaid estate taxes, because their liability extended only to assets that were included in the gross estate under Sections 2036 or 2038, and that the revocable trust assets were actually includible under Section 2033; (b) the special estate tax lien under Section 6324A had relieved them of personal liability; and (c) the trustees were entitled to attorney's fees under Section 7430, because they "substantially prevailed with respect to the amount in controversy or . . . with respect to the most significant issue or set of issues presented." IRC § 7430(c)(4)(A). The court agreed that the government position was not substantially justified with respect to whether: (a) the trust assets were included in the gross estate under Sections 2034 to 2042, so that there could be transferee liability under Section 6324(a)(2); (b) a Section 6324A special lien had in fact been furnished to the IRS, which wrongfully rejected it; and (c) the government's attempts to foreclose its tax lien were untimely or otherwise improper.

The Tenth Circuit (Judge Murphy) reversed and held that the government's state-law claim as a third-party beneficiary and its transferee liability claim under Section 6324 were both timely, and that the beneficiaries were not entitled to attorney fees because the government's position was substantially justified. The beneficiaries conceded that the Government was the third-party beneficiary of the Distribution Agreement because the beneficiaries agreed in that agreement to pay the taxes as they became due and payable, but they claimed that the government's claim was not made within the state 6-year statute of limitations. *See* Utah Code § 78B-2-309(2). The Government claimed that the relevant statute of limitations is the 10-year statute in Section 6502(a). In *United States v. Holmes*, 727 F.3d 1230 (10th Cir. 2013), the Tenth Circuit held that in a suit to enforce state rights to be paid federal taxes owed the Government, the federal tax statute of limitations, not the state statute, applied. Therefore, the Government claim was timely. The beneficiaries also argued that the Government's transferee liability claim under Section 6324(a)(2) was not correctly filed within the 10-year statute of limitations, but the court held that the procedures in Section 6901 did not apply in this case, because the Government chose to bring its transferee-liability claim under Section 6324(a)(2), as is its option, and the statute of limitations was suspended while the Section 6166 election was in effect. Finally, the court held that, because the Government prevailed in the Tenth Circuit on the third-party beneficiary claim, attorney's fees were not warranted.

2. Government Cannot Rely on State Statute of Limitations to Cure a Defective Estate Tax Lien. *Sacullo v. United States*, 913 F.3d 1010, 2019 WL 168217 (11th Cir. Jan. 11, 2019), *rev'g & rem'g* 2017 WL 6987956 120 A.F.T.R.2d 2017-6943 (M.D. Fl. 2017) (Slip copy), *reconsideration denied*, 2017 WL 6383984, 120 A.F.T.R. 2d 2017-6950 (M.D. Fl. 2017)

In 1998, Mark Saccullo's father, Anthony, executed a deed that purported to convey a certain residence to his irrevocable trust for Mark's benefit. The deed conformed to the necessary formalities, and it was properly notarized and recorded, but the deed bore only one witness's signature. Florida statutes requires that a deed be signed by two witnesses. Fla. Stat. § 689.01. When Mark's father died in 2005, Mark became trustee of the trust and filed the estate tax return for Anthony's estate. Mark mistakenly included the property among the estate's assets. In 2007, the IRS assessed an estate tax of almost $1.4 million, based on the inclusion of the property in Anthony's gross estate. Mark, acting in his capacity as trustee, conveyed the property via quitclaim deed to himself and his wife. The government filed two tax-lien notices with Charlotte County, Florida, one against the estate and another against the property itself. The IRS later administratively seized the property and unsuccessfully sought to sell it, as the estate tax liability increased to $1.6 million. After the administrative seizure, Mark filed a quiet-

title action in the United States District Court for the Middle District of Florida, contending that the liens did not attach to the property because it was not actually part of his father's estate. The government counterclaimed to foreclose on the liens. Mark noted that Florida law provides that five years after recording a deed attempting to convey real property, any defects for the lack of witnesses shall be negated. Fla. Stat. § 95.231.

The district court (Judge Honeywell) granted the government's summary-judgment motion, holding that Fla. Stat. § 95.231(1) did not create good title in the trust because the deed's missing second witness was not among the technical defects that the statute operates to cure. The court stated that T the statute "cannot be used to create title where none existed" and that the absence of the prescribed number of witnesses rendered the deed statutorily incurable. The court also held that the United States cannot be bound by state law statutes of limitations, under the principles of *United States v. Summerlin*, 310 U.S. 414 (1940).

The Eleventh Circuit (Judge Newsom) reversed and remanded, refusing to enforce the liens. First, the court explained that the Florida statute states that, after five years, "the instrument … shall be held to have its purported effect to convey [the property] ... as if there had been no lack of ... witness or witnesses." The government even agreed that the lack of a witness is precisely the type of deficiency for which the Florida statute is curative. The government argued, however, that some form of curative deed or document had been required, but the court disagreed and held that the statute was self-executing. Five years after the deed was recorded, therefore, it was a valid deed to convey the property to the trust and to remove it from Anthony's gross estate. *Citing Earp & Shriver, Inc. v. Earp*, 466 So.2d 1225, 1227 (Fla. 2d Dist. Ct. App. 1985); and *Glanville v. Glanville*, 856 So.2d 1045 (Fla. 5th Dist. Ct. App. 2003). Furthermore, the *Summerlin* principle applies only where the government has "acquired a right free of a pre-existing infirmity." *Guaranty Trust Co. of N.Y. v. United States*, 304 U.S. 126, 142 (1938). If the government comes into possession of a valid claim, it cannot be cut off later by a state statute of limitations, but if the claim already has an infirmity, the statute of limitations does not cure it. Thus, because the government's lien was first imposed on an asset that was never part of the decedent's gross estate, the statute of limitations cannot protect the lien.

3. Tax Lien Imposed on Property Held by Nominee Trust. *Saepoff v. North Cascade Trust Services, Inc*., 2019 WL 1759836 (WD Wash. April 19, 2019)

Jessica Saepoff owned certain real property in Mercer Island, Washington, against which she had two mortgages. She transferred the property to an irrevocable trust when she was already several months behind on her mortgage payments. A few weeks later, the trustee reconveyed the property to

Jessica via a quitclaim deed. Jessica lived on and managed the property before, during, and after the trust's ownership and she paid all of the utility bills and property taxes. Jessica was the sole beneficiary of the trust. Two years later, Jessica again transferred the property to a new trustee for no consideration. The new trustee was living on the property with Jessica at that time and they were later married. Again, Jessica continued to control the property and make payments of utilities and property taxes while the trust owned it. The IRS thereafter recorded a Notice of Federal Tax Lien against Jessica for unpaid income tax assessments. In a suit over the lien, the IRS moved for summary judgment that the tax liens were valid and attached to the trust property.

The U.S. District Court (Judge Lasnik) granted the government summary judgment, finding that the trust was Jessica's nominee. Nominee status is determined by applicable state law (Washington), which determined nominee status based on the following factors: (1) whether the nominee paid adequate consideration; (2) whether the property was transferred in anticipation of litigation or liabilities; (3) whether the transferor and nominee had a close relationship; (4) whether the transfer was recorded; (5) whether the transferor retained possession of the property; and (6) whether the transferor continued to enjoy the benefits of the property. *United States v. Black*, 725 F. Supp. 2d 1279, 1291–92 (E.D. Wash. 2010)). In this case, the court noted that (a) the trustee paid no consideration for the property; (b) the transfer occurred while Jessica had outstanding tax liabilities; (c) Jessica was living with the trustee and they were later married; (d) Jessica retained possession of the property; and (e) Jessica continued to make payments on the property and to control it. Thus, the trust was a nominee.

4. Estate Beneficiaries and Co-Owners Liable for Late Estate Taxes, Penalties and Interest, as Transferees of Decedent's Estate. *United States v. Ringling*, 2019 WL 858682 (D.S.D. Feb. 21, 2019) (Slip copy)

Harold Arshem died in 1999, leaving his estate to his three daughters, Donna Ringling, JoAnn Jandreau, and Kathryn Standy. Certain real estate was also left specifically to Donna as part of her one-third portion. The three daughters were named co-executors of the estate. The three daughters were named co-executors of the estate. Part of the decedent's estate was various assets owned jointly with one or more of the daughters, with a right of survivorship, and two life insurance policies naming the daughters as beneficiaries. Other property was transferred to the daughters with a reserved life estate. Several years later, a special administrator was appointed over the probate proceeding at the request of one of the daughters. The special administrator then filed an estate tax return for the decedent's estate, which the daughters had failed to do. The return reported a gross estate of $834,336.00 and a net estate tax due of $28,939, but it was not accompanied

by payment. The IRS accepted the return as filed, but assessed a deficiency of $65,874.80, representing the tax due, late filing penalties, late payment penalties, and interest. When payment was not forthcoming, the IRS filed a notice of intent to levy and sued the daughters personally, under Section 6324(a)(2). The government moved for summary judgment.

The court (Judge Schreier) granted the motion, finding that Section 6324(a)(2) makes transferees, surviving tenants, and beneficiaries who receive property included in the decedent's gross estate, personally liable for unpaid estate taxes. See *Groetzinger v. Comm'r*, 69 T.C. 309, 316 (1977). The court rejected an argument that summary judgment could not be granted when there was a $9,000 difference between the amounts requested by the IRS in different instances. It reviewed the various assets included in the gross estate and sustained their inclusion under various Code sections. The court also found no basis for the daughters to assert equitable estoppel or waiver and rejected the claim that the daughters had reasonable cause for the late filing and payment.

5. Executor Personally Liable for Estate Taxes to Extent of Distributions Made Before Estate Taxes Were Paid. *United States v. Paulson*, 331F.Supp.3d 1066, 2018 WL 4282682 (S.D. Calif. Sept. 7, 2018), *reconsideration denied*, 2018 WL 5920143, 122 A.F.T.R. 2d 2018-6648 (Nov. 13, 2018)

The decedent, Allen Paulson, was the founder of Gulfstream Aerospace Corp., manufacturer of the popular large private jet. The decedent and his fiancée (later wife), Madeleine, signed a premarital agreement stating that, at the decedent's death, Madeleine could elect to receive the property designated in the antenuptial agreement or property designated in the decedent's revocable trust (the Revocable Trust), but not under both. Allen was survived by Madeline, his three sons, and a granddaughter. Most of his assets were held in the Revocable Trust. One son, Michael, was named executor of the estate and one of the trustees of the Revocable Trust. The estate reported a total gross estate of $187,729,626, a net taxable estate of $9,234,172, and an estate tax liability of $4,459,051. The estate elected to pay part of its taxes and defer the rest under Section 6166. The IRS assessed a $38 million estate tax deficiency, which the Tax Court redetermined as $6,669,477. The estate also elected to pay this additional tax amount under the fifteen-year installment period permitted under Section 6166. In response to missed installment payments, the IRS accelerated the deferred taxes under Section 6166, which acceleration the Tax Court sustained. Several disputes arose among the family members and trustees, which were settled by an agreement and general release approved by the Superior Court, under which, in part, Michael agreed to resign as executor. Michael was also removed as trustee for malfeasance. The IRS sued Michael to collect

the estate tax deficiency, because he had made distributions from the Revocable Trust before the estate taxes were paid. Several of the fiduciaries and beneficiaries also filed claims, cross-claims, and motions galore.

The U.S. District Court for the Southern District of California held, with respect to motions to strike or for summary judgment on the tax issues, that:

- Michael was a statutory executor under Section 2203 because he was appointed by the Probate Court. He is still a statutory executor, because although he had agreed to resign, he did not, as required by state law, both file a statement with the Probate Court and settle all of the accounts of the estate. The court found that filing of the settlement agreement with the Superior Court was not the same as filing a resignation with the Probate Court.

- Michael was personally liable for the estate tax as trustee of the Revocable Trust under Section 6324(a)(2), because while he was trustee he had possession of the estate assets held by the Revocable Trust, and those assets were includible in the gross estate under Section 2038. Michael had both made distributions to some beneficiaries from the Revocable Trust and made improper investments, the losses from which were the basis for his removal as a trustee.

- Michael was not discharged of his personal liability in all fiduciary capacities under Section 2204. Section 2204(b) permits a fiduciary other than the executor to obtain a discharge from personal liability upon an application to the Treasury. The court found that there were still genuine issues of material fact as to whether Michael successfully requested discharge as the trustee of the Revocable Trust. The letter submitted to the Treasury did not strictly meet the requirements of the Code and regulations, and required notification after nine months, rather than the statutory six months.

- Madeleine was not liable for the estate tax deficiency as a co-trustee of the Revocable Trust under Section 6324(a)(2), because she did not acquire the trusteeship until three years after the date of death and Section 6324(a) refers to fiduciaries who "receive[ ], or ha[ve] on the date of the decedent's death, property included in the gross estate."

6. 2% Interest Rate on Deferred Estate Taxes on Closely-Held Business Adjusted for Inflation. Rev. Proc. 2018-57, § 3.51, 2018-49 I.R.B. 827 (Dec. 3, 2018)

The value of a closely-held business interest, the deferred estate taxes on which bear interest at a 2% rate, is increased to $1,550,000 for estates of decedents dying in 2019.

IV. GIFT TAXES

A. IRC § 2503. Gift Tax Annual Exclusion

Annual Exclusion Adjusted for Inflation. Rev. Proc. 2018-57, § 3.43, 2018-49 I.R.B. 827 (Dec. 3, 2018)

The gift tax annual exclusion is increased to $15,000 for transfers made in 2019. The annual exclusion for gifts to a non-U.S. citizen spouse was raised to $155,000 for gifts made in 2019.

B. IRC § 2511. Taxable Gifts

Gift to Museum of Remainder Interest in Artwork Would Be a Completed Taxable Gift. PLR 201825003 (June 22, 2018)

Donor executed a deed of gift that transferred an art collection to a foreign museum, subject to the reservation of donor's usufruct – lifetime use of the property. The deed also permitted the donor to revoke the gift if: (a) the donee did not comply with the specific requirements in the deed of gift regarding the housing, display and exhibition of the artwork; (b) the principles of law currently governing in the donee's country are replaced by a different set of laws; (c) the donee becomes privately owned; or (d) the tax laws of the donee's country are changed to cause the donor to become subject to taxation in that country during the donor's life or upon death in connection with the transfer of the artwork. The deed stated that it was valid only upon the issuance of a private letter ruling confirming that the gift was incomplete for gift tax purposes.

The IRS explained that none of these conditions were within the control of the donor, and so the donor had not retained control over the beneficial enjoyment of the transferred remainder interest. Reg. §25.2511-2(b). Therefore, the gift would be complete, but for the provision in the deed that made the transfer conditioned upon receipt of a favorable private letter ruling from the IRS.

Note. It is unclear why the donor did not merely leave the property to the museum in his or her will or revocable trust, but the gift tax analysis appears to be correct. Furthermore, were the gift completed, the value of the gift subject to tax would likely be determined without regard to the reserved usufruct (more-or-less a legal life estate), under Section 2702. As a gift of a future interest in tangible personal property is not deductible for income or gift tax purposes, furthermore, this could have resulted in a substantial gift tax liability.

C. IRC § 2512. Valuation of Gifts

Valuation of Closely-Held S-Corporation Shares Determined; Section 2703 Disregards Transfer Restrictions. *Kress v. United Sates*, 372 F.Supp.3d 731, 2019 WL 1352944 (E.D. Wis. March 26, 2019)

James and Julie Kress are shareholders of Green Bay Packaging, Inc. (GBP), a large "vertically integrated manufacturer of corrugated packaging, folding cartons, coated labels, and related products." GBP is an S-corporation that employs approximately 3,400 people in 14 states. The Kress family owns 90% of the GBP stock and the employees and directors own the rest. The purchase price for GBP shares sold to employees and directors is set at 120% of the book value, but there is no set price for shares transferred to Kress family members. The company's by-laws require any employee or director to give the company a right of first refusal before he or she can sell the shares to others, but Kress family members can give, bequeath, or sell GBP shares to other Kress family members without a first refusal. James and Julie gave GBP stock to their children and grandchildren in 2007, 2008, and 2009 and valued the shares at $28 in 2007, $25.90 in 2008, and $21.60 in 2009. The IRS, on examination, valued the shares based on the price used for transactions between GBP and its employees; $45.97 in 2007, $47.63 in 2008, and $50.85 in 2009. The IRS assessed $2,218,466 in gift tax deficiencies and interest. James and Julie paid the tax and sued for a refund.

The U.S. District Court (Judge Griesbach) largely held for the taxpayers. The court valued the shares based on the factors in Rev. Rul. 59-60, 1959-1 C.B. 237, including: (a) the nature of the business and the history of the enterprise from inception; (b) the economic outlook in general and the condition and outlook of the specific industry in particular; (c) the book value of the stock and the financial condition of the business; (d) the earnings capacity of the company; (e) the dividend-paying capacity; (f) whether the enterprise has goodwill or other intangible value; (g) sales of the stock and the size of the block to be valued; and (h) the market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter. Both sides proffered independent expert appraisals. The court generally agreed with the taxpayers' appraisal, which supported the gift tax return values, but with one modification. The government's appraiser valued the stock using both the market approach (sales of stock of comparable corporations) and the income approach (capitalizing corporate earnings), giving 60% weight to the market approach and 40% weight to the income approach. He then applied marketability discounts of 10.8% to 11.2% for the years in question, based on restricted stock studies, the costs of going public, and the overall academic research on the topic. The court stated that the government's appraisal did not adequately account for the 2008 recession, relied on an outlier as a comparable company, and overcounted the value of GB's non-operating assets. Also, the government's appraiser used marketability discounts that were significantly below those of the other experts and applied a premium for the corporation's S-corporation status, which the court felt

should be a neutral factor. The taxpayers' appraiser, on the other hand, valued the company largely on the basis of the market method, comparing it to other comparable companies. He did not value the non-operating assets separately, because the minority shareholders could not reach those assets, and he applied 28% to 30% discounts for both lack of control and lack of marketability. The taxpayers' appraiser also assigned a discount for the transfer restrictions on the company's shares. The court adopted the views of the taxpayers' appraiser, except that it refused to discount the shares for the transfer restrictions, because the taxpayers did not establish that the transfer restrictions were comparable to similar arrangements entered into by persons in an arm's length transaction, as required by Section 2703(a)(3).

Note. The court's Section 2703 analysis is noteworthy in several respects. First, the court stated that Section 2703(a)(2) did not apply to lifetime transfers, because it refers to transfers to "members of the decedent's family." The court contended that this was unambiguous, and so no deference was due to the government's contrary interpretation. Second, the court stated that even if that subsection applied to lifetime transfers, it would not apply in this case because the transfer served a legitimate business purpose with respect to an operating company. This interpretation is odd because Section 2703(a) clearly established that a business purpose is a separate test from the device test and passing the first test does not automatically mean that one passes the second.

D. IRC § 2514. Power of Appointment

Reformation of *Crummey* Powers to Correct Scrivener's Errors Is Not Release of General Power of Appointment. PLR 201837005 - 201837009 (Sept. 14, 2018)

Grantor executed and funded irrevocable trust (Trust) for the benefit of three grandchildren and their descendants. Grantor also made additional gifts to Trust in year 2. Trust provides for division into one separate share for each grandchild and his or her issue. Trust gives each beneficiary a 30-day Crummey right to withdraw additions to the trust. Based on affidavits of Spouse and Drafting Attorney, Grantor created Trust to provide for his descendants of all generations, to reduce the overall transfer taxes payable on Trust assets by ensuring that the assets held in Trust would not be includible in the grandchild's gross estate upon the grandchild's death, and to minimize the amount subject GST tax by utilizing Grantor's and Spouse's GST exemption. Son's new attorney discovered two drafting errors in Trust: (a) Trust grants each grandchild the right to withdraw the entire amount of any contribution to that grandchild's separate share of the trust and fails to limit the withdrawal right to the gift tax annual exclusion amount, causing the grandchild to possess general powers of appointment over the entire amount of the contribution to that grandchild's separate share of Trust; (b) each withdrawal right over the assets contributed to Trust in any given year is non-cumulative and lapses in its entirety on an annual

basis, and should have been limited to the greater of $5,000 or 5% of the value of the trust assets, to avoid a taxable gift on the lapse of the withdrawal rights. Grantor and Spouse incorrectly reported the initial gift to Trust as an indirect skip, rather than a direct skip, and allocated GST exemption to Trust. Spouse incorrectly reported the Year 2 gift as an indirect skip and allocated GST exemption to Trust. No GST transfers have been made from Trust. At Trustee's request, a state court reformed Trust to eliminate the scrivener's error retroactively to the date of Trust's creation. As reformed, Trust limits the beneficiaries' withdrawal rights to the gift tax annual exclusion amount, and it limits the annual lapse of the withdrawal rights to the greater of $5,000 or 5% of the value of the trust assets.

The IRS stated that: (a) because of the reformation, the grandchildren do not possess general powers of appointment over their respective shares of Trust, except to the extent of each grandchild's withdrawal rights under the reformed trust instrument; (b) the reformation does not constitute the exercise or release of a grandchild's general power of appointment; (c) the lapse of any grandchild's withdrawal right over additions to Trust did not result in a gift for gift tax purposes; (d) one of Trust's assets will be included in a grandchild's gross estate for federal estate tax purposes, except to the extent of each grandchild's withdrawal rights under the reformed trust instrument exercisable at the grandchild's death; and (e) grantor and Spouse substantially complied with Section 2632(a) to allocate their available GST exemption to the initial gift to Trust. The IRS recognized that, under *Comm'r v. Estate of Bosch*, 387 U.S. 456 (1967), the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute, but that when there is no binding precedent of the highest court of a state, federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. The purpose of the reformation is to correct the scrivener's error, not to alter or modify the trust instrument. In this case, Grantor and Spouse elected to gift-split on their timely filed gift tax return, and so should be each treated as the transferor of one-half of the assets given to Trust in the first year, and Spouse filed a timely gift tax return and should be treated as the transferor for the gift to Trust in Year 2. While Grantor and Spouse did not literally comply with the instructions to Form 709 to properly allocated their remaining GST exemption to the initial gift to Trust, an allocation that does not strictly comply with the instructions on Form 709 or the applicable regulations, will be deemed valid if the information on the return is sufficient to indicate that the donor intended to make the allocation. In this case, Grantor and Spouse substantially complied with the GST exemption allocation rules of Section 2632(a) in the initial year of Trust, and Spouse did so in Year 2.

E. IRC § 2516. Certain Property Settlements

Payments to Former Spouse for Buyout of Interests Held Jointly Were Incident to Divorce and Neither Taxable Sales nor Taxable Gifts Under Sections 1041 and 2516. PLR 201910003 (Jan. 4, 2019)

Within seven months after A and B were divorced, Court entered Stipulation and Order No. 1, providing that (a) A and B would hold equal interests in Property as tenants in common; (b) A and B would each be responsible for payment of an equal share of the mortgage, taxes, and similar expenses, improvements; (c) repairs or changes to the structure or décor of the Property would require the consent of both A and B; (d) the costs of repairs and changes would be shared equally by A and B; (e) neither A nor B could sell his or her interest without first giving written notice to the other to trigger a 60-day right of purchase; and (f) the purchase under this clause would be for 50% of the then-current fair market value as established by a professional appraisal, less the then-current payoff figure on the mortgage. The Property then sustained heavy smoke and water damage due to a fire at an adjoining home. These damages required repairs greater than those A and B contemplated when they obtained Stipulation and Order No. 1, which lacked a provision for resolving this dispute. A, who had the greater ability to handle unforeseen expenses, paid a disproportionate share of the repairs, costs, and then negotiated a buyout of B's interest consistent with the terms of Stipulation and Order No. 1. At the request of A and B, Court reopened the divorce case and modified Stipulation and Order No. 1, in which modification each party agreed that he or she had obtained an independent appraisal of the fair market value of Property and that this value had been used for the buy-out, with adjustments for the additional costs expended by A in the remediation and repair of Property.

The IRS stated that the payments made by A to buy B's interest in Property not taxable for either income or gift tax purposes. The IRS noted that B's transfer of an undivided one-half interest in Property to A was made pursuant to a divorce or separation instrument, as defined in Section 71(b)(2), and while they occurred more than six years after the date on which the marriage ceased, the Stipulation and Order 2 modified and amended the earlier stipulation and order and was effective at the time of the cessation of the marriage of A and B. Thus, A's payment and B's transfer of an undivided one-half interest in Property was "incident to divorce" under Section 1041, and no gain or loss was recognized. In addition, the couple's divorce occurred less than 1 year before Stipulation and Order No. 1 was entered, so that under Section 2516, the transfers pursuant to Stipulation and Order No. 1, as modified, were for gift tax purposes deemed made for full and adequate consideration in money or money's worth.

V. GENERATION-SKIPPING TRANSFER TAXES

A. IRC §§ 2631, 2632. The GST Exemption

1. Joint Committee on Taxation's Blue Book States that 2017 Increases in GST Exemption Can be Allocated to Prior Transfers. Staff of the Joint Committee on Tax'n, 115th Cong., 2d Sess. "General Explanation of Public Law 115-97," at p. 89 (Dec. 21, 2018) (Committee Print)

The Blue Book confirms that a transferor can allocate the new increases in the GST exemption to indirect skip transfers made before the new law, changing the inclusion ratio of those transfers for purposes of future taxable distributions and taxable terminations. A footnote in the Blue Book discussion of the increased applicable exclusion illustrates this option, stating:

> *For example, assume that on March 15, 2016, T gave property with a value of $6,000,000 to a trust for the benefit of T's descendants (Trust A) and T's entire then-remaining generation-skipping transfer tax exemption of $5,400,000 was allocated to trust A on a timely filed 2016 gift tax return. As of the date of the 2016 gift, Trust A has an inclusion ratio of 0.100 [1 - ($5,400,000/$6,000,000)]. On July 1, 2018, when the property in Trust A has a fair market value of $7,000,000, T files a gift tax return and allocates $700,000 of generation-skipping transfer tax exemption to Trust A, reducing Trust A's inclusion ratio from 0.100 to zero [1 - (($700,000 + (90% x $7,000,000)) / $7,000,000))], effective on July 1, 2018. Absent additional contributions to Trust A, the generation-skipping transfer tax on taxable distributions from, or a taxable termination with respect to, Trust A on or after July 1, 2018, is determined using an inclusion ratio of zero.*

Thus, a donor who has made prior transfers to generation-skipping trusts that have an inclusion ratio above zero, and who wishes to take advantage of the increased GST exemption, can do so merely by allocating additional exemption to the prior transfers, without making any additional transfers of property. If the increase still produces an inclusion ratio between zero and one, the trust can be severed into two trusts, one with an inclusion ratio of zero and the other with an inclusion ratio of one, to permit more specific tax planning on future distributions.

2. GST Exemption Adjusted for Inflation. Rev. Proc. 2018-57, § 3.41, 2018-49 I.R.B. 827 (Dec. 3, 2018)

The GST exemption was initially adjusted for inflation to $11,400,000 for transfers made in 2019.

VI. SPECIAL VALUATION RULES

IRC § 2703. Certain Rights and Restrictions Disregarded

Tax Court Refuses to Reject Application of Section 2703 to Intergenerational Split-Dollar Life Insurance Arrangements – Again. *Estate of Morrissette v. Comm'r,* https://www.ustaxcourt.gov/ InternetOrders/DocumentViewer.aspx?IndexSearchableOrdersID=264423 (June 21, 2018)

Clara M. Morrissette established a revocable trust, the Clara M. Morrissette Trust, and contributed her shares in the family's corporation, Interstate Group Holdings, Inc. (IGH), which owned and operated Interstate Van Lines. In 2006, the revocable trust was amended to permit the trustee to "(i) pay premiums on life insurance policies acquired to fund the buy-sell provisions of the * * * [Interstate Group's] business succession plan, and (ii) make loans, enter into split-dollar life insurance agreements or make other arrangements." The same amendment also authorized the trustee to transfer each receivable from the split-dollar life insurance arrangement, when paid by one of the three dynasty trusts Clara had created for her sons, back to the irrevocable trust owing the receivable or directly back to each son. A few days later, the revocable trust, the three dynasty trusts, Clara's brothers-in-law, and some other trusts entered into a buy-sell agreement, under which, upon the death of any of the three children, the remaining children and their dynasty trusts would buy the deceased's IGH stock. To fund the buy-sell agreement, each of the dynasty trusts bought a universal life insurance policy on the life of each other brother. The revocable trust entered split-dollar insurance arrangements with three dynasty trusts. The revocable trust contributed $29.9 million to the three dynasty trusts to enable them to buy universal life insurance policies on each of the sons. The revocable trust was entitled to receive a portion of the death benefit from each policy equal to the greater of the cash surrender value of the policy or the aggregate premium payments on that policy. Each dynasty trust would receive the balance of the death benefit under the policy it owns on the life of the deceased, which would be available to fund the purchase of the stock owned by or for the benefit of the deceased. The arrangement included a recital that the parties intended that the arrangement be taxed under the economic benefit regime of the split-dollar final regulations, and that the only economic benefit provided to the dynasty trusts was current life insurance protection. The dynasty trusts executed collateral assignments of the policies to the revocable trust to secure their obligations under the split-dollar arrangement. None of the trusts had the right to borrow against a policy held under this arrangement. Clara reported gifts to the trusts for the 2006-2009 tax years using the economic benefit regime in Reg. § 1.61-22. After her death, the IRS determined a gift tax deficiency and penalty against the estate, treating the entire $29.9 million as a gift in 2006.

The Tax Court (Judge Goeke), in an order, refused to hold that Section 2703 could not apply in determining the estate tax value of the decedent's interest in the split-dollar arrangements, for the reasons given by the court in *Estate of Cahill*.

VII. SELECTED ATTACHMENTS

A. Family Limited Partnership/Limited Liability Company Checklist

PLANNING AND DRAFTING

- **Create Partnership in a Good State.** Assure that the state whose law governs the partnership provides, as default rules:

  - No requirement that the partnership certificate state the time at which the limited partnership is to be dissolved;

  - Partnership does not terminate upon the withdrawal or death of a general partner (usually if there is another general partner or if a majority of the limited partners elect to continue the business);

  - Majority of the limited partners cannot remove the general partner and indirectly effect the dissolution of the partnership;

  - Transferee of a partnership interest becomes only an assignee, rather than a partner, without the vote of the remaining partners; and

  - A withdrawing partner is not entitled to his or her capital account. Often, the withdrawing partner is entitled to "fair value," but this should be based his or her right to share in reasonably anticipated future distributions from the continuing entity. Alternatively, state law may not permit a partner to withdraw without the consent of the other partners. The Tax Court and Fifth Circuit have held that a right to withdraw is not a right to liquidate under Section 2704(b), but it is just as well that the partners have no specific right to withdraw.

- **Have and Document Nontax Purposes.** Carefully document in the agreement or collateral instruments or letters the various nontax purposes for which the partnership is created. Among the nontax purposes that the courts may accept are:

  - Avoiding likely creditors, such as spouses of children, if there is a realistic basis for worrying about creditor claims, such as prior divorces by some of the children;

  - Assuring the continued management of assets according to a specific and definite investment philosophy, whether or not it is one that the donor espouses. This may also be combined with teaching this philosophy to the various family members;

  - Forcing the children to work together to manage key family assets, but the children must then actually work together to manage these assets;

- Dividing key assets among children through the use of separate partnerships, to reduce family discord; and

- Consolidating assets of various family members (or dividing interests in gifts from donor among various family members) to facilitate purchase of investments with minimum entry costs, such as hedge funds that require that the investors have at least $10 million in net worth, though it is important to show that there were actual purchases of such investments or that they were under serious consideration.

- **Consider Annual Exclusion**. Avoid undue restrictions on transfer, or give a donee partner the right to withdraw up to the annual exclusion from the partnership at the time of the gift, to assure that such gifts qualify for the gift tax annual exclusion.

- **Create Partnership ASAP**. The partnership should be created and funded while the donor is in good health and as young as practicable. Once the donor is terminally ill, the chances of the partnership being respected for tax purposes drops precipitously.

- **Fund Partnership with Active Management Assets**. Fund the partnership with assets that require active management, though favorable cases do exist regarding partnerships that hold solely passive assets.

- **Do Not Fund Partnership with Personal Use Assets.** Do not transfer personal use assets to the partnership, even if the donor then leases them from the partnership. This includes, among other things, the donor's residences.

- **Donor Should Not Control Partnership Distributions.** The donor should not be the general partner. Family members or trusts to whom the client wishes to pass the bulk of the partnership assets should be general partners and participate in the operations of the enterprises.

  There are several ways to limit or avoid control by the donor of the partnership distributions.

  - A corporate or LLC general partner could be named in which the donor has no interest;

  - You can have two classes of general partnership interests, one of which has control over distributions, and the other which manages the partnership assets. The donor can then transfer the former, retaining the latter;

  - The partnership can prohibit all distributions during the donor's lifetime;

  - In light of recent cases, the donor, even as a limited partner, should not be permitted to vote on any distributions, including termination of the partneship.

- **Each Partner Should Have Separate Representation.** All prospective partners should be represented by legal and financial counsel and should have input into the terms of the governing instruments.

- **Avoid Participation Via Powers of Attorney.** Consider a provision that precludes voting for a general partner through a power of attorney.

- **Assure that Significant Interests Are Held by Others.** Give or sell significant limited partnership interests to others, particularly including trusts with independent trustees. The retention of 99% of the partnership interests will encourage a court to ignore the transaction.

- **Assure that Limited Partners Pay for Their Interests.** Limited partners should pay for their partnership interests with their own assets. If they do not have assets, the donors should make gifts and let the gifts gather some age, before creating the partnership.

- **Reserve Adequate Assets.** Never put too much of the donor's wealth in the partnerships; the donors should retain enough assets on which to live comfortably and pay any expected estate taxes or claims. The donor should retain sufficient liquid assets, as well as sufficient wealth. It is not a bad idea if the other family member partners only contribute excess assets, too.

- **Have A Charitable Partner.** Consider giving at least a 1% interest to a charity or other unrelated person, to make it impossible for the family to remove any restrictions on liquidation in the agreement.

- **Use Independent Trustees.** Each trust that holds a partnership interest should have an independent trustee.

- **Use Good Timing to Avoid Step Transaction and Indirect Gift Doctrines.**

- **Do Not Plan Specific Gifts at Start of Transaction.** The attorney and client should not make definite plans to make gifts until they have formed the partnership and obtained an independent professional appraisal of the value of the limited partnership interests. Only then will they have enough financial data to make intelligent gift plans.

- **Form the Entity in a No-Gift Situation**. The client should first form the partnership in a non-gift environment, such as having the client and his or her U.S. spouse as the only initial owners or having the client and a controlled corporation as the only initial owners. Similarly, you can form the entity by having each prospective partner contribute a proportionate share of the nominal initial consideration. Thus, any constructive gifts would not produce a gift tax.

- **Do All Paperwork to Form Entity.** Make sure that the client signs the partnership agreement and that the partnership certificate is promptly filed. The client (and spouse, if relevant) should then transfer to the entity whatever assets they want the entity to hold.

- **Reflect the Transfers in the Donor's Capital Account.** The contributions to the partnership must be reflected in the donor's capital account. This will mean that the donor has a substantial increase in his or her (or their) proportionate partnership interest. Assure that capital accounts determine distributions on liquidation or termination.

- **Get Appraisal.** Next, obtain the best professional appraisal the client can afford. The appraiser makes an independent judgment, and the amount of gifts (or the existence of gifts at all) depends upon the judgment of the appraiser. This usually puts at least several weeks between the formation and funding of the entity and any gifts. Two or three months is even better.

- **Then Make Transfers**. Once you have an appraisal, and a reasonable time has passed, meet with the client and decide whether gifts will be made, to whom they will be made and the amount of the gifts. Execute a document of transfer and make all necessary amendments to the partnership or operating agreement, including any required waivers of buy-sell restrictions.

- **Adjust Capital Accounts**. Reduce the capital accounts of the donor and transfer the capital to the donees.

- **File a Timely Gift Tax Return.** File the gift tax return and, where appropriate, allocate GST exemption.

ADMINISTRATION

- **Have Partnership (or GP) Stationery**. The partnership should have stationery that identifies precisely who the general partners are, to assure that the general partner never acts in a different capacity.

- **Have Partnership Bank and Security Accounts.** The partnership must have its own bank and securities accounts, accessible only by the general partners.

- **Hold Regular Partners' Meetings.** The general partners should meet at least quarterly to discuss partnership activities. If possible, the attorney or paralegal should be present.

- **Keep Good Records.** The general partners should keep books of account and detailed records of their decisions and activities.

- **Inform Limited Partners**. The general partners should send copies of the minutes of the partnership meetings to the limited partners.

- **Avoid Commingling.** Never, never, never commingle partnership and personal assets.

- **Avoid Paying Personal Expenses**. Never, never, never pay personal expenses from the partnership assets, even if capital account adjustments are made.

- **Avoid Paying Estate Expenses.** Generally, the partnership should not pay estate expenses for the principal partner.

- **Avoid Non-Pro Rata Distributions.** Generally, the partnership should avoid making non-pro rata distributions.

- **Avoid Loans to the Donor or Donor's Estate**. Generally, the partnership should not make loans to the principal partner or his or her estate.

- **Do Not Unwind Partnership (Even Partially) After Donor's Death**. The partnership should not be unwound or make large distributions after the death of the donor partner.

B. IRS/Treasury Priority Guidance Plan for 2018-2019 (November 8, 2018) -- Issues Related to Estate Planning

OFFICE OF TAX POLICY
AND
INTERNAL REVENUE SERVICE
2018-2019 PRIORITY GUIDANCE PLAN
Updated as of December 31, 2018
Released April 5, 2019
2nd Quarter Update

PART 1. INITIAL IMPLEMENTATION OF TAX CUTS AND JOBS ACT (TCJA)

3. Guidance clarifying the deductibility of certain expenses described in § 67(b) and (e) that are incurred by estates and non-grantor trusts.

● PUBLISHED 07/30/18 in IRB 2018-31 as NOT. 2018-61 (RELEASED 07/13/18)

5. Guidance under §§ 101 and 1016 and new § 6050Y regarding reportable policy sales of life insurance contracts. Notice 2018-41 was published on May 14, 2018.

* * * *

13. Final regulations on computational, definitional, and anti-avoidance rules under new § 199A and § 643(f). Proposed regulations on computational, definitional, and anti-avoidance guidance under new § 199A and § 643(f) published on August 16, 2018 in FR as REG-107892-18 (NP(RM) (Released on August 8, 2018).

* * * *

31. Guidance implementing changes to § 1361 regarding electing small business trusts.

* * * *

37. Regulations under § 2010 addressing the computation of the estate tax in the event of a difference between the basic exclusion amount applicable to gifts and that applicable at the donor's date of death.[4]
● PUBLISHED 11/23/18 in FR as REG-106706-18 (NPRM).

* * * *

[4] Note that in the 2017-2018 Priority Guidance Plan, this item was described as:

"16. Guidance on computation of estate and gift taxes to reflect changes in the basic exclusion amount."

57. Regulations under §170 providing rules governing the availability of the charitable contribution deduction when a taxpayer receives or expects to receive a state or local tax credit.
- PUBLISHED 08/27/18 in FR as REG-112176-18 (NPRM).

PART 3. BURDEN REDUCTION

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

5. Guidance under § 170(e)(3) regarding charitable contributions of inventory.

* * * *

8. Final regulations under § 2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption.

PART 5. GENERAL GUIDANCE

* * * *

EMPLOYEE BENEFITS

A. Retirement Benefits

5. Regulations under § 401(a)(9) updating life expectancy and distribution tables for purposes of the required minimum distribution rules.

* * **

10. Regulations under §§219, 408, 408A, and 4973 regarding IRAs.

EXEMPT ORGANIZATIONS

* * * *

4. Final regulations and other guidance under §529A on Qualified ABLE Programs as added by section 102 of the ABLE Act of 2014. Proposed regulations were published on June 22, 2015.

5. Guidance under §4941 regarding a private foundation's investment in a partnership in which disqualified persons are also partners.

6. Guidance regarding the excise taxes on donor advised funds and fund management.

7. Guidance under § 6033 on reporting donor contributions.

   ● PUBLISHED 07/30/18 in IRB 2018-31 as REV. PROC. 2018-38 (RELEASED 07/16/18).

GENERAL TAX ISSUES

11. Final regulations under § 170 regarding charitable contributions. Proposed regulations were published on August 7, 2008.

    PUBLISHED 07/30/18 in FR as TD 9836.

GIFTS AND ESTATES AND TRUSTS

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

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

3. Regulations under § 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.

4. Regulations under § 7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests. [5]

INSURANCE COMPANIES AND PRODUCTS

1. Final regulations under § 72 on the exchange of property for an annuity contract. Proposed regulations were published on October 18, 2006.

INTERNATIONAL

H. Other

3. Regulations under §§ 6039F, 6048, and 6677 on foreign trust reporting and reporting with respect to foreign gifts, and regulations under §§ 643(i) and 679 relating to certain transactions between U.S. persons and foreign trusts.

TAX ACCOUNTING

5. Final regulations under § 453B regarding the nonrecognition of gain or loss on the disposition of certain installment obligations.

[5] This item is new in the 2018-2019 Priority Guidance Plan.

C. IRS No-Rulings – Domestic - List for 2019 -- Estate, Gift, GST Tax and Related Issues. Excerpts from Rev. Proc. 2019-3, 2019-1 I.R.B. 130 (Jan. 2, 2019)

SECTION 3. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED

.01 Specific Questions and Problems.

* * * *

(9) Section 61.—Gross Income Defined.—Whether a split-dollar life insurance arrangement is "materially modified" within the meaning of §1.61–22(j)(2) of the Income Tax Regulations. (Also §§83, 301, 1401, 2501, 3121, 3231, 3306, 3401, and 7872.)

* * *

(11) Section 79.—Group-Term Life Insurance Purchased for Employees. Whether a group insurance plan for 10 or more employees qualifies as group-term insurance, if the amount of insurance is not computed under a formula that would meet the requirements of §1.79 1(c)(2)(ii) of the Income Tax Regulations had the group consisted of fewer than 10 employees.

(12) Section 83.—Property Transferred in Connection with Performance of Services.—Whether a restriction constitutes a substantial risk of forfeiture, if the employee is a controlling shareholder. Also, whether a transfer has occurred, if the amount paid for the property involves a nonrecourse obligation.

* * *

(14) Section 101.—Certain Death Benefits.—Whether there has been a transfer for value for purposes of §101(a) in situations involving a grantor and a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§673 to 677.

(15) Sections 101, 761, and 7701. Certain Death Benefits; Terms Defined; Definitions.—Whether, in connection with the transfer of a life insurance policy to an unincorporated organization, (i) the organization will be treated as a partnership under §§761 and 7701, or (ii) the transfer of the life insurance policy to the organization will be exempt from the transfer for value rules of §101, when substantially all of the organization's assets consist or will consist of life insurance policies on the lives of the members.

(16) Section 102.—Gifts and Inheritances.—Whether a transfer is a gift within the meaning of §102(a).

* * *

(34) Section 170.—Charitable, Etc., Contributions and Gifts.—Whether a charitable contribution deduction under §170 is allowed for a transfer of an interest in a limited partnership or a limited liability company taxed as a partnership to an organization described in §170(c).

(35) Section 170.—Charitable, Etc., Contributions and Gifts.—Whether a taxpayer who advances funds to a charitable organization and receives therefor a promissory note may deduct as contributions, in one taxable year or in each of several years, amounts forgiven by the taxpayer in each of several years by endorsement on the note.

* * *

(42) Section 264(c)(1).—Contracts Treated as Single Premium Contracts. Whether "substantially all" the premiums of a contract of insurance are paid within a period of 4 years from the date on which the contract is purchased. Also, whether an amount deposited is in payment of a "substantial number" of future premiums on such a contract.

* * *

(46) Section 302.—Distributions in Redemption of Stock.—Whether §302(b) applies when the consideration given in redemption by a corporation consists entirely or partly of its notes payable, and the shareholder's stock is held in escrow or as security for payment of the notes with the possibility that the stock may or will be returned to the shareholder in the future, upon the happening of specific defaults by the corporation.

(47) Section 302.—Distributions in Redemption of Stock.—Whether §302(b) applies when the consideration given in redemption by a corporation in exchange for a shareholder's stock consists entirely or partly of the corporation's promise to pay an amount based on, or contingent on, future earnings of the corporation, when the promise to pay is contingent on working capital being maintained at a certain level, or any other similar contingency.

(48) Section 302.—Distributions in Redemption of Stock.—Whether §302(b) applies to a redemption of stock, if, after the redemption, the distributing corporation uses property that is owned by the shareholder from whom the stock is redeemed and the payments by the corporation for the use of the property are dependent upon the corporation's future earnings or are subordinate to the claims of the corporation's general creditors. Payments for the use of property will not be considered to be dependent upon future earnings merely because they are based on a fixed percentage of receipts or sales.

(49) Section 302.—Distributions in Redemption of Stock.—Whether the acquisition or disposition of stock described in §302(c)(2)(B) has, or does not have, as one of its principal purposes the avoidance of Federal income taxes within the meaning of that section, unless the facts and circumstances are materially identical to those set forth in Rev. Rul. 85–19, 1985–1 C.B. 94; Rev. Rul. 79–67, 1979–1 C.B. 128; Rev. Rul. 77–293, 1977–2 C.B. 91; Rev. Rul. 57–387, 1957–2 C.B. 225; Rev. Rul. 56–584, 1956–2 C.B. 179; or Rev. Rul. 56–556, 1956–2 C.B. 177.

(50) Section 302(b)(4) and (e).—Redemption from Noncorporate Shareholder in Partial Liquidation; Partial Liquidation Defined.—The amount of working capital attributable to a business or portion of a business terminated that may be distributed in partial liquidation.

* * *

(77) Sections 507, 664, 4941, and 4945.—Termination of Private Foundation Status; Charitable Remainder Trusts; Taxes on Self-Dealing; Taxes on Taxable Expenditures.—Issues pertaining to the tax consequences of the termination of a charitable remainder trust (as defined in §664) before the end of the trust term as defined in the trust's governing instrument in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets.

* * *

(83) Section 641.—Imposition of Tax.—Whether the period of administration or settlement of an estate or a trust (other than a trust described in §664) is reasonable or unduly prolonged.

(84) Section 642(c).—Deduction for Amounts Paid or Permanently Set Aside for a Charitable Purpose.—Allowance of an unlimited deduction for amounts set aside by a trust or estate for charitable purposes when there is a possibility that the corpus of the trust or estate may be invaded.

(85) Section 643(f).—Treatment of multiple trusts.—Whether two or more trusts shall be treated as one trust for purposes of subchapter J of chapter 1.

(86\2) Section 664.—Charitable Remainder Trusts.—Whether the settlement of a charitable remainder trust upon the termination of the noncharitable interest is made within a reasonable period of time.

(87) Section 664.—See section 3.01(77), above.

(88) Section 671.—Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners.—Whether the grantor will be considered the owner of any portion of a trust when (i) substantially all of the trust corpus consists or will consist of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, and (iv)

there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§673 to 677.

* * *

(93) Section 1001.—Determination of Amount of and Recognition of Gain or Loss.—Whether the termination of a charitable remainder trust before the end of the trust term as defined in the trust's governing instrument, in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets, is treated as a sale or other disposition by the beneficiaries of their interests in the trust.

* * *

(98) Section 1221.—Capital Asset Defined.—Whether the termination of a charitable remainder trust before the end of the trust term as defined in the trust's governing instrument, in a transaction in which the trust beneficiaries receive their actuarial shares of the value of the trust assets, is treated as a sale or exchange of a capital asset by the beneficiaries.

* * *

(104) Section 2031.—Definition of Gross Estate.—Actuarial factors for valuing interests in the prospective gross estate of a living person.

(105) Section 2055.—Transfers for Public, Charitable, and Religious Uses.—Whether a charitable contribution deduction under §2055 is allowed for the transfer of an interest in a limited partnership or a limited liability company taxed as a partnership to an organization described in §2055(a).

(106) Section 2512.—Valuation of Gifts.—Actuarial factors for valuing prospective or hypothetical gifts of a donor.

(107) Section 2522.—Charitable and Similar Gifts.—Whether a charitable contribution deduction under §2522 is allowable for a transfer of an interest in a limited partnership or a limited liability company taxed as a partnership to an organization described in §2522(a).

(108) Section 2601.—Tax Imposed.—Whether a trust exempt from generation-skipping transfer (GST) tax under §26.2601–1(b)(1), (2), or (3) of the Generation-Skipping Transfer Tax Regulations will retain its GST exempt status when there is a modification of a trust, change in the administration of a trust, or a distribution from a trust in a factual scenario that is similar to a factual scenario set forth in one or more of the examples contained in §26.2601–1(b)(4)(i)(E).

* * *

(117) Section 4941.—Taxes on Self-Dealing.—Whether transactions during the administration of an estate or trust meet the requirements of the exception to §4941 set forth in §53.4941(d)-1(b)(3)

of the Private Foundation Excise Tax Regulations, in cases in which a disqualified person issues a promissory note in exchange for property of an estate or trust.

* * *

(128) Section 6166.—Extension of Time for Payment of Estate Tax Where Estate Consists Largely of Interest in Closely Held Business.—Requests involving §6166 if there is no decedent.

* * *

(132) Section 7701.—Definitions.—The classification for Federal tax purposes of a fideicomiso or other land trust created under local law, applying the principles of Rev. Rul. 2013-14, 2013-26 I.R.B. 1267, or Rev. Rul. 92-105, 1992-2 C.B. 204.

* * *

SECTION 4. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT ORDINARILY BE ISSUED[6]

.01 Specific Questions and Problems.

* * *

(6) Sections 101 and 7702.—Certain Death Benefits; Life Insurance Contract Defined.—Whether amounts received under an arrangement with an entity that is not regulated as an insurance company may be treated as received under a "life insurance contract" within the meaning of §§101(a) and 7702.

* * *

(18) Section 170.—Charitable, Etc., Contributions and Gifts.—Whether a transfer to a pooled income fund described in §642(c)(5) qualifies for a charitable contribution deduction under §170(f)(2)(A).

(19) Section 170.—Charitable, Etc., Contributions and Gifts.—Whether a transfer to a charitable remainder trust described in §664 that provides for annuity or unitrust payments for one or two measuring lives qualifies for a charitable deduction under §170(f)(2)(A).

(20) Section 170.—Charitable, Etc., Contributions and Gifts.—Whether a taxpayer who transfers property to a charitable organization and thereafter leases back all or a portion of the transferred property may deduct the fair market value of the property transferred and leased back as a charitable contribution.

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[6] Section 2.01 states that "'Not ordinarily' means that unique or compelling reasons must be demonstrated to justify the issuance of a ruling or determination letter."

* * *

(24) Section 302.—Distributions in Redemption of Stock.—The tax effect of the redemption of stock for notes, when the payments on the notes are to be made over a period in excess of 15 years from the date of issuance of such notes.

(25) Section 302(b)(4) and (e).—Redemption from Noncorporate Shareholder in Partial Liquidation; Partial Liquidation Defined.—Whether a distribution will qualify as a distribution in partial liquidation under §302(b)(4) and (e)(1)(A), unless it results in a 20 percent or greater reduction in (i) gross revenue, (ii) net fair market value of assets, and (iii) employees. (Partial liquidations that qualify as §302(e)(2) business terminations are not subject to this provision.)

* * *

(38) Section 642.—Special Rules for Credits and Deductions.—Whether a pooled income fund satisfies the requirements described in §642(c)(5).

(39) Section 664.—Charitable Remainder Trusts.—Whether a charitable remainder trust that provides for annuity or unitrust payments for one or two measuring lives or for annuity or unitrust payments for a term of years satisfies the requirements described in §664.

(40) Section 664.—Charitable Remainder Trusts.—Whether a trust that will calculate the unitrust amount under §664(d)(3) qualifies as a §664 charitable remainder trust when a grantor, a trustee, a beneficiary, or a person related or subordinate to a grantor, a trustee, or a beneficiary can control the timing of the trust's receipt of trust income from a partnership or a deferred annuity contract to take advantage of the difference between trust income under §643(b) and income for Federal income tax purposes for the benefit of the unitrust recipient.

(41) Sections 671 to 679.—Grantors and Others Treated as Substantial Owners.—In a nonqualified, unfunded deferred compensation arrangement described in Rev. Proc. 92–64, 1992–2 C.B. 422, the tax consequences of the use of a trust, other than the model trust described in that revenue procedure.

(42) Sections 671 to 679.—Grantors and Others Treated as Substantial Owners.—Whether an Indian tribe (as defined in 25 U.S.C. §2703(5)) that establishes a trust to receive and invest per capita payments for its members under the Indian Gaming Regulatory Act (25 U.S.C. §§ 2701–2721) is the grantor and owner of the trust.

(43) Section 678.—Person Other than Grantor Treated as Substantial Owner. Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under §671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of §2041, if the trust purchases the property from that person with a note and the value

of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

* * *

(49) Sections 2035, 2036, 2037, 2038, and 2042.—Adjustments for Certain Gifts Made Within Three Years of Decedent's Death; Transfers with Retained Life Estate; Transfers Taking Effect at Death; Revocable Transfers; Proceeds of Life Insurance.—Whether trust assets are includible in a trust beneficiary's gross estate under §2035, 2036, 2037, 2038, or 2042 if the beneficiary sells property (including insurance policies) to the trust or dies within 3 years of selling such property to the trust, and (i) the beneficiary has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of §2041, (ii) the trust purchases the property with a note, and (iii) the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

(50) Section 2055.—Transfers for Public, Charitable, and Religious Uses. Whether a transfer to a pooled income fund described in §642(c)(5) qualifies for a charitable deduction under §2055(e)(2)(A).

(51) Section 2055.—Transfers for Public, Charitable, and Religious Uses. Whether a transfer to a charitable remainder trust described in §664 that provides for annuity or unitrust payments for one or two measuring lives or a term of years qualifies for a charitable deduction under §2055(e)(2)(A).

(52) Section 2501.—Imposition of Tax.—Whether the sale of property (including insurance policies) to a trust by a trust beneficiary will be treated as a gift for purposes of §2501 if (i) the beneficiary has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of §2041, (ii) the trust purchases the property with a note, and (iii) the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

(53) Section 2503.—Taxable Gifts. Whether the transfer of property to a trust will be a gift of a present interest in property when (i) the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, (iv) the trust beneficiaries have the power to withdraw, on demand, any additional transfers made to the trust, and (v) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§673 to 677.

(54) Section 2514.—Powers of Appointment.—If the beneficiaries of a trust permit a power of withdrawal to lapse, whether §2514(e) will be applicable to each beneficiary in regard to the power when (i) the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse, (ii) the trustee or any other person has a power to apply the trust's income or corpus to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse, (iii) the trustee or any other person has a power to use the trust's assets to make loans to the grantor's estate or to purchase assets from the grantor's estate, (iv) the trust beneficiaries have the power to withdraw, on demand, any additional transfers made to the trust, and (v) there is a right or power in any person that would cause the grantor to be treated as the owner of all or a portion of the trust under §§673 to 677.

(55) Section 2522.—Charitable and Similar Gifts.—Whether a transfer to a pooled income fund described in §642(c)(5) qualifies for a charitable deduction under §2522(c)(2)(A).

(56) Section 2522.—Charitable and Similar Gifts.—Whether a transfer to a charitable remainder trust described in §664 that provides for annuity or unitrust payments for one or two measuring lives or a term of years qualifies for a charitable deduction under §2522(c)(2)(A).

(57) Section 2601.—Tax Imposed. Whether a trust that is exempt from the application of the generation–skipping transfer tax because it was irrevocable on September 25, 1985, will lose its exempt status if the situs of the trust is changed from the United States to a situs outside of the United States.

(58) Section 2702.—Special Valuation Rules in Case of Transfers of Interests in Trusts.—Whether annuity interests are qualified annuity interests under §2702 if the amount of the annuity payable annually is more than 50 percent of the initial net fair market value of the property transferred to the trust, or if the value of the remainder interest is less than 10 percent of the initial net fair market value of the property transferred to the trust. For purposes of the 10 percent test, the value of the remainder interest is the present value determined under §7520 of the right to receive the trust corpus at the expiration of the term of the trust. The possibility that the grantor may die prior to the expiration of the specified term is not taken into account, nor is the value of any reversion retained by the grantor or the grantor's estate.

(59) Section 2702.—Special Valuation Rules in Case of Transfers of Interests in Trusts.—Whether a trust with one term holder satisfies the requirements of §2702(a)(3)(A) and §25.2702–5(c) to be a qualified personal residence trust.

(60) Section 2702.—Special Valuation Rules in Case of Transfers of Interests in Trusts.—Whether the sale of property (including insurance policies) to a trust by a trust beneficiary is subject to §2702 if (i) the beneficiary has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of §2041, (ii) the trust purchases the property with a note, and (iii) the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

* * *

SECTION 5. AREAS UNDER STUDY IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED UNTIL THE SERVICE RESOLVES THE ISSUE THROUGH PUBLICATION OF A REVENUE RULING, A REVENUE PROCEDURE, REGULATIONS, OR OTHERWISE

.01 Specific Questions and Problems.

* * *

(7) Sections 661 and 662.—Deduction for Estates and Trusts Accumulating Income or Distributing Corpus; Inclusion of Amounts in Gross Income of Beneficiaries of Estates and Trusts Accumulating Income or Distributing Corpus.—Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a distribution for which a deduction is allowable under §661 or which requires an amount to be included in the gross income of any person under §662.

(8) Section 1014.—Basis of Property Acquired from a Decedent.—Whether the assets in a grantor trust receive a §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.

(9) Section 2036.—Transfers with Retained Life Estate.—Whether the corpus of a trust will be included in a grantor's estate when the trustee of the trust is a private trust company owned partially or entirely by members of the grantor's family.

(10) Section 2038.—Revocable Transfers.—Whether the corpus of a trust will be included in a grantor's estate when the trustee of the trust is a private trust company owned partially or entirely by members of the grantor's family.

(11) Section 2041.—Powers of Appointment.—Whether the corpus of a trust will be included in an individual's estate when the trustee of the trust is a private trust company owned partially or entirely by members of the individual's family.

(12) Section 2501.—Imposition of Tax.—Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a gift under §2501.

(13) Sections 2601 and 2663.—Tax Imposed; Regulations.—Whether the distribution of property by a trustee from an irrevocable generation–skipping transfer tax (GST) exempt trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is the loss of GST exempt status or constitutes a taxable termination or taxable distribution under §2612.

* * *

SECTION 6. AREAS COVERED BY AUTOMATIC APPROVAL PROCEDURES IN WHICH RULINGS WILL NOT ORDINARILY BE ISSUED

.08 Section 2010(c)(5)(A).—Election Required.—All requests filed before the second anniversary of the decedent's date of death for an extension of time under § 301.9100–3 to make an election under § 2010(c)(5)(A), where the Service has provided an administrative procedure to seek such an extension. See Rev. Proc. 2017–34, 2017–26 I.R.B. 1282 (procedure providing for an extension of time to certain taxpayers to make a "portability" election under § 2010(c)(5)(A)).

* * *

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective January 2, 2019.

D. IRS No-Rulings – International - List for 2019 -- Estate, Gift, GST Tax and Related Issues. Excerpts from Rev. Proc. 2019-7 2019-1 I.R.B. 268 (Jan. 2, 2018)

SECTION 4. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT ORDINARILY BE ISSUED[7]

.01 Specific Questions and Problems.

* * * *

(29) Section 2501.-Imposition of Tax. —Whether a partnership interest is intangible property for purposes of §2501(a)(2) (dealing with transfers of intangible property by a nonresident not a citizen of the United States).

(30) Section 7701.-Definitions.- Whether an estate or trust is a foreign estate or trust for federal income tax purposes.

* * *

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective January 2, 2019.

[7] Section 2.01 states that "'Not ordinarily' means that unique or compelling reasons must be demonstrated to justify the issuance of a ruling or determination letter."

E. Direction to Executor to Elect to Give the Surviving Spouse the Decedent's Unused Applicable Exclusion Amount, Charging Costs to Surviving Spouse

__. Deceased Spousal Unused Exclusion Amount Election. I direct that my executor shall do all things necessary to make a valid election to allow my *husband/wife*, if *he/she* survives me, to have the benefit of my deceased spousal unused exclusion amount, to the greatest extent permitted under applicable federal estate tax law. My executor shall charge the incremental costs of preparing my federal estate tax return solely against my *husband/wife*, and shall reduce the amounts otherwise passing to my *husband/wife* by such costs. If the costs of preparing my federal estate tax return are greater than the amounts passing to my *husband/wife* under my will, my executor shall prepare such return only after receiving payment from my *husband/wife* adequate to reimburse my estate for the incremental costs of preparing such return. No equitable adjustment shall be made with respect to the dispositions under my estate because my executor has made this election.

F. Direction to Executor to Elect to Give the Surviving Spouse the Decedent's Unused Applicable Exclusion Amount, without Obligating Spouse to Pay Costs

__. Deceased Spousal Unused Exclusion Amount Election. I direct that my executor shall do all things necessary to make a valid election to allow my *husband/wife*, if *he/she* survives me, to have the benefit of my deceased spousal unused exclusion amount, to the greatest extent permitted under applicable federal estate tax law. My *husband/wife* shall not be required to make any payment to my estate or to its other beneficiaries in order for my executor to make or because my executor has made this election, nor shall any equitable adjustment be made with respect to the dispositions under my estate because my executor has made this election.

South Carolina Bar

Continuing Legal Education Division

Dealing with Basis in Modern Estate Planning

Howard M. Zaritsky

BASIS ISSUES IN ESTATE PLANNING – FOR MANY CLIENTS, IT IS THE KEY TAX ISSUE

by

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BASIS AFTER THE 2017 TAX ACT -- IMPORTANT BEFORE, CRUCIAL NOW[1]

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I. INTRODUCTION

The 2017 Tax Cut and Jobs Act[2] changed both income and estate tax rules, further expanding the range of cases in which taxpayers, particularly those residing in states with high income taxes and modest or no estate taxes, may have a higher income tax rate imposed on ordinary income than the estate tax rate imposed on their estate. This is particularly true with respect to ordinary income that is subject to the 3.8% surtax on net investment income.

Practitioners must, therefore, consider both the estate taxes that may be imposed on larger estates, and the income taxes that may be imposed when a decedent's assets are sold or exchanged. This, in turn, requires serious consideration of the question of basis.

One cannot begin to determine the tax on a sale or exchange without knowledge of the taxpayer's "basis" in the assets in question. Basis is a measure of the taxpayer's economic investment in the property. As such, it serves two very important functions. First, a taxpayer's basis in the property determines whether there is a gain or loss upon a taxable disposition of the property, since the measurement of gain or loss is the difference between the amount realized and the taxpayer's basis in the asset. Second, basis determines the amount of any depreciation or cost recovery deductions allowable.

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[1] This outline was written by Howard M. Zaritsky, Esq. and Lester B. Law, which was originally presented at the 49th Annual Heckerling Institute on Estate Planning sponsored by the University of Miami School of Law.

[2] Pub. L. 115-97, 115th Cong., 1st Sess. (2017), 131 Stat. 2054. The Senate Parliamentarian required that the short title of "The Tax Cuts and Jobs Act" be deleted from the final act, because it had no revenue effect and, as the bill was being passed under the budget reconciliation procedures (avoiding the Senate filibuster rules), it had to contain only revenue-related provisions. The technical name of the bill is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." We shall refer to it as the 2017 TCJA. Those who prefer a different name may feel free to use it. We do not really care.

As important as it is to determine the quantity of gain, it is important to determine the quality of the gain (i.e., long-term or short-term); thus, one must not only understand basis, but one must have a good grasp of the holding period rules.

This paper first explores "basis" and "holding period" as it applies generally to the Federal income tax system, then it delves into basis as it applies to lifetime gifts and testamentary dispositions. Finally, there are a number of specific topics that are common in estate planning, where basis and holding period are explained in depth.

II. KEY BASIS CONCEPTS: WHAT IS BASIS?

A. Brief History of Basis

Three years after the ratification of the 16th Amendment to the U.S. Constitution, the Revenue Act of 1916 introduced the concept of basis to the tax laws, providing that to compute gain from the sale of property acquired before March 1, 1913, basis was equal to the fair market value as of that date. Regulations that were later issued filled in the gaps providing that property acquired after March 1, 1913, would use the seller's cost as the basis. This later became law as a result of the Revenue Act of 1918.

The Revenue Act of 1921 provided new rules for determining basis for lifetime gifts and testamentary transfers. The transferred basis rule for gift tax is more or less the same rule that exists today. However, with respect to the testamentary transfers, inherited basis would be the basis in the hands of the decedent. A few years later, the Revenue Act of 1928 changed the rule providing basis would be the date of death value. This rule was bantered back and forth for a few years (i.e., from 1928 to 1934), finally settling more or less with the rule that we have today (i.e., date of death value).

The concept of adjusting basis has its origins in the Revenue Act of 1924, which would allow both additions to and reductions (e.g., depreciation) of basis. The concept of substituted basis introduced in 1932, was bifurcated and became later known as transferred basis and exchanged basis in 1984. Changes to the Internal Revenue Code of 1954 and 1986 had slight modifications to the concepts of and rules regarding basis.

As it applies to estate planning and administration, within the last decade, the only major modification to the basis rules was the enactment of IRC § 1022 for those decedents dying in 2010, where the executors of their estates could elect out of the estate tax regime and utilize the income tax regime.

B. Generally

1. What is Basis?

Basis represents a taxpayer's investment in property. This is a unique income tax concept. The income tax basis tracking rules are detailed below. Though the basis tracking rules for accounting purposes are similar, they not the same and often times don't correlate.

2. Basis' Significance

Basis is important because it keeps track of one's investment in property, as such property may be depreciated or as capital improvements are made thereto. Basis

measures the accretion of wealth and recognition of income when assets are bought, sold, exchanged and otherwise disposed.

Basis creates an ascertainable measure by which a taxpayer's gain or loss is calculated. Without basis, gains and losses could not be readily ascertained.

There are many terms associated with basis, such as:

* cost basis

* adjusted basis

* unadjusted basis

* depreciable basis

* transferred basis

* exchanged basis

* carryover basis

* stepped-up basis

* stepped-down basis

* gain basis

* loss basis

* outside basis

* inside basis

These terms are discussed throughout this paper.

C. Cost Basis

In general, the basis of property is initially determined by its cost. IRC § 1012(a); Reg. § 1.1012-1(a). Thus, it is generally thought that an asset's "initial basis" or "original basis" is its "cost basis." There are many adjustments that can be made to a property's basis, which is discussed below. IRC § 1012(a); Reg. § 1.1012-1(a).

1. Property Purchased

Since its inception in tax law in 1918, the term "cost" has not been defined statutorily. Although the term is used in IRC § 1012, where the statute provides that "[t]he basis of property shall be the cost of such property", it remains undefined, and when the term needs some refinement or definition, the regulations and case law have filled in the gaps over the years. Generally, cost is the amount paid for an item, and that is true regardless of whether the cost is the assets true fair market value. However, if there is great disparity between the amount paid and the fair market value, the taxpayer will generally have the burden to show that the amount paid was at an arm's length. See *e.g., Majestic Sec. Corp. v. Comm'r*, 12 F.2d 12 (8th Cir. 1941) and *Comm'r v. Matheson*, 82 F.2d 380 (5th Cir. 1936). If payment is made by debt, whether recourse or non-recourse, the debt is considered payment (and thus the "cost"). Provided however that the debt is only the principal part of the debt and that there is no unstated or disguised interest in the debt obligation. Reg. § 1.1012-1(g).

2. Property Received from Compensation

Reg. § 1.61-2(d)(2)(i) provides that property received as compensation for services takes a basis equal to the fair market value of those services. The rationale behind this is that the taxpayer would have received the compensation as cash and reported it as gross income, and then reinvested those proceeds to purchase the property.

D. Adjusted Basis

1. Generally

The taxpayer's initial basis is adjusted by various additions to and deletions from to the capital value of the asset. IRC § 1011(a); Reg. § 1011-1.

2. Common Basis Adjustments

Among the most common basis adjustments are:

a) Capital Improvements

Basis is increased by expenditures to improve or add to the property, to the extent they are properly added to the taxpayer's capital account for the asset. IRC § 1016(a)(1); Reg. §§ 1.1016-2(a), 1.1016-2(b). The real problems in this area arise in distinguishing between capital improvements (which are added to basis and depreciable over the life of the asset) and maintenance costs (which are immediately deductible, if the property is business related or held for investment, or not deductible at all if the property is not business related and not held for investment, such as a personal residence). Capital improvements must, in general, improve the value of the asset and prolong its life. Maintenance expenses keep the asset at its present or normal condition, and do not add to its value or prolong its useful life. The latter are not an addition to the owner's basis and, unless the property is a business or

investment asset, not deductible. Maintenance costs are deductible if they are related to a trade or business activity. Reg. § 1.162-4.

Example II-1

A puts a new roof on his house at a cost of $50,000. He also paints the exterior and interior of the house at a cost of $2,500. A may increase his basis by the $50,000 cost of a new roof, which is a capital improvement, but not by the cost of painting the house, which is considered routine maintenance.

b) Carrying Charges

(1) Right to Capitalize

A taxpayer may elect to capitalize carrying charges for property, such as real estate taxes or mortgage interest, rather than to deduct them. IRC § 266. Most taxpayers prefer to have the current deduction for such expenditures, but a taxpayer may have low taxable income in a given year, and may prefer to capitalize these costs as opposed to wasting the deductions.

Example II-2

A pays $50,000 in mortgage interest and $20,000 in real estate taxes on undeveloped real estate in 2014. In that year, A's taxable income will already be reduced to nearly zero by other deductions and exemptions. A may elect to add these costs to A's basis in the property and thereby reduce his gains on the eventual sale of the property.

(2) "Carrying Charges" Defined

The regulations do not actually define "carrying charges," but they state that the following items are carrying charges:

- In the case of unimproved and unproductive real property: Annual taxes, interest on a mortgage, and other carrying charges. Reg. § 1.266-1(b)(1)(i);

- In the case of real property, whether improved or unimproved and whether productive or unproductive, (a) interest on a loan (but not theoretical interest of a taxpayer using his own funds), (b) taxes of the owner of such real property measured by compensation paid to his employees, (c) taxes of the owner of such property imposed on the purchase of materials, or on the storage, use, or other consumption of

materials, and (d) other necessary expenditures paid or incurred for the development of the real property or for the construction of an improvement or additional improvement to such real property, up to the time the development or construction work has been completed. Reg. § 1.266-1(b)(1)(ii);

- In the case of personal property: (a) taxes of an employer measured by compensation for services rendered in transporting machinery or other fixed assets to the plant or installing them therein; (b) interest on a loan to buy the property or to pay for transporting or installing the same; (c) taxes of the owner thereof imposed on the purchase of such property or on the storage, use, or other consumption of such property, paid or incurred up to the date of installation or the date when such property is first put into use by the taxpayer, whichever date is later; and (d) any other taxes and carrying charges with respect to property, otherwise deductible, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to capital account. Reg. § 1.266-1(b)(1)(iii).

3. Capitalized Expenditures

a) Generally

A capital expenditure is a cost that will yield benefits in future years for the taxpayer's business or income-producing activities. The most obvious examples of capital expenditures are the costs of acquiring or improving an asset, but there are other expenditures that must also be capitalized. Generally, capitalized expenditures are added to the basis of the asset to which they relate. IRC § 1016(a)(1); Reg. §§ 1.263(a)-5(g)(2)(i) (In the case of a taxable acquisition, merger, or consolidation "an amount required to be capitalized under this section by the acquirer is added to the basis of the acquired assets . . . or the acquired stock . . . ."); Reg. § 1.1016-2(a) ("The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property"). See, however, discussion of selling expenses, below.

b) Presumption of Capitalization

In *Indopco, Inc. v. Comm'r*, 503 U.S. 79 (1992), the Supreme Court held that "deductions are exceptions to the norm of capitalization" and "are strictly construed and allowed only 'as there is a clear provision therefor.'" 503 U.S. at 84. Thus, all costs are required to be capitalized, unless the taxpayer can show that they are expressly made deductible by some provision of law. See Conjura, Zuber & Beale, *To Capitalize or Not? The INDOPCO Era Ends with Final Regulations Under Section 263(a)*, 100

J. Tax'n 215 (April 2004); Elliot, *Capitalization of Operating Expenses After INDOPCO: IRS Strikes Again*, 5 S.C. Law. 29 (1993); Seago & Crumbley, *INDOPCO: A Tiger, a Pussycat, or a Creature Somewhere in Between?* 94 J. Tax'n 14 (Jan. 2001); Sheppard, *The INDOPCO Case and Hostile Defense Expenses*, 54 Tax Notes 1458 (1992); Yale, *When are Capitalization Exceptions Justified?* 57 Tax L. Rev. 549 'summer 2004).

c) Distinguishing Deductions from Capital Expenditures

The fundamental distinction between deductible expenses and nondeductible capital expenditures is inherent in the concept of an expense as a cost of current operations. In *Comm'r v. Tellier*, 383 U.S. 687 (1966), the Supreme Court observed that the principal function of the word "ordinary" in IRC § 162(a) was "to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset."

d) Selling Expenses

Among the most common capital expenditures is the cost incurred in selling an asset. See *Woodward v. Comm'r*, 397 U.S. 572, 576 (1970) ("legal, brokerage, accounting, and similar costs incurred in the acquisition or disposition of . . . property are capital expenditures" and that "such ancillary expenses incurred in acquiring or disposing of an asset are as much part of the cost of that asset as is the price paid for it."); *Alphaco, Inc. v. Nelson*, 385 F.2d 244 (7th Cir., 1967) (broker's commissions, accounting, and attorney's fees incurred in effecting a sale of the taxpayer's capital assets must be capitalized).

(1) Selling Tangible Property

Regulations relating to tangible property state that "[c]ommissions and other transaction costs paid to facilitate the sale of property generally must be capitalized." Reg. § 1.263(a)-1T(d)(1).

(2) Selling Securities

The regulations relating to the sale of securities state that "[c]omissions paid in selling securities are an offset against the selling price." Reg. § 1.263(a)-2(e).

(3) Additions to Basis or Reductions in Amount Realized?

Selling expenses are not added to basis but are instead deducted from the amount realized on the sale. Reg. §§ 1.263(a)-1(e) ("[c]ommissions paid in selling securities are an offset against the selling price"); 1.263(a)-5(g)(2)(ii) (in a taxable acquisition, merger,

or consolidation that is treated as an asset acquisition for federal income tax purposes, "an amount required to be capitalized under this section by the target is treated as a reduction of the target's amount realized on the disposition of its assets"); see also *Spreckels v. Helvering*, 315 U.S. 626 (1942) 'sales expenses incurred by trader in securities must be used to reduce sales price, rather than be currently deducted, under predecessor statute); *Comm'r v. Covington*, 120 F.2d 768 (5th Cir. 1941), *cert. denied*, 315 U.S. 822 (1942) 'same for dealer in commodities futures); *Ward v. Comm'r*, 224 F.2d 547 (9th Cir. 1955), *aff'g* 20 T.C. 332 (1953), *acq*. 1956-2 C.B. 4 (attorney's and appraisal fees that enabled taxpayer to sell partnership interest at a greater profit were not deductible as expenses incurred in production of income, but were capital expenditures properly offset against sale price); *United States v. General Bancshares Corp.*, 388 F.2d 184 (8th Cir. 1968) (expenses in selling nonbanking assets must be used to reduce amount realized); *Jasko v. Comm'r*, 107 T.C. 30 (1996) (legal fees incurred in recovering insurance proceeds after principal residence was destroyed by fire reduce gain on receipt of proceeds, and were not deductible as expenses in production of income); *Mosby v. Comm'r*, 86 T.C. 190, 198 (1986) (property owner's expenses incurred to increase a condemnation award are nondeductible capital expenditures that serve to reduce the amount of the taxable gain); *Casalina Corp. v. Comm'r*, 60 T.C. 694, 703 (1973), *acq*. 1974-2 C.B. 1, *aff'd per curiam* 511 F.2d 1162 (4th Cir, 1975) 'same); *Washington Mkt. Co. v. Comm'r*, 25 B.T.A. 576 (1932) (engineering fees, counsel fees, and expenses of expert witnesses deductible from condemnation award).

e) Restructuring and Reorganization Expenses

Regulations expressly require capitalization of amounts expended to facilitate "[a] restructuring, recapitalization, or reorganization of the capital structure of a business entity," a transfer of property to a corporation or partnership in exchange for interests in that entity, an "acquisition of capital," or "[a] stock issuance." Reg. §§ 1.263(a)-5(a)(4), 1.263(a)-5(a)(5), 1.263(a)-5(a)(7), and 1.263(a)-5(a)(8). The term "restructuring, recapitalization, or reorganization of the capital structure of a business entity" in the regulations thus appears to encompass all forms of changes in the structure of a business entity, including the combination of partnerships or corporations into a single entity, and the division of partnerships or corporations into separate entities.

(1) Facilitation

Costs must be capitalized if they are incurred to facilitate these activities. The regulations explain that amounts paid "to facilitate a transaction" include amounts paid in the process of investigating or otherwise pursuing the transaction. The fact that the amount would

(or would not) have been paid but for the transaction is relevant, but not determinative. Reg. § 1.263-5(b).

(2) Amounts Treated as Employee Compensation

The regulations create an exception to the usual rule of capitalization for amounts treated as employee compensation, even if the employees are facilitating transactions that would normally require capitalization. Reg. § 1.263-5(d)(2)(ii). The regulations state, however, that whether an individual is employed for these purposes depends on the characterization of that individual under the rules for income tax withholding. Reg. § 1.263-5(d)(2)(i).

(3) Elective Capitalization

A taxpayer who is unsure whether or not income tax withholding was required (or who otherwise wishes to do so) can elect to capitalize costs which the regulations would not otherwise require be capitalized. Reg. § 1.263-5(d)(4). This election is made by treating the amounts as capital on a timely-filed federal income tax return for the year in which the amounts are paid. Id.

(4) Cost Recovery

Basis is reduced by appropriate deductions for depreciation (IRC § 167), accelerated cost recovery (IRC § 168), amortization (IRC § 167), and cost depletion (IRC § 611).

(a) Generally

Depreciation, in general, is a current deduction for the exhaustion, or wear and tear on property. When a taxpayer takes or could take a deduction for depreciation, whether or not actually taken, the basis in the depreciated asset must be reduced by the allowed or allowable deduction. *Comm'r v. Superior Yarn Mills*, 228 F.2d 736 (4th Cir. 1955) (reduction in the allocation of the purchase price of land and building to the building because of depreciation deductions passed over by the taxpayer); *Schrader v. United States*, 582 F.2d 1374 (6th Cir. 1978), (basis of air conditioner owned by coin laundry not actually claimed).

(b) Types of Cost Recovery

This annual deduction for depreciation goes by different names, depending upon when the asset was placed in service:

(i) MACRS

The system of deductions for writing off the basis of assets is called Modified Accelerated Cost Recovery System (MACRS), if it applies to recovery property that's placed in service after 1986. IRC § 168. See Tax Reform Act of 1986 § 203, 100 Stat. 2143 (1986). Property placed in service after July 31, 1986, and before 1987 is also subject to MACRS if the taxpayer elected to apply MACRS.

(ii) ACRS

The system of deductions for writing off the basis of assets is called Accelerated Cost Recovery System (ACRS), if it applies to recovery property that's placed in service after 1980 and before 1987. IRC § 168, before Pub. L. 99-514 § 201(a), 99th Cong., 2d Sess. (1986).

(5) Depreciation

The system of deductions for writing off the basis of assets is called depreciation if it applies to property placed in service before 1981, or to property placed in service after 1980, if it does not qualify for either MACRS or ACRS. IRC § 167(a), before the Technical and Miscellaneous Revenue Act of 1988 § 1002(a)(24), 102 Stat. 3401 (1988).

(6) Amortization

The system of deductions for writing off the basis of assets is called amortization, if the asset is intangible or under certain special provisions for tangible property. See IRC § 167(g)(8).

(7) Depletion

The system of deductions for writing off the basis of assets is called depletion, if the assets are exhaustible natural deposits, such as oil, gas, or timber. (e.g., oil and gas) or timber. See IRC § 611.

III. KEY BASIS CONCEPTS: BASIS OF PROPERTY ACQUIRED BY GIFT -- IRC § 1015

A. Brief History

1. 1913-1921

Until 1921, there was no statutory rule on the basis of property acquired by gift. Treasury allowed donees to take a basis equal to the fair market value of the property on the date of the gift. See S. Rep. No. 275, 67th Cong., 1st Sess. (1921); *Taft v. Bowers*, 278 U.S. 470 (1929).

2. Revenue Act of 1921

The Revenue Act of 1921 first provided that the donee must take a "carryover basis" from the donor and use that basis computing gain on selling or otherwise disposing of the property. 42 Stat. 227 (1921); S. Rep. No. 275, 67th Cong., 1st Sess. (1921). As a relatively useless aside, a donee who holds property that he or she received as a gift before 1921 still takes a basis equal to the fair market value of the property on the date of the gift. IRC § 1015(c).

3. Revenue Act of 1934

The Revenue Act of 1934 provided that the carryover basis could not be used to give losses to the donee; the carryover basis would be used only in calculating gain on a later sale. 48 Stat. 680 (1934); S. Rep. No. 558, 73d Cong., 2d Sess. (1934); Keller, *At a Loss: A Half Century of Confusion in the Tax Treatment of Transfers of Depreciated Property Between Related Taxpayers*, 44 Tax Law. 445 (1991).

4. Small Business Tax Revision Act of 1958 and Tax Reform Act of 1976

The Small Business Tax Revision Act of 1958 allowed donees to increase their basis by the gift tax paid on a gift. 72 Stat. 1640 (1958). The Tax Reform Act of 1976 §§ 1901(a)(122), 1906(b)(13)(A), reduced the basis adjustment to the gift tax paid on the net appreciation in a gift. 90 Stat. 1784, 1834, 1877 (1976)

5. Economic Recovery Tax Act of 1981

The basis limitation on reverse gifts in contemplation of death was enacted as part of the Economic Recovery Tax Act of 1981 § 442(d)(1). 95 Stat. 322 (1981).

6. Deficit Reduction Act of 1984

The Deficit Reduction Act of 1984§ 421(b)(5), provided the special rule of IRC § 1041 for treating interspousal transfers as gifts and for determining the basis of property received in such transfers, and modified IRC § 1015 to defer to IRC § 1041 in determining such bases. 98 Stat. 794 (1984).

B. General Rule – Transferred Basis

Transferred basis transactions generally occur when there is no sale or exchange, but property is transferred from the old owner (i.e., sometimes called the "transferor" or "donor") to the new owner (sometimes called the "transferee" or "donee"). See IRC § 7701(a)(43).

In estate planning this happens whenever there has been a completed gift. There are different rules that apply for gifts of appreciated property (i.e., where, at the time of the gift, the fair market value of the gifted property is greater than its adjusted basis), and gifts of depreciated property (i.e., where, at the time of the gift, the fair market value of the gifted asset is less than its adjusted basis), which we discuss below.

C. When Does the Basis Transfer?

The date that a donee acquires an interest in property by gift is the date on which the donor relinquishes dominion and control over the property, and not necessarily the date on which title passes to the donee. Reg. § 25.2511-2(b). The date on which a remainder beneficiary or other successive interest holder receives the interest by gift is the date on which the interest is created, rather than the date on which it becomes possessory. Reg. § 1.1015-1(c).

D. Gifts of Appreciated Property

Appreciated property is defined as property whose fair market value exceeds it adjusted tax basis. For gifts of appreciated property, the general rule is that the donee's basis is equal to the donor's basis in the asset at the time of the gift, increased by any gift tax paid on the net appreciation in the property's value (but not to exceed the asset's fair market value) at the time of the gift. IRC § 1015(a) and (d)(6).

Example III-1

On January 1, 2014, P purchased 20,000 shares of Dapple stock for $1 per share (totaling $20,000). On February 1, 2014, when Dapple's value was $1.50 per share, P gifted his 20,000 shares of Dapple to Q. Under IRC § 1015(a) P's basis of $20,000 would become Q's basis.

Example III-2

Same facts as Example III-1, except assume further that this was P's only gift and that the gift triggered a gift tax of $2,400 attributable to the net appreciation. In this case, under IRC § 1015(d)(6), Q's basis would be P's basis of $20,000 increased by the $2,400 of gift taxes paid (or $22,400). For a more detailed example and refinement of the rule, see section III.K below.

E. Gifts of Depreciated Property

1. General Rule about Gifted Depreciated Property

A different rule applies for gifts of "depreciated property". This rule is intended to prevent the transfer, through gifts of property, of deductible losses by lower-bracket donors to higher-bracket donees.

2. "Depreciated Property" Defined

"Depreciated property" is property where the fair market value is less than its adjusted basis. Thus, a gift of depreciated property arises when, at the time of the gift, the fair market value of such property is less than its adjusted basis. IRC § 1015(a) provides that in the case of gifts of depreciated property, when such property is later sold or exchanged by the donee, there is one basis to be used if the sale or exchange generates a gain, and a different basis to be used if the property generates a loss.

There are three different scenarios that could arise when the gifted, depreciated property is sold or exchanged.

> Scenario 1: The selling price is greater than the adjusted basis that was in the hands of the donor (as it may be required to be adjusted in the hands of the donee).
>
> Scenario 2: The selling price is less than adjusted basis that was in the hands of the donor (as it may be required to be adjusted in the hands of the donee), but greater than the fair market value at the date of the gift.
>
> Scenario 3: The selling price is less than the adjusted basis that was in the hands of the donor (as it may be required to be adjusted in the hands of the donee) and it is also less than the fair market value of the property at the date of the gift.

Each of these scenarios generates a different result.

a) Scenario 1 – Gain Recognized

In Scenario 1, the fair market value of the property on the date of the later sale is greater than the adjusted basis of the donor (as it may have been adjusted subsequent to the gift) at the time of sale; thus, a gain will be recognized. Specifically, IRC § 1015(a) requires that the adjusted basis shall be the transferred basis (as it may have been required to be adjusted in the hands of the donor).

Example III-3

> Donor buys a share of Acme stock for $100 on January 1, 2013. Donor gives the stock to Donee on March 1, 2014, when the fair

market value of the stock is $80. On October 1, 2014, Donee sells the stock for $125.

In this case since Donee sold the stock for more than the basis in Donor's hands, Donee's basis is the Donor's basis of $100; thus, gain recognized will be $25 (i.e., the fair market value on date of sale of $125 minus the donor's $100 basis).

b) Scenario 2: No Gain – No Loss

In Scenario 2, the fair market value of the property on the date of the later sale is between the donor's adjusted basis and the fair market value on the date of gift. In this case there is no gain or no loss recognized.

Example III-4

Same facts as Example III-3, however, on the date of the sale, the fair market value of the stock is $90. In this case, there is no gain and no loss, since the fair market value on the date of the sale is greater than the fair market value on date of the gift, but less than the adjusted basis was in Donor's hands. Reg. § 1.1015-1(a)(2).

c) Scenario 3: Loss Recognized

In Scenario 3, the fair market value of the property on the date of the later sale is below both (1) the donor's adjusted basis and (2) the fair market value on the date of gift.

IRC § 1015(a) requires that for purposes of determining the loss, the donee/seller would use the fair market value on the date of the gift to determine the basis.

Example III-5

Same facts as Example III-3, however, on the date of the sale, the fair market value of the stock was $62. In this case, the basis to be used is the fair market value on the date of the gift (i.e., $80). Thus, Donee recognizes a loss of $18 (i.e., the difference between $80 and $62).

d) Holding Period

The donee's holding period will be affected depending on whether the stock is sold for a gain or a loss. See the discussion below in section V.B.3.b)(1)(c)(iii), where these same examples are used to explain the holding period.

F. Part Gift – Part Sale

1. Generally

Situations arise where a transaction is considered partially a gift and partially a sale (i.e., the "part gift-part sale transaction"). For instance, when a donor 'sells' property to a donee at price that is below the asset's fair market value, where the donee takes property subject to a debt, or where the donor makes a gift, and the donee agrees to pay the gift tax associated with the gift (i.e., the net gift concept).

For income tax purposes, the transaction is deemed to be two separate transactions: (1) a sale for the amount of the proceeds received (relative to the entire fair market value) of the property given up; and (2) a gift for the balance.

Example III-6

Donor buys a widget for $50 many years ago, and later 'sells' it to Donee (Donor' son) for $80, when the widget's true fair market value is $100.

There is a sale of 80% (i.e., $80 ÷ $100) of the asset, and a gift of 20% (i.e., {100% - 80%} or {[$100 – $80] ÷ $100}) of the asset.

In this example, the basis would be bifurcated; therefore, for sales purposes, the basis is $40 (i.e., 80% of $50) and for gift purposes, the basis is $10 (i.e., 20% of $50).

2. Planning Strategy

When a donor plans to make gifts of depreciated business or investment property, it is usually a better idea for the donor first to sell the property, generating a loss, and then to give the donee the cash sales proceeds. This arrangement preserves any loss deduction for the donor, rather than forfeiting it entirely.

G. Sequential Gifts

The regulations state that the donee takes the basis of the donor or, if the donor acquired the property by gift, of "the last preceding owner by whom it was not acquired by gift." Reg. § 1.1015-1(a)(1). The basis of a donee in property, therefore, looks not necessarily at the basis of the immediate donor, if the immediate donor also acquired the property by gift. Of course, if the immediate donor acquired the property by gift, he or she would have a transferred basis from that of the prior donor, and this process would continue as far back as it takes to get to a donor who did not also acquire the property by gift. Thus, this statement in the regulations is rather irrelevant.

H. Recordkeeping

Donors and donees should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value on the date of the gift. Reg. § 1.1015-1(g).

I. Proving Basis

See section VII below, regarding how to prove basis, if there are insufficient records.

J. Fiduciary Reinvestments

A fiduciary takes a cost basis in property that the fiduciary purchases or otherwise acquires by reinvesting property given to the fiduciary. The gift basis rules do not continue to apply to property so acquired. Reg. §§ 1.1015-1(f), 1.1015-2(b).

K. Increase for Gift Tax Paid on Net Appreciation

1. Generally

The donee's adjusted basis in property received by gift is increased for any gift tax paid on the transfer, to the extent attributable to the net appreciation in the value of the gift.

a) Net Appreciation

The donee's basis is increased by that portion of the gift tax paid on the transfer that bears the same ratio to the total gift tax paid as the net appreciation in the value of the gift bears to the amount of the gift. IRC § 1015(d)(6)(A); Reg. § 1.1015(c)(1). For this purpose, the net appreciation in the value of the gift is the amount by which the fair market value of the gift exceeds the donor's adjusted basis immediately before the gift.

b) Amount of the Gift

The amount of the gift, for this purpose, is determined after subtracting the available gift tax annual exclusion and any available marital and charitable deductions. If there is more than one gift of a present interest in property made to the same donee during a calendar year, the annual exclusion applies to the earliest of such gifts in point of time. Reg. §§ 1.1015-5(c)(1) and 1.1015-5(c)(2).

c) Amount of Gift Tax Paid

(1) Only One Gift That Year

If only one gift was made during a calendar year, the entire amount of the gift tax paid for that year is the amount of the gift tax paid with respect to the gift. Reg. §§ 1.1015-5(b)(1)(i), 1.1015-5(c)(2).

(2) Multiple Gifts That Year

(a) Generally

Where more than one gift is made by the donor in a calendar year, the amount of gift tax paid with respect to any specific gift made during that period is the amount which bears the same ratio to the total gift tax paid for that period (determined after reduction for any available unified credit) as the amount of the gift bears to the total taxable gifts for the period. Reg. § 1.1015-5(c)(3).

(b) Say It with Formulae

Algebraically, the amount of the gift tax paid with respect to a gift equals:

$$\frac{\text{Amount of the Gift}}{\text{Total Taxable Gifts (plus exemption allowed)}} \times \text{Total Gift Taxes Paid}$$

For this purpose, the "amount of the gift" is the value of the gift reduced by any portion excluded or deducted by virtue of the annual exclusion, the charitable deduction, or the marital deduction. The values are those finally determined for gift tax purposes. Reg. § 1.1015-5(b)(1)(ii).

Example III-7

Donor has previously used up all available unified credit. In 2014, Donor gives Donee-1 a parcel of real estate worth $100,000. Donor's adjusted basis in the property immediately before the gift was $70,000. Also in 2014, Donor gives Donee-2 a painting with a fair market value of $70,000. Donor files a timely gift tax return paying $56,800 in gift tax, computed as follows:

Fair market value of real estate transferred to Donee-1	$100,000
Less: Annual Exclusion	(14,000)
Included amount of gift to Donee-1	$86,000

Fair market value of painting transferred to Donee-2	$70,000
Less: Annual Exclusion	(14,000)
Included amount of gift to Donee-2	$56,000

Total Included gifts (to Donee-1 and -2)	$142,000

Total gift tax liability for 2014 gifts (i.e., 40% of $142,000)	$56,800

The gift tax paid with respect to the real estate transferred to Donee-1, is determined as follows:

$$\frac{\$86{,}000}{\$142{,}000} \times \$56{,}800 = \$34{,}400$$

The amount by which Donee-1's basis in the real property is increased is determined as follows:

$$\frac{\$30{,}000 \text{ (net appreciation)}}{\$86{,}000 \text{ (fair market value – Annual Exclusion)}} \times \$34{,}400 = \$12{,}000$$

Donee-1's basis in the real property is $70,000 plus $12,000, or $82,000. If Donor had not exhausted any of Donor's unified credit, no gift tax would have been paid and, as a result, Donee-1's basis would not be increased at all above Donor's carryover basis of $70,000. Reg. § 1.1015-5(c)(5), Ex. 1.

(3) Planning Pointer: Gifts of Cash and Property

A donor who plans to give away both cash and appreciated property in an amount that will cause a gift tax to be imposed, should first make the cash gifts, absorbing as much of the annual exclusion and unified credit as possible. In the next year, the donor should give away the appreciated property. This strategy maximizes the increase

in the donee's adjusted basis for the gift tax paid by the donor, without increasing the amount of gift tax paid by the donor.

Example III-8

Donor plans to give Donee gifts of cash and stock in December 2014 and January 2015. Prior gifts have exhausted all but $100,000 of Donor's applicable exclusion amount. Donor's 2014 gifts to Donee consist of $114,000 in cash and an equal amount in marketable securities. Donor's adjusted basis in the securities is $20,000. Donor gives Donee the securities in 2014, and pays $40,000 of gift tax ($114,000 - $14,000 annual exclusion = $100,000 taxable gift; 40% gift tax x $100,000 = $40,000).

In 2015, Donor gives $114,000 of cash to Donee, which generates another $40,000 in gift tax. Donee obtains no basis in the cash.

If Donor makes the gift of cash in 2014 and the gift of securities in 2015, there will be no change in Donor's gift tax liability, but Donee's adjusted basis in the securities will increase by $32,000 (($40,000 gift tax paid by Donor on the appreciation in the value of the securities x [$80,000 appreciation / $100,000 value of gift]).

(4) Annual Exclusion

Where more than one gift of a present interest in property is made to the same donee during a calendar year, the annual exclusion applies to the earliest gifts. Reg. §§ 1.1015-5(b)(2) and 1.1015-5(c)(3).

(5) Gift Splitting

If the donor and the donor's spouse elect to gift split under IRC § 2513, the amount of gift tax paid is the sum of the amounts of tax paid with respect to each half of the gifts, computed separately. Reg. § 1.1015-5(b)(3).

(6) One Gift, Multiple Items of Property

If a gift consists of more than one item of property, the gift tax paid with respect to each item is computed by allocating to each item a proportionate part of the gift tax paid. Reg. § 1.1015-5(b)(1)(iii).

d) When is the Basis Adjustment Made?

(1) General

The Code and regulations state that the donee's basis is increased for the "gift tax paid" with respect to the transfer. This suggests that the donee's basis cannot be increased until those taxes are paid and raises the question about how the donee determines basis before the donor has paid the gift tax.

Example III-9

> Donor gives $10 million of zero-basis shares to Donee on January 1, 2014. Donor pays the gift tax on April 15, 2015. Donee sells the property on December 31, 2014.
>
> It is not clear how Donee calculates the tax on a sale of the shares before April 15, 2015.

(2) Regulations for Pre-1977 Gifts

Regulations applicable to gifts made before January 1, 1977, however, state:

> "*If section 1015(d)(1)(A) applies, the basis of the property is increased as of the date of the gift regardless of the date of payment of the gift tax*."

Example III-10

> Assume that property was acquired by gift on September 8, 1958, and sold by the donee on October 15, 1958, the basis of the property would be increased 'subject to the limitation of IRC § 1015(d)) as of September 8, 1958 (the date of the gift), by the amount of gift tax applicable to such gift even though such tax was not paid until March 1, 1959. Reg. § 1.1015-5(a)(1)(i).
>
> Unfortunately, this portion of the regulation does not, by its own express language, apply to gifts made after December 31, 1976, although there is nothing in the regulations that suggests a different rule for later gifts.

(3) Recommendation

There is nothing contrary in the regulations, and no reason to believe that a rule similar to that applicable prior to 1977 would not apply

to gifts made after 1976. It would make sense, therefore, for a donee to assume that the donor will pay the gift tax, and to adjust his or her basis immediately. Of course, if the donor then fails to pay the gift tax, the donee will need to make a corresponding adjustment in the basis.

2. Net Gift

The basis adjustment applies regardless of who pays the gift tax. Therefore, the gift tax paid by the donee on a net gift, to the extent allocable to appreciation, is added to the donee's basis. Reg. § 1.1015-5(b)(2). See discussion of basis and net gifts below.

3. Qualified Domestic Trusts

A distribution from a qualified domestic trust (QDOT) during the noncitizen surviving spouse's lifetime on which a tax is imposed under IRC § 2056A(b)(1)(A), is treated as a transfer by gift for this purpose, and the additional estate tax paid on the distribution is treated as a gift tax paid, for basis purposes. Reg. § 1.1015(c)(4).

On QDOTs generally, see also Moore, *Practical Estate Planning Techniques for Noncitizen Spouses*, 26 Estate Planning 205 (June, 1999); Mulligan, *Updated Planning for Marital Dispositions, Lifetime QTIPs and QDOTs,* 26 Est. Plan. 395 (Nov. 1999); Rosenberg, *Practical Tips for Dealing with Qualified Domestic Trusts*, 39 Est. Plan. 28 (Nov. 2012); Zeydel & Chung, *Estate Planning for Noncitizens and Nonresident Aliens: What Were Those Rules Again?* 106 J. Tax'n 20 (Jan. 2007).

Example III-11

Decedent dies in 2012. Spouse is not a United States citizen. In order to obtain the marital deduction for property passing to Spouse, Decedent established a testamentary QDOT. In 2014, the trustee of the QDOT makes a distribution of principal from the trust in the form of shares of stock having a fair market value of $70,000 on the date of distribution. The trustee's basis in the stock was $50,000. An estate tax is imposed on the distribution under IRC § 2056A(b)(1)(A) in the amount $28,000 and is paid. The basis of the stock in the hands of the distributee is increased by a portion of the IRC § 2056A estate tax paid determined as follows:

$20,000 (net appreciation)
---------- x $28,000 (§2056A tax)
$70,000 (distribution)

= $8,000

The distributee's basis in the stock is $50,000 (trust's basis) plus $8,000, or $58,000. Reg. § 1.1015-5(c)(5), Ex. 2.

4. Effective Date

This rule applies to gifts made after December 31, 1976. IRC § 1015(d)(6). For gifts made on or after September 2, 1958, and before January 1, 1977, the donee's basis is increased by the entire gift tax paid on the transfer. IRC § 1015(d)(1).

L. Inter-spousal Lifetime Gifts

1. Generally

IRC § 1041(a) provides that *inter vivos* transfers between spouses are always treated as gifts, rather than sales or exchanges, even if there is reciprocal consideration.

IRC § 1015(e) states that the basis of a transferee spouse is determined under IRC § 1041(b)(2), rather than IRC § 1015. IRC § 1041(b)(2) states that the transferee-spouse takes the transferor-spouse's adjusted basis immediately before the transfer. See also *Godlewski v. Comm'r*, 90 T.C. 200 (1988) (husband's basis in share of marital home bought from wife not increased by purchase price).

2. Transferred Basis for Gain and Loss

The transferor-spouse's adjusted basis transfers to the transferee-spouse under IRC § 1041. Unlike gifts to non-spouses, where there is a different treatment between "appreciated property" and "depreciated property", there is no special rule for transfer between spouses. Thus, the transferee spouse always uses the transferor's spouse's basis, whether the transferee-spouse sells the property for a gain or a loss. Reg. §1.1041-1T(d), Q & A-11.

3. Liabilities and Basis

a) Generally

IRC § 1041 requires that the transferee-spouse receive the transferor-spouse's adjusted basis, even if the transferred asset is subject to liabilities exceeding the transferor-spouse's basis. Reg. § 1.1041-1T(d), Q & A-12. See also PLR 9250031 (IRC § 1041(b) determines the basis on a transfer of a partnership interest in which the transferor-spouse's share of partnership liabilities exceeded the outside basis for the transferor-spouse's partnership interest).

b) Debt In Excess of Basis

IRC § 1041(e) provides, however, for recognition of gain on transfers that would otherwise be nontaxable under IRC § 1041(a), if the transfer is in trust and liabilities assumed or encumbering the property exceed its adjusted

basis. Gain recognized under IRC § 1041(e) is added to the transferee's transferred basis in the transferred asset.

4. No Gift Tax Adjustment

a) U.S. Citizen Resident Spouse

No provision is made for increasing this basis by gift taxes, presumably because the gift tax marital deduction will most often render it immaterial.

b) Non-Citizen Spouse

IRC § 1041(d) states that this section does not apply if either spouse is a nonresident alien, but IRC § 2523(i) does not allow the unlimited gift marital deduction unless the donee spouse is a U.S. citizen. The application of IRC § 1041, therefore, should preclude the increase in the transferee-spouse's adjusted basis for the gift taxes paid on the net appreciation, if the transferee-spouse is a resident alien.

M. Planning Strategies to Maximize Basis on Gifts

1. Expiring Loss Carryovers

Shifting a taxable gain to a donee by giving appreciated assets is particularly useful if the donee has an expiring capital loss carryover. IRC § 1212. The donee can then sell the asset and use the loss carryover to reduce or eliminate the tax on the gain.

2. Balancing Income and Wealth Transfer Taxes

A donor should compare the income tax effects of a gift with the estate, gift, and GST tax savings. The carryover basis rules for gifts create a risk that a significant taxable gain will be recognized on a later gift of appreciated property. A bequest or devise of that same property at death, or a gift of that same property with a retention of sufficient controls or beneficial interests in the property to cause it to be included in the donor's gross estate for estate tax purposes, gives the donee an income tax basis in the property equal to its value on either the date of death or, if the executor so elects, the alternate valuation date, which is generally six months after the date of death. IRC §§ 1014(a), 2032. This generally eliminates from the donee's income tax all appreciation up to the date of the donor's death or, if applicable, the alternate valuation date.

3. 2017 TCJA Implications

This is especially true in the case when the unified gift or estate tax exclusion and GST exemption is now $11.18 million (2018). There is a greater incentive not to make gifts, for those whose estate will be less than the exclusion and exemption.

IV. KEY BASIS CONCEPTS: BASIS OF PROPERTY ACQUIRED FROM A DECEDENT -- IRC § 1014

A. A Short History

The Revenue Act of 1921 § 202(a)(3), first codified the Treasury practice of giving date-of-death value basis for property received from a decedent. 42 Stat. 227 (1921) (property acquired by bequest, devise, or inheritance; by certain transfers in contemplation of, or intended to take effect at or after, death; or pursuant to a general power of appointment exercised by will); Treas. Reg. 45, art. 1562 (under Revenue Act of 1918).

A number of years later, in *Brewster v. Gage*, 280 U.S. 327 (1930), the Supreme Court clarified that the basis of property received from a decedent is determined from the value of the property on the date of death, rather than the date on which the personal representative distributes property to the legatee. This was codified by the Revenue Act of 1934 § 113(a)(5), 48 Stat. 680; see also S. Rep. No. 558, 73d Cong., 2d Sess. (1934).

The Tax Reform Act of 1976 §§ 1901(c)(8) and 2005(a)(1), repealed the estate tax value basis rules and substituted a form of carryover basis, effective for estates of decedents dying after December 31, 1976. 90 Stat. 1803, 1872. Fear about complexity lead to the suspension of the effective date by the Revenue Act of 1978 § 515(1), 92 Stat. 2884, 2926, and then it was repealed retroactively by the Crude Oil Windfall Profits Tax Act of 1980 § 401(a), 94 Stat. 299.

Enactment of the unlimited marital deduction resulted in the adoption of the reverse gift in contemplation of death rule of IRC § 1014(e), as part of the Economic Recovery Tax Act of 1981 § 425(a), 95 Stat. 318.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) § 501 (P.L. 107-15, 115 Stat 38), proposed repeal of the estate and GST taxes for 2010, and replacement with modified carryover basis EGTRRA § 542 (P.L. 107-15, 115 Stat 38). The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 § 301(a), (P.L. 111-312, 124 Stat. 3296), made the substitution of transferred basis for the estate tax elective for decedents dying in 2010. IRC § 1022.

B. Generally

The basis of property in the hands of a person acquiring it from a decedent or to whom the property passed from a decedent is the fair market value of the property at the date of the decedent's death or the alternate valuation date, if validly elected. IRC § 1014(a). See also *Helvering v. Reynolds*, 313 U.S. 428 (1941) (taxpayer received contingent remainder in testamentary trust the assets of which included securities; basis was the fair market value of those assets on the date of death, rather than the date on which the remainder interest became possessory); and *Haywood v. Gill*, 313 F.2d 454 (4th Cir. 1963) (same).

C. Property "Acquired From" or "Passed From" the Decedent

Many different situations will cause property to be considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014. Some are obvious, but others are subtler.

1. Caveat

Reg. § 1.1014-1(a) states that "[t]he purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent which is equal to the value placed upon such property for purposes of the Federal estate tax." However, neither IRC § 1014 nor the regulations actually makes a consistent effort to do that, and even the IRS has acknowledged that there are situations in which a basis adjustment is available without a concomitant inclusion of the property in a U.S. gross estate.

2. Assets Passing Under Will or By Intestacy

a) Generally

Property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent (whether under the decedent's will or under the laws of descent and distribution (i.e., intestacy)) is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014. IRC § 1014(b)(1); Reg. § 1.1014-2(a)(1).

b) Property Need Not be Includible in Gross Estate

Property need not be includible in a decedent's gross estate to be deemed to have been inherited from the decedent.

This occurs most often with nonresident alien decedents. Rev. Rul. 84-139, 1984-2 C.B. 168 (real property owned by nonresident alien and not subject to U.S. estate tax takes a basis equal to its fair market value on the date of death); PLR 201245006 (cash and stock in a foreign trust is includible in nonresident alien decedent's gross estate).

See also discussion of effect of the death of a grantor on basis of assets in grantor trust, in section XIII.B. below.

3. Assets Includible in the Decedent's Gross Estate

a) Generally

For decedents dying after 1953, property acquired from the decedent by reason of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment), that is included in the decedent's gross estate, is considered to have been acquired from or to have passed from the decedent for purposes of the basis

rules of IRC § 1014. IRC § 1014(b)(9); Reg. § 1.1014-2(b)(1); Rev. Rul. 56-215, 1956-1 C.B. 324 (portion of joint property included in gross estate eligible for basis adjustment).

b) No Return is Required

The basis adjustment under IRC § 1014 is available whether or not an estate tax return is required. Reg. § 1.1014-2(b)(2); Rev. Rul. 56-215, 1956-1 C.B. 324.

c) Cost Recovery Adjustment

The basis of property includible in the decedent's gross estate that was acquired before the decedent's death, is reduced by the amount allowed to the taxpayer as deductions in computing taxable income for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the decedent's death. Such basis shall be applicable to the property commencing on the death of the decedent. IRC § 1014(b)(9); Reg. § 1.1014-6(a)(1).

4. QTIP

Property includible in the gross estate of the decedent under IRC § 2044 (QTIP assets), is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014. The same cost recovery adjustment described above applies to IRC § 2044 assets. IRC § 1014(b)(10).

5. Surviving Spouse's One-Half Share of Community Property

a) Generally

For decedents dying after December 31, 1947, the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, U.S. possession, or foreign country, is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014, even though that property is not included in the decedent's gross estate for federal estate tax purposes. This rule applies if at least one-half of the whole of the community interest in such property is includible in the decedent's gross estate. IRC § 1014(b)(6); Reg. § 1.1014-2(a)(5); see also Rev. Rul. 87-98, 1987-2 C.B. 206, 1987-39 I.R.B. 15; Rev. Rul. 66-283, 1966-2 C.B. 297; Rev. Rul. 59-220, 1959-1 C.B. 210; Rev. Rul. 55-605, 1955-2 C.B. 382.

b) What and Where is Community Property

(1) Background

Community property is a form of concurrent ownership between a husband and wife derived from the Napoleonic Code. It came to the United States through Spanish law in several states, and through a special statutory adoption in a few more. Under community property laws, property acquired by a married couple during marriage is owned in equal shares by each spouse. Management of the property may be shared by the spouses or exercisable by one spouse only, depending upon the specific law in question. Income from community property may or may not be community property, depending upon the state in question.

(2) Where

(a) Generally

Community Property rules apply to property held by a married couple under the law of many foreign countries as well as the U.S. states of Alaska, Arizona, California, Idaho, Louisiana, Nevada, New Mexico, South Dakota, Tennessee, Texas, Washington, and Wisconsin. See AS §§ 34.77.010 to 34.77.995; Ariz. Rev. Stat. §§ 25-211 to 25-218; Calif. Fam. Code §§ 750 to 755; Idaho Code §§ 32-901 to 32-929; La. Rev. Codes, tit. 9 §§ 2801 to 2802, La. Civ. Code, arts. 2334 to 2369.8; Nev. Rev. Stat. §§ 123.010 to 123.310; NM Stat. §§ 40-3-1 to 40-3-17; Tenn. Code §§ 35-17-101 to 35-17-108; Tx. Family Code §§ 3.001 to 3.410; Wash. Rev. Codes §§ 26.16.010 to 26.16.250; Wis. Stat §§ 766.01 to 766.97.

(b) Spanish Origins

Eight of these states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas and Washington), trace their community property laws to their Spanish origins, as community property originated under the French laws of Napoleon, which pervaded Europe during his conquests.

(c) Wisconsin

Wisconsin created a form of community property in 1986, when it became the only state to adopt the Uniform Marital Property Act. One may reasonably question the use of the term "Uniform" on an act adopted by only one state, but perhaps it should just remain a testimony to the optimism of the

National Conference of Commissioners on Uniform State Laws, who proposed this "uniform" state law in 1983. Even then, the comments to the Uniform Marital Property Act state of the Wisconsin legislation that: "While the Wisconsin act is a substantial adoption of the major provisions of the Uniform Act, it departs from the official text in such manner that the various instances of substitution, omission, and additional matter cannot be clearly indicated by statutory notes." For more on the Uniform Marital Property Act, see also Cantwell, *Drafting Uniform Marital Property Act: Issues and Debate*, 21 Hous. L. Rev. 669 (1984); Furrh, *Divorce and the Marital Property Act*, 62 Wisc. Law. 23 (Jan. 1989); Furrh, *Is Marital Property Act Retroactive?*, 57 Wisc. B. Bull. 15 (July, 1984); Graham, *Uniform Marital Property Act: A Solution for Common Law Property Systems?*, 48 S.D. L.Rev. 455 (2003); Horton, *Real Estate and Conveyancing Under Marital Property Act*, 57 Wisc. B. Bull. 25 (July, 1984); Sampson, *Uniform Family Laws and Model Acts*, 42 Fam. L. Q. 673 (Fall, 2008); Wadlington, *Uniform Marital Property Act*, 57 Wisc. B. Bull. 25 (July, 1984); Sampson, *Uniform Family Laws and Model Acts*, 42 Fam. L. Q. 673 (Fall, 2008); Wadlington, *Uniform Marital Property Act Symposium*, 21 Hous. L. Rev. 595 (1984); Wenig, *Marital Property Act*, 69 Women Law. J. 9 (1983); Winter, *UMPA Fights for Recognition*, 70 ABA J. 76 (1984).

c) Alaska, South Dakota, and Tennessee - Opt-In Community Property

Alaska, South Dakota, and Tennessee enacted elect-in community property regimes, in which a married couple may elect to have some or all of the property acquired during their marriage become community property. The IRS has not yet expressly opined whether it views these laws as creating community property for basis purposes. See, *e.g.*, IRS Pub. 555, *Community Property*, p. 2 (Rev. Feb. 2016), stating that "Note. This publication does not address the federal tax treatment of income or property subject to the "community property" election under Alaska state laws." See also discussion of the elect-in regime and its utility below.

(1) Foreign Countries

Most of Western Europe has community property, because of its history of being under the control of Napoleon. The United Kingdom, because of its contrary history, does not have community property.

(2) Community Property in Common Law States

Community property acquired while residing in a community property state or country remains community property after it is transported to a common law state, unless steps are taken to convert it to separate property or it is commingled with separate property. See, e.g., *Restatement 'second) of Conflict of Laws* § 222 (1971). See also Section 3 of *The Uniform Disposition of Community Property Rights at Death Act* (1971) ("UDOCPRADA"), adopted in 16 states, which states that:

> *"Upon death of a married person, one-half of the property to which this Act applies is the property of the surviving spouse and is not subject to testamentary disposition by the decedent or distribution under the laws of succession of this State. One-half of that property is the property of the decedent and is subject to testamentary disposition or distribution under the laws of succession of this State. With respect to property to which this Act applies, the one-half of the property which is the property of the decedent is not subject to the surviving spouse's right to elect against the will [and no estate of dower or curtesy exists in the property of the decedent]."*

It may be noteworthy that this does not actually state that the property originally acquired as community property under the laws of another state retains its status as community property when moved to a non-community property state. It merely provides for the testamentary disposition of the property in a manner that resembles what would have occurred had the property been community property. The drafters of UDOCPRADA were very careful in their comments to clarify that they were only addressing the "rights" of the surviving spouse, and not addressing the nature of the property. On the other hand, the IRS has stated at least once that community property brought to a state that has the *Uniform Disposition of Community Property Rights at Death Act* is, by virtue of this act, community property. F.S.A. 1993 WL 1609164 (Nov. 24, 1993).

6. Largely Superfluous Rules

Retained Income Interests and Retained Right to Revoke

a) Generally

Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, or with the right reserved to the decedent at all times before his death to revoke the

trust, is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014. IRC § 1014(b)(2); Reg. § 1.1014-2(a)(2). See *also Hazel B. Beckman Trust v. Comm'r*, 26 T.C. 1172 (1956); *Bankers Trust Co. v. United States*, 156 F. Supp. 930 (Ct. Cl. 1957); Rev. Rul. 57-287, 1957-1 C.B. 517, modifying Rev. Rul. 55-502, 1955-2 C.B. 560. This is superfluous because these assets would be includible in the decedent's gross estate under IRC § 2036, merely on account of the income interest, or IRC § 2038, merely on account of the right to revoke. The combination of them seems to be overkill in this context.

b) Decedents Dying After 1951

For decedents dying after December 31, 1951, property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust, is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014. IRC § 1014(b)(3). This is superfluous because these assets would be includible in the decedent's gross estate under IRC § 2038.

c) Property Subject to an Exercised General Testamentary Power of Appointment

Property passing without full and adequate consideration under a general power of appointment exercised by the decedent by will, is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of Section 1014. IRC § 1014(b)(4); Reg. § 1.1014-2(a)(4). This rule is superfluous because such property would also be includible in the decedent's gross estate under Section 2041, whether or not the power was actually exercised.

7. Somewhat Dated Rules

a) Pre-2005 Foreign Personal Holding Companies

For decedents dying after August 26, 1937, and before January 1, 2005, property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent, consisting of stock or securities of a foreign personal holding company (determined which with respect to its taxable year next preceding the date of the decedent's death), is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of Section 1014. The basis of such property is its fair market value on the date of the decedent's death or, if lower, its basis in the hands of the decedent. IRC § 1014(b)(5); Reg. § 1.1014-2(c)(1).

b) Community Property Between 1942 and 1947

For decedents dying after October 21, 1942, and before January 1, 1948, the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, U.S. possession, or foreign country, is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of IRC § 1014, if it was included in the decedent's gross estate under the Internal Revenue Code of 1939. IRC § 1014(b)(7); Reg. § 1014-2(c)(2).

c) Joint and Survivor Annuities for 1951-1953 Decedents

For decedents dying after December 31, 1950, and before January 1, 1954, the survivor's interest in a joint and survivor's annuity any part of which was includible in the decedent's gross estate under the Internal Revenue Code of 1939, is considered to have been acquired from or to have passed from the decedent for purposes of the basis rules of Section 1014. IRC § 1014(b)(7); Reg. § 1.1014-2(a)(6).

d) Domestic International Sales Corporation Stock

The estate tax value basis of stock of a domestic international sales corporation (DISC) or former DISC (as defined in Section 992(a)) owned by a decedent, is reduced by the amount (if any) that would have been included in gross income under Section 995(c) as a deemed dividend, had the decedent lived and sold the stock at its fair market value on the estate tax valuation date. In computing the gain the decedent would have had if he or she had lived and sold the stock, the decedent's basis is determined without regard to the last sentence of Section 996(e)(2) (relating to reductions of basis of DISC stock). IRC § 1014(d). The DISC rules were repealed in 1984, but the basis rules do apply to former DISCs, so they may not be entirely irrelevant. It will, however, be a rare occasion in which former DISC stock will appear in the typical estate planning practice. See Reg. § 1.1014–9.

e) Restricted Stock Options

The estate tax value basis is not available for restricted stock options described in Section 421 which the employee has not exercised at death, if the employee died before January 1, 1957. Reg. § 1.1014(c)(2).

D. Income in Respect of a Decedent

1. Generally

The basis adjustment rules of Section 1014 do not apply to property that constitutes a right to receive an item of income in respect of a decedent (IRD) under Section 691. IRC § 1014(c); Reg. § 1.1014-1(c)(1). See also *Stanley v. Comm'r*,338 F.2d

434 (9th Cir. 1964), *aff'g* 40 T.C. 851 (1963) (right to installment payments was both IRD and community property, and basis provisions relating to community property did not prevent excluding asset from any basis adjustment because it was also IRD); *Collins v. United States*, 318 F. Supp. 382 (C.D. Cal. 1970), *aff'd per curiam*, 448 F.2d 787 (9th Cir. 1971) (payments made to surviving spouse by her late husband's employers under contracts negotiated by husband were IRD and ineligible for basis adjustment at husband's death).

Although not explicitly stated in the statute, the basis of the estate (or other successor in interest) is a transferred basis. So, if the basis was zero in the hands of the decedent (e.g., earned but not yet received compensation) or something other than zero (e.g., installment note owned by the decedent), that basis will be transferred to the successor in interest in the IRD property (and not adjusted to its fair market value). See IRC § 1014(c) and IRC § 691(c)(4).

2. "IRD" Defined

a) Code

The Code does not actually define "income in respect of a decedent." It only says how and when it is taxed. Specifically, Section 691(a)(1) provides that "when received", the appropriate person (generally the person who is deemed to be the owner of the IRD at the time of receipt) will include the received amount into his or her gross income. Effectively, the recipient of IRD is put on a cash basis method of accounting with respect to the IRD payments.

b) Regulations

The Regulations provide a misleadingly narrow definition of IRD as, "in general," "those amounts to which a decedent was entitled as gross income but which were not properly includable in computing his taxable income for the taxable year ending with the date of his death or for a previous taxable year under the method of accounting employed by the decedent." Reg. § 1.691-1(b). Thus, the term includes all accrued income of a decedent who reported his or her income by use of the cash receipts and disbursements method, all income accrued solely by reason of the decedent's death in the case of a decedent who reports his or her income by use of any accrual method of accounting, and income to which the decedent had a contingent claim at the time of his or her death. Reg. §§ 1.691(a)-1(b)(1), 1.691(a)-1(b)(3). The regulations define neither "accrued solely by reason of decedent's death" nor "contingent claims."

c) Cases and Rulings

Cases and rulings have provided a more workable definition of IRD as those items of income substantially earned by a decedent on the date of death, that are not properly includable in the decedent's gross income prior to death

under the decedent's method of accounting. For more than you really wanted to know about IRD, see also R. Danforth, N. Lane, & H. Zaritsky, *Federal Income Taxation of Estates and Trusts*, ch. 15 (Thomson-Reuters/ WG&L, 3rd ed. 2001). Also see Crowell, *Income in Respect of a Decedent Affects Both Income and Estate Taxes*, 16 Est. Plan. 288 (1989); Maloney, *Income and Estate Tax Impact of Income in Respect of a Decedent*, 23 Est. Plan. 165 (May 1996); Maydew, *How the Courts Interpret Income in Respect of a Decedent*, 92 J. Tax'n 41 (Jan. 2000); Steinkamp, *Identification of Income in Respect of a Decedent: The Case for Using Assignment of Income Precedents*, 46 DePaul L. Rev. 367 (Winter 1997).

d) Common Forms of IRD

The most common forms of IRD are probably unpaid current compensation, deferred compensation, and company death benefits payable to beneficiaries of deceased employees, accrued interest and rents as of the time of a property owner's death, and the gain realized on a sale of property that occurs before death if the decedent reported the gain on the installment method. Certain executory sales contracts entered into by the decedent at death may also produce IRD, only if no material conditions remained to be satisfied by the decedent at the time of death.

E. Reverse Transfers in Contemplation of Death

1. Generally

Appreciated property acquired by a decedent who dies after 1981 takes a basis equal to the decedent's basis immediately before death, if: (a) the property was acquired by the decedent by gift during the one-year period ending on the date of death, and (b) the property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the donor's spouse). IRC § 1014(e). There are no regulations under Section 1014(e), and the IRS closed its regulations project on Section 1014(e) in 1986. I.R. 86-167 (Dec. 9, 1986). See also Siegel, *I.R.C. Section 1014(e) and Gifted Property Reconveyed in Trust*, 27 Akron Tax J. 33 (2011-2012).

a) Appreciated Property

"Appreciated property" means any property the fair market value of which on the day it was transferred to the decedent by gift exceeds its adjusted basis. IRC § 1014(e)(2)(A).

b) Property Sold by Estate

The basis of the proceeds of appreciated property acquired within one-year of the date of death and sold by the decedent's estate or by a trust of which the decedent was the grantor is determined under "rules similar to the rules of paragraph (1)." IRC § 1014(e)(2)(B).

2. Timing

Section 1014(e) does not apply to property received from a decedent to whom it was given more than a year prior to death. One may, therefore, obtain a basis increase by transferring highly appreciated assets to a spouse whose health is seriously impaired. The gift can be returned to the donor through a bequest or device without additional estate or GST taxes but with a basis equal to the estate tax value of the property, provided that the donee spouse lives for more than one year. If the donee spouse does not live one year, the return of the gift will not yield a basis increase, but also will not produce any additional estate or GST tax.

a) Actual Date of Death is Crucial

The only timing issue under Section 1014(e) is whether the time between the gift to the decedent and the date of death exceeds one year. The chances that it would do so on the date of the gift are immaterial, unlike many other estate planning situations in which the health of an individual becomes important. A gift made to a decedent when he or she is in great health and almost certain to live decades, will still be subject to Section 1014(e) if the donee/decedent dies within one year of the gift.

b) Natural Death Declaration

One may question whether a spouse to whom a reverse gift in contemplation of death is made should have a natural death declaration (i.e., a living will). Such a document precludes the use of extraordinary measures to keep the client alive. If only a few additional days are needed to satisfy the one-year rule of Section 1014(e), the termination of extraordinary life prolonging measures may be inappropriate. A medical power of attorney, giving the agent the right to decide whether or not to use extraordinary measures to keep the decedent-to-be alive, might be more appropriate where time-sensitive estate planning has been undertaken.

3. Gifts That Do Not Return to the Donor Spouse

a) Generally

Property received from a decedent within one year of the gift of that property to the decedent is not subject to the transferred basis rule of Section 1014(e) if the recipient of the property is someone other than its donor or the donor's spouse.

It is, therefore, important to evaluate how a donee spouse plans to utilize his or her applicable exclusion amount. An individual who wishes to make gifts to other family members and whose spouse is terminally ill and has an unused applicable exclusion amount should give appreciated assets to the terminally ill spouse, who then can make a specific bequest of those assets

to the intended donees. This will result in a lower total tax burden than would have occurred had the healthy spouse made a gift of the appreciated asset to the donee because the donee will receive the asset free of any built-in taxable appreciation. This also can reduce estate taxes of the donor spouse because it leaves the donor spouse's applicable exclusion amount available for other transfers, because the donor spouse's transfer to the donee spouse is sheltered by the gift tax marital deduction.

This planning is especially true in light of the substantial increase in the unified gift and estate tax exclusion amount as a result of the 2017 TCJA.

b) Leaving the Property to Others

A specific bequest or devise to someone other than the donor spouse is the easiest way to assure that the appreciated property does not pass back to the donor spouse, but the same result can be achieved if the donee spouse makes someone other than his or her spouse the joint owner with right of survivorship in the property.

c) Formula Gifts

The legislative history of Section 1014(e) states:

> *"The denial of a stepped-up basis applies where the donor receives the benefit of the appreciated property regardless of whether the bequest by the decedent to the donor is a specific bequest, a general bequest, a pecuniary bequest, or a residuary bequest. However, in the case of a pecuniary bequest, the donor will receive the benefit of the appreciated property only if the inclusion of the appreciated property in the estate of the decedent affected the amount that the donor receives under the pecuniary bequest."*

H.R. Rep. No. 201, 97th Cong., 1st Sess. 188–189 (1981).

Section 1014(e) thereby denies a basis adjustment if, by increasing the decedent's gross estate, the gift also increases the amount of the surviving spouse's formula marital deduction bequest, even if the property given to the decedent is not itself used to satisfy that marital bequest. One noted commentator suggests that the result should be the same even if the bequest to the spouse assumes the form of a fractional share. Pennell, 843-3rd Tax Mgmt. *Estate Tax Marital Deduction* at ¶ III E and 2 Casner & Pennell, *Estate Planning* §10.7 (8th ed. 2012). To the extent that the donor's gift increases the amount passing back to the donor, Prof. Pennell states that the surviving spouse should take a carryover basis in the property. This analysis seems reasonable, and if regulations are ever promulgated, a similar rule may be adopted.

d) Bequests in Trust

(1) "Directly or Indirectly"

The legislative history states that Section 1014(e) applies where property is transferred to the decedent and back to the donor "directly or indirectly." H.R. Rep. No. 201, 97th Cong., 1st Sess. 188–189 (1981). The IRS has adopted this same language in its Section 1014(e) rulings. PLRs 9026036 and 9321050. A transfer to a trust of which the donor or the donor's spouse is a beneficiary could be deemed an indirect transfer to the donor (or spouse).

(2) Portion Issues

The legislative history states that: "If the heir is only entitled to a portion of the property (e.g., because the property must be used to satisfy debts or administrative expenses), the rule applies on a pro-rata basis." H.R. Rep. No. 201, 97th Cong., 1st Sess. 188–189 (1981).

(3) Property Left to the Donor Spouse in Trust

The right to the income from a trust or to receive principal for health, education, support, or maintenance, could be viewed as the right to a portion of the property. This leaves unanswered the computation of basis when the donor's interest in the trust is not ascertainable by ordinary actuarial methods.

(a) Administrative Guidance

The only guidance is private rulings that are largely unhelpful.

(i) PLR 9026036

The first ruling to address this issue was PLR 9026036, in which W transferred property owned solely by her to two trusts, as tenants in common.

W's Trust held its assets to pay income to W for life, then to H for life. W retained a power to dispose of the trust assets by her last will or by lifetime appointment, and in default thereof, the assets of W's Trust would be distributed to W's then-living issue.

H had a 30-day withdrawal right over H's trust, after which he would become the income beneficiary, with

a testamentary power to appoint the assets to the couple's issue, and in default of appointment, the assets would be held in trust for W's lifetime benefit, and then distributed to W's then-living issue.

Among other things, the IRS stated that the assets of W's trust would be includible in her gross estate, and their basis would, at her death, be their estate tax value under IRC §1014(a). With respect to H's trust, the IRS first noted that H had a general power to appoint that trust to himself, which power lapsed, after which H retained an income interest, such that the trust assets should be included in his gross estate under Section 2041. The IRS stated:

> *"However, W reserved an interest for her life in the H's Trust if she survives H and H does not exhaust the assets of the H's Trust during the 30 day period described above. Because H is the donee of an income interest in the H's Trust received from W, and she could receive back, upon H's prior death, a similar income interest in the H's Trust within one year of the creation of H's Trust, section 1014(e) could be applicable to this case. If so, the basis of a portion of the assets of the H's Trust would be the same as the adjusted basis of the assets at the time of H's death. On the other hand, if H should survive longer than one year after the creation of the H's Trust, and then die leaving W, as a survivor, section 1014(e) should not be applicable. In that case, basis to the extent of the income interest will be determined under section 1014(a)."*

But ultimately it concluded:

> "Because there exist two different possible answers that will be decided by future facts, the Service cannot rule on the basis issue with respect to the Husband's Trust."

Notwithstanding that ruling, the analysis provides that the disposition of an income interest in trust to the donor spouse is an indirect receipt of a retransfer of the original assets. The income interest is a clearly-ascertainable portion of a trust fund, so this result is somewhat less than amazing.

The IRS reconsidered part of PLR 9026036 three years later, in PLR 9321050 (May 28, 1993), but did not change its analysis with respect to Section 1014(e).

(ii) PLR 200101021

In PLR 200101021, H and W proposed to create a joint revocable trust and fund it with assets that they owned as tenants by the entirety. The trust also granted the first grantor to die a testamentary general power of appointment, exercisable alone and in all events, to appoint part or all of the assets of the trust to the deceased grantor's estate or any other person. In default of the valid exercise of this power of appointment, the trust fund to which the power relates would be divided into a credit-shelter nonmarital trust and an outright marital share. The trustee would use the nonmarital trust for the surviving spouse's support and maintenance, and for the maintenance, support, and education of the couple's descendants.

The IRS ruled, in applicable part, that Section 1014(e) might apply. The IRS stated that, on the death of the first grantor to die, the surviving grantor would be treated as relinquishing his or her dominion and control over the surviving grantor's one-half interest in the trust, and the surviving grantor would make a completed gift for gift tax purposes of the surviving grantor's entire interest in the trust, and this gift will qualify for the marital deduction under Section 2523. The IRS also stated that Section 1014(e) would apply to any trust property includible in the estate of the first grantor to die that is attributable to the surviving grantor's contribution to the trust and that is acquired by the surviving grantor, either directly or indirectly, pursuant to the deceased grantor's exercise, or failure to exercise, the general power of appointment. What the IRS did not do, however, is state whether and to what extent the passage of property to a trust for the benefit of the donor

spouse and the couple's descendants would be deemed to have passed to the donor spouse.

See also similar trusts and similar analysis in PLR 200210051.

(b) Best Analysis

The phrase "directly or indirectly" should be assumed to have some meaning in the context of a transfer in trust. As such, the most logical approach, though lacking primary authority of even the most non-precedential nature, is to treat a surviving donor spouse as having received indirectly any interest in a trust the value of which is ascertainable. Therefore, an income interest, remainder interest, or right to principal under an ascertainable standard should proportionately disallow the basis adjustment under Section 1014(e). Whether the trust is a QTIP or a nonmarital trust ought not to be relevant for this determination. Again, however, this is just a logical approach to the issue, and there is no real authority that one can rely upon to support this interpretation. See, however, Siegel, *I.R.C. Section 1014(e) and Gifted Property Reconveyed in Trust,* 27 Akron Tax J. 33 (2011-2012).

(4) Disclaimers

In PLR 8628030, Husband had given stock to Wife before she died. Husband disclaimed his income interest and all other interests in the trust which Wife created and funded with the stock she had received from Husband and which was includible in her gross estate. The trust property, therefore, passed to the children, bearing the estate tax value as the basis. This appears to have been, among other things, a successful effort to defeat the operation of Section 1014(e).

4. Additional Planning Considerations

The benefits of a reverse gift in contemplation of death must be re-evaluated if: (1) state gift, estate, or inheritance tax laws do not include an unlimited marital deduction; (2) there is a serious risk that the donee spouse will divert the assets to someone else, intentionally (by gift) or unintentionally (by creditor claim); or (3) the donee spouse may need to qualify for state or federal programs for which the contributed assets may be a disqualifying or limiting factor in determining "financial need."

F. Special Use Valuation

Property whose estate tax value is its special use as farm assets or closely-held business real estate, under Section 2032A, takes a basis equal to its estate tax value. IRC § 1014(a)(3).

G. Carryover Basis for Conservation Easement

Real property subject to a conservation easement that is excludible from a decedent's gross estate under Section 2031(c) takes a basis equal to its basis in the hands of the decedent. IRC § 1014(a)(4).

H. Fiduciary Reinvestments

A fiduciary takes a cost basis in property that the fiduciary purchases or otherwise acquires by reinvesting property given to the fiduciary. The estate tax value basis rules do not continue to apply to property so acquired. Reg. § 1.1014-3(c).

V. KEY BASIS CONCEPTS: HOLDING PERIOD

A. Holding Period's Importance

An asset's "holding period" determines whether a gain or loss will be long-term or short-term. With respect to long-term gains, currently (and for the most part historically) the Federal income tax structure provides reduced (thus favorable) tax rates. By comparison, short-term gains are typically taxed at higher (thus unfavorable) rates. See, generally, Section 1(h) for the taxation of capital gains.

For more than thirty (30) years, the law has provided that capital assets held for one year or less generate short-term gains/losses, and assets held for more than one year (i.e., a year and a day) generate long-term gains/losses. IRC §§ 1222 (1) - (4)).

Historically, the Tax Reform Act of 1976 changed the holding period from a six-month to a one-year period. For a brief period of time (for property acquired from June 23, 1984 through December 31, 1987) there was a reversion to the six-month period. However, since 1988, taxpayers have been operating under the one-year period.

B. When Does the Holding Period Begin?

1. Generally

The holding period begins when the property is "held" or "acquired" by the taxpayer. In *McFeely v. Comm'r*, 296 U.S. 102 (1935), the Supreme Court ruled that, for holding period purposes, property is "held" by a taxpayer when he or she owns the property. To determine "ownership", generally for tax purposes, one looks beyond "legal" ownership, and instead determines whether the purported owner has the "benefits and burdens" of ownership.

2. Acquisition Date is Disregarded; Sale Date is Included

For purposes of determining the holding period, the acquisition date is disregarded and the sale date is included. IRC §1223; Rev. Rul. 70-598, 1970-2 C.B. 168. Thus, the time clock begins running on the day after acquisition.

Example V-1

X purchased a capital asset, CA, on January 1, 2017. X sells CA on January 1, 2018. X has held the property for exactly one year (i.e., from January 2, 2017 to January 1, 2018; thus, gain or loss will be short-term.

Example V-2

Same facts as Example V-1, however, X sells CA on January 2, 2018. In this case, the gain or loss will be long-term, since X held the property for a year and a day.

In analyzing Example V-1, even though for state law purposes X has legal title to the property for a year and a day, for Federal income tax purposes, X's holding period is only one year (i.e., because the date of acquisition is ignored).

In *Fogel v. Comm'r*, 203 F.2d 347 (5th Cir. 1953), when the holding period was six months, property purchased on June 19th and sold on December 19th of the same year the court held that the property was not held for more than six months. In *Frederick v. United States*, USTC ¶ 9195 (E.D. Mich. 1968), Mr. Frederick exercised his option rights and purchased General Motors common stock at 10 am on April 10, 1963, and he sold the same GM stock at 11:20 am on October 10, 1963, the court held that the GM stock was not held for more than six months. Thus, the Frederick case stands for the proposition that parts of days do not count.

3. "Tacking" of Holding Period

An asset's holding period generally begins when a new owner acquires the asset. However, when property is received in a tax-free or non-recognition transaction (e.g., a tax-free exchange or gift), the new owner's holding period will generally include the holding period of a prior owner. IRC § 1223.

This concept is known as "tacking", because is it said that the prior owner's holding period is added or "tacked" onto the holding period of the new owner. In estate planning, there are two common transactions that cause tacking: (1) exchanged basis transactions, and (2) transferred basis transactions.

a) Exchanged Basis Transactions

Exchanged basis transactions generally occur when there has been a sale or exchange, but the sale or exchange is fully or partially non-taxable. See, IRC § 7701(a)(44).

In this case, the holding period of the asset in the hands of the new owner includes the holding period of the prior owner. Section 1223(1) provides, if (a) in determining gain or loss on the sale or exchange the same basis (in whole or in part) is to be used by the new owner, and (b) the asset exchanged is either a capital asset (as defined in Section 1221) or an Section 1231 asset, then the new owner could use the exchanged asset's holding period.

A good example of exchanged basis is when a family creates a family limited partnership (LP) (or limited liability company (LLC)). Generally, the formation of a LP (or LLC) is structured to be tax free under Section 721(a); however, on occasion, gain may be recognized under Section 721(b). For simplicity, we assume gain was not recognized.

(1) Exchanged Basis to the Partner

Under Section 722, the contributing partner's (i.e., the new owner's) basis in the LP interest is the amount of money and adjusted basis of the contributed property, increased by gain (if any) that may have been recognized under Section 21(b). Under Section 1223(1), the contributing partner's holding period for the LP interest would be that of the assets that were given up in exchange. Thus, the new owner's holding period for the partnership interest is said to be that of the holding period of the contributed assets.

(2) Exchanged Basis to the Partnership

Correlatively, the partnership's basis in the contributed property (from the partner) becomes the adjusted basis in the hands of the contributing partner at the time of contribution plus any gain that may have been recognized under § 721(b). IRC § 723. Section 1223(1) provides that the partnership's holding period in the contributed assets would be that of the partner immediately before the contribution.

Example V-3

X owns 100 shares of ABC stock which X bought on January 1, 2012 for $100. Y also owns 100 shares of ABC stock which Y bought on February 1, 2010 for $80. On July 1, 2018, when the stock price per share is $2 (i.e., total value contributed is $400 (i.e. 200 shares at $2 per share), X and Y each contribute their 100 shares of ABC stock to XY, FLP, forming a 50/50 partnership, where X will be the general partner (GP) and Y will be the limited partner (LP). The contribution would not trigger gain under IRC §721.

On July 1, 2018 (the date of contribution) the basis of the GP interest in X's hands will be $100 (Section 722), and, X's holding period will be January 1, 2012 (Section 1223(1)). The basis of the LP interest in Y's hands would be $80 (Section 722) and Y's holding period would be February 1, 2010.

For XY, FLP, the basis of the ABC stock would be $180 (i.e., $100 (for the for the 100 shares contributed by X) and $80 (for the 100 shares contributed by Y)) (Section 723) and XY, FLP's holding period for the 100 shares contributed by X would be January 1, 2012 and for the 100 shares contributed by Y it would be February 1, 2010 (Section 1223(2).

b) Transferred Basis Transactions

(1) Generally

Transferred basis transactions generally occur when there is no sale or exchange, but property is transferred from the old owner (i.e., sometimes called the "transferor" or "donor") to the new owner 'sometimes called the "transferee" or "donee"). See, IRC § 7701(a)(43).

In estate planning this happens whenever there is a gift. There are different rules that apply for gifts of appreciated property (i.e., where the fair market value of the gifted property is greater than its adjusted basis), and gifts of depreciated property (i.e., where the fair market value of the gifted asset is less than its adjusted basis).

(a) Gifts of Appreciated Property

As discussed above above, Section 1015(a) provides that if appreciated property is gifted, the donor's basis will become the donee's basis. Section 1223(2) provides that if the donor's basis becomes the donee's basis, in whole or in part, the donor's holding period is transferred to the donee. Thus, the donor's holding period for gifts of appreciated property tacks to the donee.

Example V-4

On January 1, 2018, P purchased 20,000 shares of Dapple stock for $1 per share (totaling $20,000). On February 1, 2018, when Dapple's value was $1.50 per share, P gifted 20,000 shares of Dapple to Q. Under Section 1015(a) P's basis of $20,000 would become Q's basis. Thus, under Section 1223(2), P's holding period would be transferred to Q. Thus, Q's holding period for the 100 shares of Dapple stock would begin on January 1, 2018.

(b) In Whole or in Part

The reference in Section 1223(2) to the term "in whole or in part" is designed to encompass situations where the transferor's basis is increased for example by gift taxes paid under Section 1015(d).

(c) Gifts of Depreciated Property

Holding period follows the rules with basis for gifts of depreciated property. As set forth above in section III.E above, there are three different scenarios that could arise when the gifted, depreciated property is sold or exchanged.

- Scenario 1: The selling price could be greater than the adjusted basis that was in the hands of the donor (as it may be required to be adjusted in the hands of the donee).

- Scenario 2: The selling price could be less than adjusted basis that was in the hands of the donor (as it may be required to be adjusted in the hands of the donee), but greater than the fair market value at the date of the gift.

- Scenario 3: The selling price is less than the adjusted basis that was in the hands of the donor (as it may be required to be adjusted in the hands of the donee) and it is also less than the fair market value of the property at the date of the gift.

Each of these scenarios generates a different result and accordingly a different holding period.

(i) Scenario 1 – Gain Recognized

In Scenario 1, the fair market value of the property on the date of the later sale is greater than the adjusted basis at the time of sale; thus, a gain will be recognized. Section 1015(a) requires that the adjusted basis shall be the transferred basis (as it may have been required to be adjusted in the hands of the donor). In this case, the holding period is determined under Section 1223(2) because basis in the hands of the donee was determined, in whole or in part, by basis in the hands of the donor.

Example V-5

Donor buys a share of Acme stock for $100 on January 1, 2018. Donor gives the stock to Donee on March 1, 2018, when the fair market value of the stock is $80. On October 1, 2018, Donee sells the stock for $125.

In this case since Donee sold the stock for more than the basis in Donor's hands, Donee's basis is the Donor's basis, and Donee is allowed to tack Donor's holding period from January 1, 2018. Thus, Donee would recognize a long-term capital gain.

(ii) Scenario 2: No Gain – No Loss

In Scenario 2, the fair market value of the property on the date of the later sale is between the adjusted basis and the fair market value on the date of gift. In this case there is no gain or no loss recognized. Since holding period is used to determine if a gain or loss is long-term or short-term, there is no need to determine the holding period, since there is no gain or loss. Thus, the determination of holding period is moot.

Example V-6

Same facts as Example V-5, however, on the date of the sale, the fair market value of the stock is $90. In this case, there is no gain and no loss, since the fair market value on the date of the sale is greater than the fair market value on date of the gift, but less than the adjusted basis was in Donor's hands.

(iii) Scenario 3: Loss Recognized

In Scenario 3, the fair market value of the property on the date of the later sale is below both the adjusted basis and the fair market value on the date of gift. Section 1015(a) requires that for purposes of determining the loss, the donee/seller would use the fair market value on the date of the gift to determine the basis. If this is the case, then the basis in the hands of the donee is not determined "in whole or in part" by the donor's basis. Thus, there is no tacking of the donor's holding period under Section 1223(2); therefore, the holding period would begin to run on the date of the gift.

Example V-7

Same facts as Example V-5, however, on the date of the sale, the fair market value of the stock was $62. In this case, the basis to be used is the fair market value on the date of the gift (i.e., $80). Thus, Donee recognizes a loss of $18 (i.e., the difference between $80 and $62). Since the basis used by Donee is not determined "in whole or in part" by reference to Donor's basis, Donor's holding period is

not tacked and Donee's holding period starts on the date of the gift. In this case, the loss would be a short-term capital loss, since Donee has only held the stock for seven months (i.e., from March 1, 2018 to October 1, 2018).

(2) Exception – Given Property Included in the Donor's Gross Estate

Where gifted property is later included in the donor's estate, the holding period would be determined as if the property was inherited at death. See, discussion below titled, "Inherited Property – Deemed Holding Period".

c) Part Gift – Part Sale

Situations arise where a transaction is considered partially a gift and partially a sale (i.e., the "part gift-part sale transaction"). For instance, when a donor 'sells' property to a donee at price that is below the asset's fair market value, where the donee takes property subject to a debt, or where the donor makes a gift, and the donee agrees to pay the gift tax associated with the gift (i.e., the net gift concept) .

For income tax purposes, the transaction is deemed to be two separate transactions: (1) a sale for the amount of the proceeds received (relative to the entire fair market value) of the property given up; and (2) a gift for the balance. For example, if Donor bought a widget for $50 many years ago, and later 'sells' it to Donee (Donor' son) for $80, when the widget's true fair market value is $100, then there is a sale of 80% (i.e., $80 / $100) of the asset, and a gift of 20% (i.e., {100% - 80%} or {[$100 – $80] ÷ $100}) of the asset. In this example, since the basis is bifurcated, for sales purposes, the basis is $40 (i.e., 80% of $50) and for gift purposes, the basis is $10 (i.e., 20% of $50).

In part gift-part sale transactions, the holding period of the entire basis of the property will be tacked under the theory that the language "in whole or in part" under Section 1223(2) would apply. See, *Citizens Nat'l Bank of Waco v. United States*, 417 F.2d 675 (5th Cir. 1969)

d) Inherited Property – Deemed Holding Period

(1) Long-Term

The general rule is that all inherited property (from a decedent) that is sold or exchanged receives long-term gain or loss treatment. The reason for this is that even if the property is sold within a year of death, IRC §§ 1223(9) and (10) provide that such sold property will

have been deemed to have been held for more than one year (thus achieving long-term capital gain or loss treatment).

In the event that property was gifted by the decedent during life and is included in the decedent's estate, the rules under Section 1223(9) and (10) would apply, instead of Section 1223(2).

It should be noted that Section 1223(9) and (10) provide that the person who disposes of the property must have "acquired property from a decedent or to whom property passed from a decedent (within the meaning of 1014(b))." Thus, if a beneficiary gifts property received from an estate to the beneficiary's child, for example, the beneficiary's child does not get the automatic long-term gain treatment, rather such child's holding period begins at the decedent's date of death.

Example V-8

> On January 1, 2018, P dies leaving his entire estate to his son, S. The estate distributed all of P's assets to S on February 1, 2018. On February 2, 2018, S sells some of the assets that S received and recognizes a gain. S also gives some of the assets to his daughter, D. On February 3, 2018, D sells the gifted assets and recognizes a gain. S's gain would be characterized as a long-term gain under Section 1223(9), however, D's gain will not be afforded the long-term treatment under § 1223(9), rather it will be a short-term gain, because D did not "acquire property from a decedent."

(2) Holding Period and the Section 1022 Election

In the case of decedents who died after December 31, 2009, and before January 1, 2011, where Section 1022 applied, the automatic "more than one year" deemed holding period rule under Section 1223(9) would not apply. Instead the holding period under Section 1223(2), which is generally applies to gifts would apply. This position is supported by Section 1022(a) which provides that to the extent that § 1022 applies, then the property is treated as "transferred by gift."

If the Section 1022 election is made and the basis is increased, the decedent's holding period would become the beneficiary's holding period. Rev. Proc. 2011-41, 2011-35 IRB 188, Sec. 0.06(1).

Interestingly, Rev. Proc. 2011-41 provides that to the extent that the recipient's basis is acquired from the decedent under Section 1022, that the recipient's holding period of that property shall "include the period during with the decedent held the property, whether or not

the executor allocates any basis increase to that property." Thus, the revenue procedure appears to apply to basis increases.

Interestingly, the revenue procedure did not address the situation where the basis is required to be decreased as a result of basis limitation rule under Section 1022(a)(2)(B). Thus, if the basis is to be decreased as a result of Section 1022(a)(2)(B), it is unclear whether the holding period would tack the decedent's holding period, or whether it begins at the decedent's date of death. Fortunately, this will be a very limited issue related to very few estates. And, it would only apply for assets sold within a year of the decedent's death.

C. Holding Period for Marketable Securities

For marketable securities transactions, when purchasing the security, whether equity (e.g., stocks) or debt (e.g., bonds), the "trade date" or "contract date" starts and ends the holding period. Thus, since the acquisition date is disregarded, when acquiring the security, the taxpayer's holding period begins on the date after the purchase order is fully executed. Rev. Rul. 70-598; Rev. Rul. 70-344, 1970-2 CB 50.

VI. KEY BASIS CONCEPTS: UNIFORM BASIS RULES

A. Generally

Property acquired from a donor or decedent has a single or uniform basis, even if multiple persons acquire an interest the property. The uniform basis of the property remains fixed 'subject to the usual adjustments under IRC §§ 1016 and 1017 for capital additions and subtractions). Reg. §§ 1.1014-1(b), 1.1015-1(b). The point of the uniform basis rules is that the basis of the property is unaffected by the identity of the persons who own interests in it; whether the life tenant is old or young has no effect on the property's basis. The regulations generally cross-reference the rules on recognition of gain under Section 1001(f).

B. Passage of Time

The value of the parts of the uniform basis represented by the respective interests of the life tenant and remainderman or other proportionate owners are adjustable to reflect the change in the relative values of such interest on account of the lapse of time. Reg. §§ 1.1001–1(f)(2), 1.1014–4(b), 1.1015-1(b). For example, the portion of the basis attributable to a remainder interest increases as the life tenants age or as a term-for-years becomes shorter. Conversely, portions of the basis attributable to a term interest tend to shrink as time passes. Both of these adjustments, however, may be offset by changes in the prevailing interest rates, since higher interest rates under Section 7520 generally increase the value of the term interest, while lower interest rates tend to increase the value of the remainder interest. The uniform basis in the property itself, however, remains constant.

C. Actuarial Calculations

1. Generally

The regulations use the actuarial factors contained in Reg. § 20.2031-7(d)(7) to determine the basis of the life interest, remainder interest, or term certain interests in property on the date such interest is sold, exchanged, or otherwise disposed of. Presumably, with respect to current gifts, the correct actuarial tables are those contained in Reg. § 25.7520-1. See Reg. §§ 1.1001–1(f)(3), 1.1014–5(a)(3), 1.1015-1(b).

Example VI-1

Securities worth $1 million and having a $500,000 adjusted basis are given by Donor to an irrevocable non-grantor trust for the lifetime benefit of Wife, remainder to Son. Wife is 48 years of age when she receives the life interest. The Section 7520 rate on the date of the gift is 2.2%. Under the IRS actuarial tables, Wife's life estate is worth 48.042% of the value of the securities, or $480,420. Son's remainder interest is worth 51.958% of the value of the securities, or $519,580. Wife's share of the uniform basis on the date

of the gift is $240,210 (48.420% x $500,000 uniform basis). Son's share of the uniform basis on the date of the gift is $259,790 (51.958% x $500,000).

Example VI-2

Assume the same facts as in Example VI-1, except that Wife retains the life interest for 12 years, until she is 60 years of age. The Section 7520 rate has increased to 3.2%, and the securities have increased in value to $3 million. The value of Wife's life estate is then $1,402,410 and the value of Son's remainder interest is then $1,597,590. Wife's share of the uniform basis on the 12th anniversary of the gift is 46.747% ($1,402,410 / $3 million), or $233,735 (46.747% x $500,000 basis). Son's share of the uniform basis on that date is 53.253%, or $266,265.

2. Property Received from a Decedent

The actuarial shares of the uniform basis in property received from a decedent is based on the value of the interests on the date of death, rather than the date of distribution or when the particular interest vests or becomes possessory. Reg. § 1.1014–4(a)(2).

Example VI-3

Securities worth $1 million on the date of Decedent's death are left in trust for lifetime benefit of Wife, remainder to Son. Wife is 48 years of age when Decedent dies, but she is 50 years of age when the estate is settled and she receives the benefit of her life interest. The Section 7520 rate on the date of death is 2.2%. Under the IRS actuarial tables, Wife's life estate is worth 48.042% of the value of the securities, or $480,420, based on the figures applicable on the date of death. This also represents her share of the trust's uniform basis in the securities. Son's remainder interest is worth 51.958% of the value of the securities, or $519,580 which also represents his share of the trust's uniform basis.

Example VI-4

Assume the same facts as in Example VI-3, except that Wife retains the life interest for 10 years after receiving it (12 years after the date of death), when she is 60 years of age. The Section 7520 rate has increased to 3.2%, and the securities have increased in value to $3 million. The value of Wife's life estate is then $1,402,410 and the value of Son's remainder interest is then $1,597,590. Wife's share of the uniform basis at that time is 46.747% ($1,402,410 / $3 million), or $467,470 (46.747% x $1 million basis). Son's share of the uniform basis on that date is 53.253%, or $532,530.

3. Property Sold to a Beneficiary

The uniform basis rules do not apply when a trust or estate sells property to a beneficiary. The beneficiary's basis in such property is determined under the usual basis rules applicable between unrelated persons. Reg. § 1.1014–4(a)(3).

Example VI-5

Trustee of Testamentary Trust transfers to Beneficiary, in satisfaction of a $100,000 specific bequest, securities worth $90,000 on the date of death and $100,000 on the date of distribution. Trustee realizes a $10,000 taxable gain and the basis of the securities in the hands of Beneficiary would be $100,000. Reg. § 1.1014–4(a)(3).

Example VI-6

Executor transfers to a trust property worth $2 million, which had a fair market value of $1.75 million for estate tax purposes, in satisfaction of the decedent's bequest in trust for the benefit of Wife of cash or securities to be selected by the executor in an amount sufficient to utilize the marital deduction to the maximum extent authorized by law (after taking into consideration any other property qualifying for the marital deduction). The estate realizes a $250,000 gain and the basis of the property in the hands of the trustees would be $2 million.

Had this bequest been a fractional share of the residuary estate, rather than a pecuniary amount, no gain would be realized by the estate upon transfer of property to the trust, and the basis of the property in the hands of the trustee would be its estate tax value.

D. Sale of Term Interests

1. Generally

Perhaps the oddest feature of the uniform basis rule is that gain or loss from the sale or other disposition (after October 9, 1969), of a term interest (a life interest or term-for-years in property or an income interest in trust) that was acquired by gift 'so that the adjusted basis is determined under Section 1015 or Section 1041) or at death 'so that the adjusted basis is determined under Section 1014), is determined by disregarding entirely that part of the adjusted uniform basis assignable to the term interest. IRC § 1001(e); Reg. §§ 1.1001–1(f)(1), 1.1014-5(b), 1.1015-1(b).

Example VI-7

Securities worth $500,000 are given by Donor to a trust to pay income to Wife for life, remainder to Son. Wife is 48 years of age when the life interest is acquired. The Section 7520 rate on the date of the gift is 2.2%. Under the IRS actuarial tables, Wife's income interest is worth 48.042% of the value of the underlying securities, or $480,420. Son's remainder interest is

worth 51.958% of the value of the securities, or $519,580. Wife's share of the uniform basis on the date of the gift is $240,210 (48.420% x $500,000 uniform basis). Son's share of the uniform basis on the date of the gift is $259,790 (51.958% x $500,000). Wife sells her income interest to Nephew for $480,420 one week after the gift, when Wife is still 48 years of age and the Section 7520 rate is still 2.2%. Wife recognizes $480,420 of gain on the sale, because none of her share of the uniform basis is allocated to the sale.

Example VI-8

Assume the same facts as in Example VI-7, except that Wife retains the income interest for 12 years, until she is 60 years of age. The Section 7520 rate has then increased to 3.2%, and the securities have increased in value to $3 million. The value of Wife's income interest is then $1,402,410 or 46.747% of the trust fund. The value of Son's remainder interest is then $1,597,590, or 53.253% of the value of the trust fund. On that date, Wife sells her remaining income interest to Grandson for $1 million. Wife's share of the uniform basis on the 12th anniversary of the gift is 46.747%, or $233,735. Wife recognizes a $1 million gain, rather than a $233,735 loss, on this sale, because her basis is ignored for purposes of calculating the gain or loss.

Example VI-9

Securities worth $1 million are left in trust to pay income to Wife for life, remainder to Son. Wife is 48 years of age on the date of death and the Section 7520 rate is 2.2%. Under the IRS actuarial tables, Wife's income interest is worth 48.042% of the value of the underlying securities, or $480,420, which is also Wife's share of the uniform basis. Son's remainder interest is worth 51.958% of the value of the securities, or $519,580, which is also his share of the uniform basis. Wife sells her income interest to Nephew for $480,420 one week after the date of death, when Wife is still 48 years of age and the Section 7520 rate is still 2.2%. Wife recognizes $480,420 of gain on the sale, because none of her share of the uniform basis is allocated to the sale.

Example VI-10

Assume the same facts as in Example VI-9, except that Wife retains the income interest for 12 years, until she is 60 years of age. The Section 7520 rate has then increased to 3.2%, and the securities have increased in value to $3 million. The value of Wife's income interest is then $1,402,410 or 46.747% of the trust fund. The value of Son's remainder interest is then $1,597,590, or 53.253% of the value of the trust fund. On that date, Wife sells her remaining income interest to Grandson for $1 million. Wife's share of the uniform basis on the 12th anniversary of the date of death is 46.747%

of $1 million, or $467,470. Wife recognizes a $1 million gain on this sale, because her basis is ignored for purposes of calculating the gain or loss.

2. Remainder Interests

This rule does not apply to the sale of a remainder interest, regardless of how it was acquired; such a sale is subject to the usual gain recognition rules for the sale of other assets, and the remainder owner's share of the uniform basis is applied against the consideration received to determine the amount realized.

3. Unitrust Interests

The IRS construes the term "life interest" to include more than a pure life estate or lifetime income interest. It also includes, for example, a unitrust interest in a net income charitable remainder trust. See PLRs 200833012 (net income charitable remainder unitrust), 200827009 (net income charitable remainder unitrust), 200733014 (net income charitable remainder unitrust). Logically, this same analysis would extend Section 1001(e) to a lifetime annuity interest, a lifetime unitrust interest, or a lifetime right to discretionary distributions of income, principal, or both.

E. Sale or Disposition of Entire Interest

1. Generally

This rule does not apply to a sale or other disposition that is part of a transaction in which the entire interest in property is transferred to any person or persons. IRC § 1001(e)(3); Reg. §§ 1.1014-6(a)(1), 1.1015-1(b); PLRs 201136011 - 201136016, 201026014 – 201026017.

Example VI-11

Securities worth $1 million and having a $500,000 adjusted basis are given by Donor to a trust to pay income to Wife for life, remainder to Son. Wife is 48 years of age when the life interest is acquired. The Section 7520 rate on the date of the gift is 2.2%. Under the IRS actuarial tables, Wife's income interest is worth 48.042% of the value of the underlying securities, or $480,420. Son's remainder interest is worth 51.958% of the value of the securities, or $519,580. Wife's share of the uniform basis on the date of the gift is $240,210 (48.420% x $500,000 uniform basis). Son's share of the uniform basis on the date of the gift is $259,790 (51.958% x $500,000). Wife and Son sell their interests to Nephew for $1 million, in a single transaction one week after the gift, when Wife is still 48 years of age and the Section 7520 rate is still 2.2%. The sales proceeds are divided equally between Wife and Son. Wife realizes a gain of $259,790 ($500,000 - $240,210 basis) and Son realizes a gain of $200,210 ($500,000 - $259,790) on the sale.

Example VI-12

Securities worth $1 million are left in trust to pay income to Wife for life, remainder to Son. Wife is 48 years of age on the date of death and the Section 7520 rate is 2.2%. Under the IRS actuarial tables, Wife's income interest is worth 48.042% of the value of the underlying securities, or $480,420, which is also Wife's share of the uniform basis. Son's remainder interest is worth 51.958% of the value of the securities, or $519,580, which is also his share of the uniform basis. Twelve years after the date of death, when Wife is 60 years of age, she the securities have increased in value to $3 million and Wife and Son sell their interests in the trust to Grandson for $3 million, dividing the sales proceeds equally between Wife and Son. The Section 7520 rate has then increased to 3.2%. The value of Wife's income interest is then $1,402,410 or 46.747% of the trust fund. The value of Son's remainder interest is then $1,597,590, or 53.253% of the value of the trust fund. Wife's share of the uniform basis on the date of the sale is 46.747% of $1 million, or $467,470. Son's share of the uniform basis is 53.253% of $1 million, or $532,530. Wife realizes a $1,032,430 million gain on this sale ($1.5 million - $467,570), and Son realizes a $967,470 gain on this sale ($1.5 million - $532,530).

2. Commuting Trusts

The IRS deems the commutation of a trust, in which the term interest holders and remainder interest holders receive their respective shares of the underlying assets, as a sale of each beneficiary's interest, to which Section 1001(e) applies. In a commutation, therefore, the term interest holder realizes gain equal to the amount realized, whereas the remainder interest holder realizes gain to the extent that the amount realized exceeds his or her basis in the remainder interest. See, e.g., PLRs 201136016 (noncharitable trust), 201136015 (noncharitable trust), 201136014 (noncharitable trust), 201136013 (noncharitable trust), 201136012 (noncharitable trust), 201026027 (noncharitable trust), 201026026 (noncharitable trust), 201026025 (noncharitable trust), 201026024 (noncharitable trust), 200833012 (net income charitable remainder unitrust), 200827009 (net income charitable remainder unitrust), 200733014 (net income charitable remainder unitrust), 200648017 (noncharitable trust), 200648016 (noncharitable trust), 200443023 (noncharitable trust), 200442020 (noncharitable trust), 200231011 (nonqualifying split-interest charitable remainder trust), 200210018 (noncharitable trust). On the other hand, if the trust is terminated by selling both the term and remainder interests to a third-party, the exception for transfers of the all interests in the trust applies and the selling term interest owner party can apply his or her basis to determine gain.

F. Effect of Sale of Interest on Uniform Basis

The sale of an interest in a trust or partial interest in property has no effect on the uniform basis, whether or not gain is recognized on the sale. Reg. §§ 1.1014-5(b) and 1.1015-1(b).

Example VI-13

Securities worth $1 million are left in trust to pay income to Wife for life, remainder to Son. Wife is 48 years of age on the date of death and the Section 7520 rate is 2.2%. Under the IRS actuarial tables, Wife's income interest is worth 48.042% of the value of the underlying securities, or $480,420, which is also Wife's share of the uniform basis. Son's remainder interest is worth 51.958% of the value of the securities, or $519,580, which is also his share of the uniform basis. Wife sells her income interest to Nephew for $480,420 one week after the date of death, when Wife is still 48 years of age and the Section 7520 rate is still 2.2%. Wife recognizes $480,420 of gain on the sale, because none of her share of the uniform basis is allocated to the sale. The trust's adjusted basis in the property remains $1 million, because the sale of Wife's interest has no effect on the uniform basis. Nephew acquires an income interest per autre vie (during Wife's lifetime), and Nephew's share of the uniform basis is the same as Wife's share would have been had she retained it.

Example VI-14

Assume the same facts as in Example VI-13, except that the property was rental real estate and that, rather than leaving it in trust, Wife was left a legal life estate and Son was left the remainder interest. Again, Wife's life estate is worth 48.042% of the value of the property, or $480,420, which is also Wife's share of the uniform basis. Son's remainder interest is worth 51.958% of the value of the property, or $519,580, which is also his share of the uniform basis. Wife sells her life estate to Nephew for $480,420 one week after the date of death, when Wife is still 48 years of age and the Section 7520 rate is still 2.2%. Wife recognizes $480,420 of gain on the sale, because none of her share of the uniform basis is allocated to the sale. The adjusted basis in the property remains $1 million, because the sale of Wife's life estate has no effect on the uniform basis. Nephew acquires a life estate *per autre vie* (for Wife's lifetime), and his share of the uniform basis is the same as Wife's share would have been had she retained it.

Example VI-15

Assume the same facts as in Example VI-13, except that the property held by the trust is depreciable real property. Wife sells her life estate to Stranger for $600,000 five months after the date of death, when Wife is still 48 years of age and the Section 7520 rate is still 2.2%. Wife recognizes $600,000 of gain on the sale, because none of her share of the uniform basis is allocated to the term interest for this purpose. The uniform adjusted basis in the property remains $1 million, however, notwithstanding the fact that Wife sold her interest for more than her share of the adjusted basis. Stranger acquires an income interest *per autre vie* (for Wife's lifetime). Stranger's share of the uniform basis is $480,420 -- the same as Wife's share would have been had she retained it – despite having paid $600,000 for the income interest. Gain or loss on sale of trust assets by the trustee will be determined without

regard to the sale of Wife's interest in the property. The trust's depreciation deductions with respect to its assets will be made to the uniform basis of the property without regard to Wife's sale. Stranger has only a $480,420 basis in his or her interest for purposes of future sales of his interest, despite having paid $600,000 for it. See Reg. § 1.1014–5(a)(1).

G. Depreciation and the Uniform Basis

1. Generally

The uniform basis is used to calculate depreciation, amortization, or cost depletion of the subject property. Reg. §§ 1.1014-5(b) and 1.1015-1(b).

a) Property in a Trust or Estate

Section 642(e) directs the practitioner to IRC §§ 167(d) (depreciation) and 611(e) (cost depletion) for directions on allocating these deductions between the relative interests of a trust or estate. Section 642(f) also states that certain amortization deductions are allowed to trusts and estates in the same manner as to individuals, but, again, must be apportioned between the fiduciary and the beneficiaries. Cost recovery deductions are allocable to beneficiaries directly, unlike other kinds of deductions that reduce the entity's distributable net income (DNI). See Reg. §§ 1.167(h)-1, 1.611-1(c)(4), and 1.611-1(c)(5). For much, much more on the allocation of depreciation and depletion deductions for trusts, estates and beneficiaries, see R. Danforth, N. Lane, and H. Zaritsky, *Federal Income Taxation of Trusts and Estates*, ¶ 2.06 (Thomson-Reuters/WG&L, 3d ed.).

b) Allocation for Trusts and Beneficiaries

The regulations apportion cost recovery deductions for a trust to the fiduciary and to beneficiaries on the basis of their respective shares of trust income, unless by the terms of the instrument or local law the trustee is required to and does maintain a reserve for depreciation.

(1) Trustee's Share

The trustee is allocated a share of depreciation regardless of whether the trustee is required to maintain a depreciation reserve or does so in his or her discretion. The deduction is first allocated to the trustee, to the extent of the reserve, so that it offsets what would otherwise be accumulated income taxable to the trustee.

(2) Beneficiaries' Share

Any remaining deduction (in excess of the reserve provision) is allocated on the basis of the trust income (less the amount of income

credited to the reserve) allocated to each beneficiary. The beneficiaries' share of the deduction is divided among the beneficiaries in accordance with their respective shares of trust income. Reg. § 1.167(h)-1(b)

Example VI-16

Trust provides that the trustee may distribute or retain net income, in the trustee's discretion, and that in determining the amount of available net income, the trustee may deduct and withhold a reasonable allowance for depreciation, which need not correspond to any allowable tax deduction.

In Year X, Trust generates net rental income, before deducting depreciation, of $80,000. Trust's depreciation allowance is $50,000. The trustee determines that $20,000 should be withheld from distribution to beneficiaries in order to reflect economic depreciation on the property so that the trust net income for fiduciary accounting purposes is $60,000. The trustee makes a distribution of $30,000 to Beneficiary-1 and retains the remaining $30,000 of net income, which it accumulates for future distribution.

The trust is allocated $35,000 of the total deduction ($20,000 reserve plus 50% of ($50,000 / $20,000)). Beneficiary-1 is allocated $15,000 of the total deduction.

Example VI-17

Assume the same facts as in Example VI-16, except that the trustee distributes $40,000 to Beneficiary-1 and $10,000 to Beneficiary-2, and retained only $10,000 of net income, plus the $20,000 provision for depreciation.

The depreciation is allocated as follows: $20,000 to Beneficiary-1, $5,000 to Beneficiary-2, and $25,000 to the trustee. The first $20,000 of the allowance was allocated to the trustee, and of the $30,000 remaining allowance, two thirds was allocated to Beneficiary-1, one sixth to Beneficiary-2, and one sixth to the trustee.

(3) Other Allocations Prohibited

No effect is given to any allocation of depreciation between the fiduciary and the beneficiaries that is inconsistent with these rules. Reg. § 1.167(h)-1(b). See also *Dusek v. Comm'r*, 376 F.2d 410 (10th Cir. 1967), *aff'g* 45 T.C. 355 (1966).

c) Allocation for Estates and Beneficiaries

The cost recovery deduction for an estate is allocated without regard to the provisions of the decedent's will: the deduction strictly follows the allocation of income. IRC § 167(d).

Example VI-18

> Estate owns depreciable property on which the allowance is $40,000 in the current taxable year. During Year X, the estate's net income, before any deduction for depreciation, is $60,000. The personal representative distributes $15,000 (1/4 of the income) to Residuary Beneficiary, which it can deduct and which Residuary Beneficiary must include in gross income. Estate may deduct $30,000 of the depreciation allowance, and Residuary Beneficiary may deduct $10,000.

2. Property Not in Trust

a) Life Estate and Remainder

When property is owned free of trust as a life estate and remainder, the cost recovery deductions are simpler to allocate. Section 167(d) states that:

> *"In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant."*

Section 611(b), dealing with cost depletion of mineral interests, contains similar language. While depreciation and depletion are deductible in full by the life tenant, they are charged against the uniform basis of the entire property, thus reducing the basis of both interests.

b) Term-for-Years and Remainder

Neither Section 167(d) nor 611(b) addresses the treatment of term interests other than life estates, such as terms-for-years. There appear to be no cases or rulings on point. The most logical approach is to treat a term-for-years like a life estate, as is done in Section 1001(e)(2), for purposes of determining gain or loss on the sale of a term interest. Of course, one could also argue that the existence of a specific rule for that limited purpose negates the ability to imply a similar rule for other purposes not covered by Section 1001(e)(2).

H. Transfer of a Remainder Interest at Remainder Owner's Death

1. Remainder Owner's Basis Not Adjusted

No adjustment is made to the uniform basis of property held by a life tenant and remainder beneficiary, when the remainder beneficiary who holds his or her interest in fee, predeceases the life tenant. Reg. § 1.1014–8(a)(1).

2. Basis of Remainder Owner's Heir, Legatee, or Devisee

The basis of the remainder beneficiary's heir, legatee, or devisee is determined by adjusting the portion of the uniform basis assigned to the remainder beneficiary under Section 1014, for the difference between the value of the remainder interest included in the remainder beneficiary's estate, and the basis of the remainder interest immediately prior to the remainder beneficiary's death. Reg. § 1.1014–8(a)(1).

3. Remainder of Distributed Property

The basis of any property distributed to the heir, legatee, or devisee upon termination of a trust or legal life estate or at any other time (unless included in the gross income of the distributee), is determined by adding to (or subtracting from) the adjusted uniform basis of the distributed property the difference between the value of the remainder interest in the property included in the remainder beneficiary's estate, and the basis of the remainder interest in the property immediately prior to the remainder beneficiary's death. Reg. § 1.1014–8(a)(2).

VII. KEY BASIS CONCEPTS: PROVING BASIS

A. Keeping Records

As stated above, donors and donees should preserve and keep accessible a record of the facts necessary to determine the cost of the property and, if pertinent, its fair market value on the date of the gift. Reg. § 1.1015-1(g).

B. Lifetime Gifts – Failure to Keep Records

1. Section 1015(a)

If the donee of a gift does not have the facts necessary to determine the basis in the hand of the donor, Section 1015 puts the burden on the Service to obtain such facts from the donor or anyone who may know the facts. If it becomes impossible to obtain such facts, then the basis shall be the fair market value of such property as of the date or approximate date when the donor acquired the property. IRC § 1015(a); Reg. § 1.1015-1(a)(3).

2. Cases

a) Initial Burden -- IRS Can't Ignore Facts

In *Burnett v. Houston*, 283 U.S. 223 (1931), the Supreme Court, citing to its earlier cases established that, "[t]he burden of proof to establish a deductible loss and the amount of it, clearly, was upon the respondent." The court goes not to state:

> *"We cannot agree that the impossibility of establishing a specific fact, made essential by the statute as a prerequisite to the allowance of a loss, justifies a decision for the taxpayer based upon a consideration only of the remaining factors which the statute contemplates. The definite requirement of section 202 (a) (1) of the act is not thus easily to be put aside. The impossibility of proving a material fact upon which the right to relief depends simply leaves the claimant upon whom the burden rests with an unenforceable claim, a misfortune to be borne by him, as it must be borne in other cases, as the result of a failure of proof."*

Although the statement seems fairly harsh, the Supreme Court went on and found that there was sufficient evidence to establish that there was some evidence of the basis in the loss property. In finding for the taxpayer, the Court set a standard for the IRS in determining basis, stating,

> *"[The Commissioner] was bound to produce the best available evidence of value which the circumstances and nature*

of the transaction permitted. It does not appear that he made any attempt to do so."

b) Close May be Good Enough - *Cohan* Rule

In *Cohan v. Comm'r*, 39 F.2d 540 (2nd Cir. 1030), Judge Learned Hand, on behalf of the Court of Appeals set forth what is sometimes now called the "Cohan Rule," which allows taxpayers and the IRS to approximate the deductible item or basis in the absence of original documents that may otherwise establish absolute proof. See also, *Cinelli v. Comm*'r, 502 F.2d 695 (6th Cir. 1974), where basis of home in Italy was approximated, and *Ternovsky v. Comm'r*, 66 T.C. 695 (1973), where stamp collection value was approximated. In *Cinelli* and *Ternovsky*, the facts seem to show that the taxpayer provided sufficient extrinsic evidence to approximate basis.

In other circumstances, taxpayers have been able to show that there were past transactions and other extrinsic evidence (including expert testimony) that established that there was some basis in the property. *Burr v. Comm'r*, T.C. Memo 1966-112, and *Alameda Realty Corporation*, 42 T.C. 273 (1955).

In other cases, taxpayers have approximated the basis based on facts and circumstances. *Magness v. Comm'r*, T.C. Memo 1965-260, and *Jones v. Comm'r*, 24 T.C. 525 (1955).

c) Service's Obligation

In *Caldwell & Co. v. Comm'r*, 234 F.2d 660 (6th Cir. 1956), *rev'g* 24 T.C. 597 (1955), the Court of Appeals reversed the Tax Court, and agreed with Tax Court Judge Bruce's dissenting opinion. In Caldwell, the taxpayer sold shares of stock that were gifted to him. The taxpayer had no records to support: (1) the basis in the hands of the donor or the identity of the last preceding owner by whom the share were not acquired by gift, and (2) the fair value of the stock that was acquired by the donor, the prior owner or at the time of the gift.

The Tax Court's majority held that since there was no such evidence, that the Service could attribute zero basis to the stock, resulting in taxing the entire proceeds from the sale to the taxpayer as gain. The Appeals Court's opinion said that they disagreed with the Tax Court's majority opinion and wholly agreed with the dissent, stating that they could add nothing to the dissent written by Judge Bruce (joined by two other judges).

The dissenting opinion (which is the Appeals Court opinion) cited to *Burnett v. Houston*, discussed above, stating that it is the taxpayer's burden in the first instance to provide evidence, but once the taxpayer has provided what it has, it is incumbent on the Service to take the evidence and make a finding as to the basis. In situations where the taxpayer cannot determine

the basis, but has relevant information, the burden is not on the taxpayer to prove the amount of basis. The Tax Court's dissenting opinion found 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. See discussion below in the section titled, "Shifting the Burden of Proof – Section 7491".

Caldwell stands for the proposition that if there is some evidence to prove basis, the IRS cannot ignore it, and must make an effort to determine the same.

C. Shifting the Burden of Proof – Section 7491

In general, the burden of proof is generally on the Taxpayer. Tax Court Rule 142(a); *Helvering v. Taylor*, 293 U.S. 507 (1935). If there is a court proceeding and the taxpayer produces credible evidence, complies with the requirement to substantiate the item in question, maintained all records required, and cooperated with reasonable requests by the IRS for witnesses, information, meetings and interviews, the burden will shift from the taxpayer to the IRS. Thus, taxpayers who may not have sufficient direct evidence of the basis, may wish to consider this approach, if they decide to go to court over the matter. See IRC § 7491.

VIII. KEY BASIS CONCEPTS: BASIS OF GIFTS INCLUDED IN THE DONOR'S GROSS ESTATE – A PROBLEM FOR GIFTS WITH STRINGS

A. Gifts in Trust or Split-Interest Gifts Included in the Gross Estate

If gift property is acquired from a decedent prior to his death by multiple persons with different interests, their shares of the basis are determined under the uniform basis rules, regardless of whether they are or are not included in the decedent's gross estate. Reg. § 1.1014-6(b)(1). See discussion in section VI above for a discussion of the uniform basis rules.

B. Property Fully Included in Gross Estate

Where property is acquired from a donor and the donor dies and the entire property is included in the deceased donor's gross estate (i.e., the uniform basis of the property, as well as the basis of each of the several interests). Reg. § 1.1014-6(b)(2).

Example VIII-1

Decedent gives 100 shares of X Corporation common stock to a trust for the benefit of A for life, remainder to B or to B's estate. The basis of the stock on the date of the gift was $100,000. Decedent dies when the stock is worth $200,000. The transfer is includible in Decedent's gross estate, because Decedent retained control over its beneficial enjoyment, which Decedent relinquished two years prior to death. The uniform basis of the property in the hands of the trustee, the life tenant, and the remainder beneficiary, is adjusted to $200,000. Immediately prior to Decedent's death, A's share of the uniform basis of $100,000 was $60,000, and B's share was $40,000. Immediately after Decedent's death, A's share of the uniform basis of $200,000 is increased to $120,000, and B's share is increased to $80,000. Reg. § 1.1014-6(b)(2).

C. Property Partially Included in Gross Estate

1. Generally

Where only part of the property acquired from a donor before his or her death is included in the deceased donor's gross estate, such as where the donor retained a reversion to take effect upon the expiration of a life estate in another, the uniform basis of the entire property is determined by taking into account any basis adjustments under Section 1014(a) resulting from the partial inclusion.

The uniform basis is the adjusted basis of the entire property immediately prior to the decedent's death, adjusted by an amount which bears the same relation to the total appreciation or diminution in value of the entire property (over the adjusted basis of the entire property immediately prior to the decedent's death) as the value

of the property included in the decedent's gross estate bears to the value of the entire property. Reg. § 1.1014-6(b)(3).

Example VIII-2

Decedent creates a trust to pay the income to A for life, remainder to B or B's estate. The trust instrument provides that if Decedent survives A, the income shall be paid to Decedent for life. Decedent predeceases A, and only the present value of the remainder interest is included in Decedent's gross estate. The trust consists of 100 shares of X Corporation common stock with an adjusted basis immediately prior to Decedent's death of $100,000. At the time of Decedent's death, the stock is worth $200,000 and the remainder interest is worth $80,000. The uniform basis of the entire property following Decedent's death is $140,000, computed as follows:

	Uniform basis prior to death	$100,000
+	Increase in uniform basis	40,000[3]
		$140,000

Reg. § 1.1014-6(b)(3)(i).

2. Basis for Cost Recovery Purposes

Where only a portion of the value of property is included in a decedent's gross estate, the basis for computing the depreciation, amortization, or depletion is the uniform basis for property received from a decedent, with several special limitations.

a) Life Estate Excluded from Gross Estate

The cost recovery deductions, where the value of the life interest is not included in the decedent's gross estate, the gross estate inclusion can increase, but not decrease, the uniform basis that existed immediately before death, with proper adjustments as required by Section 1016. Reg. § 1.1014-6(b)(3)(iii)(a).

b) Life Tenant Does Not Share in Some Basis Increases

Any remaining portion of the increase in the amount of cost recovery deductions resulting from any increase in the uniform basis of the property in these situations is not allowed to the life tenant, but rather is allowed to the trustee, to the extent that the trustee both: (a) is required or permitted, by

[3] Determined by the following formula:

$$\frac{\text{Increase in uniform basis (to be determined)}}{\text{\$10,000 (total appreciation)}} = \frac{\text{\$8,000 (value of property included in gross estate}}{\text{\$20,000 (value of entire property}}$$

the governing trust instrument (or under local law), to maintain a reserve for depreciation, amortization, or depletion, and (b) actually maintains such a reserve. If the trustee does maintain such a reserve, the remaining allowance shall be taken into account, under Section 1016 in adjusting the uniform basis of the property in the hands of the trustee and in adjusting the basis of the remainder interest in the hands of the remainder beneficiary, but shall not be taken into account, in determining the basis of the life interest in the hands of the life tenant. Reg. § 1.1014-6(b)(3)(iii)(b). See also Reg. § 1.1014–7 for a complex example of this rule.

3. Cost Recovery Deductions During Before Donor's Death

The uniform basis of property acquired from a decedent before death must be reduced for depreciation, depletion, or other cost recovery deductions allowed in respect of the property during the decedent's lifetime, other than those allowed to the decedent personally. If only part of the value of the property is included in the decedent's gross estate, the basis adjustment for the cost recovery deductions is proportionate, based on the portion of the value of the total property that is includible in the gross estate. Reg. § 1.1014-6(c)(1).

Example VIII -3

Decedent creates a trust to pay the income to A for life, remainder to B or B's estate. The property transferred in trust consists of an apartment building with a basis of $5 million at the time of the gift. Decedent dies two years after the transfer and the gift is included in Decedent's gross estate because Decedent retained a power to alter beneficial enjoyment, which Decedent relinquished two years prior to death. Depreciation on the property was allowed in the amount of $100,000 annually. On the date of death, the value of the property was $5.8 million. The uniform basis of the property in the hands of the trustee, the life tenant, and the remainder beneficiary, immediately after Decedent's death, is $5.6 million ($5.8 million fair market value of the property immediately after Decedent's death, reduced by $200,000, deductions for depreciation allowed prior to Decedent's death). Reg. § 1.1014-6(c)(2), Ex. 1.

Example VIII-4

Decedent creates a trust to pay the income to A for life, remainder to B or B's estate. The trust instrument provides that if Decedent survives A, the income shall be paid to Decedent for life. Decedent predeceases A and the present value of the remainder interest is included in Decedent's gross estate for estate tax purposes.

The property transferred consists of an apartment building with a basis of $1.1 million at the time of the transfer. Following the creation of the trust and during the balance of Decedent's life, deductions for depreciation were

allowed on the property in the amount of $100,000. At the time of Decedent's death the value of the entire property is $1.5 million, and the value of the remainder interest is $1 million. Accordingly, the uniform basis of the property in the hands of the trustee, the life tenant, and the remainder beneficiary is $1,266,666, computed as follows:

Uniform basis prior to decedent's death	$100,000
+ Increase in uniform basis--before Reduction[4]	$ 33,333
	$133,000
- Deductions allowed prior to Decedent's death--taken into account under IRC § 1014(b)(9) [5]	(6,667)
Uniform basis	$126,666

[4] The reduction is determined by the following formula:

$$\frac{\text{Increase in uniform basis to be determined}}{\text{\$50,000 (total appreciation of property since time of transfer)}} = \frac{\text{\$100,000 (value of property included in gross estate)}}{\text{\$150,000 (value of entire property)}} = \$133,333$$

[5] These deductions taken into account are determined by the following formula:

$$\frac{\text{Prior deductions taken into account (to be determined)}}{\text{\$10,000 (total deductions allowed prior to decedent's death)}} = \frac{\text{\$100,000 (value of property included in gross estate)}}{\text{\$150,000 (value of entire property)}}$$

IX. KEY BASIS CONCEPTS: CONSISTENT BASIS RULES

A. Background

1. Generally

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Public Law 114-41, 129 Stat. 443 (the "Surface Transportation Act") adopted new rules to improve the consistency between the adjusted basis of a recipient of property acquired from a decedent and the estate tax values of that property.

2. History

The Administration has included in its budget proposals for fiscal years 2009 – 2016 a suggestion that taxpayers who receive property from a decedent must use the relevant estate tax value as their basis, even if they disagree with the estate tax value selected by the estate. Under the Administration's proposals, a taxpayer who received property from a decedent under conditions in which the basis is determined under Section 1014, would be required to use as his or her basis the value as reported for estate tax purposes 'subject to later adjustments). A taxpayer who receives property by gift would be required to use as his or her basis the donor's basis determined under Section 1015, and as reported for gift tax purposes 'subject to later adjustments). A reporting requirement would be imposed on the executor of the decedent's estate and on the donor of a lifetime gift to provide the necessary information to both the recipient and the IRS.

3. Enactment

The Surface Transportation Act added new IRC §§ 1014(f), 6035, 6662(b)(8), 6662(k), 6724(d)(1)(D), and 6724(d)(2)(II), create and provide for enforcement of two distinct sets of rules.

a) Section 6035

(1) Generally

New Section 6035 requires the executor of a decedent's estate that is required to file a Federal estate tax return must also file a valuation statement (Form 8971) with the IRS and with each person acquiring any interest in property included in the decedent's gross estate 'schedule A).

(2) Statutory Requirements for Form 8971 and Schedule A

(a) Contents

The Code states that the statement must identify the value reported on the decedent's estate tax return for each property

interest and whatever other information the Secretary prescribes. IRC § 6035(a)(1). A similar valuation statement must be filed by a person other than an executor who holds a legal or beneficial interest in property that is included in a decedent's gross estate, as to which the executor lacks sufficient information to prepare a complete return, and who is notified by the IRS that he or she is obligated to file an additional estate tax return. See IRC §§ 6018(b), 6035(a)(2).

(b) Filing Date

These valuation statements must be filed at such time as the Secretary prescribes, but not later than the earlier of: (a) the date 30 days after the date on which the estate tax return was required to be filed (including extensions, if any); and (b) the date 30 days after the estate tax return was actually filed. IRC § 6035(a)(3)(A). Thus, an executor who files an estate tax return early must also file the valuation statements early; an executor who files an estate tax return late must still file the valuation statements within 30 days of the date the estate tax return should have been filed.

(c) Supplemental Statements

A supplemental statement reporting any later adjustment in the value of the property or any other information on these statements, must be filed not later to the date 30 days after the adjustment. IRC § 6035(a)(3)(B).

(d) Regulatory Authority

The Secretary is given broad authority to prescribe such regulations as necessary to carry out these reporting requirements, including adopting rules relating to the application of the valuation reporting requirements to property with regard to which no estate tax return is required to be filed, and situations in which the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property. IRC § 6035(b).

(3) Penalties

The valuation statement that must be filed with the IRS is an "information return" for penalty purposes, and the valuation statement that must be filed with the beneficiaries or other persons receiving property from a decedent is a "payee statement" for penalty purposes. IRC §§ 6724(d)(1)(D) and 6724(d)(2)(II). The penalty for failing to file a complete and timely valuation statement with either the IRS

or a beneficiary is $250 ($100 for returns or statements required before 2016), with a $3 million maximum penalty for all failures during the same calendar year ($1,500,000 for statements required before 2016). If the failure to furnish the required statement is due to intentional disregard, the penalty is $500 ($250 for statements required before 2016) or if greater, 10% of the aggregate amount of the items required to be reported correctly. IRC §§ 6721(e) and 6722(e).

(4) Effective Date

The reporting requirements apply with respect to property with respect to which an estate tax return is filed after July 31, 2015 (the date of the enactment).

b) Section 1014(f)

(1) Generally

The Surface Transportation Act adds Section 1014(f), which states that the income tax basis of any property received from a decedent to which the basis adjustment rules of Section 1014(a) apply, cannot exceed the value of the property for estate tax purposes or, if an estate provides a statement to beneficiaries under new Section 1014(f)(1). 6035(a), the value reflected in that statement. IRC § 1014(f)(1).

(2) Background

(a) Basis Under Section 1014(a)

The income tax basis of property received from a decedent is most often determined under Section 1014(a), which creates a basis equal to the fair market value of the property at the date of the decedent's death or, if properly elected, the alternate valuation date.

(b) Presumptive Value

The value reported on a Federal estate tax return is presumed to be correct for purposes of determining the recipient's basis, but the beneficiary has always been able to establish a different date-of-death (or alternate valuation date) value for the property by his or her own analysis and evidence. See Reg. § 1.1014-3(a) (for purposes of Section 1014, "the value of property as of the date of the decedent's death as appraised for the purpose of the Federal estate tax or the alternate value as appraised for such purpose, whichever is applicable, shall

be deemed to be its fair market value"); Rev. Rul. 54-97, 1954-1 C.B. 113 ("the value of the property as determined for the purpose of the Federal estate tax shall be deemed to be its fair market value at the time of acquisition. Except where the taxpayer is estopped by his previous actions or statements, such value is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence"); TAM 199933001. See also *Hawkinson v. Comm'r*, T.C. Memo. 1972-32 (upholding the validity of Reg. § 1.1014-3(a), but characterizing it as establishing only an evidentiary presumption).

(c) Duty of Consistency

Courts have imposed a duty of consistency where the executor and the beneficiary are the same person or in privity. See *Estate of Letts v. Comm'r*, 109 T.C. 290 (1997) (wife's estate estopped from asserting that trust did not qualify for QTIP treatment); *LeFever v. Comm'r*, 100 F.3d 778 (10th Cir. 1996) (taxpayer was the executor of the decedent's estate); *Cluck v. Comm'r*, 105 T.C. 324 (1995) (estoppel applied because the taxpayer's spouse was executor and the spouses had filed joint tax returns for the years at issue); *Beltzer v. United States*, 495 F.2d 211 (8th Cir. 1974) (taxpayer was co-executor of the decedent's estate); *Hess v. United States*, 537 F.2d 457 (Ct. Cl. 1976), *cert. denied*, 430 U.S. 931 (1977) (testamentary trust whose trustees were executors of the estate). Courts have not estopped beneficiaries from arguing a different value than that reported on the estate tax return where such a close relationship did not exist. *Ford v. United States*, 270 F.2d 17 (Ct. Cl. 1960) (decedent's minor beneficiaries residing outside of the United States were not estopped from arguing a different value because they were not fiduciaries of the decedent's estate and had no knowledge of the decedent's estate tax return); *Shook v. United States*, 713 F.2d 662 (11th Cir. 1983) (estoppel not extended to an estate beneficiary for merely indicating approval of the executor's handling of the estate over which the executor had total control and the beneficiary none).

(3) Scope of New Statutory Rule

Section 1014(f) applies only to property whose inclusion in the decedent's estate "increased the liability for the "[estate tax] (reduced by credits allowable against such tax) on such estate." IRC § 1014(f)(2). The consistent basis rule will not, therefore, apply to estates that are not themselves taxable (after application of the available credits), or to property the transfer of which qualifies for the

estate tax marital or charitable deduction. This appears to reflect the fact that the IRS is placed in an especially difficult position when an estate reduces its estate taxes by using a lower value for an asset, and the recipient of that asset then reduces income taxes by using a higher value. The consistent basis rules will apply only where such a whipsaw could occur.

(4) Basis Determination under New Rule

For purposes of determining the basis of property for this purpose, the basis of property is determined for estate tax purposes if: (i) the value of the property is shown on an estate tax return and not contested by the Secretary before the expiration of the time for assessing a deficiency; (ii) the value of property is not shown on an estate tax return, but is specified by the Secretary and not timely contested by the executor of the estate; or (iii) the value is determined by a court or pursuant to a settlement agreement with the Secretary. IRC § 1014(f)(3).

(5) Broad Regulatory Authority

The Treasury Secretary is given broad authority to issue regulations providing exceptions to the application of the consistent basis rule. IRC § 1014(f)(4). This broad authority will make it difficult for taxpayers to challenge any reasonable approach taken by the Treasury in forthcoming regulations.

(6) Penalties

Section 6662(b)(7) imposes a penalty on a taxpayer who reports a basis that exceeds the basis determined under Section 1014(f). The penalty under Section 6662 is equal to 20% of the portion of the underpayment attributable to the inconsistent basis reporting. See IRC § 6662(a).

(7) Effective Date

The consistent reporting requirement applies with respect to property with respect to which an estate tax return is filed after July 31, 2015.

(8) 2018 Update

The Treasury issued a report highlighting efforts to reduce regulatory burden pursuant to President Trump's mandate under Executive Order 13772, issued February 2017. Pursuant to that mandate, Treasury added to its "burden-reducing guidance" projects the regulations under Code Sections 1014(f) and 6035. Regulatory Reform

Accomplishments under President Trump's Executive Orders, U.S. Department of Treasury, April 24, 2018.

c) Revenue Estimate

The Joint Committee on Taxation estimated that this change in the law will raise $1.542 billion between 2015 and 2025. This is not an insignificant amount of money, but it will be raised at the expense of all estates that are above the applicable exclusion amount, and the reporting requirements, in particular, are likely to prove relatively time-consuming and, therefore, expensive for many executors and the estates they serve.

B. Delayed Filing Date

The Treasury has repeatedly delayed the filing date of the first Form 8971.

1. Notice 2015-57, 2015-36, I.R.B. 294 (Sept. 8, 2015)

Not long after enactment of the Surface Transportation Act, the IRS provided that, despite the legislative requirement that executors and certain other persons to file a notice of the valuation of certain assets with beneficiaries and the IRS within 30-day after the estate tax return due date, effective July 31, 2015, the first such returns need not be filed until February 29, 2016.

The IRS noted that Section 6081(a) allows it to grant a reasonable extension of time for filing any return, declaration, statement, or other document, though except in the case of taxpayers who are abroad, no such extension shall be for more than 6 months. This IRS stated that this delay was needed to allow the Treasury Department and IRS to issue guidance implementing the reporting requirements of Section 6035.

The IRS also stated that executors and other persons required to file or furnish a statement under Section 6035(a)(1) or (a)(2) should not do so until the issuance of forms or further guidance by the Treasury Department and the IRS addressing the requirements of Section 6035, which the IRS and the Treasury expect to issue.

2. Notice 2016-19, 2016-9 I.R.B. 362 (Feb. 29, 2016)

When guidance was not forthcoming promptly, the IRS again extended the filing date until March 31, 2016, for the first returns under Section 6035. The IRS again repeated its cautionary suggestion that persons should not attempt to file these forms until after the IRS has issued guidance.

3. Notice 2016-27, 2016-15 I.R.B. 576 (April 11, 2016)

The IRS again extended the filing date until June 30, 2016, for the first returns under Section 6035. The IRS noted that it had received numerous comments that

executors and other persons "have not had sufficient time to adopt the systemic changes that would enable the filing of an accurate and complete Form 8971 and Schedule A." As indicated above, the Treasury is reconsidering how to revise these regulations in light of the current administration's mandate to make them less burdensome.

4. Temp. Regs. § 1.6035-2T (March 4, 2016)

Temporary regulations issued on March 4, 2016, reiterate that executors or other persons required to file or furnish a Form 8971 or Schedule A before March 31, 2016, need not do so until March 31, 2016.

C. Section 6035 – IRS Guidance (Proposed Regulations)

1. Generally

The proposed regulations confirm that Form 8971, "Information Regarding Beneficiaries Acquiring Property from a Decedent," including a Schedule A 'statement) for each person who has received or will receive property from the estate or by reason of the decedent's death, is the information return to which Section 6035 refers.

2. Who Must File

a) Generally

The proposed regulations confirm what the instructions state, that an executor who is required to file a Federal estate tax return also must file Form 8971 to report the final estate tax value of certain property, the recipient of that property, and other information prescribed by that form and instructions. The executor also is required to furnish a Statement to each beneficiary who has acquired (or will acquire) property from the decedent or by reason of the death of the decedent to report the property the beneficiary has acquired (or will acquire) and the final value of that property. Prop. Reg. § 1.6035-1(a)(1).

b) Surviving Joint Tenants or Other Recipients

The preamble to the proposed regulations states that Section 6018(b) already requires that an executor who cannot make a complete return as to any part of the gross estate, must include on the return a description of that part of the gross estate and the name of every person holding a legal or beneficial interest in it. See Reg. § 20.6018-2. Upon notice from the IRS, any such person, such as a surviving joint tenant or other recipient who has better information than the executor regarding the basis or fair market value of the property received from a decedent, must make an estate tax return. Likewise, Section 6035 requires that a Form 8971 and Schedule A be filed

by any person required to file an estate tax return under Section 6018(b), so these rules extend to joint tenants and other recipients in such cases.

c) "Executor" Defined

(1) Generally

The proposed regulations adopt the estate tax definition of "executor" contained in Section 2203 and expand it to include a person required to file a return under Section 6018(b). This rule applies for both reporting requirements under Section 6035 and the consistent basis requirement under Section 1014(f), discussed below. See Prop. Reg. § 1.1014-10(d).

(2) Section 2203 Examined

(a) Code

Section 2203 states that a decedent's "executor" means (i) the executor or administrator of the decedent's estate as properly appointed by the local court or (ii) if there is no executor or administrator appointed, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent.

(b) Regulations

Reg. § 20.2203-1 states that:

> *"The term "person in actual or constructive possession of any property of the decedent" includes, among others, the decedent's agents and representatives; safe-deposit companies, warehouse companies, and other custodians of property in this country; brokers holding, as collateral, securities belonging to the decedent; and debtors of the decedent in this country."*

(c) Application

It is not uncommon for some or all of a decedent's assets to be held in forms of title that do not require the probate of a will or the appointment of an executor. Where there is no executor or administrator appointed by a state court to oversee the estate administration (because there is no probate estate), a trustee of the decedent's revocable trust, a beneficiary under the decedent's life insurance policy, or a beneficiary

under a decedent's retirement plan will all be deemed "executors" of the decedent's estate for purposes of the modified carryover basis regime election. In such cases, all of these people will be required to file Form 8971 and Schedule A for the assets under their control.

3. Estates for Which No Form 8971 Required

No Form 8971 is required for an estate that is not required to file an estate tax return because it is below the filing threshold of Section 6018. Furthermore, no Form 8971 is required for an estate that files a return solely to make the portability election or a GST tax election or GST exemption allocation, because these returns are not required by Section 6018. The proposed regulations do not explain how this should be reconciled with the statement in the portability regulations that "[a]n estate that elects portability will be considered, for purposes of subtitle B and subtitle F of the Internal Revenue Code (Code), to be required to file a return under section 6018(a)." Reg. § 20.2010-2(a)(1). Subtitle F of the Code covers procedure and administration, and includes Section 6035, prompting some to speculate that the IRS could have extended Section 6035 to returns filed solely to elect portability.

4. Property to be Reported on Form 8971 and Schedule A

a) Generally

The property that must be reported on Form 8971 (and Schedule A) includes all property included in the decedent's gross estate for Federal estate tax purposes, except for four specific classes of assets. Prop. Reg. § 1.6035-1(b)(2).

b) Excepted Assets

The Form 8971 does not include any of the following:

- Cash (other than a coin collection or other coins or bills with numismatic value). Prop. Reg. § 1.6035-1(b)(1)(i).

- Items of income in respect of a decedent (as defined in Section 691). Prop. Reg. § 1.6035-1(b)(1)(ii). This will include, for example, retirement benefits.

- Tangible personal property for which an appraisal is not required under Reg. § 20.2031-6(b). This includes household and personal effects articles that do not have a marked artistic or intrinsic value of a total of more than $3,000. Prop. Reg. § 1.6035-1(b)(1)(iii).

- Assets that are sold, exchanged, or otherwise disposed of (and therefore not distributed to a beneficiary) by the estate in a transaction in

which capital gain or loss is recognized. Prop. Reg. § 1.6035-1(b)(1)(iv).

Example IX-1

D's gross estate includes the contents of D's residence. The executor attaches to the required estate tax return a room-by-room itemization of household and personal effects, as required by the regulations under Section 2031. All articles are named specifically. Each room contains a number of articles, none of which has a value in excess of $100. A value is provided for each named article. Included in the household and personal effects are a painting, a rug, and a clock, each of which has a value in excess of $3,000. The executor obtains an appraisal from a disinterested, competent appraiser of recognized standing and ability, or a disinterested dealer in the class of personal property involved for the painting, rug, and clock, and attaches these appraisals to the estate tax return. The reporting requirements of Section 6035 apply only to the painting, rug, and clock. Prop. Reg. § 1.6035-1(b)(2), Ex. 1.

Example IX-2

D's estate includes shares in C, a publicly traded company. After D's death but before the estate tax return is filed, C is acquired by T, another publicly traded company, for cash and stock of T, in a fully-taxable exchange. The reporting requirements of Section 6035 do not apply to the new shares in T or the cash. Prop. Reg. § 1.6035-1(b)(2), Ex. 2.

c) What is Cash?

The exception for "cash" is particularly confusing, as the Code and regulations are replete with uses of the term "cash," but there are few definitions and they tend to be inconsistent.

It may be noteworthy that the proposed regulations under Section 6035 do not refer to either "cash or cash equivalents" or to "currency."

Regulations under several Code sections adopt various definitions of "cash," generally including coins and currency of the United States, but sometimes also including cashier's checks, traveler's checks, or money orders and other bank drafts. See Temp. Reg. § 1.71-1T, A-5; Reg. § 1.6050I-1(c)(1)(ii)(B); Prop. Reg. § 1.42-18(c)(6)(i).

One may also note that Section 170(f)(17) states that, for purposes of charitable contributions, "No deduction shall be allowed under subsection (a) for any contribution of a cash, check, or other monetary gift unless the donor maintains as a record of such contribution a bank record or a written

communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution." This suggests that "cash" and "check" are both monetary gifts, but that they are not necessarily the same as each other. Prop. Reg. § 1.170A-15(b)(1) also defines a "monetary gift" as including "a transfer of a gift card redeemable for cash, and a payment made by credit card, electronic fund transfer . . , an online payment service, or payroll deduction." This suggests that an electronic fund transfer or credit card payment may not be treated as a cash gift to a charity for purposes of the 60% limitation.

See also, Reg. §15a.453-1(b)(3)(i), involving the installment sales method, states "receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, . . ." This states that a bank certificate of deposit or a treasury note are not cash, at least for some purposes.

No reasonable view of the word "cash" can include items that can have a basis other than their face amount. Similarly, any reasonable definition should include payment by check or credit card. It is less clear, however, whether cash includes, for this purpose, money market funds, bitcoins, traveler's checks, or certificates of deposit.

With respect to foreign currency, the rules are not consistent. Section 643(i)(2)(A) states that "cash" includes "foreign currencies and cash equivalents" for purposes of the taxation of certain loans from foreign trusts. Section 6050l(d) (relating to returns filed by a business that receives a payment of more than $10,000 in cash) states that cash includes foreign currency and checks drawn on foreign currency. Reg. § 1.446-3T(g)(4)(C)(1), dealing with notional principal contracts, states that cash includes "U.S. dollars or cash in any currency in which payment obligations under the notional principal contract are denominated." These limited definitions suggest that foreign currency and checks drawn on foreign currency are not necessarily "cash," and that Congress and the IRS know how to state that, in a particular context, cash specifically includes various foreign currencies and checks payable in foreign currency.

Section 6867(d) (dealing with certain persons found in possession of more than $10,000 of cash), states that cash includes a cash equivalent, and defines "cash equivalent" as including foreign currency and any bearer obligation. Again, context is important, this limited definition suggests that cash does not normally include foreign currency or bearer obligations, or other "cash equivalents."

d) IRD that Has a Basis?

The exception for items of income in respect of a decedent leaves unclear the treatment of items of IRD that have a basis, such as promissory notes or

retirement benefits to which the decedent had contributed. One could reasonably either view those items as IRD exempt from the reporting requirement, or as a combination of exempt IRD and an asset that requires reporting. Either approach is arguably correct, though the safer approach is for a practitioner to err in favor of reporting, rather than not reporting. There are penalties for not reporting the estate tax value of an asset that should have been reported; there are no penalties for reporting the estate tax value of an asset that did not need to be reported.

e) "Pick and Choose" Clauses

One could also argue that an executor who has a "pick and choose" power and can satisfy a bequest with any asset, should report to each beneficiary the value of all assets other than these excluded assets that could be used to satisfy the bequest. This clearly would not be true if the cash legacy included a statement that "This gift shall, in all events, be satisfied only in cash and may not be satisfied by distributions of property other than cash."

This analysis is more complicated than it at first appears. An estate or trust must recognize all realized gain or loss on the distribution of property in satisfaction of a cash legacy. Reg. § 1.661(a)–2(f)(1); *Kenan v. Comm'r*, 114 F.2d 217 (2d Cir.1940), *aff'g* 40 B.T.A. 824 (1939); and *Suisman v. Eaton*, 15 F. Supp. 113 (D. Conn. 1935), *aff'd per curiam*, 83 F.2d 1019 (2d Cir.1936). The distribution of property in satisfaction of a pecuniary bequest should be a disposition "in a transaction in which capital gain or loss is recognized." The proposed regulations do not state when the distribution must occur. Therefore, the best analysis is that the executor can reasonably determine that a cash legacy will either be satisfied in cash or satisfied by a disposition in a transaction in which capital gain or loss is recognized.

One should also recognize that the reference in the proposed regulations to a transaction in which capital gain or loss is recognized includes a transaction in which no gain or loss is recognized because the value of the asset is the same as its basis. The phrase "transaction in which gain or loss is recognized" is used throughout the Code and regulations, and it defines a class of transactions in which a carryover basis is not allowed and gain or loss is not deferred.

An executor who really does not want to file Form 8971 and Schedule A could consider selling the estate assets (other than cash, IRD, and limited amounts of tangible personal property), before the estate tax return is filed. This would leave only assets exempt from reporting on the Form 8971. That seems a bit of an extreme solution, but it is available and the executor who anticipates selling some assets may choose to do so earlier, rather than later, in order to avoid listing them on Form 8971.

f) Where Selecting the Funding is Unknown

Few estates can be distributed completely within 30 days after filing a federal estate tax return, and often the executor will not know the exact distribution of the estate's property by the filing date of the Form 8971. This occurs when, for example, there are multiple residuary beneficiaries. The proposed regulations, like the Instructions, state that such an executor must report on the Schedule A for each beneficiary all of the property that could be used to satisfy that beneficiary's interest. Prop. Reg. § 1.6035-1(c)(3). This means that there will usually be duplicate reporting of assets on multiple Schedules.

Note, however, that no supplemental Form 8971 is required when the assets are finally chosen for distribution, as long as the selected assets were already reported on Form 8971 and Schedule or, presumably, are excludible assets ‘such as assets acquired after the date of death). The executor can, but is not required to, file such a supplemental Form 8971 and Schedule A. Prop. Reg. § 1.6035-1(c)(3) (last sentence).

g) Beneficiaries Entitled to Receive Schedule A

(1) Generally

The proposed regulations state that each beneficiary (including a beneficiary who is also an executor) who receives property that is required to be reported on the Form 8971 must receive a copy of the Schedule A reporting the property distributable to him or her. Prop. Reg. § 1.6035-1(c)(1).

(2) Entities as Beneficiaries

As indicated in the instructions to Form 8971, where a trust, estate, or business entity is a beneficiary, rather than an individual, the executor must send Schedule A to the trustee, executor, or to the business entity itself, and not to the beneficiaries of the trust or estate or to the owners of the business entity. Prop. Reg. § 1.6035-1(c)(2).

(3) The Revocable Trust

If a decedent has a fully funded revocable trust, there would not usually be an executor and the trustee would be the "executor" for this purpose. The trustee would then file the Form 8971 and Schedule A with respect to all distributions from the trust to its beneficiaries.

If a revocable trust holds some, but not all, of the decedent’s assets and an executor is appointed, the executor must file Form 8971 and Schedule A with respect distributions from the trust of those assets already held by the trust on the date of death. The trust is not a

beneficiary of the estate, because it receives no distribution from the estate, so it seems inappropriate to view the trustee as the beneficiary.

The executor should, however, report assets poured-over to the trustee as a distribution to the trustee, without regard to the ultimate distributees of the trust. Neither the executor nor the trustee appears to have an obligation to file another Form 8971 or Schedule A with respect to re-distribution of the assets received by the trust from the estate. Note that a different rule is adopted, as discussed below, with respect to the supplemental Form 8971 and Schedule A that is required to be filed in certain situations, but the express adoption of a separate rule only in this limited situation supports the notion that no similar rule applies for filing the initial Form 8971 and Schedule A. See Prop. Reg. 1.6035-1(e)(4)(ii). Perhaps the final regulations will address this odd result, but at present, this appears to be the applicable rule.

(4) Trusts Created by Others

The executor must also file a Form 8971 and Schedule A with respect to assets held in trusts created by others, but included in the decedent's gross estate, such as a QTIP or power of appointment trust created for the decedent's benefit. The executor is treated, for this purpose, as possessing the trust assets, and so it appears that it should report to the trust's beneficiaries as if they were beneficiaries of the decedent's estate. An executor cannot obtain information from the trustee with which to do the report must notify the IRS of this fact. The IRS will then require that the trustee file both an estate tax return, reporting those assets, and Form 8971.

(5) Section 645 Election

It is unclear whether an election under Section 645 to treat the revocable trust and the estate as a single entity for income tax purposes would alter this result.

(6) Life Tenants, Remainder Owners, Contingent Beneficiaries

The beneficiary of a life estate for purposes of Section 6035 is the life tenant; the beneficiary of a remainder interest is the remainder beneficiary (identified as if the life tenant were to die immediately after the decedent); and the beneficiary of a contingent interest is a beneficiary, unless the contingency has occurred prior to the filing of Form 8971. The executor must file a supplemental Form 8971 and Schedule A if the contingency subsequently negates the beneficiary's inheritance. Prop. Reg. § 1.6035-1(c)(1).

The rule on contingent interests is problematic for several reasons. First, it means that the executor should give Schedule A to every person who could be a beneficiary under the contingency, which could be a substantial number of persons. Second, a contingency can negate a beneficiary's inheritance at any point during the lifetime of the measuring lives (and subject to any applicable rule against perpetuities). This seems to impose on the executor a continuing obligation to file another Form 8971 and Schedule A years or decades after the estate is otherwise closed, if a contingency has caused the beneficiary's interest to terminate. One can only hope that this will be clarified in the final regulations.

(7) Missing Beneficiaries

(a) Duty of Due Diligence

An executor must use reasonable due diligence to identify and locate all beneficiaries, but an executor who is unable to locate a beneficiary by the due date of Form 8971 is required to report this fact on that form and explain the efforts the executor has taken to locate the beneficiary and to satisfy the obligation of reasonable due diligence. Prop. Reg. § 1.6035-1(c)(4).

(b) The Late-Discovered Beneficiary

An executor who later locates the beneficiary must furnish the beneficiary with a Schedule A and file a supplemental Form 8971 with the IRS within 30 days of locating the beneficiary. *Id.*

(c) The Undiscovered Beneficiary

An executor who cannot locate a beneficiary and ultimately distributes the estate property to someone else who was not identified in the Form 8971 as the recipient of that property, must file a supplemental Form 8971 with the IRS and furnish the successor beneficiary with a Schedule A within 30 days after distributing the property. *Id.*

h) Due Date

(1) Generally

An executor must file Form 8971 with the IRS, and furnish each beneficiary with that beneficiary's Schedule A, on or before the earlier of the date that is 30 days after the due date of the Federal estate tax return (including any extensions actually granted), or the date

that is 30 days after the date on which that return is filed with the IRS. Prop. Reg. § 1.6035-1(d)(1).

Thus, even if the estate tax return is not timely filed, the executor must still file the Form 8971 within 30 days after the date on which the estate tax return was due or face additional penalties. If the estate tax return is filed early, the due date for the Form 8971 is advanced to 30 days after the actual filing date.

(2) Estate Tax Returns Due Before August 1, 2015

The due date for the Form 8971 and Schedule A with respect to a Federal estate tax return that was due on or before July 31, 2015, but that was actually filed after July 31, 2015, is 30 days after the date on which the return is filed. Prop. Reg. § 1.6035-1(d)(1). Otherwise, the due date for the Form 8971 and Schedule A could be earlier than the actual effective date of Section 6035.

5. Supplemental Form 8971 and Schedule A

a) Mandatory Supplemental Form and Schedule

(1) Generally

A supplemental Form 8971 and Schedule A is required whenever there is a change to the information required to be reported that causes the reported information to be incorrect or incomplete. Prop. Reg. §§ 1.6035-1(e)(1) and 1.6035-1(e)(2). Such changes include, for example, the discovery of property that should have been, but was not, reported on the Federal estate tax return, a change in the value of property pursuant to an examination or litigation, or a change in the identity of the beneficiary to whom the property is to be distributed (for example, pursuant to a death or disclaimer).

(2) Due Date of Mandatory Supplemental Return

(a) Generally

A mandatory supplemental Form 8971 and Schedule A must be filed not later than 30 days after (i) the date on which the final value is determined; (ii) the date on which the executor discovers that information on the Form 8971 or Schedule A was incorrect or incomplete; or (iii) the date on which a supplemental estate tax return is filed reporting property not previously reported on the estate tax return. Prop. Reg. § 1.6035-1(e)(4).

(b) Event Occurs Before Distribution

If an event that determines the date for filing a supplemental Form 8971 and Schedule A occurs after the date of death but before or on the date the property is distributed to the beneficiary from the decedent's estate or revocable trust, the due date for the supplemental Form 8971 and Schedule A is not later than 30 days after the date the property is distributed to the beneficiary.

b) Optional Supplemental Form and Schedule

(1) Details of the Actual Distribution

An executor may, but is not required to, file Form 8971 or Schedule A to specify the actual distribution of assets from among a group of assets that were listed on a prior Form 8971 and Schedule A. Prop. Reg. § 1.6035-1(e)(3).

Example IX-3

D's Will provided for D's residuary estate to be distributed to D's three children (E, F, and G). D's residuary estate includes stock in X Co., a publicly traded company, D's personal residence, and three paintings. On the due date of the Form 8971 and Schedule A, D's executor had not yet determined which property each child would receive from D's residuary estate in satisfaction of that child's bequest. In accordance with Prop. Reg. § 1.6035-1(e)(3), D's executor reported on Form 8971 and on each child's own Schedule A that each child might receive an interest in the stock in X Co., the personal residence, and the three paintings. Several months later, the executor determined that E would receive the stock in X Co., F would receive the residence, and G would receive the paintings. No child will receive any assets not already reported on his or her Schedule A, so the executor may, but is not required to, file a supplemental Form 8971 and Schedule A to report accurately which beneficiary received what property. Prop. Reg. § 1.6035-1(e)(3)(ii), Ex. 1.

Example IX-4

D's Will leaves D's jewelry and household effects to be distributed among D's three children (E, F, and G) as determined by the children. D's executor reports on Form 8971 and on each child's own Schedule A each item of personal property (other than items with an aggregate value of under

$3,000). Several months later, the children agree who is to receive each item of personal property. The executor may, but is not required to, file a supplemental Form 8971 and Schedule A to report accurately which beneficiary received which items of personal property. Prop. Reg. § 1.6035-1(e)(3)(ii), Ex. 2.

(2) Inconsequential Error

An executor may, but need not, file Form 8971 or Schedule A to correct an inconsequential error or omission. *Id*. An "inconsequential error or omission" means any failure that cannot reasonably be expected to prevent or hinder the payee from timely receiving correct information and reporting it on his or her return or from otherwise putting the statement to its intended use. Reg. § 301.6722-1(b)(1). Errors or omissions relating to the following are never inconsequential (i) a dollar amount; (ii) the significant items in the address of a payee, which is the address provided by the payee to the filer; and (iii) the appropriate form for the information provided (i.e., whether or not the form is an acceptable substitute for an official form of the IRS). *Id.*

c) Due Date for Supplemental Form

Supplemental Form 8971 and Schedule A are due 30 days after: (i) the final value of property is determined; (ii) the executor discovers that the information reported on the Information Return or Statement is otherwise incorrect or incomplete; or (iii) a supplemental Federal estate tax return is filed. Prop. Reg. § 1.6035-1(e)(4). If these occur before the distribution to the beneficiary of probate or revocable trust property, a supplemental Form 8971 or Schedule A is not due until 30 days after the property is distributed.

This is likely to be approximately the same time when the executor would provide the beneficiary with information as to changes, if any, to the basis of the property that have occurred since the decedent's death and prior to the distribution. That basis adjustment information is not part of what is required to be reported under Section 6035, so if the executor chooses to provide that basis adjustment information on the Schedule A provided to the beneficiary, the basis adjustment information must be shown separately from the final value required to be reported on the beneficiary's Schedule A.

6. Subsequent Transfers

a) Generally

The Treasury states that Section 6035 reporting is intended to enable the IRS to monitor whether the basis claimed by an owner of the property is

properly based on the final value of that property for estate tax purposes, so Treasury and IRS are attempting to eliminate some opportunities to circumvent the statute. The proposed regulations require that when a recipient of previously reported property (including unreported property that was required to be reported), distributes or transfers (by gift or otherwise, directly or indirectly) all or any portion of that property to a "related transferee" in a transaction in which the transferee's basis is determined in whole or in part with reference to the transferor's basis, the transferor must file with the IRS and furnish the IRS and the transferee a supplemental Schedule A documenting the new ownership of this property. Prop. Reg. § 1.6035-1(f).

This creates a chain letter effect, under which a beneficiary who disposes of an asset to a related transferee, other than by sale for full and adequate consideration, will need to file another Schedule A with both the IRS and the transferee, as if he or she were an executor. The practitioner should note this in the cover letter to the beneficiaries accompanying the Schedule A.

There is no time limit on the retransfer rules. The retransfer of property received from a decedent to a related transferee could occur decades after the original transfer, and still require the original transferee to file a Schedule A.

It is also unclear whether a subsequent retransfer by the first re-transferee requires yet another Schedule A. Unless the final regulations clarify this point, it is best to assume that all retransfers to related parties with a carryover basis, in whole or in part, no matter how long after the original distribution from the decedent's estate or trust, must be reported on a new Schedule A filed with the transferee and the IRS.

b) "Related Transferee" Defined

The retransfer rules apply only to transfers to a "related transferee." A "related transferee" means (a) a member of the transferor's family (as defined in Section 2704(c)(2)); (b) a controlled corporation or other entity in which the transferor and members of the transferor's family, whether directly or indirectly, have control (as defined in Section 2701(b)(2)(A) or (B)); and (c) any trust of which the transferor is a deemed owner for income tax purposes. Prop. Reg. § 1.6035-1(f).

c) Covered Retransfers

The related transferee rule applies both to transfers to a related transferee and distributions or transfers of property the basis of which is determined, in whole or in part, by reference to the basis of property that was reported on Form 8971. *Id*. Thus, for example, a transfer of property to a grantor trust requires a supplemental Form 8971 and Schedule A, and so should a distribution from such a trust to a family member of the original transferee.

d) "Member of the Transferor's Family" Defined

Section 2704(c)(2) states that a "member of the family" of an individual means (i) such individual's spouse, (ii) any ancestor or lineal descendant of such individual or such individual's spouse, (iii) any brother or sister of the individual, and (iv) any spouse of any individual described in items (ii) or (iii). Prop. Reg. § 1.6035-1(f).

e) "Controlled" Entity Defined

Section 2701(b)(2) states that a corporation or other entity in which the transferor and members of the transferor's family, directly or indirectly, have control is a controlled entity, if the transferor and members of his or her family have (i) in the case of a corporation, at least 50% (by vote or value) of the stock of the corporation; or (ii) in the case of a partnership, at least 50% of the capital or profits interests in the partnership, or in the case of a limited partnership, the holding of any interest as a general partner.

(1) Voting Rights

Equity interests that carry no right to vote other than on liquidation, merger, or a similar event are not considered to have voting rights for purposes of corporate control. Generally, a voting right is considered held by an individual to the extent that the individual, either alone or in conjunction with any other person, is entitled to exercise (or direct the exercise of) the right. Voting rights held in a fiduciary capacity are not considered held by the fiduciary, but rather held by each beneficial owner of the interest and by each individual who is a permissible recipient of the income from the interest. A voting right does not include a right to vote that is subject to a contingency that has not occurred, other than a contingency that is within the control of the individual holding the right. Regs. § 25.2701-2(b)(5)(ii)(B).

(2) Guaranteed Payments

With respect to partnership control, any right to a guaranteed payment under Section 707(c) of a fixed amount is disregarded in making this determination. Regs. § 25.2701-2(b)(5)(iii).

f) Retransfers and Trusts

A trust will only be deemed a related transferee if it is a grantor trust deemed owned by the grantor for income tax purposes. Prop. Reg. § 1.6035-1(f). The regulations do not limit this to irrevocable grantor trusts, so that a transferee who retransfers property to a revocable trust would be required to file a new Schedule A, even though the trustee of that trust is not required to

make such filings when it distributes the trust assets to the ultimate beneficiaries. This seems an unnecessary burden that could be alleviated in the final regulations.

It is strange that the proposed regulations do not require that a supplemental Schedule A be filed to report a gift to a trust that is not a grantor trust, even if the trust is solely for members of the transferor's family. Such a trust is not, under the proposed regulations, a "related transferee." This is particularly odd, because the preamble to the proposed regulations states that this rule is an attempt to address "opportunities [that] may exist in some circumstances for the recipient of such reporting to circumvent the purpose of the statute (for example, by making a gift of the property to a complex trust for the benefit of the transferor's family)." The regulations, however, do not appear to treat such transfers as a further transfer requiring a Schedule A, unless the trust is a grantor trust.

The regulations do not state what to do where property received from a decedent is then transferred to a trust that is not a grantor trust, but that later becomes a grantor trust. Arguably, the transferee (grantor) should file Schedule A when the trust becomes a grantor trust, but the regulations do not actually say this. In some ways, it would have been more logical for the regulations to state that any transfer to a trust for family members required another Schedule A, unless the trust was a grantor trust, because for income tax purposes a grantor trust is not a separate taxpayer from the grantor. This deserves clarification in the final regulations, but it is difficult to guess what that clarification might be. One possibility is that the regulations could just remove the grantor trust reference and require a new Schedule A to report a retransfer to any trust that has family members as beneficiaries, whether or not it is a grantor trust.

It is also not clear whether a distribution to a trust a trustee of which is a member of the transferor's family will be treated as a distribution to a related transferee. Certainly, the trust is the beneficiary for purposes of Section 6035 reporting, but the proposed regulations on the consistent basis rule state that a trust is a related transferee only if it is a grantor trust. Thus, the best interpretation, pending further clarification, appears to be that the relationship between the transferor and the trustee of a transferee trust should be irrelevant.

7. Subsequent Transfers Before Final Value Determined

If a retransfer to a related person occurs before the final value of the property is determined (see discussion of Prop. Reg. § 1.1014-10(c), below), the transferor must provide the executor with a copy of the supplemental Schedule A reporting the new ownership of the property. When a final value is determined, the executor will then provide a supplemental Schedule A to the new transferee instead of to the transferor. The supplemental Schedule A is due no later than 30 days after the

transferor distributes or transfers all or a portion of the property to the transferee. Prop. Reg. § 1.6035-1(f).

The proposed regulations do not, however, explain how the retransfer rule might apply where a decedent transfers property to a trust in which someone is given a limited power of appointment. The exercise of that limited power of appointment in favor of a related transferee appears to be a retransfer under these rules, but it is unclear whether the new Schedule A must be filed by the trustee or the holder of the power of appointment.

The proposed regulations also do not expressly state whether a testamentary transfer by a transferee is a retransfer for this purpose, but it should not be, for two reasons. First, the transferee's death would produce a new basis, so the Schedule A reporting the original transferor's estate tax value would be misleading and rather useless to the retransferee. Second, this would create a conflict with the statutory rule that a Schedule A should only be filed for estates that are required to file an estate tax return.

D. Consistent Basis Rule of Section 1014(f) – IRS Guidance (Proposed Regulations)

1. Generally

As noted above, Section 1014(f)(1) states that the basis of certain property acquired from a decedent cannot exceed that property's final value as determined for Federal estate tax purposes. This is the consistent basis rule. Prop. Reg. § 1.1014-10(a)(1).

This sets a highest basis – it does not set a floor on basis. A lower basis may exist with respect to property received from a decedent the basis of which is not determined with reference to the value of the property for estate tax purposes, such as items of IRD, assets transferred to the decedent within one year of the date of death and which are left back to the transferor, or stock of a domestic international sales corporation. *See*, IRC §§ 1014(c) (IRD), 1014(d) (stock of a DISC), 1014(e) (appreciated property acquired by decedent by gift within one year of death).

2. Effective Date

Starting with the date on which the final regulations are published, the regulations will apply to property acquired from a decedent by reason of the death of the decedent whose estate tax return was required to be filed after July 31, 2015. "Persons may rely upon these rules before the date of publication of the Treasury Decision adopting these rules as final in the Federal Register." Prop. Reg. § 1.1014-10(f).

3. "Final Value" Defined

a) Generally

The taxpayer's initial basis in property acquired from a decedent may not exceed the "final value" of the property. Prop. Reg. § 1.1014-10(a)(1). The "final value" of property received from a decedent is, in order of priority: (i) the value reported on the federal estate tax return, once the statute of limitations on assessment of deficiencies has expired without that value having been timely adjusted or contested by the IRS; (ii) otherwise, the value determined or specified by the IRS once the statute of limitations for assessment and for claim for refund or credit of estate tax have expired without that value having been timely contested; (iii) if neither of these rules apply, the value determined in an agreement, once that agreement is final and binding on all parties; or (iv) if none of these rules apply, the value determined by a court, once the court's determination is final. Prop. Reg. § 1.1014-10(c)(1).

The preamble explains that the IRS may specify a value for property by determining a value in the course of an audit, and if it determines a value different from the value reported, the final value is that value determined by the IRS, once that value can no longer be contested by the estate. If the value determined or specified by the IRS is timely contested by the estate, the final value is the value determined in an agreement that is binding on all parties, or the value determined by a court once the court's determination is final.

Example IX-5

At D's death, D owned 50% of Partnership P, which owned a rental building with a fair market value of $10 million subject to nonrecourse debt of $2 million. D's sole beneficiary is C, D's child. P is valued at $8 million. D's interest in P is reported on a federal estate tax return at $4 million. The IRS accepts the return as filed and the time for assessing estate tax deficiencies expires. C sells the interest for $6 million shortly thereafter. The final value of D's interest is $4 million under the consistent basis rule. Under Section 742 and the regulations thereunder, C's basis in the partnership interest at the time of its sale is $5 million (the final value of D's interest ($4 million) plus 50% of the $2 million nonrecourse debt). Following the sale, C reports taxable gain of $1 million. C has complied with the consistent basis rule. However, had the IRS adjusted the value of the partnership interest from $4 million to $4.5 million, and had the estate not contested that adjustment before expiration of the statute of limitations on assessment, the final value of D's partnership interest would have been $4.5 million, requiring that C claim a $5.5 million basis at the time of sale and that C report gain on the sale of $500,000. Prop. Reg. § 1.1014-10(e), Ex. 1.

Example IX-6

At D's death, D's gross estate includes a residence valued at $300,000 encumbered by nonrecourse debt in the amount of $100,000. Title to the residence is held jointly by D and C (D's child) with right of survivorship. D provided all the consideration for the residence and the entire value of the residence was included in D's gross estate under Section 2040. D's executor reports the value of the residence as $200,000 on the estate tax return for D's estate and claims no other deduction for the debt. Schedule A reports the value of the residence as $300,000. C sells the residence before the final value is determined for $375,000 and claims a gain of $75,000 on C's Federal income tax return. A court subsequently determines that the value of the residence was $290,000 and the time for contesting this value in any court expires before the expiration of the statute of limitations for assessing C's income tax for the year in which the property was sold. The final value of the residence is $290,000 and, because C claimed a basis in the residence that exceeds the final value, C may have a deficiency and underpayment. Prop. Reg. § 1.1014-10(e), Ex. 4.

b) Only Initial Basis Determined by Consistent Basis Rule

(1) Generally

Section 1014(f) applies only to determine the taxpayer's initial basis in property received from a decedent. That basis may thereafter be adjusted for depreciation, depletion, capital improvements, sales and other events that otherwise affect basis. Prop. Reg. § 1.1014-10(a)(2).

(2) Decedent's Debt Amortization

Post mortem payments on debts of the decedent do not affect basis. *Id.*

Example IX-7

At D's death, D owned (among other assets) a private residence that was not encumbered. D's sole beneficiary is C, D's child. D's executor reports the value of the residence on the estate tax return at $600,000 and pays the estate tax liability. The IRS timely contests the reported value and determines that the value of the residence is $725,000. The parties enter into a settlement agreement that provides that the value of the residence for estate tax purposes is $650,000. The final value of the residence is $650,000. Several years later, C adds a master suite to the residence at a cost of

$45,000, and under Section 1016(a), C's basis in the residence is increased by $45,000 to $695,000. Subsequently, C sells the residence to an unrelated third party for $900,000. C claims a basis in the residence of $695,000 and reports a gain of $205,000 ($900,000 - $695,000). C has complied with the consistent basis requirement. Prop. Reg. § 1.1014-10(e), Ex. 2.

c) Basis Pending Determination of Final Value

The proposed regulations also state that, if no final value has been determined when the taxpayer's basis in the property becomes relevant (such as to calculate depreciation or gain or loss on the sale, exchange or disposition of the property), the taxpayer must use the value reported on the Form 8971 (the fair market value reported on the Federal estate tax return) to determine the taxpayer's basis for Federal tax purposes. If the final value is determined before the statute of limitations on assessment expires for any Federal income tax return of the recipient on which the basis is relevant, and the final value differs from the initial basis claimed with respect to that return, a deficiency and an underpayment may result. Prop. Reg. § 1.1014-10(c)(2).

4. Property to which the Consistent Basis Rule Applies

a) Generally

The consistent basis rule applies only to property the inclusion of which in the decedent's gross estate for Federal estate tax purposes increases the estate's actual Federal estate tax liability. Prop. Reg. § 1.1014-10(b)(1).

b) Covered Property

(1) Includible in Federal Gross Estate

Property is covered by Section 1014(f) if it is includible in the decedent's gross estate under Section 2031 or the taxable estate of a nonresident alien individual under Section 2106, if that inclusion generates a Federal estate tax liability in excess of allowable credits. Prop. Reg. § 1.1014-10(b)(1).

The only issue is the inclusion of the property in the gross estate for Federal estate tax purposes. The fact that there may be state, local, or even foreign estate taxes imposed is immaterial.

Note also that the regulations refer to property "that is includable in the decedent's gross estate under Section 2031, any property subject to tax under section 2106. . . ." The reference to Section 2031 is odd for several reasons. First, Section 2031, despite its title, is a valuation provision, rather than an inclusion provision. It directs that the

value of property that is included in the gross estate shall be its fair market value on the date of death, except as otherwise provided. It does not actually state that any particular property is includible in the gross estate. That is covered by IRC §§ 2033 – 2044. Section 1014(f) merely refers to property includible in the gross estate, so one should not try and read too much into the reference to Section 2031.

(2) Transferred Basis Property

Property is also covered by Section 1014(f) if it has a basis determined, in whole or in part, by reference to the basis of property that was includible in the decedent's gross estate and that generated a Federal estate tax liability. Prop. Reg. § 1.1014-10(b)(1). Thus, for example, property obtained in a tax-free exchange for property to which Section 1014(f) applies also takes a mandatory basis under that subsection.

c) Excluded Property

(1) Deductible Property

The proposed regulations exclude property that qualifies for a charitable or marital deduction under IRC §§ 2055, 2056, or 2056A, because this property does not increase the Federal estate tax liability. Prop. Reg. § 1.1014-10(b)(2).

(2) Modest Amounts of Tangible Personal Property

The proposed regulations also exclude from the consistent basis rule any tangible personal property for which an appraisal is not required under Reg. § 20.2031-6(b) (under $3,000 aggregate value of personal effects). It appears that the language issued by Treasury was to exempt lower-valued items of tangible personal property. However, the language was not quite exact, thus, some confusion exists as to what items of tangible personal property is exempt. See, generally, ABA Section of Real Property Trust & Estate Law letter to Treasury dated June 23, 2016, addressing the issues in the Proposed Regulations 1.1014-10 and 1.6035-1.

(3) Property Under the Available Credits

The proposed regulations also exclude from the consistent basis rule property reported on an estate tax return if no estate tax was imposed upon the estate due to allowable credits (other than a credit for a prepayment of that tax). Prop. Reg. § 1.1014-10(b)(2). Thus, an

estate that generates no estate tax because of the unified credit, modest amounts of tangible personal property, and deductible bequests, is not subject to consistent basis rule. Prop. Reg. § 1.1014-10(b)(3).

Of course, such an estate is still required to file Form 8971 and Schedule A.

d) After-Discovered or Omitted Property (and the Dreaded "Zero Basis Rule")

(1) Generally

The basis of property that is discovered after the filing of the Federal estate tax return or is otherwise omitted from that return, which had it been reported would have generated a Federal estate tax liability, takes a different basis under the consistent basis rule, depending upon whether the statute of limitations on the estate tax return has expired.

For an excellent discussion of the problems with the zero basis rule, including its possible invalidity, see Bramwell & Tucci, *Treasury's Proposed Zero Basis Rule: Will It Survive?,* 159 TAX NOTES 683 *(April 30, 2018).*

(2) Property Reported within the Statute of Limitations on Assessing Estate Tax Deficiency

Where an estate tax return is filed, after-discovered or omitted property that is reported on a supplemental estate tax return filed before the expiration of the statute of limitation on assessment of deficiencies, takes an initial basis determined under the regular consistent basis rule. Prop. Reg. § 1.1014-10(c)(3)(i)(A).

(3) Property Not Reported within the Statute of Limitations

Where an estate tax return is filed, after-discovered or omitted property that is not reported on a supplemental estate tax return filed before the expiration of the statute of limitation on assessment of deficiencies, takes a final value and initial basis of zero. Prop. Reg. § 1.1014-10(c)(3)(i)(B).

(4) No Estate Tax Return Filed

Where an estate tax return should be filed but none has been filed, the basis of all property includible in the gross estate subject to the consistent basis requirement is zero, until the final value is determined, if it ever is determined. Prop. Reg. § 1.1014-10(c)(3)(ii).

Example IX-8

At D's death, D owned various assets. D's sole beneficiary is C, D's child. D's executor reports the value of the assets on the estate tax return and pays the estate tax liability. After the expiration of the statute of limitations for assessing an estate tax deficiency, D's executor discovers property that had not been reported on the estate tax return, but which, if reported, would have generated additional estate tax on the entire value of the newly discovered property. For income tax purposes, C's basis in the additional unreported property is zero. Had an estate tax return been required to be filed before discovering the additional property (and none in fact was filed) but, after the application of the applicable credit amount, D's taxable estate including the unreported property would have been $200,000, the final value of all property included in D's gross estate (other than excluded property) would be zero, until the executor files an estate tax return with the IRS pursuant or the IRS determines a value for the property. In either of those events, the final value of property reported on the return is determined in accordance with the usual consistent basis rules. Prop. Reg. § 1.1014-10(e), Ex. 3.

(5) Problems with After-Discovered or Omitted Property

The rules on after-discovered or omitted property raise several points of note.

(a) After-Discovered Cash

If the statute of limitations has expired or no return was filed, how does one treat after-discovered or omitted cash that has a zero basis? Since cash always is supposed to take a basis equal to its face value, it is possible that the receipt of the cash would be taxed as ordinary income under the tax benefit rule. On the tax benefit rule generally, see Bierman & Severin, *Effect of Deduction Phase-Out on Tax Benefit Rule*, 80 J. Tax'n 181 (Mar. 1994); Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. Rev. 265 (1978); Goldman, *Tax Benefit Rule Affects Trusts and their Beneficiaries*, 75 Pract. Tax Strat. 293 (Nov. 2005); Yin, *Supreme Court's Tax Benefit Rule Decision: Unanswered Questions Invite Future Litigation*, 59 J. Tax'n 130 (1983).

(b) No Obligation to File a Supplemental Estate Tax Return

There appears to be no legal requirement that a supplemental estate tax return be filed to report after-discovered property. See discussion in Pratt & Karibjanian, *Filing a Supplemental Estate Tax Return After Probate Litigation*, 36 Est. Plan. 17 (Sept. 2009) (noting, in part, that the Supreme Court referred to an amended estate tax return as not required by statute and "a creature of administrative origin and grace." *Badaracco v. Comm'r*, 464 US 386, at 393 (1984)); see also CCM 1998-024. Thus, Treasury is arguably penalizing executors for not filing a return that they do are not otherwise required to file. Executors may, however, want to consider the relative merit of filing a supplemental estate tax return and incurring an estate tax of 40% on the after-discovered assets, in exchange for a higher adjusted basis. In most cases, the tax cost of the lost basis will be less than 40%, but the additional estate taxes may be charged generally against the residue, while the tax savings from the higher basis will accrue only to the beneficiary who receives the after-discovered property.

(c) Estates Near the Filing Threshold

The zero-basis rule poses a particular problem for executors of estates that are very near in value to the threshold amount for filing an estate tax return. If the assets are all marketable and there is no chance of an estate tax return being required, the executor need not file a return, but if there are assets whose value may be disputed, not filing a return could expose the beneficiaries to having a zero basis for all of the inherited assets. It may be better in such cases to file a return and report the values at below the filing threshold. That should avoid the zero-basis risk.

5. Penalties

Section 6662(b)(8) imposes an accuracy-related penalty on the portion of any underpayment of tax required to be shown on a return that is attributable to an inconsistent estate basis, which Section 6662(k) defines as arising if the basis of property claimed on a return exceeds its final value as determined under Section 1014(f). The proposed regulations clarify that this relates to the initial basis and that basis adjustments as a result of post mortem events, such as capital improvements or depreciation, will not result in accuracy-related penalties. Prop. Reg. §§ 1.1014-10(a)(2) and 1.6662-8(b).

E. Form 8971 and Instructions

1. Overview

On January 29, 2016, the IRS issued Form 8971, (Information Regarding Beneficiaries Acquiring Property from a Decedent), and the accompanying instructions, which must be used to provide this information to the IRS and the beneficiaries of a decedent's estate.

a) Short

Form 8971 is a relatively short form (one page, plus a two page Schedule A. The real issue is Schedule A, which must be prepared for and provided to each beneficiary receiving property from an estate.

b) Caveat

Both the form and the instructions very specifically caution executors not to provide the entire Form 8971 to any beneficiary, in order to protect the identities and personal information of the other beneficiaries. Rather, the executor must provide Form 8971 and a copy of Schedule's) A to the IRS and provide each beneficiary with only the Schedule A for that particular beneficiary.

2. Form 8971, Part I

Part I of Form 8971 provides the basic information to identify the estate and the executor, including the decedent's name, date-of-death, and Social Security Number, and the executor's name, address, telephone number, and taxpayer identification number (TIN).

a) Multiple Executors

If there are multiple executors, the information in Part I is provided for the executor who signs the form, but that executor must attach a statement with the names, addresses, telephone numbers, and TINs of the additional executors.

b) Change of Address

Form 8822, (Change of Address) should be filed to report a change of the executor's address. See instructions, page 3, columns 1 and 2.

c) Alternate Valuation Date

Part 1 also requires a notification whether the estate elected alternate valuation, and, if so, the alternate valuation date.

3. Form 8971, Part II

a) Generally

Part II of Form 8971 requires a statement of the number of beneficiaries who have received or are expected to receive property from the estate, and each beneficiary's name, TIN, address, and the date the Schedule A is given to the beneficiary.

The form asks "How many beneficiaries received (or are expected to receive) property from the estate?" It does not ask "how many Schedule A's are required to be filed with the Form 8971." The number entered on Part II regarding the number of beneficiaries who are to receive estate assets will often be substantially higher than the number of Schedule A's, because it will include beneficiaries who receive cash, items of IRD, minor amounts of tangible personal property, and assets acquired by the estate after the date of death. It seems likely that the IRS intended to ask for the number of beneficiaries who are going to receive Schedule A, but as they did not, you should answer the question that they do ask and accept that there will be a mis-matching of the number entered and the number of Schedules A. You may, however, wish to explain in the cover letter accompanying Form 8971 why these two figures are different.

b) Trusts, Estates, Etc. as Beneficiaries

The instructions explain that a beneficiary, for this purpose, can be an "individual, trust, or other estate who has acquired (or is expected to acquire) property from the estate." Instructions, page 3, column 2. Clearly, therefore, testamentary transfers to a trust require only a single Schedule A to the trustee, rather than separate Schedules A to each beneficiary. This is logical, as the fiduciary of the distributee trust or estate will be the most likely person to report a gain or loss on the disposition of the asset.

4. Form 8971 Filing, Generally

a) Executors Who Are Also Beneficiaries

There is no special exception for executors who are also beneficiaries of the estate. The instructions state that an executor who is also a beneficiary and who has acquired (or is expected to acquire) property from the estate, must provide himself or herself a Schedule A and be included in the list of beneficiaries under Form 8971. Instructions page 3, column 2.

b) TINs Count

The IRS is adamant about obtaining the TIN for a beneficiary. The Instructions state that "[e]ntering 'none,' 'unknown,' or similar language, or oth-

erwise failing to enter a TIN, will cause the form to be considered incomplete and may subject the estate to penalties." Instructions, page 3, columns 2 and 3.

c) Power of Attorney

As with estate tax returns, the IRS will discuss an estate's Form 8971 only with the executor of the estate, and not with the return preparer, unless a complete Form 2848, (Power of Attorney and Declaration of Representative) has been provided to the IRS.

d) Preparers

Anyone who is paid to prepare the Form 8971 and/or any Schedule A must sign the form as a paid preparer and give a copy of the completed Form 8971 and/or Schedules A to the executor required to file the estate tax return or Form 706-A. "The preparer may, however, sign the return by rubber stamp, mechanical device, or computer software program." Instructions, page 3, column 3.

e) Responsible Persons

All executors shown on Form 8971 or listed on an attached statement are responsible for the reporting requirements under Section 6035, though only one signs the form. The return, like other returns, is signed under penalties of perjury and all executors are responsible for the information included on Form 8971 and Schedules A filed with the IRS or provided to beneficiaries. All executors are also liable for all applicable penalties for failure to file. Instructions, page 3, column 3.

5. Who Must File

a) Persons Responsible for 706, 706-NA, or 706-A

The instructions explain that an executor or any other person required to file a federal estate tax return (Form 706 or 706-NA) under Sections 6018(a) and 6018(b) or a qualified heir required to file Form 706-A under Section 2032A, must file Form 8971 and the Schedules A. Anyone required to file Form 8971 must also provide each beneficiary listed on the form with that beneficiary's Schedule A.

b) Portability-Only and GST Allocation Returns

The instructions state that the Form 8971 need not be filed by an executor who is not required to file an estate tax return because the gross estate plus adjusted taxable gifts is less than the basic exclusion amount, but the estate tax return "is filed solely to make an allocation or election respecting the

generation-skipping transfer tax ... [or] to elect portability of the deceased spousal exclusion amount (DSUE)." Instructions, Page 1, column 2.

6. Effective Date

Form 8971 is required only if the return is filed after July 2015, but it does not matter whether the return was actually required to be filed before that date. An executor filing an estate tax return after July 31, 2015 that was actually required to be filed before August 1, 2015 must file Form 8971 and Schedule(s) A.

7. When to File

a) Generally

The instructions state that the Form 8971 and the Schedules A must be filed not later than the earlier of (a) 30 days after the date on which the estate tax return (or Form 706-A) is required to be filed, or (b) 30 days after such a return actually is filed.

b) Extensions

The filing deadlines in the instruction reflect those set by Section 6035, and there is no provision in the statute for extensions of that date. It appears unlikely that extensions will be permitted, even under Reg. § 301.9100-3. Nothing in the form or instructions mentions obtaining an extension of the time to file this return and Schedules.

8. File Form 8971 Separately from the Estate Tax Return

a) Generally

Form 8971 is a separate filing requirement from the estate tax return (or Form 706-A), and the IRS cautions that it should never be attached to the estate tax return (or Form 706-A). It must be filed separately. Instructions, page 1, column 2.

b) What Happens if You File Them Together

The IRS does not state that it will treat a Form 8971 that is filed with the estate tax return as not having been filed for penalty purposes -- only that one should not do this. Some additional clarity on this issue would be helpful, though it seems unlikely that the IRS will treat as filed a Form 8971 that is actually filed with an estate tax return. Practitioners, therefore, should adopt the practice of filing Form 8971 in a separate envelope, though they may file it at the same time as the related estate tax return (or Form 706-A).

9. Where to File

File Form 8971 (including all Schedules A) must, for all estates, be filed with Department of the Treasury, Internal Revenue Service Center Mail Stop #824G, Cincinnati, OH 45999. Other than adding a mail stop, this is the same address at which estate tax returns (and Form 706-A) are required to be filed. Additionally, unlike the Form 706 or Form 706-A, where the IRS provides a separate address for a private delivery source (e.g., Fed Ex or UPS), there is no separate address for private delivery of the Form 8971 (and Schedules A), the instructions merely say to go to the IRS website and find the address, which would be the same address as one uses for filing an estate tax return (i.e., 201 W. River Center Boulevard, Covington, KY 41011, Attn: Submission Processing, Stop 31).

10. Schedule A

Section 6035(a)(2) requires that Schedule A be provided to "each other person who holds a legal or beneficial interest in the property to which such return [estate tax return or Form 706-A] relates."

a) How to Provide

The instructions state that Schedule A can be provided to the beneficiary or the fiduciaries of a beneficiary trust or estate: (a) in person; (b) by email; (c) by U.S. mail to the beneficiary's last known address; or (d) by an approved private delivery service to the beneficiary's last known address (the approved private delivery services are listed in the Instructions). Instructions, page 1, column 3.

b) Certification

The executor (or other person required to file) must certify on Form 8971, Part II, Column D, the date on which Schedule A was provided to each beneficiary, and the instructions suggest that the executor should retain proof of mailing, proof of delivery, acknowledgment of receipt, or other information relevant for the estate's records. Instructions, page 1, column 3. They also state that a private delivery service can tell you how to get written proof of the mailing date. Instructions, page 2, column 1.

c) Trust or Estate with Multiple Fiduciaries

Where a trust or estate is a beneficiary and has multiple fiduciaries, the instructions state expressly that "providing Schedule A to one trustee or executor is enough to meet the requirement." Instructions, page 3, column 2.

d) Contents

A beneficiary's Schedule A must list all property acquired (or expected to be acquired) by the beneficiary. An executor who has not determined which

beneficiary is to receive a particular item of property by the Form 8971 due date must list on the beneficiary's Schedule A all items of property that could be used to fund the beneficiary's distribution. The same property can, and often will, therefore, be reflected on more than one Schedule A. Instructions, page 4, column 1.

e) Schedule A, Part 1

Part 1 of Schedule A includes the basic identifying information, including the decedent's name and Social Security Number, the beneficiary's name and TIN, and the executor's name, address and telephone number.

f) Schedule A, Part 2

(1) Columns A and B – List of Assets

Part 2 of Schedule A lists the items passing to the beneficiary. Part 2 requires that each item be numbered (column A) and described (column B).

(a) Consistency

The instructions state that the description of property acquired from the decedent should be the same as that reported on the estate tax return or Form 706-A, and should include the schedule and item number where reported on the estate tax return or Form 706-A.

(b) Partial Interests

If a beneficiary acquired (or is expected to acquire) a joint interest, a fractional interest, or any other interest in property which is less than 100%, the executor should indicate the interest that the beneficiary will acquire. Instructions, page 4, column 1.

(2) Column C -- Assets Increasing Estate Tax Liability

The executor states on Column C whether the asset increased the estate tax liability. This is a "yes or no" question. There is no requirement that the executor explain why the asset did or did not increase the estate tax liability, or the amount of any such increase. Section 1014(f)(2) states that this rule applies to property the inclusion of which in the decedent's estate actually increased the decedent's estate tax liability. It would not be relevant to a nontaxable estate or to property qualifying for the charitable or marital deduction. Any property that qualifies for the estate tax marital deduction

or the estate tax charitable deduction should be reported as not having increased the estate tax. Instructions, page 4, column 2.

(3) Column D -- Valuation Date

The executor includes in Column D the valuation date, which will be either the date-of-death or the alternate valuation date.

(4) Column D – Estate Tax Return Value

Column E provides the estate tax return value of the asset or assets listed.

11. Thoughts on the Form and Instructions

a) You May Not Really be a Winner

One criticism of the new Schedule A is an annoying notice at the bottom of the Schedule A, which begins "You have received this schedule to inform you of the value of property you received from the estate of the decedent named above." It seems highly unlikely that the person receiving Schedule A will, in fact, have received any property from the decedent's estate by the time they receive Schedule A. In most taxable estates, no significant distributions will be made until the estate tax liability has been settled between the estate and the IRS. One cannot even request a closing letter until four (4) months after the return has been filed, so distributions will be delayed and the declaration in the Schedule A will almost always be false.

Another error in the form is the statement in Schedule A, Part II, that the value reported on Schedule A is the "estate tax return value." There are situations in which the estate tax return may show a different value from that which should be reported on Form 8971, such as where there is non-recourse debt that affects the estate tax value of the property but that does not encumber the property received by the decedent. See Prop. Reg. § 1.1014-10(e), Ex. 4. The title to this column is likely to be confusing, and should be addressed in the cover letter accompanying Schedule A.

The executor will need to address this issue in the cover letter sent with the Schedule A, explaining that the Schedule A shows the estate tax value of property that the beneficiary may or may not actually receive, and that while this value may be relevant in determining basis, it may not actually reflect the basis of the property in the hands of the beneficiary. The beneficiary should be urged to consult a personal tax advisor to determine the beneficiary's actual adjusted basis, since in most jurisdictions the attorney and accountant for the fiduciary do not actually represent the beneficiaries.

b) Over-Reporting Will Be the Norm

The requirement that the executor list all items of property that could be used to satisfy the beneficiary's gift will, in many cases, mean that every residuary beneficiary must receive a list of all estate assets that have not been specifically bequeathed or devised. This both requires that the fiduciary prepare a number of relatively long Forms 8971 and Schedules As, and also that this mass of data will most often be incorrect. Most estates sell or buy some assets during estate administration, whether for investment purposes or to raise money for estate expenses and taxes. Such purchases and sales will alter the accuracy of the beneficiary's Schedule A. The date for providing Schedule A to the beneficiaries is set by statute, so it is not clear how else the IRS could have handled this issue. A technical correction in the statute to require that the Schedule A be provided within 30 days of the date on which the assets are actually distributed would make far more sense and, one hopes, will be added by the next Congress to its already-impressive "to-do list."

c) Caution: This Is Not Your Real Basis

Note also that no attempt is made to inform the beneficiary of his or her actual basis in the asset. The basis of depreciable or depletable assets of the decedent could be well below the asset's estate tax value but Form 8971 and Schedule A only requires that the estate tax value be reported.

d) Why Stop at Just One

The requirement that a supplemental Form 8971 and Schedules A be filed whenever there is an adjustment to the information that was reported means that all fiduciaries should expect to file several forms and Schedules during the administration of a taxable estate. Every time an asset reported on Form 8971 or a Schedule A is sold or other assets are bought, a supplemental Form 8971 and Schedule A should probably be filed.

X. BASIS PLANNING: BASIS AND PORTABILITY – PERHAPS THE MOST IMPORTANT QUESTION IN MARITAL DEDUCTION PLANNING

A. Generally

Portability is probably the single biggest change in planning for the married couple since the passage of the unlimited marital deduction in 1981. Much has been written about portability since its inception[6] and there will be much more to come in the future. In light of this game changing evolution in marital planning, some question the efficacy of the traditional by-pass trust. For those, however, who choose to use the by-pass or credit shelter (which we call a "non-marital") trust, with the increased basic exclusion amounts, it may be worth considering how to possibly include part or all of the by-pass trust's assets into the survivor's gross estate to accomplish a step-up at death.

B. Factors Favoring Portability Type Plans

There is no single factor that favors portability; there are a number of factors. From a pure mathematical and tax perspective, however, we found that use of the traditional non-marital trust planning, is less beneficial than using a qualified terminal interest property (QTIP) trust, combined with subsequent giving to a grantor trust after the first spouse dies. See, Law and Zaritsky, *Portability – So Many Questions, So Few Answers,* 51st Heckerling Est. Pl. Inst. (2017), and Franklin and Law, *Clinical Trials with Portability*, 48th Heckerling Est. Pl. Inst. (2014).

1. Small Estates – Less than One Basic Exclusion Amount

Portability is probably most favorable where the anticipated combined gross estates of the couple will not be more than one spouse's anticipated basic exclusion amount (currently $11,180,000 at the time of the writing of this paper in October 2018).

In cases such as this, if there are no asset protection issues, then perhaps consider holding assets jointly with rights of survivorship (or tenants by the entireties), for simplicity. If there is some concern with asset protection, consider having the first spouse's estate pour into a QTIP trust for the benefit of the surviving spouse, with

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[6] See, e.g., *Portability – Part One*, written on behalf of the ABA-RPTE section, http://www.americanbar.org/ content/dam/aba/events/real_property_trust_estate/heckerling/2013/portability_the_game_changer_2013_01_15_paper_2.authcheckdam.pdf, 2012, Franklin, Law and Karibjanian, *Portability - The Game Changer*, http://meetings.abanet.org/webupload/commupload/RP512500/otherlinks_files/TheGameChanger-3-12-13v11.pdf, 2013; Franklin, Law and Karibjanian, P*ortability – The Regulations*, http://meetings.abanet.org/webupload/ commupload/RP512500/otherlinks_files/portability_the_regulations_2013_01_14_paper_1.authcheckdam.pdf. 2013; Franklin and Law, *Clinical Trials in Portability*, 48th Heckerling Institute, 2014. Franklin, Creative Intervivos QTIP Planning, ABA-RPTE / Tax 2014 Joint Fall Meeting, Denver, Sept. 2014; and Karibjanian and Law, *Portability and Prenuptials; A Plethora of Preventative, Progressive and Precautionary Provisions, Probate and Property*, Vol. 27, No. 3, May/Jun 2013; Franklin and Law, *Portability's Role in the Evolution Away from Traditional By-Pass Truss to Grantor Trusts*, BNA Tax Management Trusts and Estates Journal, March, 2012; and *Blattmachr, Bramwell and Zeydel, Portability or No: The Death of the Credit Shelter Trust?*, J. Tax'n (May 2013).

flexible provisions to allow an independent trustee to distribute the assets for the survivor's best interest.

2. Medium Estates – Between One and Two Basic Exclusion Amounts

For those couples with estates that are anticipated to be greater than one basic exclusion amount, but less than two basic exclusion amounts, a portability-based estate plan may be also be the best viable alternative (over a traditional non-marital trust plan). By using a QTIP marital trust, since there will likely be no estate tax upon the survivor's death, not only can one preserve all of both spouse's GST exemptions (through the use of a reverse QTIP election), but one would also be able to obtain a basis adjustment (under Section 1014(b)(1)) in the assets that pass to the QTIP trust upon the first spouse's death, and obtain a second step up in basis with regard to all of the assets (i.e., those in the QTIP trust (by reason of IRC § 2044) and those owed by the survivor) on the survivor's death (under Section 1014(b)(10)). This portability type plan reduces any built-in gain tax typically associated with traditional non-marital trust plans (imposed on the non-marital trust's assets when later sold after the second spouse's death).

Both the QTIP marital and non-marital trusts have asset protection qualities, and both will be able to preserve first spouse's GST exemption. Thus, as to those issues there is really little or no difference between a portability type or traditional non-marital type plan.

3. Larger Estates – Over Two Basic Exclusion Amounts

For the larger estates, the portability type plan, purely from a tax perspective, is generally still a better plan. However, where there is a state death tax imposed either upon the first, second or both spouses' deaths, a pure portability type plan may not be better. In those cases, it may be better to use a traditional non-marital type trust to absorb the state death tax credit, and to the extent that a QTIP trust can be used for assets in excess of the state death tax credit, that would be the preferable plan.

C. Factors Favoring Traditional Non-Marital Trust Plans

Going forward, non-marital trusts may be favored in those states where there is a state death tax credit, and no state portability provision. And, it would likely be favored only to the extent of the state death tax credit and if there is a state QTIP marital deduction. If there is no such state QTIP marital deduction, then perhaps using the non-marital to the extent of the federal basic exclusion amount may be the better alternative. Non-marital trusts may also be favored in 2nd, 3rd, 4th, etc., marriage situations; however, see Franklin and Karibjanian, *Portability and Second Marriages – Worth a Second Look*, BNA – Tax Management Estates, Gifts, and Trusts Journal, Sept. 11, 2014, where the authors suggest some planning that may make marital trusts viable in certain multiple marriage situations.

Non-marital trusts may also be worthwhile for those who already have such a plan, and the planner would find it difficult to change the plan for client reasons. Typically, this would be the case where the client is reluctant to consider any changes. Non-marital trusts may be worthwhile in cases where the client may be unable (due to some incapacity) to change the documents.

Some argue that non-marital trusts are worthwhile because the appreciation avoids future transfer tax (where there will be a taxable estate subject to tax on the survivor's death). This argument has some merit, however, use of a marital QTIP trust (where there is a reverse QTIP election to preserve the GST exemption) combined with giving by the surviving spouse into an irrevocable grantor trust soon after the decedent-spouse's death, is far superior from a tax perspective. The grantor trust captures any appreciation, and more importantly, the assets in the grantor trust grow income tax free while the survivor is alive, and there is a possibility that with proper attention, basis can be adjusted by "swapping" assets of equivalent value during the survivor-grantor's lifetime. However, if this is too complicated for the survivor, or if there is concern that the survivor may not make the gift after the decedent-spouse's death, then perhaps the non-marital trust approach has some merit.

D. Running the Numbers

The above suggestions for using portability type versus traditional non-marital plans only make sense when the planner runs the numbers, taking into consideration the impact of time (deaths of the spouses), taxes (transfer as well as income taxes) and returns (the rates of return and turn-over of assets). Additionally, the planner should also consider consumption of assets/income by the surviving spouse, and alternative planning that the survivor can do during his/her lifetime, and the ability for the survivor to implement post-death planning after the first spouse dies. Finally, the planner has to consider non-tax reasons to see if one plan is better than the other. Running the numbers is very important, but it is not the only factor. Additionally, from a practical standpoint, the planner needs to weigh the benefits and burdens, together with the costs of analysis, on presenting and helping to guide his/her clients to select one plan over the another).

Unfortunately, the authors have yet to find any "number-crunching" software that takes all of the different variables into consideration and provides a mechanism that gives reasonable certainty that one plan works better than another. The authors surmise that it is because there are too many variables to take into consideration and building such a piece of software would be cumbersome to build and difficult to use. For example, the software would have to not only take federal gift and estate taxes into consideration, but also state gift and death taxes. Moreover, the software would have to be able to have an income tax calculator to look at computing ordinary and AMT income tax, as well as having side computations for state income taxes. Additionally, it would have to have a module that would do side income tax computations (both federal and state) for income taxed in trusts (i.e., the QTIP and/or non-marital trusts). With all of these complexities, building such a piece of software would be daunting.

To run the numbers the planner is faced with the challenging task of using old fashioned spreadsheets and tailoring it to the particular client. Based on the foregoing, because of the risk of making the many assumptions, together with the time-consuming nature of the above, it would not surprise the authors if the planner simply relies on the planning vehicles of yore and continues to plan the way they did years before. This will likely be the case in those close calls (i.e., in larger estates, estates that may be subject to a state death tax and those with multiple marriage situations).

XI. BASIS PLANNING: OBTAINING A BASIS ADJUSTMENT IN A NON-MARITAL TRUST AT THE SURVIVING SPOUSE'S DEATH[7]

A. Generally

One may draft a nonmarital trust expecting to desire that the assets all be excluded from the surviving spouse's gross estate, but discover that the surviving spouse's estate is significantly smaller than his or her available applicable exclusion amount. Whether initially drafting a nonmarital trust or deciding whether to modify an existing trust by decanting, judicial modification, or nonjudicial modification, the estate planner should include in the trust instrument a device by which all or some of the trust's appreciated assets may be rendered includible in the surviving spouse's gross estate.

There are four potential mechanisms to achieve the basis step-up:

- Independent trustee power of distribution;
- Contingent general power of appointment;
- Trust protector with the ability to create a general power of appointment; and
- Delaware Tax Trap.

B. Independent Trustee Power of Distribution

1. Generally

The first alternative to achieve a basis step-up is to grant an independent trustee broad authority to make distributions to the surviving spouse (i.e., not limited to an ascertainable standard, as defined in the regulations under Section 2041).

Using such power, the independent trustee could make distributions to the surviving spouse of appreciated by-pass trust property. If the amount distributed does not exceed the surviving spouse's excess exclusion, federal estate taxes are not triggered. Once the asset is distributed, the asset will be part of the surviving spouse's gross estate for federal estate tax purposes. Section 2033. The asset will be considered to have been acquired from the decedent (i.e., who is the second spouse to die) so that it is subject to the general basis adjustment rule. IRC § 1014(b)(1).

[7] Some of this discussion was taken from Franklin and Law, *Clinical Trials in Portability*, 48th Heckerling Est. Pl. Inst. (2014). Richard Franklin, Esq., was the primary contributor to that portion of *Clinical Trials in Portability* which discussed basis adjustment, any mistakes in this section are those of the authors; Mr. Franklin does not make mistakes herein.

2. Benefits

a) Selection of Appreciated Assets

This method allows the independent trustee to pick and choose the appreciated assets to be distributed.

b) Retention of Depreciated Assets

Depreciated assets can remain in the by-pass trust preserving the existing basis and preventing a step-down in basis to fair market value.

c) Simplicity

This is a relatively simple arrangement, not based on a formula or involving complicated power of appointment issues. It is likely that clients, accountants, and financial representatives could all understand this approach.

Explaining formula or springing general powers of appointment or the Delaware Tax Trap will be more challenging. Therefore, the simplicity of this approach should not be dismissed lightly.

3. Risks

a) Finding a Bold Independent Trustee is Hard

Of course, an independent trustee may be reluctant to exercise this authority and the surviving spouse's death may occur unexpectedly, so that the distributions might not be made and the basis opportunity may be lost.

b) Timing Problems

The ideal time for distributing appreciated property is close to the death of the surviving spouse, so that any estimation of his or her potential taxable estate is more likely to be correct. This means that the independent trustee needs to have current information on the health and finances of the spouse. This may not be easy to obtain in many cases, as elderly surviving spouses may not wish to share this information.

c) Diversion Creditors

Another risk is that any distributed assets might be given by the spouse to persons other than those intended by the first spouse, such as a new spouse or the family of a new spouse or a charity with which the first spouse was not comfortable. Similarly, the assets could be diverted to other persons by exposing them to the surviving spouse's creditors.

d) Irrevocability of Distribution

Once you distribute assets to the surviving spouse, they belong to the spouse. There is no means of correcting this if the independent trustee later determines that the assets should not be held by the spouse, because of the possibility of diversion or creditor claims, or because the spouse's estate grows faster than anticipated, cannot be remedied.

C. Contingent Formula General Power of Appointment

1. Generally

An alternative to the independent trustee's distribution power is for the by-pass trust to grant a contingent general power of appointment to the surviving spouse. As explained below, this strategy has some gaps in the legal analysis, and is thus not without its risks.

If the surviving spouse is granted a general power of appointment over all, or a portion, of the by-pass trust the general power of appointment will cause inclusion in the estate of the surviving spouse for Federal estate tax purposes. IRC § 2041.

If the surviving spouse exercises a testamentary general power of appointment, the property passing, without full and adequate consideration, as a result of the exercise is considered to have been acquired from or to have passed from the now deceased surviving spouse, and thereby the general basis adjustment rule will apply. IRC § 1014(b)(4).

If the surviving spouse does not exercise the general power of appointment, the property required to be included in determining the value of the surviving spouse's gross estate is considered to have been acquired, or to have passed, from the now deceased surviving spouse, and thereby the general basis adjustment rule will also apply. IRC § 1014(b)(9).

Granting the surviving spouse a general power of appointment over all, or a portion, of the by-pass trust is not abusive for purposes of the general basis adjustment rule. The by-pass trust is funded upon the death of the deceased spouse. The surviving spouse is granted a testamentary general power of appointment over that trust. Even if the surviving spouse dies within one year of the deceased donor spouse's death, the by-pass trust cannot ever pass assets back to the deceased donor spouse. Therefore, Section 1014(e) (i.e., the one-year rule) is inapplicable.

2. Is it Possible to Create a Contingent General Power of Appointment?

a) Generally

This section of the paper addresses whether it is possible to create a formula general power of appointment that is (i) contingent on the surviving spouse

having any unused applicable exclusion amount, and (ii) structured to be applicable to particular assets in the by-pass trust that, without an automatic basis adjustment under Section 1014, upon the surviving spouse's death would have the potential of triggering an income tax liability upon disposition as a result of appreciation in value or for other reasons such as having been depreciated for income tax purposes.

Also addressed is whether it is possible to structure the general power of appointment over the assets or classes of assets that (i) have the most significant appreciation, (ii) will be taxed at the highest rates (e.g., collectables at higher capital gains rates or depreciated assets subject to recapture at ordinary rates), or (iii) will be subject to disposition at the earliest point in time.

b) Limiting a Formula General Power of Appointment Based on the Surviving Spouse's Unused Applicable Exclusion Amount

(1) Private Rulings

The Service has approved of formula general powers of appointment based on the remaining estate tax exclusion of the decedent spouse. In PLRs 200403094 and 200604028, the decedent spouse was granted a formula general power of appointment over a share of the surviving spouse's revocable trust based on the amount of the decedent spouse's applicable exclusion amount that would otherwise be unused. The power of appointment in PLR 200403094 is quoted in the ruling as follows:

> *"At my wife's death, if I am still living, I give to my wife a testamentary general power of appointment, exercisable alone and in all events to appoint part of the assets of the Trust Estate, having a value equal to (i) the amount of my wife's remaining applicable exclusion amount less (ii) the value of my wife's taxable estate determined by excluding the amount of those assets subject to this power, free of trust to my deceased wife's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my wife may direct in her Will."*

The power of appointment in PLR 200604028 is described as follows:

> *"Trust 1 provides that if Wife is living at the time of Husband's death, Husband shall have a testamentary general power of appointment equal to the amount of Husband's remaining applicable exclusion amount*

set forth in § 2010 of the Internal Revenue Code ("Code") minus the value of Husband's taxable estate (determined by excluding the amount of those assets subject to this power)."

The strategy of the planning outlined in these PLRs allowed for the use of the lesser moneyed spouse's applicable exclusion amount if he or she died first by granting the lesser moneyed spouse a general power of appointment over the moneyed spouse's revocable trust but only to the extent the lesser moneyed spouse had exclusion that would otherwise be unused. This structure enables the moneyed spouse to retain control over his or her assets to be used for this purpose, unless and until the lesser moneyed spouse died first.

These rulings raise many interesting tax questions that are not of concern for purposes of this discussion. Importantly, however, no one questioned the scope of the formula general power of appointment being defined by reference to the deceased spouse's remaining unused applicable exclusion amount, which by definition would not be determined until the deceased spouse died.

(2) Regulations

Similar formula structures are sanctioned in the contexts of disclaimers and partial QTIP elections. For example, Reg. § 25.2518-3(d), Ex. 20, allows a fractional formula disclaimer by reference to the smallest amount which would allow the decedent's estate to pass free of Federal estate tax.

Additionally, Reg. § 25.2523(f)-1(b)(3) provides that the taxpayer may make the gift tax QTIP election by means of a formula that relates to a fraction or percentage of the QTIP trust, but the gift tax regulations provide no examples of such an election.

The estate tax QTIP regulations, however, are helpful in illustrating such formula elections. See, Examples 7 and 8 of Reg. § 20.2056(b)-7(h).

The type of contingent general power of appointment contemplated as a basis increase mechanism upon the surviving spouse's death must be fixed and determinable upon the surviving spouse's date of death. A power of appointment is considered to exist even when the time for the exercise of the power is determined by the date of the donee's death.

While the assets of the by-pass trust may fluctuate during the surviving spouse's lifetime, the rights of the surviving spouse should

not be considered a mere expectancy. For example, the Eighth Circuit Court of Appeals, in *Estate of Margrave v. Comm'r*, 618 F.2d 34 (8th Cir. 1980), *aff'g* 71 T.C. 13 (1978), considered a situation in which the wife owned a life insurance policy made payable by revocable beneficiary designation to trust over which the husband held an *inter vivos* general power of appointment. The court found that the husband had a mere expectancy in the policy because the designation could be revoked; additionally, it held that the policy was not includible under Sections 2041 or 2042 in husband's estate. This is distinguishable from a funded by-pass trust subject to a testamentary general power of appointment. The surviving spouse's beneficial interests in and the testamentary general power of appointment over the by-pass trust are generally considered vested. Perhaps the testamentary general power of appointment could be vested subject to divestment based on the trustee's exercise of fiduciary discretion to make distributions.

(3) *Estate of Kurz,* General Powers of Appointment Conditioned on Acts of Independent Significance

(a) Facts

In *Kurz v. Comm'r*, 101 T.C. 44 (1993), *aff'd*, 68 F.3d 1027 (7th Cir. 1995), the Tax Court and the Seventh Circuit decided whether the decedent's 5% withdrawal right over a family trust would be included in her gross estate, when its exercise was subject to a precondition of the exhaustion of the marital trust, and the decedent had a unilateral right to withdraw all of the assets of the marital trust.

The unremarkable facts are as follows: The decedent, a surviving spouse, had a 5% withdrawal right over the family trust, but only after the marital trust was exhausted. The surviving spouse was entitled to withdraw as much of the principal of the marital trust as she wished; she had only to notify the trustee in writing.

When the decedent died, the marital trust was worth about $3.5 million and the family trust was worth about $3.4 million.

The estate argued that, because the marital trust was not exhausted on the date of death, the contingency on the 5% withdrawal power was not satisfied and none of the family trust was includible in the decedent's gross estate. The Service argued that a power of appointment (or withdrawal) is exercisable even if there is an unsatisfied condition, if the holder of the power has the power to remove the condition.

(b) Tax Court

The Tax Court held for the government. The court examined the legislative history of Section 2041, and concluded that:

> *This legislative history clearly indicates that Congress intended to eliminate what it considered an abusive technique for avoiding the application of certain taxes; i.e., by the use of minor restrictions that did not affect the decedent's "practical, if not technical, ownership" of the property. However, we can find nothing in the legislative history, or the language of the statute, that would indicate that Congress equated this precedent-notice or period-of-delay language with a broad proscription against all conditions precedent within the control of a decedent.*

101 T.C. at 55.

With respect to the nature of a precondition to the exercise of a general power of appointment that will suffice to prevent its taxation, if the precondition is not met on the date of death, he court added that:

> *. . . the condition does not have to be beyond the decedent's control, [but] it must have some significant non-tax consequence independent of the decedent's power to appoint the property. [Taxpayer] has not demonstrated that withdrawing principal from the Marital Trust Fund has any significant non-tax consequence independent of decedent's power to withdraw principal from the Family Trust Fund. Such condition is illusory and, thus, is not an event or a contingency contemplated by the Reg. § 20.2041-3(b).*

101 T.C. at 55. The court noted that Section 2038 is rendered inapplicable if the transferor retains a power that is subject to a precondition that is not beyond the power of the transferor to satisfy. The rule for powers of appointment, however, is different.

> *"[i]f by its terms a general power of appointment is exercisable only upon the occurrence*

> *during the decedent's lifetime of an event or contingency that has no significant non-tax consequence independent of the decedent's ability to exercise the power, the power exists on the date of decedent's death, regardless of whether the event or contingency did in fact occur during such time. Because [taxpayer] has failed to demonstrate any significant non-tax consequence independent of decedent's right to withdraw principal from the Family Trust Fund, we hold that, on the date of her death, decedent had a general power of appointment over 5 percent of the Family Trust Fund that causes that portion to be includable in her estate under section 2041."*

101 T.C. at 61.

(c) Seventh Circuit

The Seventh Circuit affirmed, noting that:

> *The Tax Court was troubled by an implication of the Commissioner's argument. Suppose the Family Trust had provided that Kurz could reach 5% of the principal if and only if she lost 20 pounds, or achieved a chess rating of 1600, or survived all of her children. She could have gone on a crash diet, or studied the games of Gary Kasparov, or even murdered her children. These are not financial decisions, however, and it would be absurd to have taxes measured by one's ability to lose weight, or lack of moral scruples. . . . The Tax Court accordingly rejected the Commissioner's principal argument, ruling that raw ability to satisfy a condition is insufficient to make a power of appointment "exercisable".*
> . . .
>
> * * *
>
> *No matter how the second sentence of § 20.2041–3(b) should be applied to a contingency like losing 20 pounds or achieving a chess rating of 1600, the regulation does not permit the beneficiary of multiple trusts to exclude all but the first from the estate by the*

> *expedient of arranging the trusts in a sequence. No matter how long the sequence, the beneficiary exercises economic dominion over all funds that can be withdrawn at any given moment. The estate tax is a wealth tax, and dominion over property is wealth. Until her death, Ethel Kurz could have withdrawn all of the Marital Trust and 5% of the Family Trust by notifying the Trustee of her wish to do so.*

68 F.3d 1028, 1030.

(d) Analysis

The import of *Kurz* is that a precondition must have some real economic effect independent of taxes in order for it to prevent the taxation of a general power of appointment.

With respect to a formula contingent general power of appointment for basis adjustment purposes, several issues arise. First, if the holder of the power is also the trustee, he or she would have discretion over investments. The trustee could sell appreciated assets or retain them. Retaining the appreciated asset would potentially subject the asset to the surviving spouse's formula general power of appointment.

Arguably, the surviving spouse as trustee has a duty to invest the trust assets fairly and prudently for the benefit of all trust beneficiaries. The principles governing the trustee's fiduciary obligations for investment are not illusory and should have independent significance. Thus, perhaps the surviving spouse could be trustee.

Second, one must consider the extent to which the holder of the formula conditional general power of appointment has the power to alter the size of his or her potential taxable estate and, thereby, the amount of the power of appointment, by acts that lack independent significance. For example, a surviving spouse could enlarge the scope of the general power of appointment by making testamentary transfers that qualify for the unlimited estate tax marital or charitable deduction or by incurring deductible debts.

Giving assets to a surviving spouse or to charity seems and incurring debt seem best characterized as acts of independent significance. There are, however, few precedents regarding the meaning of an act of independent significance with

respect to estate tax inclusion provisions. See, *e.g.*, Rev. Rul. 80-255, 1980-2 C.B. 272 (power to bear or adopt children involves act of independent significance, whose effect on a trust that included after-born and after-adopted children was "incidental and collateral"); Rev. Rul. 72-307, 1972-1 C.B. 307 (power to cancel group term life insurance policy by terminating employment is not an incident of ownership, because it is exercisable only by performing an act of great independent significance); *Estate of Tully v. United States*, 208 Ct. Cl. 596, 528 F2d 1401, 1406 (1976) ("In reality, a man might divorce his wife, but to assume that he would fight through an entire divorce process merely to alter employee death benefits approaches the absurd."); *Ellis v. Comm'r*, 51 T.C. 182 (1968), *aff'd*, 437 F.2d 442 (9th Cir. 1971) ("For petitioner to cause a situation to occur which would compel the trustee to distribute the trust's income to Viola, petitioner would have to create a major domestic crisis."

One may, therefore, wish to use a formula that determines the powerholder's taxable estate without considering any transfers by the surviving spouse that qualify for the estate tax charitable or marital deduction or any deductions for indebtedness. This provides a safer formula, though if there are debts or dispositions to a surviving spouse or charity, it may create a general power of appointment that is much smaller than an optimal power.

One may also give a nonadverse third-party, such as a trust protector, the power to increase the amount of property to which the formula power applies, thereby obtaining an automatic modest amount of appointive property and a possible correct full amount of appointive property.

3. Benefits

a) Power Only Over Appreciated Assets

The regulations under Section 2041 do not directly address situations in which the power holder has a power over particular assets. The term power of appointment is defined as follows:

> *"The term "power of appointment" includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations. For example,*

if a trust instrument provides that the beneficiary may appropriate or consume the principal of the trust, the power to consume or appropriate is a power of appointment. Similarly, a power given to a decedent to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust is a power of appointment. Treas. Reg. § 20.2041-1(b)(1).”

The regulations refer to powers over “part” of a trust or an interest in a trust:

“If a power of appointment exists as to part of an entire group of assets or only over a limited interest in property, section 2041 applies only to such part or interest. For example, if a trust created by S provides for the payment of income to A for life, then to W for life, with power in A to appoint the remainder by will and in default of appointment for payment of the remainder to B or his estate, and if A dies before W, section 2041 applies only to the value of the remainder interest excluding W's life estate. If A dies after W, section 2041 would apply to the value of the entire property. If the power were only over one-half the remainder interest, section 2041 would apply only to one-half the value of the amounts described above. Treas. Reg. § 20.2041-1(b)(3).”

The following examples illuminate the issues presented in the regulations:

Example XI-1

The assets of Trust A consist of a tract of land and shares of a family company. B, a beneficiary, is granted a power to appoint the land to the creditors of B’s estate. There appear to be neither rulings nor cases in which a power was defined in terms of specific assets rather than a fraction or share of the trust, but the power should, by logic and the plain meaning of the regulations, be a general power of appointment.

Example XI-2

Assume the same facts as in Example IX-1, except that B’s power to appoint the land is contingent on whether an increase in basis would be possible if the land were considered to have passed from the surviving spouse as contemplated by Section 1014(b).

There appears to be no impediment to this contingency or means of classification of assets over which the general power of appointment should be granted.

b) Retention of Depreciated Assets

The power need not extend to depreciated assets, which can remain in the by-pass trust preserving the existing basis and preventing a step-down in basis to fair market value.

c) Complexity

This is a far more complex strategy than an outright distribution of assets, but it is self-effectuating and, therefore, the surviving spouse need not understand it quite as well as he or she does an outright distribution.

d) Self-Adjusting Power Removes Need for Data on Spouse's Health and Finances

Unlike an outright distribution, the formula general power of appointment automatically adjusts to a change in the spouse's estate. Furthermore, there is no need for the trustee to monitor the spouse's health and finances, because the grant of the power adjusts itself.

e) The Trustee Need Not be Bold

The trustee does nothing to make this grant of a general power occur. It is automatic, so the trustee need not be particularly bold or even attentive.

4. Risks

a) Spouse's Creditors

Some states provide that the creditors of a decedent can reach property over which the decedent has a general power of appointment. It is unclear, however, how this interacts with a power that can be exercised only with the consent of a nonadverse party.

b) Disclaimer Funded Nonmarital Trusts

Reg. § 25.2518-2(e)(1) states:

> *"(1) In general. A disclaimer is not a qualified disclaimer unless the disclaimed interest passes without any direction on the part of the disclaimant to a person other than the disclaimant . . . . If there is an express or implied agreement that the disclaimed interest in property is to be given or bequeathed to a person specified by the disclaimant, the disclaimant shall be treated as directing the transfer of the property interest. The requirements of a qualified disclaimer under section 2518 are not satisfied if— (i) The disclaimant,*

either alone or in conjunction with another, directs the redistribution or transfer of the property or interest in property to another person (or has the power to direct the redistribution or transfer of the property or interest in property to another person unless such power is limited by an ascertainable standard); or (ii) The disclaimed property or interest in property passes to or for the benefit of the disclaimant as a result of the disclaimer . . . ."

This appears to preclude a spouse who funds a nonmarital trust by disclaimer of all or part of the marital share, from retaining any form of power of appointment (other than a right to invade the trust limited by an ascertainable standard).

5. Requiring Consent of a Non-Adverse Party

If the donor of the power is concerned with the surviving spouse actually exercising the power or exercising it in an undesirable manner, the contingent general power of appointment could be designed with the requirement that the donee obtain the consent of a nonadverse person. Caution is warranted, however, because under Section 2041(b)(1)(C)(ii), a person is not treated as holding a general power of appointment if the power is not exercisable except in conjunction with a person having a substantial interest, in the property subject to the power, which interest is adverse to exercise of the power in favor of the person who holds the power. A taker in default of the power's exercise is adverse.

6. Drafting

a) Simple Formula General Power of Appointment over Share that Will Not Increase Federal Estate Tax

Consider the following sample language in drafting a formula general power of appointment attempting to take advantage of the basis adjustment rule for income tax purposes, while limiting any inclusion in the donee spouse's estate to the maximum amount that will not cause an estate tax liability.

"[By-Pass Trust - Spousal Testamentary General Power of Appointment]

I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the By-Pass Trust. The fractional share and other terms applicable to the power are as follows:

A. Fractional Share. *The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate, will not result in or increase the federal estate tax payable by reason*

of my spouse's death. The denominator of the fraction shall be the value of the By-Pass Trust as of my spouse's death.

B. How Exercised. *My spouse may exercise the power by appointing the said fractional share free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment."*

b) Detailed Formula General Power of Appointment over Share that Will Not Increase Federal Estate Tax

The language that one would have to consider is how to draft a clause that, on the one hand, will minimize and eliminate any federal (and possibly state) estate tax, and on the other hand provide the largest basis to an asset, which when sold would minimize income taxes. This is perhaps the most difficult part of using this basis-adjustment planning tool.

To simply allocate basis across the board to all assets may not maximize the tax benefits. One of the issues is some assets may not be sold in the foreseeable future (e.g., it may be a family heirloom or family business that will pass from generation to generation, accordingly, the likelihood of triggering income tax is little or none). Another issue is that of the assets may be taxed at higher rates than other assets (e.g., sale of bullion is taxed at a different rate than stock and bonds). But, grouping the assets based on tax rates (when sold) may not be the best result, because they may have high enough basis, so that the tax liability when sold may be minimal, and you would have wasted the use of exemption on those assets. Another issue is to segregate the assets with the largest difference between basis and fair market value at the date of death. This again may not be beneficial, since some assets may not be sold in the foreseeable future and some may have higher income tax rates. It appears that the better way to draft a clause may be to have a general power of appointment granted over those assets that would yield the lowest income tax burden when sold. The problem with this is that when the asset will be sold is generally unknown to the drafter at the time of drafting. For a more detailed explanation of the issues and for sample language that may be possible, see, Franklin and Law, *Clinical Trials with Portability*, 48th U. Miami Heckerling Inst. on Est. Plan. ___ (2014).

c) Sample Language

(1) Formula Automatic General Power of Appointment

The following is sample language for a formula general power of appointment attempting to take advantage of the basis adjustment rule for income tax purposes, while limiting any inclusion in the donee spouse's estate to the maximum amount that will not cause an

estate tax liability. It does not assure the avoidance of the *Kurz* arguments.

*"**Spousal Testamentary General Power of Appointment.***

I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the By-Pass Trust. The fractional share and other terms applicable to the power are as follows:

***A. Fractional Share**. The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death. The denominator of the fraction shall be the value of the By-Pass Trust as of my spouse's death.*

***B. How Exercised.** My spouse may exercise the power by appointing the said fractional share free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment."*

(2) Granting Power Over Appreciated Assets

(a) Generally

One could also attempt to grant this general power of appointment over specific trust assets that have most substantially appreciated. There is no direct authority for the ability to so direct a power of appointment, but the regulations do appear to acknowledge that a power of appointment may be limited to specific assets within a trust. See Reg. § 20.2041-1(b)(3).

(b) Sample Language

"***Spousal Testamentary General Power of Appointment**.*

I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of the Appreciated

Assets (as such term is defined hereunder). The fractional share and other terms applicable to the power are as follows:

***A. Fractional Share**. The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death. The denominator of the fraction shall be the value of the Appreciated Assets as of my spouse's death.*

***B. Appreciated Assets**. The Appreciated Assets shall mean those assets owned by the By-Pass Trust upon my spouse's death the income tax basis of which may increase (and not decrease) pursuant to Code § 1014(a), if such assets passed from my spouse within the meaning of Code § 1014(b).*

***C. How Exercised**. My spouse may exercise the power by appointing the said fractional share of the Appreciated Assets of the By-Pass Trust free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment*."

(3) Tiered Formula General Powers of Appointment

(a) Generally

As discussed above, not all gains are taxed alike. Ideally, one would like to include in the powerholder's estate only those assets likely to produce the highest tax on sale or exchange. One approach would be to have a tiered formula. This tiered formula would be a series of sequential contingent general powers of appointment.

(b) Tiered Classes of Assets

(i) General

One approach is to establish tiers by class of assets. The first general power of appointment would be over a fractional share of the appreciated assets that

would be exposed to the highest tax rate if sold by the by-pass trust immediately prior to the surviving spouse's death. The second power would be over a fractional share of the appreciated assets that would be exposed to the second highest tax rate if sold by the by-pass trust immediately prior to the surviving spouse's death, and so on.

(ii) Sample Language

"Spousal Testamentary General Power of Appointment.

A. General Power of Appointment Over Class #1 Appreciated Assets*. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Class #1. The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death. The denominator of the fraction shall be the value of Class #1 as of my spouse's death. Class #1 shall mean those Appreciated Assets (as such term is defined below), if any, that would be subject to the highest aggregate rate of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse's death.*

B. General Power of Appointment Over Class #2 Appreciated Assets*. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Class #2. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death over (b) the denominator of the fraction in*

Paragraph A above. The denominator of the fraction shall be the value of Class #2 as of my spouse's death. Class #2 shall mean those Appreciated Assets, if any, that would be subject to the second highest aggregate rate of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse's death.

C. General Power of Appointment Over Class #3 Appreciated Assets*. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Class #3. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death over (b) the sum of the denominators of the fractions in Paragraphs A and B above. The denominator of the fraction shall be the value of Class #3 as of my spouse's death. Class #3 shall mean those Appreciated Assets, if any, that would be subject to the third highest aggregate rate of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse's death.*

D. Additional General Powers of Appointment Over Additional Classes of Appreciated Assets*. I give to my spouse additional testamentary general powers of appointment following the pattern of Paragraphs A, B and C over additional Classes of Appreciated Assets, with each successive Class of Appreciated Assets being those assets of the By-Pass Trust subject to the next highest aggregate rate of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse's death. The numerator of the fraction of each successive power of appointment shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction),*

will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death over (b) the sum of the denominators of the fractions used in the prior powers of appointment.

E. Last General Power of Appointment*. Notwithstanding the above, the last general power of appointment granted by this Section shall be the power whose fraction has a numerator less than its denominator.*

F. Appreciated Assets of the By-Pass Trust*. For purposes of this Section, the term "Appreciated Assets" shall mean those assets owned by the By-Pass Trust upon my spouse's death the income tax basis of which may increase (and not decrease) pursuant to Code § 1014(a) if such assets passed from my spouse within the meaning Code § 1014(b).*

G. How Exercised*. My spouse may exercise the powers granted by this section by appointing the said fractional shares of the particular Class of Appreciated Assets free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment.".*

d) Tiered Individual Assets

(1) Generally

This formula may not achieve the best results, because grouping the assets by classes having the highest to lowest rate of income tax applicable to a sale will not necessarily increase the basis of the assets that have the most potential gain subject to tax.

Example IX-3

Trust owns asset A, worth $1 million and with an adjusted basis of $900,000, and asset B, worth $1 million and with an adjusted basis of $500,000. The surviving spouse has $1

million of available applicable exclusion amount. If sold immediately prior to the surviving spouse's death, the assume rate of tax applicable to asset A is 30% and asset B is 25%. The formula recited above would grant a general power of appointment first over asset A, which would achieve a less favorable result than if it were granted over asset B, because granting it over asset B would save more total taxes, even though the rate of tax applicable to asset B is less than the rate that would be applicable to asset A.

(2) A Better Approach

A better result might be achieved by restructuring the formula to be based on each asset, such that the general power of appointment is first subject to the individual asset that would produce the most income tax liability if sold by the by-pass trust immediately prior to the surviving spouse's death. This approach will consider both the by-pass trust's adjusted basis in each asset, as well as the rate of tax that would be applicable on a sale by the by-pass trust.

(3) Sample Language

"Spousal Testamentary General Power of Appointment.

A. General Power of Appointment Over Asset #1 of the Appreciated Assets*. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #1. The numerator of the fraction shall be the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax][8] payable by reason of my spouse's death. The denominator of the fraction shall be the value of Asset #1 as of my spouse's death. Asset #1 shall mean that asset from among the Appreciated Assets (defined below), if any, that if sold by the By-Pass Trust immediately prior to my spouse's death would generate the greatest aggregate amount of federal and state income tax.*

B. General Power of Appointment Over Asset #2 of the Appreciated Assets*. I give to my spouse a testamentary general power of appointment, exercisable alone and in all*

[8] This clause may be desirable if the testator resides or owns substantial tangible property in a jurisdiction that imposes a significant state estate tax.

events to appoint a fractional share of Asset #2. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death over (b) the denominator of the fraction in Paragraph A above. The denominator of the fraction shall be the value of Asset #2 as of my spouse's death. Asset #2 shall mean that asset from among the Appreciated Assets, if any, that if sold by the By-Pass Trust immediately prior to my spouse's death would generate the second greatest aggregate amount of federal and state income tax.

C. General Power of Appointment Over Asset #3 of the Appreciated Assets*. I give to my spouse a testamentary general power of appointment, exercisable alone and in all events to appoint a fractional share of Asset #3. The numerator of the fraction shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my spouse's death over (b) the sum of the denominators of the fractions in Paragraphs A and B above. The denominator of the fraction shall be the value of Asset #3 as of my spouse's death. The Asset #3 shall mean that asset from among the Appreciated Assets, if any, that, if sold by the By-Pass Trust immediately prior to my spouse's death would generate the third greatest aggregate amount of federal and state income tax.*

D. Additional General Powers of Appointment Over Additional Assets of the Appreciated Assets. *I give to my spouse additional testamentary general powers of appointment following the pattern of Paragraphs A, B and C over additional assets of the Appreciated Assets, with each successive asset of the Appreciated Assets being that asset of the By-Pass Trust subject to the next highest aggregate amount of federal and state income tax if sold by the By-Pass Trust immediately prior to my spouse's death. The numerator of the fraction of each successive power of appointment shall be the excess of (a) the largest amount which, if added to my spouse's taxable estate (determined for this purpose without regard to any available charitable or marital deduction), will not result in or increase the federal estate tax [OPTION: or state, district, or local estate tax] payable by reason of my*

spouse's death over (b) the sum of the denominators of the fractions used in the prior powers of appointment.

***E. Last General Power of Appointment**. Notwithstanding the above, the last general power of appointment granted by this Section shall be the power whose fraction has a numerator less than its denominator.*

***F. Appreciated Assets of the By-Pass Trust**. For purposes of this Section, the term "Appreciated Assets" shall mean those assets owned by the By-Pass Trust upon my spouse's death the income tax basis of which may increase (and not decrease) pursuant to Code § 1014(a)*[9] *if such assets passed from my spouse within the meaning Code § 1014(b) [OPTIONAL PROVISION: ,provided, however, that any Family Assets shall be considered last (and then classed based on greatest aggregate amount of federal and state income tax in a similar manner as provided above) For purposes of this Section the term "Family Assets" means _____ (e.g., the family farm or private family company, which is unlikely to be sold in the near future, etc.)]. For this purpose, blocks of shares of the same stock in the same company and having the same basis shall be consider as a block as one asset.*

***G. How Exercised**. My spouse may exercise the powers granted by this section by appointing the said fractional shares of the particular assets of Appreciated Assets free of trust to my spouse's estate or to or for the benefit of one or more persons or entities, in such proportions, outright, in trust, or otherwise as my spouse may direct in my spouse's Will that specifically refers to this general power of appointment."*

e) Caveat

This clause still does not take into account that some assets may be sold quickly, while others may never be sold. Increasing the basis of heirloom assets that are unlikely ever to be sold is of little value. One may consider leaving such assets to a separate non-marital trust that does not include a contingent general power of appointment.

[9] The instrument must elsewhere define "Code" to mean the Internal Revenue Code of 1986, as amended from time to time.

D. Independent Power to Grant a General Power of Appointment

1. Generally

Another basis-adjustment alternative is to grant an independent trustee or trust protector broad authority to grant the surviving spouse a general power of appointment. For the reasons discussed above, it appears that the independent trustee or trust protector could grant the surviving spouse a general power of appointment over particular appreciated by-pass trust assets – e.g., the assets that are likely to generate the greatest aggregate income tax liability if they do not receive a basis adjustment – and/or those assets that are likely to be sold nearest in time following the surviving spouse's death.

If the value of the assets subject to the general power of appointment do not exceed the surviving spouse's excess exclusion, federal estate taxes are not triggered, and yet there will be a basis adjustment under Section 1014.

2. Benefits

a) Selection of Appreciated Assets

This method allows the grant of a general power that applies only to those appreciated assets selected by the independent trustee or trust protector.

b) Retention of Depreciated Assets

The independent trustee or trust protector need not grant a general power over depreciated assets, preserving the existing basis and preventing a step-down in basis to fair market value.

c) Simplicity

This is a relatively simple arrangement, not based on a formula.

d) Revocability of Distribution

The independent trustee or trust protector can revoke or modify the general power after it is granted, as long as it is done before the surviving spouse's death.

3. Risks

a) Finding a Bold Independent Trustee is Hard

The independent trustee or trust protector may be shy in exercising the authority and that the surviving spouse's death may occur unexpectedly. The

result of which is that the power might not be granted and the basis opportunity is lost.

b) Timing Problems

Again, the independent trustee or trust protector needs to have current information on the health and finances of the spouse. This may not be easy to obtain in many cases, as elderly surviving spouses may not wish freely to share this information.

c) Creditors

Some states provide that the creditors of a decedent can reach property over which the decedent has a general power of appointment. It is unclear, however, how this interacts with a power that can be exercised only with the consent of a nonadverse party.

d) Disclaimer Funded Nonmarital Trusts

Reg. § 25.2518-2(e)(1), as quoted above, provides that a spouse who disclaims a portion of the marital share in order to fund the nonmarital share cannot, therefore, retain any power of appointment over the disclaimed portion, whether general or limited (other than a right to withdraw subject to an ascertainable standard). The regulations, however, are not limited to retained powers to direct the beneficial enjoyment; they simply state that the property must pass "without any direction on the part of the disclaimant to a person other than the disclaimant." While there is no case or ruling on point, it is inadvisably risky for a spouse who funds a nonmarital share by disclaimer later to be granted a general power of appointment over the disclaimed portion of the trust.

Of course, the penalty for violating the disclaimer rules would be that the spouse is deemed to have made a taxable gift of the disclaimed assets. If the surviving spouse filed a gift tax return in the year in which the disclaimer was made and if the statute of limitations on that return has expired, the spouse could accept the power of appointment with relative impunity.

e) Is the Power General?

One might argue that the independent person granting the power and the person to whom it would be granted can together exercise the power, which could make it a general power of appointment even if not granted. This analysis seems strained. While there appear to be no cases directly on point, see *Johnstone v. Comm'r*, 76 F.2d 55 (9th Cir. 1935), *cert. denied*, 296 U.S. 578 (1935), *aff'g* 29 B.T.A. 957 (1934); *Keeter v. United States*, 461 F.2d 714 (5th Cir. 1972), *rev'g* 323 F. Supp. 1093 (N.D. Fl. 1971); and GCM 37428 (1981), which take the position that a donor's right to dispose of the property to which a power of appointment relates following the exercise of

the power is not equivalent to requiring that the power be exercised jointly by the donor and donee of the power.

4. Drafting -- Clause Allowing Disinterested Trustee to Grant Surviving Spouse General Power of Appointment Over Assets in Nonmarital Trust, to Take Advantage of Increased Applicable Exclusion Amount

"ARTICLE __. Grant of a General Power of Appointmen*t*

*A "disinterested trustee" (defined below) may at any time and from time to time grant to my *husband/wife*, if *he/she* survives me, a power to appoint at *his/her* death, all or a portion of the assets of the family trust.*

A. Granting the Power. *A disinterested trustee shall grant this power of appointment by an instrument in writing delivered to my *husband/wife*, designating the specific trust assets or fractional share of the trust, which may include the entire trust, over which my *husband/wife* shall hold this power of appointment.*

B. Changing or Rescinding a Granted Power*. A disinterested trustee may revoke any prior grant of a general power of appointment under this article or change the property to which such previously granted power shall be exercisable, or the terms under which such previously granted power may be exercised.*

C. Permissible Appointees. *My *husband/wife* may exercise this power to appoint the subject trust assets to and among a class that includes the estate of my *husband/wife* and the persons who are otherwise current or potential beneficiaries of this trust.*

1. Appointment Outright or in Further Trust. *My *husband/wife* may exercise this power to appoint the trust assets outright or in further trust, and if exercised to appoint in further trust, may appoint on such terms and conditions as *he/she* shall select.*

2. Unequal Appointment. *My *husband/wife* may appoint the trust assets among this class of appointees unequally and in such proportions as *he/she* deems appropriate for any purpose whatsoever.*

3. Appointment to My *Husband/ Wife*'s Estate. *My *husband/wife* may appoint trust assets to *his/her* estate only with the express signed written consent of a "nonadverse person" (defined below) designated by the disinterested trustee in the instrument granting the power of appointment under this article. For this purpose, a "nonadverse person" is any person who has no substantial interest in the property subject to the power of appointment, which interest is adverse to the exercise of the power in favor of my *husband/wife*'s estate. Any attempted appointment to my*

**husband/wife*'s estate without the express signed written consent of the nonadverse party designated by the disinterested trustee who granted *him/her* this power of appointment shall be void and of no effect, and this power of appointment shall be deemed not to have been validly exercised.*

D. Exercise of This Power. *My *husband/wife* may exercise this power of appointment by express reference to this power in *his/her* last will, or by express reference to this power in another dated and notarized writing signed by *him/her*, which writing shall be revocable and ineffective during *his/her* life and effective only upon the death of my *husband/wife*.*

E. No Liability. *I recognize the difficulty attendant in the exercise of the power of the disinterested trustee to grant my *husband/wife* a general power of appointment in a manner that best reduces income taxes on the disposition of the distributed assets without also increasing the estate tax obligation of the estate of my *husband/wife*. I direct that the disinterested trustee shall have no liability to any beneficiary of this trust or to any other person for the disinterested trustee's actions under this article. Without exclusion, the disinterested trustee shall have no liability to any beneficiary or any other person for: (1) failing to grant my *husband/wife* a power of appointment; (2) granting my *husband/wife* a power of appointment that does not cause an amount of trust assets to be included in my *husband/wife*'s gross estate for Federal estate tax purposes that will obtain the optimal income tax benefit for the trust; (3) granting a power of appointment to my *husband/wife* under this instrument, even if such granting causes adverse income or estate tax results; (4) granting a power of appointment to my *husband/wife* that causes more property to be included in *his/her* gross estate than can be sheltered from Federal or state estate taxes by my *husband/wife*'s available exemptions and deductions; and (5) the actions of any nonadverse party in consenting or refusing to consent to the exercise of a granted power of appointed in favor of the estate of my *husband/wife*, or the action of the disinterested trustee in naming or refusing to name such a nonadverse party. A nonadverse party named by the disinterested trustee shall have no liability to any beneficiary of this trust or to any other person for consenting or refusing to consent to the exercise of any granted power of appointment in favor of the estate of my *husband/wife*.*

F. Disinterested Trustee" Defined. *A "disinterested trustee" means a trustee who is not an interested trustee. An "interested trustee" means a trustee who is also (1) a beneficiary of the trust of which he or she is the insured under a policy of insurance owned by a trust of which he or she is a trustee; (2) married to and living together with a beneficiary of the trust of which he or she is a trustee; (3) the father, mother, issue, brother or sister, of a beneficiary of the trust of which he or she is a trustee; (4) an employee of a beneficiary of the trust of which he or she is a trustee; (5) a corporation or any employee of a corporation in which the stock holdings*

of the trustee and the trust are significant from the viewpoint of voting control; or (6) a subordinate employee of a corporation in which the trustee is an executive."

E. The Delaware Tax Trap

1. Generally

Perhaps the most technical of the basis adjustment mechanisms is the so-called "Delaware Tax Trap."

Section 2041(a)(3) states that a limited power of appointment is taxed as a general power, if it is exercised to create a new power of appointment and if doing so postpones the vesting or suspends the absolute ownership or power of alienation of the appointed property, for a period ascertainable without regard to the date of the creation of the first power.

The practical hurdles of using this technique as a standardized basis adjustment mechanism in by-pass trusts are mostly focused on the fact that the trap and its operation are complex and almost unfathomable to anyone other than a certifiable estate tax geek. The attorney preparing the document should understand it – and how many of us can honestly say that we do? The concept will be challenging to explain to the couple when implementing the estate plan and when the surviving spouse springs the trap. Moreover, it will be challenging for rest of the estate planning team to understand, the trust officers, accountants and financial advisors. How likely is it that anyone other than the drafting attorney could spot the language and understand the potential planning possibilities?

2. The History – It is Complicated!

Just understanding the background of the Delaware Tax Trap – why it is called a trap – is complicated. Historically, Delaware allowed successive exercises of non-general powers of appointment in favor of non-charitable beneficiaries, which could in effect extend the life of a trust indefinitely without running afoul of the rule against perpetuities. Thus, assets that would otherwise have to be distributed and vest in a non-charitable beneficiary within the rule against perpetuities could be held in trust for a longer period of time (or indefinitely) simply by exercising the power and creating another non-general power of appointment. Historically, since donees of non-general power of appointments were not subject to gift and estate taxes at that time, not only could the assets be held in trust indefinitely, but estate and gift taxes could also be avoided indefinitely.

Congress responded by amending Sections 2514 and 2041 so that exercises of the non-general powers of appointment in those cases would be considered the exercise of a general power of appointment and thus be subject to gift and estate taxes, respectively. Thus, if the non-general power of appointment was exercised, the exercise would be a taxable gift (if exercised during life) or included in the donee's

estate (if exercised in the donee's testamentary instrument). Causing the donee of the non-general power to be taxed on the exercise (where the holder was a beneficiary and did not have the assets of the trust to pay the tax) was viewed as a tax trap – hence the "Delaware Tax Trap". Delaware amended its law to eliminate the trap.

On the Delaware tax trap generally, see Blattmachr, Kamin & Bergman, *Estate Planning's Most Powerful Tool: Powers of Appointment Refreshed, Redefined, and Reexamined*, 47 Real Prop., Tr. & Est. LJ 529 (Winter 2013); Blattmachr & Pennell, *Using 'Delaware Tax Trap' to Avoid Generation-Skipping Taxes*, 68 J. Tax'n 242 (1988); Blattmachr & Pennell, *Adventures in Generation-Skipping or How We Learned to Love the 'Delaware Tax Trap*, 24 Real Prop., Prob. & Tr. J. 75 (1989); Bloom, *Transfer Tax Avoidance: The Impact of Perpetuities Restrictions Before and After Generation-Skipping Taxation*, 45 Albany L. Rev. 261 (1981); Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 Est. Plan. 68 (Feb. 2001); Nenno, *To Bridge or Not to Bridge the Generation-Skipping Transfer Gap: Dynasty Trusts From the Client's Perspective*, 33 U. Miami Philip E. Heckerling Inst. on Est. Plan. (1999); Raatz, *"Delaware Tax Trap" Opens Door to Higher Basis for Trust Assets*, 41 Est. Plan. 3 (Feb. 2014); Spica, *A Practical Look at Springing the Delaware Tax Trap to Avert Generation-Skipping Transfer Tax*, 41 Real Prop., Prob. & Tr. J. 165 (Spring 2006).

3. Planning for the Delaware Tax Trap

As noted above, Section 2041(a)(3) provides that a non-general power of appointment will be taxed as if it were a general power of appointment if the non-general power of appointment is exercised to create another power of appointment that can be exercised to postpone vesting beyond the rule against perpetuities applicable to the original special power of appointment.

The planning idea is that the surviving spouse as a beneficiary of the by-pass trust is granted a non-general power of appointment that can be exercised to create another power of appointment in a potential appointee that can extend the trust beyond the rule against perpetuities originally applicable when the trust was created at the first spouse's death. The surviving spouse then has the option of springing the trap by exercising the special power of appointment in such manner and subject assets of the by-pass trust to federal gift and estate taxes in the surviving spouse's estate, and attaining a desired basis adjustment. Thus, it is the surviving spouse who can spring the trap for the tax benefits it may provide.

The by-pass trust needs to enable the trap to operate when and if the surviving spouse decides to spring it. Some states have prophylactic statutes that are designed prevent a non-general power of appointment from operating in a manner that could postpone vesting, ownership, or alienation beyond the originally applicable rule against perpetuities. Some trust forms also have provisions designed to do the same. Thus, it may not be possible to use the trap in certain states.

4. The Delaware Tax Trap in States That Have No Rule Against Perpetuities

a) Generally

Springing the Delaware Tax Trap is particularly complicated if the exercise of the power is governed by law of a state that has abolished the rule against perpetuities, whether for all trusts or for those for which abolition is elected. See 25 Del. Code § 503(a) (repealed for personal property interests held in trust); Ky. Rev. Stat. § 381.224; NJ Stat. §§ 46:2F-9, 46:2F-10; 20 Pa. Con. Stat. §§ 6104, 6107.1; Gen. Laws R.I. § 34-11-38; S.D. Cod. Laws §§ 43-5-1, 43-5-8, 55-1-20. More states, including Virginia, allow an election not to have the rule against perpetuities apply to the trust: Ariz. Rev. Stat. § 14-2901(A)(3); D.C. Code § 19-904(a)(10); 765 Ill. Comp. Stat. §§ 305/3(9-5), 305/4; 33 Me. Rev. Stat. § 101-A; Md. Est. & Tr. Code § 11-102(b)(5); Mo. Ann. § 456.025; Neb. Rev. Stat. § 76-2005(9); N.H. Rev. Stat. §§ 564:24, 547:3-K; N.C. Gen. Stat. § 41-23(d); N.D. Cent. Code § 47-02-27.4; Ohio Rev. Code § 2131.09(B)(2) (this does not apply to trusts created by the exercise of a non-general power of appointment); Ohio Rev. Code § 2131.09(B)(4)); Va. Code § 55-12.4(A)(8).

It is unclear how the Delaware tax trap applies when there is no applicable rule against perpetuities. Absent a restriction on vesting, ownership, or alienation, it is unclear that a non-general power of appointment can create a second power that springs the Delaware tax trap.

One can reasonably argue that: (1) the Delaware tax trap can never be executed in such states because the date on which the first power is created is irrelevant in determining the date on which vesting, ownership, or alienation can be postponed; (2) every new power postpones the vesting, ownership, or alienation, and because the date on which the first power was created is ignored in determining when such periods must end, the new power always executes the Delaware tax trap; or (3) the Delaware tax trap should operate the same in states that lack a rule against perpetuities as it does in those that have such a rule.

The correct analysis depends on the details of the state statute, in light of the Tax Court's analysis in *Murphy v. Comm'r*, 71 T.C. 671 (1979), *acq. recommended* A.O.D. 1979-87, 1979 WL 53162 (May 30, 1979), *acq*. 1979-2 C.B. 1.

(1) Murphy v. Comm'r

(a) Facts

Mary Margaret was one of three beneficiaries of the Harris Trust, created by her late father, which provided for payment of income in equal shares to Mary, her sister, and their mother, until the death of Mary's mother. Upon the death of

Mary's mother, the trust would terminate and its principal would be distributed in equal shares to the two sisters, if both were then living. A sister who predeceased their mother could appoint her share of the trust to anyone she chose, other than to her own estate, her creditors, or the creditors of her estate. Mary predeceased her mother and appointed her share of the trust to a new trust created under her will—the MMM Family Trust.

The MMM Family Trust provided for distribution of income to Mary's husband as needed by him "to maintain himself in the manner of living to which he has become accustomed" and to her issue, in the discretion of the trustee. The MMM Family Trust was to continue for the lifetime of Mary's husband and thereafter until her youngest child reached 35 years of age, at which time the trust fund would be distributed to Mary's children or lineal issue. In addition, Mary's will gave her husband a non-general testamentary power of appointment.

Wisconsin law at that time had a statutory rule against perpetuities concerned only with the suspension of the power of alienation. Wis. Stat. § 700.16, as then in force. Under this statute, an interest was void only if it suspended the power of alienation for a period longer than a life or lives in being, plus 30 years. The Wisconsin statute also stated that there was no suspension of the power of alienation when the property interest is held in a trust and the trustee has the power to sell the assets of the trust. Thus, the unlimited postponement of vesting and ownership was permitted, as long as there was a current power of sale. *In re Walker's Will*, 258 Wis. 65, 45 N.W.2d 94 (1950).

In *Murphy*, the decedent exercised a limited power by creating in her husband a power that he could exercise by placing the appointive property in a perpetual trust. By giving the trustee of the newly created trust a power of sale over the corpus, the Wisconsin rule against perpetuities was not violated, despite the fact that ownership of the property might never vest in anyone.

(b) Estate's Argument

Mary's estate argued that, because Wisconsin law "expresses its rule against perpetuities in terms of a prohibition on the suspension of the power of alienation, and because the perpetuities period is measured from the date the first power

is created, section 2041(a)(3) is not violated." *Murphy v. Comm'r*, 71 T.C. 671 at 677 (1979).

(c) IRS Argument

The IRS argued that Section 2041(a)(3) functioned independently of state law and that the Code states that if a power violates any one of three conditions of title (postponement of vesting, suspension of the powers of alienation, or suspension of absolute ownership), then the property subject to the power must be included in the gross estate.

(d) Tax Court Holds for Estate

The Tax Court held for the taxpayer. The court admitted that the IRS argument was consistent with a literal reading of Section 2041(a)(3), but that the legislative history and the regulations suggested that the applicable state law dictated how and whether the trap could be triggered. The court noted that in 1951, when the predecessor to Section 2041(a)(3) was adopted, there were two prevailing types of perpetuities statutes. One group of States adopted the New York approach, and prohibited unlimited suspension of the power of alienation or absolute ownership. The other states prohibited unlimited suspension of vesting. The Code refers to a power of appointment that is exercised by creating a second power which "under the applicable local law" can be exercised so as to postpone vesting, ownership, or alienation. Thus, local law is critical in determining how this trap is applied and sprung.

If the local rule is expressed in terms of remoteness of vesting, the court stated, the IRS must determine if vesting of appointed property may be postponed for a period ascertainable without regard to the date of the creation of the first power. Similarly, if the local rule is expressed in terms of suspension of the power of alienation or absolute ownership, a determination must be made as to whether the prohibited condition may exist for longer than the permissible period.

The court noted that the regulations actually supported the estate's position. The regulations indicate that postponing of vesting and suspension of ownership or alienation are mutually exclusive conditions of includibility, and the correct test is governed by applicable state law. Reg. § 20.2041-3(e)(1)(ii).

Under Wisconsin law, one could suspend vesting and ownership with virtual impunity, as long as the trustee was given the power to sell trust assets. Therefore, the exercise of the power in this case did not extend the rule against perpetuities.

(e) Acquiescence

The IRS acquiesced, noting in its Action on Decision that "the Tax Court's holding is reasonable, and an appeal, (while possibly warranted based on the legislative history), would be inappropriate in light of the specific wording of the regulation and the last portion of section 2041(a)(3)." A.O.D. 1979-87, 1979 WL 53162 (May 30, 1979).

In light of *Murphy* and the IRS's acquiescence, one must consider carefully the operation of the state rule against perpetuities in order to determine whether the particular exercise of a power of appointment executes the Delaware tax trap. See Greer, *The Delaware Tax Trap and the Abolition of the Rule Against Perpetuities*, 28 Est. Plan. 68 (Feb. 2001).

(2) Planning Under *Murphy*

Where state law imposes limitations on alienation, but not on vesting or ownership, as in *Murphy*, the execution of the Delaware tax trap is based on how the grant of a new power of appointment affects the right to alienate. All but one of the states that permit a waiver of the rule against perpetuities with respect to a trust require that the trustee have the power to sell the trust assets. (Virginia does not.) Thus, in those states, as long as the trustee has a power of alienation, the trap is not sprung because the period of the rule is not extended. If, on the other hand, the trustee has no power of alienation, and the power created by the decedent can postpone the duration of the trust beyond the period of the rule, the trap can be sprung.

The IRS argument in *Murphy* that the Delaware tax trap applies to the creation of all new powers of appointment in a state that lacks a rule against perpetuities also would result in far more executions of the Delaware tax trap than the legislation appears to anticipate. This seems an unreasonable and unintended result. If the law of the state that controls the construction of a decedent's non-general power of appointment permits any fixed limit (even if a very long one) on vesting, alienation, or ownership, the Delaware tax trap should be sprung if the first power of appointment creates a presently exercisable general power of appointment.

If the state does not limit vesting or ownership, but does limit alienation (like Wisconsin in *Murphy*), the Delaware tax trap can be sprung if the first power creates an interest in trust in which the trustee lacks the power of sale within the period of the rule against perpetuities. This may also occur if a beneficiary is given a presently exercisable general power of appointment.

If state law imposes no limitation on vesting, ownership, or alienation, as when a Virginia trust elects out of the rule against perpetuities, the result is simply unclear. The best analysis in such cases is that the exercise of a non-general power of appointment to create a new presently exercisable general power of appointment cannot spring the Delaware tax trap in such cases, but it is unclear whether this position will actually be approved by the IRS and the courts.

(3) Drafting Sample Language

Below is a rule against perpetuities clause under Missouri that contemplates the possibility of springing the Trap, complements of Steven B. Gorin. It appears that, to accomplish the basis adjustment mechanism goal, the design of the by-pass trust could be structured to grant the surviving spouse a non-general power of appointment that could be exercised to create in a possible appointee a presently exercisable general power of appointment. Under this structure, the second power of appointment is a general power of appointment and as such it would trigger the Trap by creating a taxable power in the object of power, and this structure should not be caught by the prophylactic statutes.

Drafting Suggestion for Provision in Will Exercising Non-General Power of Appointment to Give Appointees a Presently Exercisable General Power of Appointment and Suspending Trustee's Power of Sale, to Trigger Delaware Tax Trap

"ARTICLE ___
Exercise of Power of Appointment

*I am granted a power of appointment under Article ....., Paragraph ..... of the trust created under the law will of *grantor*. I am, under that instrument, authorized to appoint the trust held for my benefit to and among the descendants of *grantor*, outright or in further trust and on such terms as I select. I hereby exercise that non-general power to appoint the said trust share as follows:*

A. Existence of Non-General Power of Appointment. *The trustee shall divide the appointed trust fund into*

*as many separate equal shares as shall be required to provide one (1) separate equal share for each of *grantor*'s children who survives me, and one (1) separate equal share for the then-living descendants, per stirpes, of each of *grantor*'s children who does not survive me but who is survived by then-living descendants.*

B. Creation of Presently Exercisable General Power of Appointment. *The trustee shall hold the share for each child or other descendant of *grantor* in trust as follows:*

1. Until the termination date, defined below, the trustee shall distribute to or for the benefit of each such child or descendant (1) all of the net income of the trust, not less often than annually; (2) so much of the principal of the trust as is appropriate for such child or descendant's health, education, support, or maintenance, taking into account other income available to such child or descendant from any source; and (3) so much of the trust fund (including all or none) held for such child or descendant as such child or descendant shall direct by specific exercise of this presently exercisable general power of appointment. Commencing twenty (20) years after the date of my death and continuing until the termination date, the trustee shall also have no authority to sell assets of this trust fund.

2. Upon the termination date, the trustee shall distribute the remaining trust fund as follows:

a. The trustee shall distribute the remaining assets of a child's or descendant's separate trust under this article as such child or descendant may direct, by specific reference to this non-general power of appointment in his or her last will or in a signed, dated, and written instrument delivered to a trustee. This power may be exercised to appoint a child's or descendant's separate trust fund, either outright or in further trust, to or among any of my descendants, excluding the person holding the power of appointment, his or her creditors, his or her estate, and the creditors of his or her estate.

b. The trustee shall distribute the unappointed assets of such child's or descendant's separate trust to the child's or descendant's then-living descendants, per stirpes. If there are no such then-living descendants, the trustee shall distribute the unappointed assets of such child's or descendant's separate trust to my then-living children and

*other then-living descendants, per stirpes, except that the share for any child or other descendant of mine who has not then reached the age of *Termination-Age* years shall be added to the trust for that child or descendant under this article.*

C. "Termination Date" Defined. *The termination date is the date on which the child or descendant dies.*

F. Asset Protection Concerns for Basis Adjustment Mechanisms

1. Generally

Initially, when designing the estate plans, compare the asset protection issues involved with a traditional by-pass trust to that involved with a portability plan, such as the QTIP trust portability plan. Implementing traditional by-pass trust plans frequently involve transferring assets out of tenancy by the entirety into the spouses' separate ownership to enable the by-pass trust funding. This destroys asset protection. It is important to evaluate asset protection issues in three phases: when both spouses are alive, after the first spouse's death and after both spouses' deaths. For example, with portability planning, assets may remain in tenancy by the entirety when both spouses are alive. Moreover, many assets, such as retirement accounts, homestead property and insurance policies, already offer some creditor protection features depending on applicable state and federal law.

A discretionary by-pass trust with spendthrift provisions likely offers creditor protection for its beneficiaries. The QTIP trust in the portability plan would likely provide creditor protection as to the trust principal, but creditors may be able to reach the income of the trust once distributed to the surviving spouse. Also, in a portability plan, a disclaimer by the surviving spouse to enable the funding of the back-up disclaimer by-pass trust might be problematic if the surviving spouse has creditor problems at the time of the first spouse's death. Some states require that the disclaimant be solvent or provide that a disclaimer by an insolvent person is treated as a fraudulent transfer, and a disclaimer may create a new period of ineligibility for Medicaid benefits.

The asset protection overlay to the approaches for applicable exclusion use is more complicated than it at first appears. If one of the basis adjustment mechanisms is used with the by-pass trust to soak-up any of the surviving spouse's excess applicable exclusion, the asset protection features of the mechanism should also be considered.

2. Independent Power to Distribute

If an independent trustee actually distributes appreciated assets out of the by-pass trust to the surviving spouse to soak-up any of the surviving spouse's excess applicable exclusion, then in most cases the spendthrift trust protection of the by-pass

trust is lost and the distributed assets are exposed to the surviving spouse's creditors. If the surviving spouse has creditor problems, this method of achieving a basis adjustment seems unsatisfactory.

3. General Power of Appointment

The rights of the creditors of the holder of a general testamentary power of appointment to reach the subject property depends on state law.

a) Uniform Trust Code

The Uniform Trust Code does not address creditor issues with respect to property subject to a testamentary general power of appointment. The comments to Uniform Trust Code § 505 refer to *Restatement (Second) of Property: Donative Transfers* §§ 13.1 to 13.7 (1986), discussed below.

b) Restatement (Second) of Property: Donative Transfers

Traditionally, property subject to an exercised general testamentary power of appointment could be subjected to the payment of claims against the powerholder's estate. *Restatement (Second) of Property* § 13.4 (1986). The idea is that until the powerholder exercises the power, he or she has not accepted sufficient control over the subject property to be treated as if it were owned outright.

c) Restatement (Third) of Property: Donative Transfers

The more modern rule is reflected in *Restatement (Third) of Trusts* § 56, Comments (2007), which states that property subject to a testamentary general power of appointment is subject to the claims of the creditors of the powerholder's estate, whether or not the power is exercised, because the power alone is equivalent to outright ownership. The subject property is subject to the claims of the powerholder's creditors to the extent the powerholder's estate is insufficient satisfy the claims of those creditors. Property subject to a general testamentary power of appointment does not enable the powerholder's creditors to reach the trust assets during his or her lifetime. California, Michigan and New York all have specific statutory provisions following the pattern of the *Restatement (Third) Trusts*.

d) Uniform Power of Appointment Act

Section 502 of the Uniform Power of Appointment Act (2013) follows *Restatement (Third) Trusts* and permits the creditors of the estate of the powerholder to reach the subject property, to the extent the estate's other property is insufficient to meet all claims. This right is subject to the power-

holder's right to direct the source from which liabilities are paid. See, however, Va. Code § 64.2-2736(B), adopting this *Restatement (Second) Trusts* position.

e) Bankruptcy Act

The U.S. Bankruptcy Code states that the trustee in bankruptcy "stands in the shoes" of the debtor and so may be able to exercise the general power on behalf of the debtor/powerholder and in favor of the bankrupt estate. 11 U.S.C. § 541(b)(1); *In re Behan*, 506 B.R. 8 (Bankr. D. Mass. 2014); *In re Gilroy*, 235 B.R. 512 (Bankr. D. Kan. 2006); Bove, *Using the Power of Appointment to Protect Assets – More Power than You Ever Imagined*, 346 ACTEC L. J. 333, 338 (Fall 2010).

4. Creditors and a Presently Exercisable General Power of Appointment

Use of a Delaware Tax Trap may not cause an asset protection issue for the surviving spouse but may create an issue for the object of the power in whose favor it is exercised. If the powerholder is granted a presently exercisable general power of appointment, the assets subject to the power are likely exposed to the powerholder's creditors.

XII. BASIS PLANNING: THE POWER OF APPOINTMENT SUPPORT TRUST ("POAST") -- TAX SHELTER LEASING OF THE ELDERLY?

A. Generally

At the risk of being tactless, the death of a parent, grandparent, or other older relation or friend is a sad enough event without also wasting the opportunity for a significant basis increase. If such an older person (an "upstream person") has an excess of applicable exclusion amount, his or her death will be a wasted opportunity to obtain additional basis increase.

B. Outright Upstream Gifts

One can, of course, give an upstream person sufficient appreciated assets to take advantage of his or her unused applicable exclusion amount. This is a relatively simple approach, but it presents several important problems.

1. Poor Use of Donor's Applicable Exclusion Amount

The donor of an upstream gift will be subject to gift tax on the fair market value of the gift, to the extent that it exceeds the donor's available gift tax annual exclusion. This can be offset by the donor's applicable exclusion amount but using the donor's applicable exclusion amount to move assets to a higher generation is contrary to most estate planning wisdom.

2. Diversion by Donee

The upstream gift allows the donee to give or leave the property to someone other than the donor or the natural objects of the donor's bounty. This may be intentional – a gift or bequest – or unintentional – an elective share, forced share, or claim of a creditor.

3. Risk of Access by Donee's Creditors and Spouse

A subset of the risk of diversion is the risk that the donee's creditors and spouse may have claims against the assets given to the donee. This risk can be reduced by only making transfers to donees who have few or no creditors and who are unmarried or married with a very well drafted premarital agreement, but this eliminates an entire category of individuals who are likely to have a significant excess of unused applicable exclusion amount. Also, creditors can be created at any time, and the elderly are susceptible to incurring large medical expenses and to making poor investments.

4. Gift Back to Donor or Donor's Spouse within One Year

Section 1014(e) states that there is no basis adjustment at a decedent's death with respect to assets given to the decedent within one year of the date of death by the

person to whom the asset passes at the decedent's death. Therefore, if one makes a gift to an upstream person who dies within one year and leaves the asset back to the donor, there is no basis increase.

C. The Power of Appointment Support Trust – A Death is a Terrible Thing to Waste

The power of appointment support trust ("POAST") involves a transfer of property to an irrevocable trust for donees, who may include (or even be limited to) the donor's spouse, but which gives a general power of appointment over appreciated trust assets to one or more upstream persons. See Austin, Beaudry and Law, *The Power of Appointment Support Trust*, 154 Trusts & Est. 55 (Dec. 2015); Morrow, *Morrow and the Upstream Optimal Basis Increase Trust*, LISI Estate Planning Newsletter #2635 (April 17, 2018) at http://www.leimbergservices.com; and Morrow, *Morrow and the Optimal Basis Increase Trust (OBIT)*, LISI Estate Planning Newsletter #2080 (March 20, 2013), updated as of late 2017 and available for download at www.ssrn.com.

1. Transfer Must be a Completed Gift

The transfer must be a completed gift; the trust must be irrevocable and the donor cannot retain the power to alter beneficial enjoyment. Otherwise, the IRS will assert that the grant of a general power of appointment is completed only upon the death of the donee of the power, and that no basis increase is available under Section 1014(e).

2. Granting a General Power of Appointment is Not Itself a Taxable Gift

The gift tax law treats the exercise or lapse of a general power of appointment as a taxable gift, but the granting of a general power is not itself a taxable gift. Section 2501(a)(1) states that the gift tax is imposed on "the transfer of property by gift." It does not apply to the grant of powers to appoint property, whether they are general or special powers. Merely granting someone a general power of appointment is not itself a taxable gift, because it does not involve the transfer of property. See also S. Rep. No. 665, 72nd Cong., 1st Sess. (1932), reprinted in 1939-1 (Part 2) C.B. 496, 524 ("property" for this purpose is to be construed broadly and include "the broadest and most comprehensive sense" to reach "every species of right or interest protected by law and having an exchangeable value." Nonetheless, it still does not include a power to appoint property.)

3. Holder of a General Power May be Naked (Figuratively)

a) Generally

A general power of appointment causes the subject property to be included in the holder's gross estate even if the holder has only a naked power of appointment and no beneficial interest in the trust. The power will still be taxable for estate tax purposes and its possession will still cause the subject assets to have their basis adjusted under Section 1014. See, e.g., PLR

(TAM) 200907025 ("the fact that the Decedent could receive only income at the discretion of the trustee and could not receive distributions of corpus during life, is in no way indicative of the Settlors' intent to restrict Decedent's power to appoint the property at his death. A right to receive trust income and a power of appointment are separate interests among the possible interests that a beneficiary may have in a trust. It is the province of a settlor to control the rights and interests set forth in a trust according to the settlor's own wishes.")

b) Why Give Powerholder a Beneficial Interest

One possible reason to give the upstream powerholder at least a contingent beneficial interest in the trust assets is to avoid the analysis proposed by the IRS in *Cristofani v. Comm'r*, 97 T.C. 74 (1991), *acq. in result only* 1992-1 C.B. 1, *acq. in result only* 1996-2 C.B. 1, that a naked power of appointment should be ignored for tax purposes. *Cristofani* involved the grant of *Crummey* withdrawal powers (which are themselves general powers of appointment) to persons who had little or no fixed beneficial interest in the trust. The IRS took the position that these grants were illusory; the beneficiaries would refrain from exercising these powers only if they had agreed in advance not to do so. The Tax Court disagreed and stated that no other beneficial interest was required to create a present interest. Even with this precedent, it may be practical to name the upstream person a contingent beneficiary in order to deter the IRS from disputing the validity of the grant of a general power. See also reliance on *Cristofani* in *Estate of Kohlsaat v. Comm'r*, T.C. Memo. 1997-212; and Morrow & Gassman, *Ed Morrow and Alan Gassman on Mikel v. Commissioner: Tax Court Approves the Mother of All Crummey Trusts with 60 Beneficiaries*, LISI Estate Planning Newsletter #2309 (May 14, 2015).

An important distinction between the situation in *Cristofani* and that in the upstream basis increase trust is that the IRS, in the latter situation, may not want to be recorded having argued that a general power of appointment is not taxable unless the powerholder has a beneficial interest in the trust. This argument may be utile to it in this particular context, but one can imagine many situations in which it would result in a substantial decline in estate tax revenues.

4. Introduction of the "Support" Concept

In light of the issues with giving a naked general power of appointment, consider allowing the Trustee to make discretionary distributions of income and/or principal for the benefit of the upstream beneficiary. Thus, the upstream beneficiary is given both a power of appointment and the ability to receive support; hence, the name "Power of Appointment Support Trust" or "POAST".

5. Decedent Need Not be Competent to Exercise the Power

A testamentary power to appoint the subject property to one's estate or its creditors is taxed as a general power of appointment, even if the individual is, on the date of death and at all times when he or she held the power, legally incompetent to exercise it. The law taxes a powerholder on the property subject to a general power if he or she "possessed" the power on or before the date of death, not whether he or she could legally exercise it. *Fish v. United States*, 432 F.2d. 1278 (9th Cir 1970); *Estate of Alperstein v. Comm'r*, 613 F.2d 1213 (2nd Cir 1979), cert. *denied sub nom. Greenberg v. Comm'r*, 446 U.S. 918 (1980); *Williams v. United States*, 634 F.2d. 894 (5th Cir. 1981); *Boeving v. United States,* 650 F.2d. 493 (8th Cir. 1981), *rev'g* 493 F. Supp. 665 (E..D. Mo. 1980); *Doyle v. United States,* 358 F. Supp. 300 (E.D. Pa 1973); *Pennsylvania Bank & Trust Co. v. United States*, 451 F. Supp. 1296 (W.D. Pa. 1978), *aff'd* 597 F.2d 382 (3rd Cir. 1979); Rev. Rul. 75-350, 1975-2 C.B. 366 (marital deduction allowed for power of appointment marital trust, even though surviving spouse was mentally ill from the time of first spouse's death until time of surviving spouse's death, and under applicable state law, incapable of exercising the power); Rev. Rul.75-351, 1975-2 C.B. 368 (minor had a general testamentary power of appointment even though, under applicable state law, minor was legally incompetent to execute a will at the time of death). But, see also *Finley v. United States*, 404 F. Supp. 200 (S.D. Fla., 1975) *vacated on jurisdictional grounds*, 612 F.2d 166 (5th Cir. 1980) (decedent, from time of devise of general power of appointment until her death lacked legal capacity to exercise general testamentary power of appointment, and so did not "possess" a general power of appointment for estate tax purposes).

6. Decedent Need not Know of Power's Existence

a) Generally

There appear to be no cases directly on point, but as a decedent who lacks the legal ability to understand the power of appointment is deemed to possess it for estate tax purposes, then a competent decedent who simply is unaware of the power's existence should be deemed to possess it. See *Estate of Freeman v. Comm'r*, 67 TC. 202 (1976) (power holder never saw the trust instrument and never knew he had a power of appointment). The only question should be whether the grant of the power is legally effective under state law, when the donee of the power is unaware of the transfer.

Also, the IRS may not want to argue that a general power of appointment is not taxable unless the powerholder knows of its existence. This argument may be useful to it in dealing with POASTs, but it could be turned against the IRS in many cases in which a holder of a power of appointment wishes not to have the subject property included in his or her gross estate; the lack of knowledge is easy to assert and often difficult to disprove.

b) Trustee's Obligation to Inform Powerholder

(1) The Uniform Trust Code

The trustee may not be required to inform a competent adult powerholder of the power's existence in a state in which the Uniform Trust Code has been adopted.

(a) Duty to Inform

Uniform Trust Code § 813(a) requires a trustee to "keep the qualified beneficiaries of the trust reasonably informed about the administration of the trust and of the material facts necessary for them to protect their interests."

(b) Powerholders are Beneficiaries

Uniform Trust Code § 103(3) states that a beneficiary is any person who has either has a present or future beneficial interest in a trust, or a power of appointment over trust property. The Comments to this section explain that:

> *"While the holder of a power of appointment is not considered a trust beneficiary under the common law of trusts, holders of powers are classified as beneficiaries under the Uniform Trust Code. Holders of powers are included on the assumption that their interests are significant enough that they should be afforded the rights of beneficiaries."*

(c) Powerholders May be Qualified Beneficiaries

Qualified beneficiaries include "a distributee or permissible distributee of trust income or principal," someone who would be such a distributee "if the interests of the distributees . . . terminated on that date without causing the trust to terminate," and someone who "would be a distributee or permissible distributee of trust income or principal if the trust terminated on that date." Uniform Trust Code § 103(13). Under the Uniform Trust Code, therefore, a powerholder who is a discretionary beneficiary is clearly a qualified beneficiary entitled to notice of the trust's terms, while one who has no beneficial interest is not a qualified beneficiary and the trustee has no obligation to give him or her notice of the trust and its terms.

(d) Waiver of Notice by the Trust Instrument

Uniform Trust Code § 103(b)(8) states that the duty of the trustee to notify qualified beneficiaries of an irrevocable trust who have reached 25 years of age of the trust's existence, the identity of the trustee, and of their right to request trustee's reports, cannot be waived by the trust instrument. See, however, Va. Code § 64.2-703, allowing waiver of this requirement.

(2) Common Law

The trustee is less likely to be required to inform a competent adult powerholder of the power's existence in a state in which the Uniform Trust Code has not been adopted. The comments to Uniform Trust Code § 103 note that treating holders of powers of appointment as beneficiaries is a departure from the common law of trusts, but that the Uniform Trust Code changes this rule.

Restatement (Third) of Trusts § 82 (2007) provides that the trustee of an irrevocable trust, unless the instrument provides otherwise, must inform fairly representative beneficiaries of the trust's existence, their status as beneficiaries, and their right to obtain other information regarding the trust and the trustee, and under this section "[o]ccasionally . . . the trustee's duty to provide information about a trust will extend also to a donee of a power of appointment . . ." Oddly, the Restatement (Third) of Trusts does not state what those conditions might be, but the fact that a power would cause assets to be included in the gross estate of the powerholder would seem a compelling reason to require a trustee to inform the powerholder of its existence. See also George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* § 961 (rev. 2d ed. 1983) ("the trustee must inform the beneficiary of all material facts affecting the beneficiary's interest that the trustee knows the beneficiary does not know, but that the beneficiary needs to know to protect the beneficiary's interest in dealing with a third party.")

(3) Possible Analogy to *Crummey* Powers

(a) Rev. Rul. 81-7 Requires Notice -- Sort Of

In Rev. Rul. 81-7, 1981-1 C.B. 474, the IRS stated that a withdrawal power does not create a present interest unless the beneficiary is aware of its existence and of any gift against which it may be exercised. Absent such knowledge, the IRS views such a withdrawal power as illusory and inadequate to create a present interest. In that ruling, however, G created a trust giving to A, the beneficiary, a

Crummey power that lapsed at the end of the year. G made a gift to the trust on December 29. No notice was given to A. The IRS stated that the gift tax annual exclusion was not available for these gifts, because

> *"[i]n failing to communicate the existence of the demand right and in narrowly restricting the time for its exercise, G did not give A a reasonable opportunity to learn of and to exercise the demand right before it lapsed. G's conduct made the demand right illusory and effectively deprived A of the power."*

The use of the conjunctive "and" in the quoted material, however, suggests that only the combination of (1) the failure to give notice and (2) the lack of a reasonable amount of time within which to exercise the withdrawal rights justified denial of the annual exclusion. This interpretation suggests that failure to give notice, alone, does not deprive the donor of the annual exclusion and, by analogy, and does not impair the effectiveness of a power of appointment to produce a basis adjustment at the powerholder's death.

(b) IRS Requires Notice; Tax Court Does Not

The Tax Court has repeatedly rejected the requirement of notice for a *Crummey* power. *Estate of Turner v. Comm'r*, T.C. Memo. 2011-209; *Estate of Cristofani v. Comm'r, supra.* In fact, notice was not given to the beneficiary in *Crummey v. Comm'r*, 397 F.2d 82, 86–87 (9th Cir. 1968), *aff'g in part and rev'g in part* T.C. Memo. 1966-144, but in that case the beneficiary was a minor. Thus, the IRS view that notice of a power to appoint to oneself or, by extension, to others, is required in order to make the power effective for income and transfer tax purposes is without much legal support.

(4) Practical Planning

Nonetheless, a practical practitioner may deem it appropriate to give the powerholder notice of the power and his or her right to exercise it, to minimize the chances of a challenge to the validity of the power as a tool for increasing the basis of the subject property. Of course, this brings one back to the most difficult issue – finding an upstream powerholder who will not, either voluntarily or involuntarily, divert

the funds from the natural objects of the donor's affection, and minimizing the risk that one's choice turns out to be less reliable than one hoped.

7. Avoiding Voluntary Diversion by the Exercise of the Power

One can minimize the risk of diversion of the subject property by requiring that the power be exercised only with the consent of a nonadverse party. Reg. § 20.2041-3(c).

a) "Nonadverse party" defined

(1) Generally

Reg. § 20.2041-3(c) does not refer to a "nonadverse party, but states that a power of appointment is not a general power if it is exercisable only in conjunction with the creator or "with the consent or joinder of a person having a substantial interest in the property subject to the power which is adverse to the exercise of the power in favor of the decedent, his estate, his creditors, or the creditors of his estate." Thus, a nonadverse party is anyone who does not have a substantial interest in the subject property and whose interest in the subject property is not adverse to the exercise of the power in favor of the powerholder, his or her estate, the powerholder's creditors, or the creditors of the powerholder's estate.

(2) Substantiality of the Interest

Reg. § 20.2041-3(c) states that an interest is substantial if its value in relation to the total value of the property subject to the power is not insignificant. For this purpose, these interests are to be valued actuarially. Unfortunately, the regulations do not define "insignificant."

(3) Adverse Nature of the Interest

Reg. § 20.2041-3(c) states also that a taker in default has an adverse interest, but a coholder of the power does not, unless the coholder obtains the power after the holder's death and can then exercise it in favor of himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate. One example in the regulations states that a sole remainder beneficiary who is entitled to the subject property after the death of both the powerholder and another person has a substantial adverse interest. Reg. § 20.2041-3(c), Ex. 1. Another example demonstrates that a discretionary beneficiary to whom the trust principal may be distributed has a substantial adverse interest. Reg. § 20.2041-3(c), Ex. 2. On the other hand, a third example shows that a beneficiary who is entitled to trust income during

his or her lifetime does not have an interest adverse to a power to appoint the trust funds at the beneficiary's death. Reg. § 20.2041-3(c), Ex. 3.

(4) Drafting

One of the more difficult problems is finding a nonadverse party who is willing to risk being sued by the unhappy holder of a power of appointment. There are several ways to approach this.

First, one could name an independent trustee as the nonadverse party. The trustee has a fiduciary duty to protect the interests of the beneficiaries named in the instrument, and so is less likely to consent to a different exercise of the power than would be an uninvolved person. The trustee's fiduciary duty also gives the trustee a better litigating position if the powerholder does sue. Also, the trust can provide that the cost of the defense of such a suit should be borne by the trust assets, rather than the trustee's personal resources.

Second, one could seek out that family member who exists in most families, who never agrees with anyone on anything. Such persons are uniquely well-suited to the role as consenting nonadverse person, and they are used to having disputes with family members. Again, however, the trust should provide that the cost of defense of any such suit will be borne by the trust assets.

Third, one could require that the local court serve as the nonadverse party. A local court has no financial interest in the trust, and is clearly a nonadverse party. The time required to obtain the consent of the court means that the powerholder cannot effective act rashly, and the local court is likely to require that all financially-interested persons be notified of the suit and have an opportunity to make their views known. This protects the trustee and slows down the process to minimize the risk of a rash exercise of the power of appointment.

Also, the required consent of a nonadverse party could be imposed in all cases or only where the holder attempts to exercise the power in favor of someone other than the donor or the natural objects of the donor's bounty. The latter group could be described, for example, as "the descendants of the donor's grandparents, and all charitable organizations". A key difficulty with this approach is finding a nonadverse party whom the donor trusts implicitly and who is willing to be the possible target of abuse from the holder of the power or his or her intended appointees who disagree with the decision of the nonadverse party to reject the proposed appointment.

b) Limit Appointees to Powerholder's Creditors

Some practitioners believe that allowing the powerholder to appoint only to his or her creditors will be restrain diversion, while still creating a general power of appointment. In reality, it does not restrain the powerholder very much, because he or she can merely borrow money to spend or give away, and then appoint the trust assets to the lender in satisfaction of the debt. It does force the powerholder to take this additional step, rather than just to appoint the property to his or her estate, but it is hardly a significant restraint on diversion. Also, while the authors disagree, some practitioners are concerned that a power exercisable in favor of one's creditors (or the creditors of one's estate) could be interpreted as general only to the extent that there are actual creditors. This seems inconsistent with the point just made, that the holder of the power has the ability to borrow money and thus expand the appointive property.

8. Rights of the Powerholder's Creditors

a) Generally

Property subject to a nongeneral power of appointment is not usually subject to the claims of the donee's creditors, but property subject to a general testamentary power of appointment may be subject to the claims of the creditors of the powerholder's estate.

b) Uniform Trust Code

The Uniform Trust Code does not address creditor issues with respect to property subject to a testamentary general power of appointment. The comments to Uniform Trust Code § 505 refer to *Restatement (Second) of Property: Donative Transfers* §§ 13.1 to 13.7 (1986), discussed below.

c) Restatement (Second) of Property: Donative Transfers

Traditionally, property subject to an exercised general testamentary power of appointment could be subjected to the payment of claims against the powerholder's estate. *Restatement (Second) of Property* § 13.4 (1986). The idea is that until the powerholder exercises the power, he or she has not accepted sufficient control over the subject property to be treated as if it were owned outright.

d) Restatement (Third) of Property: Donative Transfers

The more modern rule is reflected in *Restatement (Third) of Trusts* § 56, Comments (2007), which states that property subject to a testamentary general power of appointment is subject to the claims of the creditors of the powerholder's estate, whether or not the power is exercised, because the power alone is equivalent to outright ownership. The subject property is

subject to the claims of the powerholder's creditors to the extent the powerholder's estate is insufficient satisfy the claims of those creditors. Property subject to a general testamentary power of appointment does not enable the powerholder's creditors to reach the trust assets during his or her lifetime. California, Michigan and New York all have specific statutory provisions following the pattern of the Restatement (Third).

e) Uniform Power of Appointment Act

Section 502 of the Uniform Power of Appointment Act (2013) follows *Restatement (Third) Trusts* and permits the creditors of the estate of the powerholder to reach the subject property, to the extent the estate's other property is insufficient to meet all claims. This right is subject to the powerholder's right to direct the source from which liabilities are paid.

f) Bankruptcy Act

The U.S. Bankruptcy Code states that the trustee in bankruptcy "stands in the shoes" of the debtor and so may be able to exercise the general power on behalf of the debtor/powerholder and in favor of the bankrupt estate. 11 U.S.C. § 541(b)(1); *In re Behan*, 506 B.R. 8 (Bankr. D. Mass. 2014); *In re Gilroy*, 235 B.R. 512 (Bankr. D. Mass. 1999); see also Bove, *Using the Power of Appointment to Protect Assets – More Power than You Ever Imagined*, 346 ACTEC L. J. 333, 338 (Fall 2010).

g) Planning Considerations

(1) Requiring Solvency

One could precondition the valid exercise of the power in favor of the powerholder's estate upon the solvency of the powerholder's estate. Reg. § 20.2041-3(b), while not expressly authorizing such conditions, seems to presume their viability, when it provides that "a power which by its terms is exercisable only upon the occurrence during the decedent's lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent's death." However, the Tax Court's decision in *Kurz v. Comm'r, supra.*, could pose a problem. The powerholder can always incur new debts, so *Kurz* could cause an insolvent powerholder's gross estate to include the full value of the maximum assets that could have been subject to the power had the powerholder died solvent. *Kurz* was just a tax case, but a state court could apply this same analysis to the rights of the powerholder's creditors, and permit creditors of an insolvent powerholder's estate to reach the power, even though it was not, by its terms, exercisable.

(2) Careful Selection of Powerholder

The best solution to the risk that the powerholder's creditors may seek to attach the trust assets that are subject to the powerholder's general power of appointment is to grant such powers only to persons who have no significant debts and who are unlikely to incur significant debts. This sounds easier than it is, of course, because the fortunes of an individual can change. One way to minimize the risk is to grant the power of appointment only to individuals who are quite elderly and, therefore, unlikely to live long enough to create substantial new debts. Unfortunately, most people do not come with a "use by" date tattooed on their forehead, so that one must rely upon an educated guess as to the donee's life expectancy.

(3) Use a Limited Power of Appointment

One could give the powerholder only a limited power of appointment, which could then be exercised to trigger the Delaware Tax Trap under Section 2041(a)(3), by appointing the property in trust for the benefit of the desired beneficiaries, giving them a currently exercisable general power of appointment. In states that permit one to trigger the Delaware Tax Trap, this should result in inclusion of the subject property in the upstream powerholder's gross estate, with the desired income tax basis adjustment, without subjecting the assets to the claims of the creditors of the powerholder. Of course, the Delaware Tax Trap does cause the assets to become subject to the claims of the appointees' beneficiaries, because a presently exercisable power to appoint trust assets to oneself is treated as equivalent to outright ownership for most state law purposes, including creditors' rights.

(4) Requiring Consent of Nonadverse Party

Generally, property subject to a general power of appointment that is exercisable only after a condition is met is not subject to the claims of the powerholder's creditors until that condition has been met, because the powerholder's creditors cannot reach assets that the powerholder cannot personally appoint. Peter Spero, *Asset Protection: Legal Planning, Strategies and Forms* ¶ 13.10 (Thomson Reuters/Tax & Accounting, 2001 & Supp. 2018-2); Bove, *Using the Power of Appointment to Protect Assets – More Power than You Ever Imagined*, 346 ACTEC L. J. 333, 337-338 (Fall 2010). Thus, creditors ought not to be able to reach assets that can be appointed only with the consent of a nonadverse party, unless they can prove that there was a prearrangement under which the nonadverse party would always consent to whatever appointment the powerholder made.

(5) Amount of the Power

The power granted could be tied directly to the older generation powerholder's available applicable exclusion amount, though it would be appropriate to set it at the lower of the available applicable exclusion amount and the available GST exemption, since GST exemption will need to be allocated to the transfer occurring upon the lapse or exercise of the power of appointment.

To avoid forcing the older generation powerholder to file an estate tax return, one might set the appointable amount at $10,000 or $20,000 less than the available applicable exclusion amount or GST exemption.

9. GST Tax Issues

a) Generally

An upstream general power of appointment should not cause GST tax problems, but it does effect a series of changes in the GST status of the trust and it does require that the upstream person holding the general power of appointment allocate or be deemed to have allocated GST exemption to the trust at his or her death.

b) New Transferor

If property is subject to estate tax in a decedent's estate, the decedent becomes the transferor of that property for GST tax purposes. Reg. § 26.2652-1(a)(2). Thus, the death of the upstream powerholder causes the powerholder to be substituted as the transferor of the property that was the subject of the power of appointment, whether it was exercised or lapsed. This is particularly problematic because the upstream powerholder is, by definition, likely to be assigned to an even higher generation than the original transferor, so that individuals who were previously not skip-persons may become skip-persons with respect to this portion of the trust.

c) Loss of Original GST Exemption Allocation

The change in the identity of the transferor, because the trust is subject to estate taxation in the upstream person's estate, results in a determination of a new inclusion ratio. Thus, a new transferor for a trust results in the loss of any further benefit from the GST exemption previously allocated to the trust. This is not stated directly in the statute. This result follows from the rule in Section 2631(a) that only the transferor can allocate the GST exemption to a trust or transfer. See C. Harrington, L.L. Plaine, J. Miraglia Kwon, & H. Zaritsky, *Generation-Skipping Transfer Tax* ¶ 4.06[4][g] (Thomson Reuters/Tax & Accounting, 2d ed. 2001 & 2018 Cum. Supp. No. 2).

d) New Allocation of GST Exemption Required

(1) Generally

It is easy to use up one's applicable exclusion amount without using an equal amount of GST exemption, merely by making gifts to non-skip persons. Large generation-skipping transfers, however, always utilize applicable exclusion amount. (Annual exclusion gifts, however, may require GST exemption allocation but not exhaust the donor's applicable exclusion amount.) taxable gifts Thus, the upstream person should usually have at least as much unused GST exemption as his or her unused applicable exclusion amount. The upstream person should then allocate (or be deemed to have allocated) his or her GST exemption to the trust, preserving or creating a zero inclusion ratio.

(2) Automatic Trust Division

When different persons make transfers to the same trust, the trust must recalculate its inclusion ratio, and the trust is automatically treated like two separate trusts for GST tax purposes. IRC § 2654(b); Reg. § 26.2654-1(a)(2)(i). Treatment of a single trust as separate trusts under this rule is solely for purposes of calculating the GST tax; it does not mean that the trust files two income tax returns. Reg. § 26.2654-1(a)(2)(i). Because the two trusts should both have zero inclusion ratios (one based on the allocation of GST exemption by the original transferor and the other based on the allocation of GST exemption by the upstream person).

(3) Automatic Deemed Allocations

Obviously, the estate of the upstream person can file an estate tax return and allocate GST exemption to the trust. IRC § 2632(a). The unused GST exemption of a deceased upstream person will be automatically allocated to the trust, after allocation to any direct skip transfers, because the trust individual is a transferor and taxable distribution or a taxable termination might occur from the trust at or after such individual's death. IRC § 2632(e).

e) Don't Allocate GST Exemption – Wait for Upstream Powerholder to Pass

One way to avoid the issue of wasting the original donor's GST exemption is simply for the original donor to opt-out of being his/her GST exemption. Thus, when the upstream powerholder dies, such upstream powerholder's GST exemption is allocated to the trust. However, care must be given when giving the upstream powerholder an unlimited general power of appoint-

ment, because if the assets to which the power is given exceeds the donee/upstream beneficiary's unused lifetime exclusion amount or GST exemption, there could be estate or GST tax implications.

10. Limiting the Power of Appointment

If the upstream beneficiary is given a testamentary general power of appointment over the POAST, at the time of such upstream beneficiary's death, the entire value of the POAST would be included in his/her gross estate. This could cause unintended consequences (i.e., it may cause a Federal estate tax, where one was not anticipated).

To eliminate this contingency, the upstream beneficiary's testamentary general power of appointment should be structured as a contingent testamentary general power of appointment. Using a contingent general power of appointment is not a new concept. It has been used for over 30 years (i.e., since the inception of the 1986 version of the GST tax) to minimize the impact of such tax. The drafter should be careful in structuring the contingent general power of appointment to minimize risking the IRS raising the step transaction / implied agreement doctrine, however.

a) Limiting to the Upstream Beneficiary's Otherwise Unused Applicable Exclusion Amount

Limiting the contingent general power of appointment to the upstream beneficiary's otherwise unused applicable exclusion amount avoids the imposition of any estate tax when the upstream beneficiary dies. If the assets in the POAST exceed the upstream beneficiary's otherwise unused applicable exclusion amount, and there is no limit on the general power of appointment, then the upstream beneficiary would have a taxable estate with an estate tax liability.

For example, if the upstream beneficiary, G1, never made taxable gifts in his lifetime and had a gross estate of $2.18 million, and the POAST had assets of $10 million, the basic exclusion amount at the time of death was $11.18 million, and G1 has an unlimited general power of appointment, then there would be an estate tax due on $1 million (i.e., $2.18 million + $10 million - $11.18 million = $1 million). Thus, even though there would be a basis adjustment on all of the assets, there would now be an estate tax of $400,000 (assuming a 40% estate tax rate).

Thus, the contingent general power of appointment should be limited to the upstream beneficiary's otherwise unused applicable exclusion amount.

From a planning perspective, we suggest that the contingent general power of appointment should be limited to an amount equal to the upstream beneficiary's otherwise unused applicable exclusion amount less $10,000. The reason for this is that the gross estate of the upstream beneficiary will be

less than the threshold for filing an estate tax return. Thus, you get all of the benefits of a basis adjustment without having to file an estate tax return!

b) Limiting to the Upstream Beneficiary's Otherwise Unused GST Exemption

The upstream beneficiary's contingent general power of appointment should also be limited to his/her otherwise unused GST Exemption, because if it is not, then it is entirely possible that there could be a taxable termination at the upstream beneficiary's death, which would cause a GST tax to be imposed.

Example XII-1

Assume that the upstream beneficiary (G1) made significant annual exclusion gifts to GST trusts where he used $5.18 million of his GST exemption, but had never used any of his applicable exclusion amount. At the time of death G1 had a gross estate of $1.18 million and had an unlimited general power of appointment over a POAST worth $10 million at the time of his death. G1 dies in 2018 when the basic exclusion amount and GST exemption is $11.18 million. The trust was created by upstream beneficiary's son, G2, where G1 had a discretionary income interest for support and G2's children (i.e., G1's grandchildren) were also discretionary beneficiaries. And upon G1's death, the trust is for G3 (i.e., G1's grandchildren) and their descendants.

As a result of G1's death, there will be no estate tax, because the gross estate (i.e., $1.18 million + $10 million = $11.18 million) is equal to G1's applicable exclusion amount (of $11.18 million), thus, there is no estate tax. However, because G1 only had $6 million of GST Exemption remaining (having used $5.18 million of his $11.18 million during his life), $4 million of the POAST will not be GST exempt. And, because G1 becomes the 'transferor' for GST tax purposes as a result of including the POAST in G1's estate for estate tax purposes, and because the only beneficiaries are G3 and their descendants, who are skip persons as to G1, there is now a taxable termination and $1.6 million of GST tax due (assuming a 40% GST tax rate).

To avoid the unintended incursion of estate tax or GST tax liability, the upstream beneficiary should be given a contingent general power of appointment limited to the lesser of (a) the upstream beneficiary's otherwise unused applicable exclusion amount (reduced by $10,000), or (b) the upstream beneficiary's otherwise unused GST Exemption (reduced by $10,000).

By limiting the general power of appointment, you not only avoid the possibility of the imposition of the estate and/or GST tax liability, but also eliminate the need to file an estate tax return for the upstream beneficiary, while at the same time obtaining a basis adjustment for the assets. This can be accomplished by using a POAST.

11. Interaction of an Upstream General Power of Appointment and a *Crummey* Power

There is no case or ruling on point, but a testamentary general power that gives the upstream person the power to appoint all or some part of a gift that is still subject to the donee's *Crummey* withdrawal power could disqualify the gift for the annual exclusion, because the beneficiary's withdrawal right is not absolute. Furthermore, a testamentary general power that gives the upstream person the power to appoint all or some part of a gift that is still subject to the donee's hanging *Crummey* withdrawal rights could be deemed to cause those rights to lapse in excess of the five percent or $5,000 limitation, thereby causing a taxable gift. To avoid this, the upstream power of appointment should expressly not apply to any portion of the trust that is subject to a beneficiary's *Crummey* withdrawal right.

One astute author has noted that:

> *"Ironically, any power to appoint trust assets that can only be made to a trust which keeps the existing Crummey withdrawal right intact is not a general power as to that portion (as it cannot be appointed to the power holder, his/her creditors, estate, or creditors of estate). [citation omitted] However, because any such appointive trust would have a presently exercisable general power of appointment (a Crummey power is a presently exercisable power of appointment), the exercise of the limited power of appointment would trigger the Delaware Tax Trap under most every state law. [citation omitted] Thus, the appointment of any portion subject to Crummey rights would trigger inclusion under §2041(a)(3) and the appointment of the remaining portion would trigger inclusion under §2041(a)(2)."*

See Morrow, *Morrow and the Upstream Optimal Basis Increase Trust*, LISI Estate Planning Newsletter #2635 (April 17, 2018).

12. Death of Upstream Powerholder within One Year of Gift to Trust – Section 1014(e)

a) Generally

If the powerholder dies within one year of the gift funding the trust, a step up in basis should not be denied under Section 1014(e), even if the same assets return to the donor by appointment or in default of a valid appoint-

ment. Section 1014(e)(1) denies a basis adjustment only for "appreciated property . . . acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death. . . ." This rule requires a transfer of property, and the grant of a general power of appointment is not a transfer of property; it is a transfer of the ability to dispose of property that the transferee (powerholder) does not possess. There are no cases or rulings on this point, and the IRS may take a different position. One should caution the client that there is always a chance that this type of trust will not provide the desired basis adjustment unless the powerholder lives for at least one year.

b) The Gift and Sale Approach

(1) Generally

Some practitioners suggest that the trust be funded with cash or unappreciated assets, and that the grantor then sell appreciated property to the trust for a promissory note. The theory is that the sale is not a gift for purposes of Section 1014(e), and the original gift was not of appreciated property, so that this rule should not apply.

(2) The Step Transaction Doctrine Rears its Ugly Head

The problem with this analysis is that the step transaction doctrine is likely to cause the gift and sale to be treated as part of an integrated transaction, to which Section 1014(e) may apply.

(a) Using Older Powerholders Increases Step Transaction Problems

This is particularly true because one tends to use the upstream power of appointment with an elderly powerholder, so that there may be relatively little time between the grant of the power and its lapse or exercise. The proximity of the two steps is, admittedly, only one factor in determining the application of the step transaction doctrine, but it is one of the most important.

(b) Planning to Avoid the Step Transaction Doctrine on a Gift and Sale Transaction

The planner must take steps to treat the initial gift as transaction from the later sale to the trust.

(i) Time is Not on Your Side

This may be as simple as waiting a substantial time between the initial gift and the sale, but as noted above, one may not have a long time to wait between the transactions. Also, there is no bright line test for time. The longer the time between steps, the less likely it is that the steps will be treated as part of a single integrated transaction. *Compare, however, Henricksen v. Braicks*, 137 F.2d 632 (9th Cir. 1943) (transactions one-half hour apart were independent); and *Comm'r v. Ashland Oil & Refining Co.*, 99 F.2d 588 (6th Cir. 1938), *cert. denied*, 306 U.S. 661 (1939) (steps six years apart were part of a single integrated transaction).

(ii) Do Not Document the Multiple Steps

The planner should not explain in writing that the gift of cash or unappreciated assets will be followed by a sale for appreciated assets. Even privileged communications have a nasty habit of turning up in IRS files. Instead, the planning memo should describe the creation of the trust and the cash or unappreciated property gift. The trustee should then invest the cash, rather than keeping it in its present form. The memo should also state that, after a reasonable time, the grantor and the trustee should meet with the planner to discuss further investment options for the trust. After that meeting, the planner can document the sale to the trust.

13. Grantor Trust Status After the Powerholder's Death

A trust is a grantor trust if the grantor retains (or a nonadverse person holds) the delineated powers and interests described in Sections 673-677. The grantor does not own any portion of the trust attributable to a transfer by someone else, unless the grantor holds a withdrawal power described in Section 678. The death of the powerholder constitutes a constructive addition to the trust for grantor trust purposes only if the powerholder exercises the power in favor of the trust; the lapse of the power does not constitute a constructive addition to the trust. See Reg. §§ 1.671-2(e)(5), 167.1-2(e)(6), Ex. 9.

This may (or may not) be tied to the clear property law in most states that allows the creditors of the holder of an exercised general power of appointment to reach the appointive assets, while denying such access to the creditors of the holder of a lapsed general power of appointment.

Thus, if the trust is a grantor trust and the grantor wants it to remain a grantor trust, the powerholder should allow the general power of appointment to lapse, rather than exercise it.

14. Exercising an Upstream General Power to Appoint Assets in Trust for the Grantor's Benefit

a) Generally

A grantor who retains beneficial enjoyment or the power to alter beneficial enjoyment of a trust fund may have the trust assets included in his or her gross estate under Sections 2036 or 2038. The law is unclear, but there is a good chance that the same result may occur if an upstream powerholder exercises his or her general power of appointment in further trust for the benefit of the grantor.

b) Does the General Power of Appointment Negate the Original Transfer by the Grantor for Estate Tax Purposes?

(1) Section 2036 – Not Usually a Problem

Section 2036(a) includes in a decedent's gross estate property transferred by the decedent during his or her lifetime (except for a *bona fide* sale for an adequate and full consideration in money or money's worth), and as to which the decedent retains a lifetime right to income or enjoyment of the property or a right to designate who shall enjoy the beneficial enjoyment of the property. The requirement that the interest or power be "retained" renders it difficult to apply Section 2036(a) to an interest that is granted the donor by the exercise of an upstream testamentary power of appointment.

Section 2036(a) could apply, however, if there is an understanding or agreement between the donor and the upstream powerholder that the latter will exercise the power in a manner that bestows an interest or power to the former. In such a situation, the interest could be deemed retained. For this reason, the upstream powerholder should have separate counsel draft the will that exercises his or her power of appointment; use of the same counsel who prepared the trust instrument could raise a suggestion that there was an understanding or agreement to benefit the donor.

(2) Section 2038, However, is Another Matter Entirely

(a) Generally

Section 2038(a)(1) includes in a decedent's gross estate property transferred by the decedent during his or her lifetime (except for a *bona fide* sale for an adequate and full consideration in money or money's worth), and the decedent possessed on the date of death a power to alter, amend, revoke, or terminate. Section 2038(a)(1) does not require that the decedent have retained this power; it requires only that it exist on the date of the decedent's death. See Rev. Rul. 70-348, 1970-2 C.B. 193 (property included in estate of decedent who became custodian of gift to minor on death of original custodian).

Therefore, on its face, Section 2038(a)(1) should apply if the upstream powerholder exercises a general power to appoint the subject assets in further trust, either for the beneficial enjoyment of the original grantor (such as a right to invade principal or income) or for the beneficial enjoyment of others in the discretion of the original grantor. See *Seasongood v. United States*, 331 F. Supp. 486 (S.D. Ohio 1971). A grantor's right to distribute trust assets subject to an external ascertainable standard, however, does not fall under Section 2038(a)(1). *Estate of Ford v. Comm'r*, 53 T.C. 114 (1969), *acq. in part, nonacq. in part recommended*, AOD, 1970 WL 22802 (May 13, 1970), 1978 WL 194691 (Dec. 31, 1978), *aff'd per curiam,* 450 F.2d 878 (2d Cir. 1971).

(b) Is the Upstream Powerholder the True Transferor?

Most practitioners would treat the inclusion of the subject assets in the powerholder's gross estate under Section 2041 as rendering the powerholder the new transferor in lieu of the original grantor, for purposes of Section 2038. Unfortunately, there appears to be no authority to support this analysis and one could as easily argue that the original grantor remains a transferor for this purpose.

(i) Point Against

Section 2038(a)(1) states that it applies "without regard to when or from what source the decedent acquired such power." This would appear to undercut the argument that the upstream powerholder should

supplant the original grantor for purposes of Section 2038.

(ii) Comparison with Section 2044

A contrary rule applies where property is included in the gross estate of a donee-spouse under Section 2044. In such cases, the donee-spouse is treated as the transferor for estate and GST tax purposes and can create a trust for the original grantor without the application of Sections 2036 or 2038. This, however, is because of a specific statutory direction that a deceased spouse be treated as the transferor of any property includible in his or her gross estate because of a lifetime QTIP election. IRC § 2044(c).

(iii) Comparison with Grantor Trust Rules

In determining who is the grantor of a trust for grantor trust purposes, Reg. § 1.671-2(e)(5) states that:

> *"If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code."*

This, however, is an income tax rule, and there is no authority for adopting a similar rule for estate tax purposes.

15. Combining a POAST with a Domestic Asset Protection Trust

The only reason why a general power of appointment might not be appropriately granted to an upstream person with respect to a trust created for the grantor's lifetime benefit under a domestic asset protection trust statute, would be that it could expose the trust assets to the claims of the powerholder's creditors. There appears

to be no inconsistency between the rules for an upstream general power of appointment and those for a domestic asset protection trust.

16. Other Innovative Planning Opportunities with POASTs

One of the major goals of the POAST is to utilize the upstream beneficiary's otherwise unused applicable exclusion amount and GST exemption, by causing part or all of the assets in the POAST to be included in G1's gross estate. A goal, not explicitly stated before, is to try to fund the POAST with assets, but to do so without using too much of the donor's (i.e., the lower generation's) applicable exclusion amount.

For purposes of this section, we call the upstream beneficiary, G1, the donor, G2 and the donor's other beneficiaries (e.g., his descendants), G3.

Funding by using G2's annual exclusion amounts accomplishes that goal; however, it is limited to the amount of G1s and G3s. But, there are other ways to fund the POAST.

a) The Pour-Over GRAT Approach

Using zeroed-out GRATs are generally a good planning tool in low interest rate environments, because they are very little of G2's applicable exclusion amount. However, they are not good tools from a GST tax perspective (because of the so-called "ETIP" rules). With successful GRATs, assets remaining in the GRAT could pour-over into the POAST.

Remember, we do not suggest allocating G2's GST exemption to the POAST. We wait until G1 dies and uses his otherwise unused GST exemption and allocates it to the POAST. This way, you get the benefit of the GRAT (i.e., passing assets gift/estate tax free) as to G2, and the allocation of G1's GST exemption, and a basis adjustment at G1's death.

b) The Pour-Over CLAT Approach

CLATs, like GRATs, are also good, low-interest rate estate planning tools. Like GRATs, if the CLAT is successful, the remainder generally passes to non-charitable beneficiaries. And, like GRATs, the ETIP rules apply. To get the same benefits as using a "pour-over GRAT", if there is a POAST, consider leaving the remainder of the CLAT to the POAST.

c) The Convertible POAST

Consider converting an otherwise irrevocable, dynastic trust to a POAST. Many irrevocable, dynastic grantor trusts have trust protectors with the power to add a beneficiary (i.e., often to achieve grantor trust status under

Section 674(c)). If the trust has such a provision, simply add G1 as a beneficiary and give G1 a contingent testamentary general power of appointment.

If there is no trust protector, consider judicial modification. For instance, the grantor, beneficiaries and trustee could petition a count to add G1 as a discretionary income and principal beneficiary, and also provide G1 with a contingent testamentary general power of appointment.

Alternatively, if the state law permits, it may be possible to accomplish the same (i.e., adding G1 as a beneficiary with a contingent testamentary general power of appointment) through non-judicial modification.

d) Insuring G1's Life

Another efficient way to leverage the POAST is to purchase life insurance on G1s life, if it is financially feasible.

e) The Sale to a POAST

To add value to the POAST, consider the "sale to the intentionally defective grantor trust" approach. Since the POAST is structured as a grantor trust for income tax purposes, consider the sale of discounted assets to the POAST, where G2 would take back a promissory note with a favorable interest rate. If the assets outperform the interest rate on the promissory note, the appreciation will increase the net value of the POAST.

17. Premature Death of the Donor

It is entirely possible that the donor (G2) predeceases the upstream beneficiary (G1). If this is the case, the basis of the transferred assets into the POAST will not get a basis adjustment at G2's premature death (i.e., the opposite result had G2 done nothing). So, one may think that the planning did not succeed. That is not accurate. Let's put things into perspective.

If G2's death was foreseeable (i.e., G2 was ill at the time of the planning), the POAST should not have been a suggested planning tool. Conversely, if death was not foreseeable, the statistical likelihood of G2 predeceasing G1 would have been small, and thus likely ignored.

Remember, premature death simply delays the income tax benefit of the basis adjustment (unless you take the position that the basis can be adjusted at G1's death).

However, because the POAST was a grantor trust, it is likely that there would be a 'swap power' under Section 675(4)(C), which could have allowed G2 to swap some higher basis assets into the POAST and lower basis assets back into G2's estate before death to reduce the impact of waiting for the lower-basis assets to be adjusted when G1 dies.

Finally, it is important to remember the income tax benefit (i.e., basis adjustment) is only one of the benefits, the other benefits include the allocation of G1's otherwise unused GST exemption, the basis adjustment when G1 dies, and the ability to care financially for G1, should the need arise.

18. The SLAT-POAST

The so-called, Spousal Lifetime Access Trust, or SLAT, became a highly-touted estate planning tool in the early 2000s. The idea behind the SLAT was to create a trust for the benefit of one's spouse and descendants, and, assuming a happy marriage (or a relatively happy marriage, or a so-so marriage, but one that will likely end with death of one spouse), the donor and spouse get to effectively use the assets for their benefit, even though the assets have been moved out of the donor's estate for estate tax purposes.

The POAST can be structured as a SLAT. In other words, if the donor is (happily, relatively happily, etc.) married, he/she could consider creating a SLAT, and adding an upstream beneficiary as a discretionary beneficiary (for support) and giving the upstream beneficiary a contingent testamentary general power of appointment.

This combines the benefits (and burdens) of the SLAT with the benefits (and burdens) of a POAST ... The "SLAT-POAST."

XIII. BASIS PLANNING: POST-FORMATION TECHNIQUES TO CREATE BASIS IN AN IRREVOCABLE TRUST AT THE GRANTOR'S DEATH – TRICKIER THAN IT OUGHT TO BE

A. The Problem Explained

The 2017 TCJA continues a recent history of legislative significant increases in the applicable exclusion amount. Many grantors will find that they now have more applicable exclusion amount than they require, and that their prior gifts to irrevocable trusts will now provide no estate tax savings. Yet, these gifts did remove property from the grantor's gross estate and so will deprive those assets of a basis adjustment at the grantor's death. The grantor has, in essence, foregone a basis increase at death in exchange for no actual estate tax savings. Such grantors will often wish to cause their irrevocable trusts to be included in the grantor's gross estate, either entirely or in part.

B. Give the Grantor a General Power of Appointment

The regulations state that an individual cannot retain to himself or herself a general power of appointment, for estate tax purposes. Reg. § 20.2041-1(a)(2) ("For purposes of §§20.2041-1 to 20.2041-3, the term 'power of appointment' does not include powers reserved by the decedent to himself within the concept of sections 2036 through 2038.") Where such a power was not "reserved" by the decedent, however, one could arguably be granted later. Nonetheless, there is no real precedent on this issue, and one might find it useful to evaluate the addition of a power in the grantor to appoint the trust assets under Sections 2036 and 2038, rather than under Section 2041.

C. Gross Estate Inclusion under Section 2036

1. Generally

It is difficult to cause the grantor's estate to include trust assets under Section 2036, because that section applies only to interests and powers that are retained by the grantor. One could, perhaps, argue that the grantor retained this interest or power by not expressly negating the power of the trustee and beneficiaries to decant or reform the trust, though there is no authority in support of this analysis. See, *e.g.*, Va. Code §§ 64.2-729 (modification of noncharitable irrevocable trust by court order upon consent of grantor and beneficiaries, even if modification is inconsistent with a material purpose of the trust); 64.2-730 (modification of a noncharitable irrevocable trust by court order upon finding that, because of circumstances not anticipated by the grantor, modification will further the trust purposes or prevent the trust from being impracticable or wasteful or impair the trust administration); 64.2-733 (judicial modification to conform the terms of the trust to the grantor's intentions, upon proof by clear and convincing evidence that both the grantor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement); 64.2-734 (judicial modification to achieve the grantor's

tax objectives in a manner that is not contrary to the grantor's probable effect); 64.2-779.8(D) (power to create and modify powers of appointment in new trust decanted under expanded distributive discretion (discretion that is not limited by an ascertainable standard or a reasonably definite standard).

2. Grantor Cannot Assert Substance Over Form

Section 2036 applies to a power or interest in a trust that is retained by an express or implied agreement or understanding, even if it is not expressed in the trust instrument. *Skinner v. United States,* 316 F.2d 517 (3d Cir. 1963); *Estate of Linderme v. Comm'r,* 52 T.C. 305 (1969); *Estate of Kerdolff v. Comm'r,* 57 T.C. 643 (1972); Rev. Rul. 70-155, 1970-1 C.B. 189; Rev. Rul. 78-409, 1978-2 CB 234.

A grantor may, therefore, assert that such an interest or power was retained by an agreement with the trustees that was not expressed in the trust instrument. For example, a grantor who creates a QPRT and outlives the reserved use term could then continue to use the residence without paying adequate rent. Such continued use of the property would normally be deemed a retained beneficial enjoyment, if it were anticipated from the creation of the trust.

The courts and the IRS, however, have held that the taxpayer cannot argue substance over form, because the taxpayer selects the form of the transaction and cannot thereafter challenge it. *City of New York v. Comm'r,* 103 T.C. 481 (1994), *aff'd*, 70 F.3d 142 (D.C. Cir. 1995) ("To freely allow taxpayers to argue for alternative tax treatment of a transaction upon the examination of the returns would be tantamount to administering the tax laws based on a policy that tax consequences flow from the 'transaction taxpayers have chosen or from any other form [of transaction] they might have chosen, whichever is … [more favorable]'"); *Estate of Durkin v. Comm'r*, 99 T.C. 561, 571-573 (1992); *Comm'r v. Danielson,* 378 F.2d 771 (3d Cir. 1967), *rev'g* 44 T.C. 549 (1965); *Coleman v. Comm'r*, 87 T.C. 178 (1986), *aff'd without op.* 833 F.2d 303 (3d Cir. 1987); *Howell v. Comm'r*, T.C. Memo. 2012-303. See also, CCA 201121020; FSAs 199921002, 199909018, 200004011, and 200242004; and TAMs 9515003, 200334001, and 200418008.

The Ninth Circuit explained this in *In re Steen v. United States,* 509 F.2d 1398, 1402-1403 fn. 4 (9th Cir.1975), in which it stated:

> *"The rule [that the government may bind a taxpayer to the form in which he has factually cast a transaction] exists because to permit a taxpayer at will to challenge his own forms in favor of what he subsequently asserts to be true substance would encourage post-transactional tax planning and unwarranted litigation on the part of many taxpayers and raise a monumental administrative burden and substantial problems of proof on the part of the government."*
>
> * * *
>
> *In a case such as this one, where the documentary form of the transaction is ambiguous, the government's assertion of the rule will nor-*

mally render the taxpayer's factual characterization of the transaction on his income tax return conclusive against his conflicting and subjective testimony."

The taxpayer can overcome this rule only by "strong proof" of the original intent of the transaction. Strong proof, a uniquely tax-related standard, is similar to the clear and convincing evidence required to reform a written contract. *Muskat v. United States*, 554 F.3d 183 (1st Cir. 2009), *aff'g* 2008 WL 1733598, 101 A.F.T.R. 2d 2008-1606 (D.N.H. 2008).

D. Gross Estate Inclusion under Section 2038

1. Generally

A grantor may be able to cause trust assets to be included in his or her gross estate by obtaining a power to alter, amend, revoke, or terminate the beneficial enjoyment of those assets. Section 2038(a)(1) applies to such a power as long as it is held by the grantor on the date of his or her death (or released within three years of the date of his or her death) "without regard to when or from what source the decedent acquired such power." This suggests that gross estate inclusion should be possible by granting the grantor a power to control the beneficial enjoyment of all or specific trust assets, whether the grantor obtains this power by decanting, judicial reformation, or nonjudicial reformation. Unfortunately, the law is not quite that simple.

2. *Skifter* and the Origin of the Power

Under a line of cases, an Section 2038(a)(1) power cannot exist unless its creation was reasonably anticipated by the grantor when the trust was created.

a) *Estate of Skifter*

(1) Facts

In *Estate of Skifter v. Comm'r*, 468 F.2d 699 (2d Cir. 1972), *aff'g* 56 T.C. 1190 (1971), *nonacq. recommended* AOD (Dec. 22, 1971), *acq*. 1978-2 C.B. 1, Hector Skifter gave his wife an insurance policy he owned on his own life. Hector lived more than three years, but unfortunately, his wife predeceased him, leaving the policy to a trust of which he was trustee. As trustee, Hector had the right to change the policy beneficiaries, though he could not benefit himself by so doing.

(2) Government Argument

The IRS contended that Hector held incidents of ownership over the policy, notwithstanding that his exercise of those incidents was circumscribed by his fiduciary duties.

(3) Courts Treat Life Insurance Policy Like Other Assets are Treated Under Sections 2036 - 2038 and 2041

The Tax Court and the Second Circuit both held for Hector's estate, that he might have incidents of ownership, but that he should not be taxed on the policy proceeds under Section 2042. The courts stated that life insurance is supposed to be treated under Section 2042 like other property is treated under Sections 2036 and 2038. In this situation, the courts held, Hector had obtained the power to control the policy's beneficial enjoyment from an unexpected and uncontrolled source – his late wife's death. The Second Circuit explained:

> *"This type of power would fall under both § 2036 and § 2038. The former provision is clearly not triggered in this case because it only applies to a power retained by the grantor over the income from property when he transferred it to another. Thus, for purposes of § 2036, it would not matter that the decedent effectively had the power to deprive later income beneficiaries of the income from the corpus in favor of an earlier income beneficiary. However, the latter provision, § 2038, would apply because decedent had the power "to alter, amend . . ., or terminate" the trust. The Commissioner has pointed to many cases holding that such a power would result in the property interest over which the power could be exercised being included in the estate of the holder of the power. [citations omitted] Therefore, he argues, this power must be an incident of ownership for § 2042 purposes also.*
>
> *But the Commissioner's reliance on § 2038 cases exposes the fatal flaw in his position. The cases he cites dealt with powers that were retained by the transferor or settlor of a trust. That is not what we have here; the power the decedent had was given to him long after he had divested himself of all interest in the policies-it was not reserved by him at the time of the transfer. This difference between powers retained by a decedent and powers that devolved upon him at a time subsequent to the assignment is not merely formal, but has considerable substance. A taxpayer planning the disposition of his estate can select the powers that he reserves and those that he transfers in order to implement an overall scheme of testamentary disposition; however, a trustee, unless there is agreement by the settlor and/or beneficiaries, can only act within the powers he is granted.*

> *When the decedent is the transferee of such a power and holds it in a fiduciary capacity, with no beneficial interest therein, it is difficult to construe this arrangement as a substitute for a testamentary disposition by the decedent. [citations omitted]"*

468 F.2d 699, at 703-704.

b) Split in the Circuits

The Sixth and Eighth Circuits followed *Skifter*. See *Hunter v. United States*, 474 F. Supp. 763, 764-65 (W.D.Mo.1979), *aff'd*, 624 F.2d 833 (8th Cir. 1980); and *Estate of Fruehauf v. Comm'r,* 427 F.2d 80 (6th Cir. 1970). See also *Estate of Reed v. United States*, 36 AFTR 75-6413 (S.D. Fl. 1974), stating that Section 2038 applies only

> *"where the transferor-decedent himself sets the machinery in motion that purposefully allows fiduciary powers over the property interest to subsequently return to him."*

The Fifth Circuit, however, twice rejected the Second Circuit's analysis, because it did not believe that the legislative history of Section 2038 was relevant to analysis of life insurance policies under Section 2042. *Terriberry v. United States*, 517 F.2d 286 (5th Cir. 1975), *cert. denied*, 424 U.S. 977 (1976); and *Rose v. United States*, 511 F.2d 259 (5th Cir. 1975).

c) IRS Fudges and then Acquiesces -- Rev. Rul. 84-179

The IRS nonacquiesced in *Skifter*, but then acquiesced and adopted its analysis in Rev. Rul. 84-179, 1984-2 C.B. 195, in which it excluded the proceeds of a life insurance policy from an insured decedent's gross estate, if the policy was held in a fiduciary capacity, the incidents could not be exercised for the decedent's personal benefit, and:

> *"the decedent did not transfer the policy or any of the consideration for purchasing or maintaining the policy to the trust from personal assets, and the devolution of the powers on decedent was not part of a prearranged plan involving the participation of decedent."*

See Folk, *Fiduciary Powers and Life Insurance: Putting Rev. Rul. 84-179 Into Perspective*, 63 Taxes 417 (1985). This, albeit indirectly, appears to accept the concept that Section 2041 and, by analogy, Section 2038, cannot apply unless the grantor initiates the transfer that results in his or her

possession of a power to alter, amend, revoke, or terminate beneficial enjoyment.

a) Analysis

(1) *Skifter* Seems Correct

Skifter poses a distinct obstacle in using Section 2038 to cause an irrevocable trust to be included in a grantor's gross estate. The legislative history of various tax acts suggests that the court in *Skifter* was correct, and that Section 2038 requires that the grantor's actions ultimately produce the right to alter, amend, revoke, or terminate. See discussion in Blattmachr, Zeydel, and Gans, *The World's Greatest Gift Tax Mystery, Solved*, Tax Notes 61 (April 27, 2007). Thus, one may reasonably expect the IRS to contest the use of a trust reformation or decanting to give the grantor a Section 2038 power over an extant irrevocable trust.

(2) Level of Grantor Involvement Required

It is not clear what *Skifter* actually requires in the way of grantor initiation of the power. It ought not to require that the power be retained by the grantor, because the Code was quite clear in imposing this requirement in Section 2036(a) and the plain language that was used there is missing from Section 2038. This may be a logical inference, but it is not necessarily legally required. See *Kirtsaeng v. John Wiley & Sons, Inc.*, 568 U.S. 519 (2013) (No canon of interpretation forbids interpreting different words used in different parts of the same statute to mean roughly the same thing.)

The *Skifter* analysis appears to require that the grantor take some affirmative action to obtain the power in question, and that he or she not merely sit passively while the power is granted to him or her. Thus, a decanting by the trustee that gives the grantor a power to appoint the trust assets would not seem to satisfy the *Skifter* requirements, possibly unless if the trustee's decision to decant was prompted by a letter from the grantor stating that the grantor had unused applicable exclusion amount and that the trustee ought to take steps to cause the assets to be included in the grantor's gross estate. A trust reformation initiated by the grantor, either alone or together with the trustee, the beneficiaries, or both, to give the grantor such a power would certainly seem to satisfy the *Skifter* requirements.

Uniform Trust Code § 411(a) states, in part, that:

> *"(a) [A noncharitable irrevocable trust may be modified or terminated upon consent of the settlor and all*

> *beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust.] [If, upon petition, the court finds that the settlor and all beneficiaries consent to the modification or termination of a noncharitable irrevocable trust, the court shall approve the modification or termination even if the modification or termination is inconsistent with a material purpose of the trust.] A settlor's power to consent to a trust's modification or termination may be exercised by an agent under a power of attorney only to the extent expressly authorized by the power of attorney or the terms of the trust; by the settlor's [conservator] with the approval of the court supervising the [conservatorship] if an agent is not so authorized; or by the settlor's [guardian] with the approval of the court supervising the [guardianship] if an agent is not so authorized and a conservator has not been appointed.*

See, Ar. Stat. § 28-73-411; D.C. Code § 19-1304.11; Kan. Stat. 58a-411; K.Y. Stat. § 386B.4-110; 18-B Me Stat. § 411; Mo. Stat. 456.4-411A; Minn. Stat. § 501C.0411; N.M. Stat. § 46A-4-411; N.C. Stat. § 36C-4-411; 20 Pa. C.S.A. § 7740.1; S.C. Stat. § 62-7-411; Utah Stat. § 75-7-411; Va. Code § 64.2-729; 14A Vt. Stat. § 411; Wis. Stat. 701.0411; Wy. Stat. § 4-10-412. The grantor can initiate the suit and join the beneficiaries as petitioners. This should satisfy the requirement of *Skifter*.

For those states that did not adopt UTC's version of section 411, such as Florida, perhaps using non-judicial modification provisions under UTC section 411 (Fl. Stat. § 736.0111) or using the modification to achieve the settlor's tax objectives under UTC 416 (Fl. Stat. § 736.0416) may be another way to accomplish this. Note, however, the settlor would have to be a party to the non-judicial modification under section 111 and/or join in the court proceeding under section 416.

States that permit a reformation but have not adopted the Uniform Trust Code may still permit the grantor to file the petition for reformation.

The courts have not provided details on what actions by a grantor are sufficient to cause gross estate inclusion under Section 2038 after the trust has been created, but it seems reasonable that such a suit to reform would suffice. In any event, this is the most promising avenue for causing Section 2038 to apply to an irrevocable trust in which the grantor originally retained no power to alter, amend, revoke or terminate.

E. Boxing in the IRS

The best approach may be to have a trust protector grant the grantor a general power of appointment. The regulations state that Section 2041 does not apply to a power of appointment retained by the grantor. If the IRS argues that the power is not a Section 2038 power under *Skifter*, then the grantor should be able to contend that it is a Section 2041 power, because it has not been retained. *Skifter* requires something akin to retention, and if you fail to satisfy *Skifter*, then logically, you cannot have retained the power.

XIV. BASIS PLANNING: DOUBLE BASIS INCREASE -- THE TAX BASIS REVOCABLE TRUST, THE JEST, AND THE OPT-IN COMMUNITY PROPERTY TRUST

A. The Tax Basis Revocable Trust

1. Using a General Power of Appointment to Obtain a Basis Increase

Property subject to a general power of appointment held by a decedent is included in his or her gross estate for federal estate tax purposes under Section 2041, and that property included in a decedent's gross estate for federal estate tax purposes obtains a new basis equal to its estate tax value. In a technical advice memorandum and several private letter rulings, the IRS has taken the position that the mere fact that property is subject to a deceased spouse's general power of appointment does not assure that it will receive a basis step-up, and that Section 1014(e) will avoid such a step-up if the surviving spouse who granted the power of appointment had the right to revoke the transfers to the trust during the year prior to the first deceased spouse's death. These rulings form the basic authority on so-called "tax basis revocable trusts" and "joint estate step-up trusts (JESTs)."

2. TAM 9308002 and the Tax Basis Revocable Trust

This technique, its rejection, and the possibility that the IRS is incorrect, can best be understood in the context of the various rulings on this transaction, now known as the tax basis revocable trust. The first such ruling was TAM 9308002.

a) Community Property Tax Treatment in a Common Law State?

H and W, U.S. citizens living in Oregon (a non-community property state), created a joint revocable trust that they funded with substantially all of their assets, most of which had been held as joint tenants, into the trust. The trustees were directed to distribute the net income from the trust property to or for the benefit of the grantors in quarter-annual or more frequent installments, and to distribute as much of the principal of the trust property as the trustees determined necessary for the grantors' health, education, support, and maintenance so that the grantors could continue their accustomed manner of living.

Either grantor, acting alone and without the consent of the other grantor, could revoke the trust during their joint lifetimes, in which case an undivided one-half interest in the trust property would be distributed free of the trust to each grantor. Neither grantor exercised the power to revoke the trust.

At the date of death of the first grantor to die, the decedent's one-half interest in the property would pass to the surviving grantor outright and free of trust.

Each grantor had the power to compel the trustee by an *inter vivos* instrument to pay from the trust funds the taxes, debts, and expenses of that grantor. The other grantor's right to revoke the trust was not affected during the lifetime of the grantor making the request, but if a grantor made the request and the other grantor had not elected to revoke the trust prior to the requesting grantor's death, then at the time of the requesting grantor's death, the surviving grantor's powers to amend, revoke and withdraw would be subordinate to the trustee's duty to pay the taxes, debts, and expenses of the deceased grantor.

W died one month after the trust was funded. At W's death, neither grantor had notified the trustee that the trustee was to pay the notifying grantor's taxes, debts, and expenses.

W's personal representative included the entire trust fund in her gross estate, including one-half of the trust fund under Section 2038, because of the right to revoke, and the other half under Section 2041, because of the power of appointment.

b) IRS Analysis and Conclusions

The IRS concluded that the entire trust fund was includible in W's gross estate, as reported on the estate tax return, but that under Section 1014(e), no basis step-up was available for H's one-half of the trust assets included in W's gross estate under Section 2041. The IRS explained that the legislative history of Section 1014(e) expresses Congress' concern that under the pre-1982 rules, an individual could transfer appreciated property to a family member immediately prior to the family member's death, anticipating that on the family member's death the individual would receive the property back (through bequest or devise) and obtain a step-up in basis. Under such circumstances, there is little substance to the initial transfer to the decedent, because of the short period of time between the two transfers.

Further, the IRS stated, Congress recognized that the allowance of an unlimited marital deduction and the increase in the unified credit provided an even greater incentive for persons to plan such death-time transfers of appreciated property, since in many cases, the provisions eliminated any estate and gift tax consequences with respect to the transfers. See H. Rep. No. 201, 97th Cong. 1st Sess. 188 (1981), characterizing the step-up in basis in such circumstances as "unintended and inappropriate." Section 1014(e) applies, the IRS stated, unless the deceased donor relinquished actual dominion and control over the property for a full year prior to death.

The IRS explained that

> *"In the instant case, the surviving spouse (i.e., donor) held dominion and control over the property throughout the year prior to the decedent's death, since he could revoke the trust*

at any time. It was only at the decedent's death that the power to revoke the trust became ineffective. Because the donor never relinquished dominion and control over the property (and the property reverted back to the donor at the spouse's death) the property was not acquired from the decedent under section 1014(a) and (e), notwithstanding that it is includible in the decedent's gross estate. Taxpayer's position in this case would produce the "unintended and inappropriate" tax benefit Congress expressly eliminated in enacting section 1014(e)."

3. Later Private Rulings

The IRS has issued several other private rulings involving similar transactions. Each one concluded that the portion of the trust contributed by the surviving spouse was includible in the deceased spouse's gross estate under Section 2041, but that no basis adjustment was allowed for that portion of the trust fund under Section 1014(e).

a) PLR 200101021

(1) Facts

In PLR 200101021, the grantors, a married couple, proposed to create a joint trust and fund it with assets that they owned as tenants by the entirety. The trustee would apply trust income and principal as the trustee deemed advisable for the comfort, support, maintenance, health, and general welfare of the grantors. Either grantor could terminate the trust by notice to the other grantor. The trustee would, upon termination of the trust, deliver the trust property to the grantors in their joint names as tenants in common.

Either grantor also could amend the trust while both grantors were living, by delivering to the other grantor the amendment in writing at least 90 days before the effective date of the amendment.

The trust also granted the first grantor to die a testamentary general power of appointment, exercisable alone and in all events, to appoint part or all of the assets of the trust to the deceased grantor's estate or any other person.

In default of the valid exercise of this power of appointment, the trust fund to which the power relates would be divided into marital and nonmarital shares. The marital share would be paid outright to the surviving spouse, and the nonmarital share held in a trust for the benefit of the surviving spouse, for his or her support and maintenance, and to the couple's descendants, for their maintenance, support, and education.

(2) IRS Conclusions

The IRS ruled, without significant analysis, that:

- The transfer of joint property to the trust would not be a completed gift for gift tax purposes, because each grantor would retain the power to terminate the trust by written notice to the other grantor, and upon such termination, the trustee would deliver the trust property to the grantors in both their names as tenants in common;

- Distributions of trust property to either of the grantors during their joint lives would constitute a gift by the other grantor to the extent of one half of the value of the trust assets distributed, but the gift would qualify for the gift tax marital deduction under Section 2523;

- The first grantor to die would possess a general power of appointment over the portion of the trust fund contributed by the other grantor and a power to revoke the trust over the portion of the trust he or she had personally contributed, causing the entire trust fund to be included in the deceased grantor's gross estate;

- On the death of the first grantor to die, the surviving grantor would be treated as relinquishing his or her dominion and control over the surviving grantor's one-half interest in the trust, and the surviving grantor would make a completed gift for gift tax purposes of the surviving grantor's entire interest in the trust, and this gift will qualify for the marital deduction under Section 2523; and

- Section 1014(e) would apply to any trust property includible in the estate of the first grantor to die that is attributable to the surviving grantor's contribution to the trust and that is acquired by the surviving grantor, either directly or indirectly, pursuant to the deceased grantor's exercise, or failure to exercise, the general power of appointment.

b) Other Rulings

See also PLR 200403094 and PLR 200604028, reaffirming the same points as PLR 200101021, but not addressing Section 1014(e).

B. The Joint Estate Step-Up Trust (JEST)

An effective variation on the tax-basis revocable trust is the joint estate step-up trust, or JEST. See, Gassman, Denicolo, & Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses – Parts 1 and 2*, 40 Est. Plan. 3, 14 (Oct., Nov. 2013).

1. Structure of the JEST

A JEST is a joint revocable trust created by a married couple residing in a non-community property state. Each spouse has the power to terminate the trust during their joint lives. If the trust is so terminated, each spouse's one-half share will be distributed to him or her individually. The JEST becomes irrevocable when the first spouse dies.

The first spouse to die is given a testamentary general power to appoint the entire trust fund, including the share contributed by the surviving spouse. On the first spouse's death, the assets of his or her share of the trust are divided into a credit shelter trust A, for the benefit of the surviving spouse and descendants, and if this share exceeds the first spouse's applicable exclusion amount, a QTIP marital trust for the excess.

If the trust share of the first spouse to die is less than his or her applicable exclusion amount, then the difference between the first spouse's share and his or her applicable exclusion amount is appointed to credit shelter trust B. Credit shelter trust B is held for the benefit of other family members; the surviving spouse is not a beneficiary of credit shelter trust B.

The surviving spouse may be added as a beneficiary of credit shelter trust B by a trust protector at some later date, if the trust protector determines it desirable to do so.

2. Analysis of the JEST

The JEST has one noteworthy advantage over the tax-basis revocable trust -- the assets contributed by the surviving spouse and appointed by the first spouse to die do not pass to the surviving spouse. They are held by a trust of which the surviving spouse is not a beneficiary. This should make application of Section 1014(e) extremely difficult.

The IRS could attempt to apply Section 1014(e) is the trust protector later adds the surviving spouse, though this likely would require the IRS to prove that there was an existing agreement or understanding that the trust protector would do so. This can be made more difficult if there is no trust protector appointed until after the first spouse's death, because without the existence of a trust protector at the first spouse's death, an agreement between the trust protector and the surviving spouse seems impossible.

C. Analysis of the IRS Position on the Tax Basis Revocable Trust (and, by Extension, on the JEST)

1. Gift at Moment Before Death

a) Generally

TAM 9308002 states that Section 1014(e) applies to property acquired by the decedent by gift unless, at least one year before death, the donor relinquishes "actual dominion and control over the property." Property is "acquired from the decedent by gift" under Section 1014(a) only upon such cessation of dominion and control. This is a reasonable interpretation of the requirement of Section 1014(e) that the property be acquired by gift within one year of death.

b) Moment Before Death and Basis

The concept is that the surviving spouse made a revocable gift to the first spouse to die that became a completed gift at the moment before the first spouse's death. This presupposes that the completion of the gift occurs before the first spouse dies. An interpretation that the gift was completed after death would mean that no transfer was made before the first spouse's death.

c) Moment Before Death and Marital Deduction

PLR 200101021 states that on the death of the first grantor to die, the surviving grantor would be treated as relinquishing his or her dominion and control over the surviving grantor's one-half interest in the trust, and the surviving grantor would make a completed gift for gift tax purposes of the surviving grantor's entire interest in the trust, and this gift will qualify for the marital deduction under Section 2523. If the gift were deemed to have been made at the moment after the spouse's death, which seems equally tenable in theory, the gift could not be made to the spouse while he or she was married to the transferor; it would be made to the beneficiaries of the deceased spouse's estate, and it would not qualify for the estate tax marital deduction. Some commentators believe that this interpretation is at least as valid as the one adopted by the IRS. See Blattmachr, Bramwell & Gans, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do In The Interim?*, 42 Real Prop. Prob. & Tr. J. 413 (Fall, 2007). If the IRS took this position, however, the basis adjustment would have to be allowed, because the property would not pass back to the donor spouse.

d) What Was Transferred within One Year of Death?

(1) The Surviving Spouse's Contributed Property

TAM 9308002 and the various private rulings do not actually state whether, within one year of death the surviving spouse transferred to the deceased spouse the assets contributed by the surviving spouse or the power of appointment over those assets. TAM 9308002 speaks of relinquishing dominion and control "over the property" within one year of death. PLR 200101021 refers to the release of dominion and control over "the Trust property."

(2) The Power of Appointment

Several commentators have interpreted the IRS as having treated the power of appointment as having been transferred within one year of death. See, e.g., Blattmachr, Bramwell & Gans, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do In The Interim?*, 42 Real Prop. Prob. & Tr. J. 413, 421 (Fall, 2007); and Fletcher, *Drafting Revocable Trusts to Facilitate a Stepped-Up Basis*, 22 Est. Plan. 100, 105 (March/April 1995). This would seem to stretch Section 1014(e) well beyond its statutory language, because the power of appointment is not itself property, but rather a power to control the disposition of property. A more careful reading of the rulings, however, shows that the IRS treated the funding of the trust as a transfer that was incomplete until the moment immediately before the first spouse's death, when the power to revoke terminated. Thus, the death of the first spouse completed the transfer and triggered the one-year period under Section 1014(e).

2. Existence of a General Power of Appointment

The use of a tax-basis revocable trust or JEST to make the surviving spouse's assets available to take advantage of the first spouse's applicable exclusion amount depends upon the existence of a general power of appointment. The IRS did not raise in the various rulings the question of whether the power of appointment was actually a general power, though it is understood that the IRS addressed this issue in the negotiations over TAM 9308002.

a) Exercise with Consent of the Creator

The IRS estate tax examiner in TAM 9308002 argued that the power of appointment was a limited power because it was exercisable solely in conjunction with its creator. The agent noted that W could exercise the power only by giving notice to the trustees (including H) and that H would then be able to revoke the trust and withdraw his share of the trust assets. This, the agent argued, had the effect of requiring W to exercise the power together

with its creator. The IRS National Office determined that W's power of appointment was a general power of appointment.

This is consistent with several cases which have held that a donor's right to dispose of the property to which a power of appointment relates after the exercise of that power is not equivalent to a requirement that the power be exercised jointly with the creator. *Johnstone v. Comm'r*, 76 F.2d 55 (9th Cir. 1935), *cert. denied*, 296 U.S. 578 (1935), *aff'g* 29 B.T.A. 957 (1934); *Keeter v. United States*, 461 F.2d 714 (5th Cir. 1972), *rev'g* 323 F. Supp. 1093 (N.D. Fl. 1971); GCM 37428 (1981). See discussion in Fletcher, *Drafting Revocable Trusts to Facilitate a Stepped-Up Basis*, 22 Est. Plan. 100, 105 (March/April 1995).

b) Requirement of Notice

The requirement that notice must be given to the other spouse before exercise of an *inter vivos* power of appointment is insufficient to preclude the existence of the general power of appointment even if notice must be given to the creator of the power, acting as trustee. IRC § 2041(a)(2); Reg. § 20.2041-3(b).

3. Exclusion of Property from Surviving Spouse's Gross Estate

One article suggests that the weakest element in the IRS analysis is that, any portion of the assets contributed by the surviving spouse that are included in the first spouse's gross estate under Section 2041 and that pass to a nonmarital trust of which the surviving spouse is a beneficiary, could be includible in the surviving spouse's gross estate. This article suggests that, under the step transaction doctrine, the transfer of property to the revocable trust by the surviving spouse could be combined with their passage to a nonmarital trust, to cause the nonmarital trust to be treated as self-settled by the surviving spouse for estate tax purposes. Blattmachr, Bramwell & Gans, *Estate Tax Exemption Portability: What Should the IRS Do? And What Should Planners Do In the Interim?*, 42 Real Prop. Prob. & Tr. J. 413, 430-434 (Fall, 2007). This argument is very fact-sensitive; the longer the property remains in trust before the first spouse's death, and the broader the powers granted the first spouse to appoint the trust to someone other than the surviving spouse, the less appropriate it would be to apply the step transaction doctrine.

D. Alaska, South Dakota, and Tennessee Opt-In Community Property Trusts

1. Generally

Alaska, South Dakota, and Tennessee currently provide that property acquired by a married couple is separate property, unless the couple elect to treat it as community property, in contrast with the general rule in most community property states

that all property acquired by a married couple is presumed to be community property, unless they have clearly provided to the contrary. Alaska permits the creation of a trust to hold property as community property and treat the assets of such trusts as community property, even if the couple creating the trust do not reside within the state. AS §§ 34.77.010 to 34.77.995. South Dakota and Tennessee provide that holding property in trust is the only way in which to create community property in those states. S.D. Cent. Code §§ 55-17-1 to 55-17-14; Tenn. Code §§ 35-17-101 to 35-17-108. In effect, all three are opt-in states, because the creation of a trust constitutes an election to adopt community property. See Asher, Blattmachr & Zaritsky, *Tax Planning with Consensual Community Property: Alaska's New Community Property Law*, 33 Real Prop. Prob. & Tr. J. 615 (Winter 1999); Shaftel & Greer, *Alaska Enacts an Optional Community Property System Which Can Be Elected by Both Residents and Nonresidents*, SD 36 ALI-ABA 1, 12–13 (1999); Singleton, *Yes, Virginia, Tax Loopholes Still Exist: An Examination of the Tennessee Community Property Trust Act of 2010*, 42 U. Mem. L. Rev. 369 (Winter 2011); Ware, *Section 1014(b)(6) and the Boundaries of Community Property*, 5 Nev. L.J. 704 (Spring 2005).

2. Early Opt-In State

Oklahoma enacted an opt-in community property system in 1939 and Oregon enacted one in 1943. 32 Ok. Stat. of 1941, §§ 51 et seq.; Ore. Laws of 1943, ch. 440.

3. Alaska

Alaska enacted an opt-in community property system in 1998. Alas. State Laws of 1998, ch. 42.

4. Tennessee

Tennessee enacted its opt-in community property in trust system in 2010. Tenn. State Laws of 2010, ch. 658.

5. South Dakota

South Dakota enacted its opt-in community property in trust system in 2016. South Dakota Laws 2016, ch. 231 (HB 1039).

6. The Community Property Trust

Alaska, South Dakota, and Tennessee permit residents and nonresidents to create trusts with their situs in the opt-in state, and to have in-state trustees hold those assets for the grantors as community property.

a) Alaska

(1) Mandatory Requirements of an Alaska Community Property Trust

The Alaska Community Property Act states that property held in a trust is community property if:

- One or both spouses transfer property to the trust. AS § 34.77.100(a);

- The trust expressly declares that some or all the property transferred is community property under Title 34, Chapter 77 of the Alaska Statutes. AS § 34.77.100(a);

- At least one trustee is a "qualified person," defined as (a) an individual who, except for brief intervals, military service, attendance at an educational or training institution, or absences for good cause shown, resides in Alaska, whose true and permanent home is in Alaska, who does not have a present intention of moving from Alaska, and who intends to return to Alaska when away; (b) a trust company that is organized under Alaska law and that has its principal place of business in Alaska; or (c) a bank that is organized under Alaska law or a national banking association that is organized under federal banking law, if the bank or national banking association possesses and exercises trust powers and has its principal place of business in Alaska. AS § 34.77.100(a);

- The powers of the qualified person who is a trustee include or are limited to (a) maintaining records for the trust on an exclusive or a nonexclusive basis; and (b) preparing or arranging for the preparation of, on an exclusive or a nonexclusive basis, any income tax returns that must be filed by the trust. AS § 34.77.100(a);

- The trust is signed by both spouses. AS § 34.77.100(a); and

- The trust contains, at the beginning of the trust and in capital letters, the following declaration:

> *"THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH RESPECT TO CREDITORS AND OTHER THIRD PARTIES, AND YOUR RIGHTS WITH YOUR SPOUSE BOTH*

DURING THE COURSE OF YOUR MARRIAGE AND AT THE TIME OF A DIVORCE. ACCORDINGLY, THIS AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS AGREEMENT, YOU SHOULD SEEK COMPETENT ADVICE."

AS § 34.77.100(b).

(2) Optional Features of an Alaska Community Property Trust

The statute states that an Alaska community property trust may also include the following provisions:

- The rights and obligations in the property transferred to the trust, regardless of when and where the property was acquired or located. AS § 34.77.100(d)(1);

- The management and control of the property transferred to the trust. AS § 34.77.100(d)(2);

- The disposition of the property transferred to the trust on dissolution, death, or the occurrence or nonoccurrence of another event. AS § 34.77.100(d)(3);

- The choice of law governing the interpretation of the trust. AS § 34.77.100(d)(4);

- Any other matter affecting the property transferred to the trust and does not violate public policy or a statute imposing a criminal penalty. AS § 34.77.100(d)(5);

- Provisions respecting the right to amend or revoke. AS § 34.77.100(e). An Alaska community property trust may not be amended or revoked unless the agreement itself provides for amendment or revocation, or unless amended or revoked by a later community property trust (which need not actually declare that it holds any community property). An amended trust or the revocation of a trust is enforceable without consideration. Unless a community property trust expressly provides otherwise, at any time after the death of the first spouse the surviving spouse may amend the community property trust with regard to the surviving spouse's property to be disposed of at the surviving spouse's death. In this subsection, "surviving spouse's property" means the property that con-

sists of the surviving spouse's separate property and the surviving spouse's share of the community property determined as of the date of the first spouse's death. *Id.*

(3) Trustees

The Alaska statute also provides that either or both spouses may be trustees, but it does not require that either spouse be a trustee. AS § 34.77.100(a). Thus, the management rights of the spouses over community property owned outright can be changed by the transfer of that property to an Alaska community property trust. The trustee of a community property trust shall maintain records that identify which property held by the trust is community property and which property held by the trust is not community property. AS § 34.77.100(h).

(4) Conditions of Enforcement

An Alaska community property trust is not enforceable if the spouse against whom enforcement is sought proves that:

- The trust was unconscionable when made. AS § 34.77.100(f). Whether or not a community property trust is unconscionable is determined by a court as a matter of law. AS § 34.77.100(g);

- The spouse against whom enforcement is sought did not execute the community property trust agreement voluntarily; or

- Before execution of the community property trust agreement, the spouse against whom enforcement is sought (a) was not given a fair and reasonable disclosure of the property and financial obligations of the other spouse; (b) did not voluntarily sign a written waiver expressly waiving right to disclosure of the property and financial obligations of the other spouse beyond the disclosure provided; and (c) did not have notice of the property or financial obligations of the other spouse.

b) South Dakota

(1) Mandatory Requirements of an South Dakota Special Spousal (Community Property) Trust

The South Dakota Special Spousal Trust permits the use of a trust to opt in to a community property system. S.D. Cent. Code § 55-

17-1. Property held in a trust is South Dakota Special Spousal Trust if:

- One or both spouses transfer property to a trust. S.D. Cent. Code § 55-17-1;

- The trust expressly declares that some or all the property transferred is South Dakota special spousal property as provided in S.D. Cent. Code §§ 55-17-1 to 55-17-14;

- At least one trustee is a "qualified person." S.D. Cent. Code § 55-17-1. A "qualified person" means

  - □ An individual who, except for brief intervals, military service, attendance at an educational or training institution, or for absences for good cause shown, resides in South Dakota, whose true and permanent home is in South Dakota, who does not have a present intention of moving from South Dakota, and who has the intention of returning to South Dakota when away. S.D. Cent. Code §§ 55-3-41(1) and 55-16-3;

  - □ A trust company that is organized under South Dakota or federal law and that has its principal place of business in South Dakota. S.D. Cent. Code §§ 55-3-41(2) and 55-16-3; or

  - □ A bank or savings association that possesses and exercises trust powers, has its principal place of business in South Dakota, and the deposits of which are insured by the Federal Deposit Insurance Corporation. S.D. Cent. Code §§ 55-3-41(3) and 55-16-3;

  - □ Some or all of the trust assets are deposited in South Dakota or physical evidence of such assets is held in the state and the trust is being administered by a qualified person S.D. Cent. Code §§ 55-3-39(1) and 55-16-3;

  - □ The qualified person must be designated as a trustee under the governing instrument, a successor trusteeship, or designated by a court having jurisdiction over the trust. S.D. Cent. Code §§ 55-3-39(2) and 55-16-3;

- □ The administration of the trust must be wholly or partly in South Dakota. S.D. Cent. Code §§ 55-3-39(3) and 55-16-3;

- The instrument expressly declares that the property is community property. S.D. Cent. Code § 55-17-3; and

- The trust contains, at the beginning and in capital letters, the following declaration:

> *"THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING YOUR RIGHTS WITH RESPECT TO CREDITORS AND OTHER THIRD PARTIES, AND YOUR RIGHTS WITH YOUR SPOUSE BOTH DURING THE COURSE OF YOUR MARRIAGE, AT THE TIME OF A DIVORCE, AND AT THE DEATH OF YOU OR YOUR SPOUSE. ACCORDINGLY, THIS TRUST AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS TRUST AGREEMENT, YOU SHOULD SEEK INDEPENDENT LEGAL ADVICE."*

S.D. Cent. Code § 55-17-2.

(2) Optional Features of an South Dakota Special Spousal (Community Property) Trust

- A South Dakota Special Spousal Trust is enforceable without consideration. S.D. Cent. Code § 55-17-1;

- The trust may be revocable or irrevocable. S.D. Cent. Code § 55-17-1;

- A South Dakota Special Spousal Trust may not be amended or revoked unless the trust agreement provides for amendment or revocation, or unless the trust agreement is amended or revoked by a later South Dakota Special Spousal Trust. S.D. Cent. Code § 55-17-4;

- To amend or revoke the trust, a later South Dakota Special Spousal Trust need not declare any property held by the trustee as special spousal property (community property). The amended trust or the revocation is enforceable without consideration. S.D. Cent. Code § 55-17-4;

- Unless a South Dakota Special Spousal Trust expressly provides otherwise, after the first spouse's death, the surviving spouse can amend the trust with regard to his or her property to be disposed of at his or her death. S.D. Cent. Code § 55-17-4;

- The spouses may also include in a South Dakota Special Spousal Trust their agreements on the following:

  - The rights and obligations in the property transferred to the trust, notwithstanding when and where the property is acquired or located;

  - The management and control of the property transferred to the trust;

  - The disposition of the property transferred to the trust on dissolution, death, or the occurrence or nonoccurrence of another event;

  - The choice of law governing the interpretation of the trust; and

  - Any other matter that affects the property transferred to the trust and does not violate public policy or a statute imposing a criminal penalty. S.D. Cent. Code § 55-17-9;

- A South Dakota Special Spousal Trust can also be a self-settled spendthrift trust, which South Dakota law refers to as a qualified disposition in trust. S.D. Cent. Code § 55-17-11(1). Nonetheless, a South Dakota Special Spousal Trust may not adversely affect the right of a child to support. S.D. Cent. Code § 55-17-10;

- No provision of a revocable South Dakota Special Spousal Property Trust can adversely affect the interest of a creditor unless the creditor has actual knowledge of the trust when the obligation to the creditor is incurred. S.D. Cent. Code § 55-17-11(1);

- The South Dakota law also expressly permits the creation of community property by a transfer at death. It states that, in addition to other transfers of property to a South Dakota Special Spousal Trust, property is considered transferred to such a trust if it is subject to a nonprobate transfer on death under

an insurance policy, contract of employment, bond, mortgage, promissory note, certificated or uncertificated security, account agreement, custodial agreement, deposit agreement, compensation plan, pension plan, individual retirement plan, employee benefit plan, trust, conveyance, deed of gift, marital property agreement, or other written instrument of a similar nature and the South Dakota special spousal trust is designated as a beneficiary to receive the property under the transfer. The property is considered the surviving spouse's property that is not South Dakota special spousal property. S.D. Cent. Code § 55-17-7;

- A spouse is required to act in good faith with respect to the other spouse in matters involving South Dakota special spousal property. This is one of the provisions that cannot be varied by the express terms of a South Dakota Special Spousal Property Trust. S.D. Cent. Code § 55-17-11;

- The South Dakota statute also provides protections for a bona fide purchaser who buys property from a South Dakota Special Spousal Property Trust. First, it provides that notice of the existence of a South Dakota Special Spousal Property Trust, a marriage, or the termination of a marriage does not affect the status of a purchaser as a bona fide purchaser. S.D. Cent. Code § 55-17-12(1). Second, it provides that community property bought by a bona fide purchaser from a spouse having the right to manage and control the property is acquired free of any claim of the other spouse. The effect of this subsection may not be varied by a South Dakota Special Spousal Property Trust. S.D. Cent. Code § 55-17-12(2);

- A South Dakota Special Spousal Trust executed during marriage is not enforceable if the spouse against whom enforcement is sought proves the following:

  - The trust was unconscionable when made;

  - The spouse against whom enforcement is sought did not execute the trust agreement voluntarily; or

  - Before execution of the trust, the spouse against whom enforcement is sought:

    - Was not given a fair and reasonable disclosure of the property and financial obligations of the other spouse;

- Did not voluntarily sign a written waiver expressly waiving right to disclosure of the property and financial obligations of the other spouse beyond the disclosure provided; and

- Did not have notice of the property or financial obligations of the other spouse.

S.D. Cent. Code § 55-17-14.

c) Tennessee

Tennessee provide for the ownership of community property in Tennessee, but only if the property is held in a Tennessee Community Property Trust. Tenn. Code § 37-15-105(a).

(1) Mandatory Requirements of a Tennessee Community Property Trust

Property held in a trust is Tennessee community property is community property, if:

- One or both spouses transfer property to the trust. Tenn. Code § 37-15-103;

- At least one trustee is a "qualified trustee," defined as (a) a natural person who is a resident of Tennessee; or (b) a company authorized to act as a fiduciary in Tennessee. Tenn. Code §§ 37-15-103(2), 37-15-102(6);

- The powers of the qualified trustee include or are limited to (a) maintaining records for the trust on an exclusive or a nonexclusive basis; and (b) preparing or arranging for the preparation of, on an exclusive or a nonexclusive basis, any income tax returns that must be filed by the trust. Tenn. Code § 37-15-103(2);

- The trust is signed by both spouses. Tenn. Code § 37-15-103(2); and

- The trust contains, at the beginning of the trust and in capital letters, the following declaration:

> *"THE CONSEQUENCES OF THIS TRUST MAY BE VERY EXTENSIVE, INCLUDING, BUT NOT LIMITED TO, YOUR RIGHTS WITH YOUR SPOUSE BOTH DURING THE*

COURSE OF YOUR MARRIAGE AND AT THE TIME OF A DIVORCE. ACCORDINGLY, THIS AGREEMENT SHOULD ONLY BE SIGNED AFTER CAREFUL CONSIDERATION. IF YOU HAVE ANY QUESTIONS ABOUT THIS AGREEMENT, YOU SHOULD SEEK COMPETENT ADVICE."

Tenn. Code § 37-15-103(4).

(2) Optional Features of a Tennessee Community Property Trust

A Tennessee community property trust may also include the following provisions

- The rights and obligations in the property transferred to the trust, notwithstanding when and where the property is acquired or located. Tenn. Code § 37-15-104(a)(1);

- The management and control of the property transferred to the trust. Tenn. Code § 37-15-104(a)(2);

- The disposition of the property transferred to the trust on dissolution, death, or the occurrence or nonoccurrence of another event. Tenn. Code § 37-15-104(a)(3);

- The choice of law governing the interpretation of the trust. Tenn. Code § 37-15-104(a)(4);

- Any other matter that affects the property transferred to the trust and does not violate public policy or a statute imposing a criminal penalty. Tenn. Code § 37-15-104(a)(5);

- The right to manage and control the trust property. Tenn. Code § 37-15-104(d);

- Either spouse may amend a Tennessee community property trust regarding the disposition of that spouse's one-half share of the community property in the occurrence of that spouse's death. Except as provided in such a provision, a Tennessee community property trust may not be amended or revoked unless the agreement itself provides for amendment or revocation. Tenn. Code § 37-15-104(b).

(3) Character of Property

(a) Distributed Property

Property distributed from a Tennessee community property trust ceases to be community property. Tenn. Code § 37-15-105(e).

(b) Death of First Spouse

On the death of a spouse, one-half of the property owned by a Tennessee community property trust is treated as the surviving spouse's community property interest. Tenn. Code § 35-17-107.

(4) Distributions in Kind

Unless the trust agreement provides to the contrary, the trustee can distribute trust assets in divided or undivided interests and adjust resulting differences in valuation. A distribution in kind may be made on the basis of a non-pro rata division of the aggregate value of the trust assets, on the basis of a pro rata division of each individual asset, or by using both methods. Tenn. Code § 35-17-107.

(5) Divorce

The trust terminates upon the dissolution of the grantors' marriage. On termination, the trustee distributes one-half of the trust assets to each spouse, unless otherwise agreed to in writing by both spouses. Tenn. Code § 35-17-108.

7. Legal Efficacy of the Alaska, South Dakota, or Tennessee Community Property Trust

a) Community Property is Statutory

The interest of one spouse in the property brought to the marriage or acquired during marriage by the other spouse, absent agreement between them, is generally determined by the laws of their domicile. *Westerdahl v. Comm'r*, 82 T.C. 83, 86 (1984); *Rosenkranz v. Comm'r*, 65 T.C. 993, 996 (1976); *Zaffaroni v. Comm'r*, 65 T.C. 982, 986-987 (1976).

Community property did not exist at common law and exists in the United States solely by statute in specific states. Therefore, the status of property as community property should initially be determined the statute of the state in which the property is acquired.

b) Changing Residency

When spouses change their domicile or residency from a community property state to a non-community property state, or *vice versa*, the change of domicile or residency does not change the status of the property as separate or community; the property retains its original status in the new jurisdiction, unless thereafter modified. See, *e.g., Johnson v. Comm'r*, 88 F.2d 952 (8th Cir 1937), *later app.*, 105 F.2d 454 (8th Cir. 1939), *cert. denied*, 308 U.S. 625 (1940) (husband and wife moved from Texas to Missouri; Texas community property continued to be community property in Missouri); *Commonwealth v Terjen*, 197 Va. 596, 90 S.E.2d 801 (1956) (husband bought Virginia realty and took title in name of wife, paying for it with $19,000 he had acquired as California community property; community property retained its status when the owners moved to Virginia). See also *Nationwide Resources Corp. v. Massabni*, 143 Aris. 460, 694 P.2d 290 (Ariz. App. 1984); *Ladd v Ladd*, 580 S.W.2d 696 (Ark. 1962); *Kraemer v Kraemer,* 52 Cal 302 (1877); *Paley v Bank of America Nat. Trust & Sav. Asso.*, 159 Cal.App.2d 500, 324 P2d 35 (1958); *Lane-Burslem v. Comm'r*, 659 F.2d 209 (D.C. Cir. 1981); *Quintana v Ordono* (Fla App) 195 So.2d 577 (Fla. App. 1967), *cert discharged*, 202 So. 2d 178 (1967) (assets acquired by husband in Florida transaction, after he and wife had moved to Florida, involving stock bought by him in Cuba with community property funds under laws of that country, were community property for purposes of administration of husband's estate in Florida; domicile of parties at time of purchase of Cuban assets being controlling factor); *Tanner v. Robert*, 5 Mart. NS 255 (La. 1826); *Mahmud v Mahmud,* (1984, La App) 444 So.2d 774 (La. App. 1984); *Hughes v. Hughes*, 91 N.M. 399, 573 P.2d 1194 (1978) (the character of property as community or separate property is determined under the law of the state in which the couple is domiciled at the time of its acquisition); *Karp v Karp,* 109 App.Div. 2d 661, 486 N.Y.S.2d 249 (1st Dept 1985); *Re Estate of Warburg*, 38 Misc. 2d 997, 237 N.Y.S.2d 557 (1963); *Re Estate of Kessler*, 177 Ohio St 136, 29 Ohio Ops 2d 348, 203 N.E.2d 221 (1964) (the character of community property, even personal property, does not change where the married couple owning it removes from a community property state to a common-law state; the converse is also true); *Bosma v. Harder*, 94 Or. 219, 185 P.741 (1919); *Parson v. United States*, 460 F.2d 228 (5th Cir. 1972); *Oliver v. Robertson*, 41 Tex. 422 (1874); *Re Gulstine's Estate*, 166 Wash 325, 6 P.2d 628 (1932); *Devine v. Devine,* 42 Wash.App. 740, 711 P.2d 1034 (1985).

c) Property Held in Trust

The cases noted above, however, do not address property held in trust. Should the community character of property owned by a trustee of a trust domiciled in one state be dictated by the law of the state of the trust's situs or that of its grantors or beneficiaries?

(1) Generally

The rules by which a state that should assume jurisdiction over various aspects of trust administration, construction, and the rights of beneficiaries, depend upon whether the trust corpus is real or personal property. Generally, the intent of the grantor determines the jurisdiction for a trust holding personal property, while the sites of the real property is determinative with respect to a trust on real property. Issues of the administration of a trust holding personal property (whether tangible or intangible) are determined under the jurisdiction in which the trust is otherwise administered, which itself is determined on the basis of the intent of the grantor, as disclosed in the governing instrument. Absent an express declaration in the instrument as to the place of administration, the grantor's intent is usually assumed to be that the trustee shall administer the trust at the trustee's principal place of business or domicile. A grantor who names two or more trustees who are domiciled in different states may manifest an intention that the trust should be administered at the domicile or place of business of one of them. Therefore, if the grantor names one or more trustees situated in Alaska or Tennessee, as is required by the two state statutes, it may be assumed that the trust should be administered in the state of the trustee and that it should be supervised by the courts of that state.

(2) Application of Choice of Law Rules to Alaska, South Dakota, and Tennessee Community Property Trusts

The requirements for an Alaska Community Property Trust, a South Dakota Special Spousal Trust, or a Tennessee Community Property Trust include the designation of at least one in-state trustee and refer repeatedly to the construction of the rights of the parties in the property under that state's law. Under the general rule, therefore, the courts of the state in which the trusts are created should have jurisdiction over matters involving the administration of the trust even though they might lack jurisdiction over some or all of the beneficiaries. See *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950).

(a) Personal Property

(i) Situs for Construction

Questions relating to the construction of an *inter vivos* trust holding personal property and the rights of the various beneficiaries will be based on the law of the state designated in the instrument, or in the absence of such a designation, the law of the place of

administration, if the issue relates to trust administration, or otherwise the jurisdiction that the grantor would probably have desired to apply. *Restatement (Second) Conflicts of Law* § 268. A state need have no connection with the trust in order to use its law in construing the trust instrument, if the grantor has selected that particular state's law. *Hughes v. Comm'r*, 104 F.2d 144 (9th Cir. 1939); *Noble v. Rogan*, 49 F. Supp. 370 's.D.Cal.1943); *Application of Eyre*, 133 N.Y.S.2d 511 (1954); *Matter of Grant- Suttie*, 205 Misc. 940, 129 N.Y.S.2d 572 (1954); *Matter of Carter*, 13 Misc.2d 1040, 178 N.Y.S.2d 569 (1958).

(ii) Situs for Validity

A similar rule applies in determining the overall validity of a trust of personal property. The validity of the trust is determined under the law of the state designated by the grantor, as long as that state has a substantial relation to the trust and that the application of its law does not violate a strong public policy of the state with which the trust has its most significant relationship. *Restatement (Second) Conflicts of Law* § 270. A state has a substantial relation to a trust if the grantor designates that the trust is to be administered there, or if any trustee has its principal place of business or domicile in that state when the trust is created, or if the trust is administered in that state, or if it is the domicile of the beneficiaries.

(b) Real Property

(i) Generally

As to trusts of interests in land, however, the law of the situs of the land becomes more important.

(ii) Situs for Administration and Validity

The administration and validity of a trust in land is determined according to the law of the state in which the land is situated, even if the trustees are situated elsewhere. *Restatement (Second) Conflicts of Law* § 276. A court of a state other than that in which the property is situated may still exercise jurisdiction over the administration of the trust, if this does not unduly interfere with the control by the courts of the situs. *Fuller v. McKim*, 187 Mich. 667, 154 N.W. 55

(1915); *Knox v. Jones*, 47 N.Y. 389 (1872); *Matter of Osborn*, 151 Misc. 52, 270 N.Y.S. 616 (1934); *In re Sandford's Wil*l, 81 N.Y.S.2d 377 (1948); *In re Fagan's Estate*, 84 N.Y.S.2d 558 (1948); *In re Piazza's Estate*, 130 N.Y.S.2d 244 (1954); *In re Master's Will*, 136 N.Y.S.2d 907 (1954); *In re Warburg's Estate*, 237 N.Y.S.2d 557 (1963).

(iii) Situs for Construction

Issues of construction of the trust instrument, however, have not always been construed according to the situs. Some courts apply the law of the situs. *Bowen v. Frank*, 179 Ark. 1004, 18 S.W.2d 1037 (1929); *Veach v. Veach*, 205 Ga. 185, 53 S.E.2d 98 (1949); *Peet v. Peet*, 229 Ill. 341, 82 N.E. 376 (1907); *Scofield v. Hadden*, 206 Iowa 597, 220 N.W. 1 (1928); *Thompson v. Penn*, 149 Ky. 158, 148 S.W. 33 (1912); *In re Estate of Hencke*, 220 Minn. 414, 19 N.W.2d 718 (1945); *Minot v. Minot*, 17 App.Div. 521, 45 N.Y.S. 554 (1st Dep't 1897); *Matter of Good*, 304 N.Y. 110, 106 N.E.2d 36 (1952), *aff'g* 278 App.Div. 806, 927, 104 N.Y.S.2d 804 (1st Dep't 1951), *aff'g* 278 App.Div. 806, 927, 104 N.Y.S.2d 804 (1st Dep't 1951), *aff'g* 96 N.Y.S.2d 798 (1950). A few others have applied the law designated by the grantor in construing a trust on real estate. *Greenwood v. Page*, 138 F.2d 921 (D.C.Cir.1943); *Guerard v. Guerard*, 73 Ga. 506 (1884); *Brown v. Ramsey*, 74 Ga. 210 (1884); *Keith v. Eaton*, 58 Kan. 732, 51 P. 271 (1897); *Houghton v. Hughes*, 108 Me. 233, 79 A. 909 (1911); *Martin v. Eslick*, 229 Miss. 234, 90 So.2d 635 (1956); *Zombro v. Moffett*, 329 Mo. 137, 44 S.W.2d 149 (1931); *Applegate v. Brown*, 344 S.W.2d 13 (Mo. 1961); *Cary v. Carman*, 116 Misc. 463, 190 N.Y.S. 193 (1921). The law of the situs almost certainly controls issues of construction only in the absence of a designation in the instrument of the governing law.

(iv) Enforceability in Domicile State

Generally, the couple can select the law to govern particular property. In *Stein-Sapir v. Stein-Sapir*, 382 N.Y.S.2d 799 (N.Y. App. Div. 1976), for example, a couple domiciled in New York married in Mexico, and elected under Mexican law to have their future assets be held as community property. They

later divorced in New York and the New York court held that the community property election was valid, and that the wife owned one-half of the property earned by the husband. *Restatement (Second) of Conflicts of Laws* § 258, cmt. (b) states that a couple can choose the law of a state other than their domicile to govern their property, and such a choice will apply unless it is "outweighed . . . by the intensity of the interest of another state . . . in having its own rules applied."

(c) Caveat: *Huber v. Huber*

Despite the rules set out in the Restatement (Second) Conflicts of Law and various cases, the courts sometimes look at things in a different manner. *In re Huber v. Huber*, 493 B.R. 798 (Bankr. W.D. Wash. 2013), a U.S. district court applied the law of the state in which the settlor and his creditors resided and refused to apply the law of the state under whose law a domestic asset protection trust was allegedly created and permitted a trustee in bankruptcy to set aside transfers made to the trust as both actually and constructively fraudulent.

(i) Facts

Donald Huber was a real estate developer and manager and a lifelong resident of the state of Washington. When Donald realized that many of his real estate projects were about to fail and be foreclosed upon, that he would become personally liable as guarantor on several loans, and that he would be sued, he transferred substantially all of his assets to the Donald Huber Family Trust, an irrevocable trust, for his own benefit and that of his descendants and stepchildren.

The trust was prepared by a Washington attorney, and the trust instrument stated that Alaska law would apply. An Alaska corporation was the trustee.

It was shown that Donald created the trust for both estate planning purposes and to protect at least part of his assets from the claims of his creditors.

The trust was funded with interests in an Alaska limited liability company established for that purpose, and to which Donald had transferred substantially all

of his assets. These assets were all situated in Washington, except for one $10,000 certificate of deposit that was situated in Alaska.

Donald did not expressly retain the right to direct how or if distributions were made from the trust, but substantially all of his requests for distributions were granted and there was a record of only one refusal. The only party to review the requests was Donald's son, with whom he was in business.

(ii) Bankruptcy

Donald filed for Chapter 11 bankruptcy protection in 2011. The trustee in bankruptcy moved for summary judgment that the transfers to the trust were void under applicable state law and should be set aside for purposes of the bankruptcy action. The trustee contended that the trust should be invalidated under Washington state law and federal bankruptcy law, despite the trust instrument's own designation of itself as an Alaska trust.

(iii) Held: Trust Controlled by Washington Law, Not Alaska Law

(a) Generally

The bankruptcy judge (Judge Snyder) for the Western District of Washington granted a summary judgment to the trustee, finding that the trust did not protect its assets from the claims of Donald's creditors and should be set aside on three separate bases.

(b) Conflict Between Two State Laws

The court held that the trust was not protected from the claims of the settlor's creditors by the provisions of Alaska law that expressly recognize the validity of self-settled asset protection trusts, but instead were invalid under the provisions of Washington state law that reject self-settled spendthrift trusts. Compare AS § 34.40.110 and Rev. Codes of Wash. § 19.36.020. The court stated that the conflict between the laws of the two states must be settled under federal choice of law

rules, rather than state choice of law rules. Citing *Lindsay v. Beneficial Reinsurance Co. (In re Lindsay)*, 59 F.3d 942, 948 (9th Cir. 1995).

(c) Ninth Circuit Applies Restatement (Second) Conflicts

The Ninth Circuit, to which the case would be appealed, applies the choice of law rules set forth in of the *Restatement (Second) of Conflict of Laws* (1971), which states at section 270, that a provision in the instrument governing an *inter vivos* trust of personal property that declares the validity of the trust will be controlled by the law of a specific state, will be followed only if:

- the state declared in the instrument as controlling has a substantial relation to the trust, and

- the application of its local law does not violate a strong public policy of the state with which as to the matter at issue the trust has its most significant relationship. *Liberty Tool & Mfg. v. Vortex Fishing Sys., Inc. (In re Vortex Fishing Sys., Inc.)*, 277 F.3d 1057, 1069 (9th Cir. 2002).

(d) Most Significant Relationship

Comment 6 to this section of the *Restatement (Second) of Conflict of Laws* also states that the state with the most significant relationship is determined by the following factors:

- the needs of the interstate and international systems;

- the relevant policies of the forum;

- the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue;

- the protection of justified expectations;
- the basic policies underlying the particular field of law;
- certainty, predictability and uniformity of result; and
- ease in the determination and application of the law to be applied.

(e) Substantial State Relation to the Trust

The comment also provides that a state has a substantial relation to a trust if

- The settlor designated it as the state in which the trust is to be administered;
- It is the trustee's place of business or domicile at the time of the trust's creation;
- It is the trust assets' location at the time of the trust's creation;
- It is the settlor's domicile at the time of the trust's creation; or
- It is the beneficiaries' domicile at the time of the trust's creation.

The court stated that Alaska law would apply only if Alaska had a substantial relation to the trust. *Restatement (Second) of Conflict of Laws* § 270, cmt. b (1971).

(f) Searching for a Substantial Relationship

When Donald created his trust, neither he nor the beneficiaries were domiciled in Alaska and the trust assets were not located in Alaska. The trust's only connection with Alaska was the location of the trustee and the administration of the trust in Alaska.

On the other hand, at that time, Donald and the trust beneficiaries all resided in Washington, the trust assets (other than a certificate of deposit) were transferred from Washington, Donald's creditors were located in Washington, and the drafting attorney was located in Washington. When the trust was created, therefore, Alaska had only a minimal relation to the trust, but Washington had a substantial relation to the trust.

(g) Strong Washington Public Policy

Washington, however, had a strong public policy against self-settled asset protection trusts; its statutes declare them void against both existing and future creditors. Revenue Codes of Wash., § 19.36.020; *Carroll v. Carroll*, 18 Wash. 2d 171, 175, 138 P.2d 653 (1943); *Rigby v. Mastro (In re Mastro)*, 465 B.R. 576, 611 (Bankr. W.D. Wash. 2011). Therefore, as the trust was a self-settled trust, Donald's transfers of assets into the trust were void, and the trustee was entitled to summary judgment voiding the transfers.

(h) Fraudulent Transfer

The court also held that the transfers to the trust were fraudulent under Section 548(e)(1) of the Bankruptcy Code.

(3) Analysis

The strongest argument appears to be that the situs of a trust determines the nature of the property interests it acquires, and where statutory rules are imposed to determine this character, particularly with respect to community property, which is itself solely statutory, this rule seems stronger.

d) Application of Community Property Basis Rules

The major tax advantage of creating an Alaska, South Dakota, or Tennessee community property trust is to enable residents of non-community property states to take advantage of Section 1014(b)(6), which states that, upon the death of either spouse, the basis of the entire community property asset (and not just one-half of the asset) becomes equal to the estate tax value of the asset. Section 1014(b)(6) does not distinguish between property that is held

as community property under automatic (opt out) state laws or under elective (opt in) state laws. Furthermore, significant authority strongly suggests that community property under an (opt in) law, such as that adopted in Alaska, South Dakota, or Tennessee, would be eligible for the basis adjustment at death under Section 1014(b)(6), as long as the state statute created property rights that are generally the same as those created by other state community property laws.

(1) Poe v. Seaborne

In *Poe v. Seaborne*, 282 U.S. 101 (1930), the Supreme Court held that income from community property might, or might not, be taxable in equal shares to the two spouses. The Court stated that, where community property law created a vested interest in each spouse, each spouse received one-half of the income from the community property for federal income tax purposes. The Court distinguished the community property laws of Washington, Arizona, and Texas, in which the law vested an equal interest in each spouse with respect to all community property, from the law of California, which gave each spouse a mere expectancy in the income from community property. Therefore, in California, community property did not result in a valid assignment of income, but in the other three states, it did.

(2) Harmon

In *Comm'r v. Harmon*, 323 U.S. 44 (1944), the U.S. Supreme Court held that the taxpayers in an opt-in community property state could not split their community property income for U.S. income tax purposes. The case arose out of Oklahoma, which in 1939 enacted a community property system that applied only if married Oklahoma residents opted into the system. 32 Ok. Stat. of 1941 §§ 51 *et seq.* The Harmons opted into the community property system, and then each reported one-half of the community property income for federal income tax purposes.

(a) Supreme Court Recognizes Two Styles of Community Property

The Court stated that community property systems

> *"are of two sorts--consensual and legal. A consensual community arises out of contract. It does not significantly differ in origin or nature from such a status as was in question in Lucas v. Earl, where by contract future income of the spouses was to vest in them as joint tenants. In Poe v. Seaborn, supra., the*

court was not dealing with a consensual community but one made an incident of marriage by the inveterate policy of the State."

323 U.S. 44, at 46 (1944).

(b) Opt-In Community Property Cannot Assign Incidence of Income Tax

The Court held that the Oklahoma community property "does not significantly differ in origin or nature from such a status as was in question in *Lucas v. Earl*, where by contract future income of the spouses was to vest in them as joint tenants." 323 U.S. 44, at 46 (1944)." The Court noted that, under *Lucas v. Earl,* 281 U.S. 111 (1930), the spouses could not use community property to split income, under the anticipatory assignment of income doctrine.

(c) Analysis of *Harmon*

(i) One View

Some commentators focus on this holding to conclude that the modern opt-in community property cannot qualify for the basis adjustment under Section 1014(b)(6). D. Westfall & G. P. Mair, *Estate Planning Law & Taxation*, § 4.01(1) (4th ed. 2001 & Supp. 2017) (arguing that an elective community property system such as adopted by Alaska will not be effective under *Harmon*); and Roberts, *A Cautionary Tale -- Community Property Trusts*, 47 Tenn. Bar J. 24 (July 2011).

(ii) A Better View

The Court in *Harmon* stated that it assumed "that, once established, the community property status of Oklahoma spouses is at least equal to that of man and wife in any community property State . . . ." 323 U.S. 44, at 47 (1944). Thus, the Court recognized that the property was community property, but determined that the spouse who earned Oklahoma consensual community property income must report it under the assignment of income doctrine. Cf. *United States v. Robbins*, 269 U.S. 315 (1926) (couple's income was community property, but wife could not report any part of it for federal income tax purposes because her

interest had not vested). In discussing the history of the case, the Court stated:

> *"[The lower courts] overruled the [Commissioner's] contention that, as the [Oklahoma] statute permits voluntary action which effects a transfer of rights of the husband and wife, the case is governed by Lucas v. Earl and other decisions of like import. We hold that the [Commissioner's] view is the right one."*

323 U.S. 44, at 45-46 (1944).

Harmon, therefore, actually says that consensual or opt-in community property is community property under the community property laws of a state, and therefore, Section 1014(b)(6) should determine the basis of the surviving spouse's one-half interest. *Harmon* predates Section 1014(b)(6), however, and thus may not be controlling.

(d) Justice Douglas' Dissent

Justice Douglas (joined by Justice Black) dissented in *Harmon*, noting that

> *"One dubious decision does not of course justify another. But if Texas can reduce the husband's income tax by creating in his wife a 'vested' interest in half his salary and other income, I fail to see why its neighbor, Oklahoma, may not do the same thing. The Court now concedes that once established, the community property status of Oklahoma spouses is at least equal to that of man and wife in any community property state. How then can Oklahoma be denied the same privilege which other community property states enjoy?*
>
> * * *
>
> *But it is said that the filing of a written election under the Oklahoma statute is an 'anticipatory arrangement' for the disposition of income under the rule of Lucas v. Earl; that a 'consensual' community will not*

> *be recognized for federal income tax purposes but that a 'legal' community will. As the Tax Court, however, pointed out (1 T.C. 40, 49) such a distinction will not stand scrutiny. Community property created by marriage is the effect of a contract. [footnote omitted] It is the result of a consensual act. The same is true where husband and wife agree to leave Oklahoma and establish their domicile in Texas so as to gain the advantages of a community property system. I can see no difference in substance whether the state puts its community property system in effect by one kind of contract or another. One is as much 'legal' as another. The agreement to marry or the agreement to move from Oklahoma to Texas is as 'consensual' as the act of filing a written election under the Oklahoma statute."*

323 U.S. 44, at 51-53.

The dissent also stated that maintaining any meaningful distinction between consensual community property under a mandatory community property system and consensual community property under a consensual community property system may be impracticable.

(3) McCollum

A lower court decision in *McCollum v. United States*, 1958 WL 10206 (N.D. Okla. 1958), is also instructive. The couple in *McCollum* elected to treat their assets as community property under Oklahoma's opt-in statute. In 1945, after *Harmon*, Oklahoma adopted a mandatory community property regime, under which all property that a husband and wife acquired after enactment of the 1945 law would be community property. See *Kane v. Comm'r*, 11 T.C. 74 (1948) (providing a brief history of Oklahoma's experiment with community property). The 1945 law also declared that assets designated by couples as community property under its 1939 opt-in law were community property. Mr. McCollum died after the predecessor to Section 1014(b)(6) became effective. His wife succeeded to his community property interest in a particular piece of land they acquired after electing the Oklahoma community property regime. Mrs. McCollum took the position that the basis of her one-half interest in the property changed upon his death under the predecessor to Section 1014(b)(6).

The U.S. District Court agreed that the predecessor to Section 1014(b)(6) applied. While Oklahoma had a mandatory community property system when Mr. McCollum died, he had acquired the property when it still had an opt-in system.

(4) Angerhofer

Angerhofer v. Comm'r, 87 T.C. 814 (1984) provides a slight twist on the classification of community property. The case involved several married couples, all of whom were German citizens and domiciliaries. All of the husbands were employed by IBM or a related corporation. All of the couples held property under one of three community property systems available in Germany at that time. The husbands claimed that they were taxable in the U.S. on only one-half of their community property income.

(a) German Law Had Three Choices for Marital Regime

German law provided for three alternative marital regimes: gutertrennung, gutergemeinschaft, and zugewinngemeinschaft. The first two were elective; in the absence of a proper election under one of the first two regimes, the third, zugewinngemeinschaft, also known as the statutory marital regime, automatically applied. None of the taxpayers elected into either of the first two regimes.

Gutertrennung. Under gutertrennung, absent a contrary marriage contract, each spouse acquires and maintains his or her own separate property, with no ownership interest in property acquired by the other spouse. A spouse may freely manage his or her income or property without restriction.

Gutergemeinschaft. Under gutergemeinschaft, there is a joint pot of marital property, known as the gesamtgut, which both spouses own equally. The management of the gesamtgut is therefore subject to restrictions intended to assure the protection of each spouse's share of the marital property. Also under gutergemeinschaft, the property of the husband and the property of the wife become the joint (common) property of both spouses. Property which comes into the ownership of either spouse during the application of this regime is common property. Property owned by either spouse before the marriage can remain separate property, along with its appreciation. The common property is managed by both spouses jointly, in the absence of an agreement providing otherwise. Upon termination of the marriage, the common property is divided equally between the spouses. If

the marriage terminates at death, the share of the deceased spouse in the common property belongs to his or her estate and thus passes to his or her beneficiaries or legal heirs.

Zugewinnegemeinschaft. Under zugewinngemeinschaft, there was ownership and maintenance of separate property by husband and wife, with an "equalization of gains" upon termination of the marriage. Equalization occurs in different ways, depending on whether the marriage terminates by death or during life. Where the marriage ends by divorce, each spouse's share of the gain is calculated and the two figures are compared. The difference is divided in half and this amount becomes a monetary claim of the spouse with the smaller share. Gifts or inheritances received by a spouse during the marriage are included in his or her beginning property. Where a spouse's beginning property has appreciated during the marriage, the appreciation is included in accrued gains; however, there is an adjustment to account for inflationary gains. The procedure for partitioning the "community of accrued gains" is thus one of valuation, computation, and payment of a monetary amount to the spouse with the smaller zugewinn.

(b) Tax Court Held that Zugewinngemeinschaft Was Not Community Property.

The Tax Court explained that Community property, as understood in the United States, involved protection of the interest of each spouse (1) by legally assuring its testamentary disposition or its passage to the decedent's issue rather than to the surviving spouse, and (2) by limiting the managing spouse's powers of management and control so that detriment to the nonmanaging spouse from fraud or mismanagement will be minimized. See *Westerdahl v. Comm'r*, 82 T.C. 83, 91 (1984). The court stated that:

> *"In reviewing the statutes of the eight American community property States, we are aware of the presence or lack of presence of rules that—*
>
> *(1) Make the community property liable for the managing spouse's separate torts;*
>
> *(2) Prevent the nonmanaging spouse from obligating by contract the community property;*
>
> *(3) Require, except in extraordinary circumstances, equal division of the community property upon its partition at divorce;*

(4) Allow the managing spouse to discharge his separate debts from community; and

(5) Require the managing spouse to make an accounting of all community property, including wages, when partitioned at the time of divorce.

No one factor is determinative of the issue at hand."

87 T.C. 814 at 826.

While zugewinngemeinschaft was similar to American community property law with respect to restrictions on management, liability of the property for debts and torts of each spouse, and division of the property upon lifetime termination of the marriage or marital regime, it lacked the essential automatic passage of a decedent-spouse's share of the community property (or, in this case, equalization claim) to his or her heirs at death. The spouses' inability to transfer or oblige their equalization claims showed that those claims are not present vested interests. To be recognized as community property, the court held, a state's law must assure its testamentary disposition or its passage to the decedent's issue rather than to the surviving spouse and limit the managing spouse's powers of management and control so that detriment to the nonmanaging spouse from fraud or mismanagement will be minimized.

(5) Santiago

In *Santiago v. Comm'r*, 61 T.C. 53 (1973), *aff'd per curiam*, 510 F.2d 223 (D.C. Cir. 1975), the taxpayer was a U.S. citizen employed by the U.S. Air Force in Spain as a civilian. The taxpayer was a resident of Spain and married to a Spanish citizen who had no United States residence. The marriage ceremony took place outside Spain. Under Spanish community property law, the court held, the community property rules did not apply to couples like the taxpayers. Thus, none of the husband's earnings belonged to the wife under Spanish law.

The important feature of *Santiago* is one statement by the court, that:

"Petitioner was a citizen of the United States and not of Spain, and there is, of course, no Federal community property law in this country (nor is there any in New York State, where petitioner was born and with

which he appears to have been more closely identified than with any other State)." (emphasis supplied)

61 T.C. at 59. Therefore, when analyzing the nature of the property interests of a decedent and a surviving spouse must focus on the law of the state that governs that property, rather than on any federal definition of community property. (It is hard to reconcile this with the analysis in *Angerhofer*, which appeared to turn on just such a federal notion of what constitutes community property.)

(6) Rev. Rul. 77-359

Rev. Rul. 77-359, 1977-2 C.B. 24 also supports the notion that the basis of opt-in community property should be determined under Section 1014(b)(6). In Rev. Rul. 77-359, Husband and Wife were residents of Washington state. In 1975, the taxpayers agreed in writing that all presently-owned separate property and all thereafter acquired property would be community property.

(a) Conversion of Property Recognized

The Service stated that such an agreement changes the status of presently owned separate property and subsequently acquired separate property into community property under applicable state law, and should, therefore, be respected for federal tax purposes.

(b) State Law Allows Contractual Creation of Community Property

The Service noted that the Washington Supreme Court had held that a written agreement between spouses that property then-owned and thereafter acquired would be community property was legally effective under applicable state law. *Volz v. Zang*, 113 Wash. 378, 194 P. 409 (1920). The court held that the agreement was a valid contract and operated converted separate real property into community property, because state law gave spouses the right to deal in every possible manner with their property, and that the couple could change the status of separate property to community property. See also *Estate of Shea*, 60 Wash. 2d 810, 376 P.2d 147 (1962); *Neeley v. Lockton*, 63 Wash. 2d 929, 389 P.2d 909 (1964); *Estate of Verbeek*, 2 Wash. App. 144, 467 P.2d 178 (1970); and *Merriman v. Curl*, 8 Wash. App. 894, 509 F.2d 765 (1973).

To the extent that the agreement affects the income from separate property and not the separate property itself, the Service stated that it would not permit the spouses to split that income for Federal income tax purposes where they file separate income tax returns. Citing *Comm'r v. Harmon*, *supra*. Thus, the IRS stated that the property was community property, but that it did not split income because it was created by an election. The clear implication is that property that becomes community by election may still be community property, even if it does not, under *Harmon*, shift the incidence of taxable income.

(7) PLR 199917025

See also PLR 199917025, in which separate property that was converted into community property by an agreement between the spouses, which agreement was enforceable under applicable state law, became community property for tax purposes. See, also Randall, *Estate Planning and Community Property*, 28 Idaho L. Rev. 807, 815 (1991/1992); Rasmussen, *Divorce Provisions in Opt-In Marital Property Agreements*, 67 Wis. Law. 15 (April 1994); Smith, *The Unique Agreements: Premarital and Marital Agreements, Their Impact Upon Estate Planning, and Proposed Solutions to Problems Arising at Death*, 28 Idaho L. Rev. 833, 873-74 (1991/1992); Treacy, Jr., *Planning to Preserve the Advantages of Community Property*, 23 Est. Plan. 24, 26, 29 (1996).

(8) Rev. Rul. 66-283

In Rev. Rul. 66-283, 1966-1966-2 C.B. 297, California grantors transferred community property to a California revocable trust. Each spouse reserved a lifetime income interest in his or her share of the trust, and upon the death of one of the spouses, one-half of the value of the community interest in the property held in the trust was includible in his or her gross estate under Sections 2033, 2036(a)(1), and 2038(a)(1). The trust included language that any community property transferred to the trust would retain its status as community property, even though owned by the trustees. The IRS concluded that the property representing the surviving spouse's one-half interest in the community property held in the revocable trust was deemed to have passed from the decedent and its basis would be determined in accordance with the provisions of Section 1014(a), so that both halves of the community property received a basis adjustment at the first spouse's death. See similar conclusions in PLRs 201852009, 2018500001, 6603075360A, 6601074700A.

(9) DING Rulings

Several rulings that involved non-grantor trusts created to shift the incidence of state income taxes from the grantor to the trust and its beneficiaries, also involved taxpayers who resided in a community property state. In these rulings, the trust had a situs in another state, and provided that all transferred property to the trust is community property or is being transmuted into community property. Upon the death of each grantor, his or her respective interest in the trust will be includible in his or her respective gross estate for federal estate tax purposes. The IRS concluded that the basis of all community property in the trust on the date of death of the first grantor will receive an adjustment in basis to the fair market value of such property at the date of death of the first grantor to die. See PLRs 201850001 – 201850006, 201852009, and 201852018.

(10) The Specific Language of Section 1014(b)(6)

Section 1014(b)(6) requires that the property be community property under the laws of any State (or possession or foreign country). If nonresident married persons transfer property to an Alaska, South Dakota, or Tennessee Community Property Trust, and there are sufficient contacts of the property with the trust such that that state's law should control, the property should be community property under the law of that state, and so should literally fall under the basis adjustment rules of Section 1014(b)(6).

(11) Caveat: Alaska vs. Tennessee and South Dakota

The Alaska Community Property Act closely mirrors the Uniform Marital Property Act, which Wisconsin adopted and which the IRS has ruled creates valid community property. Rev. Rul. 87-13, 1987-1 CB 20. The only significant difference is that the Alaska rules are opt in, rather than default. In particular, the Uniform Marital Property Act details the rights of the parties to manage and control the property and to dispose of it at death. South Dakota's community property statute merely states that assets in a South Dakota Special Spousal Trust are community property. It does not address management, control, or disposition at death. Tennessee's statute addresses dispositions at death and some issues of rights during lifetime, but it does not address management and control. These distinctions between the Tennessee and South Dakota statutes and both the common law rules and the Uniform Marital Property Act may give the IRS a basis for denying a basis adjustment for the entire property held in such state community property trusts.

8. Drafting and Planning

a) Generally

The Alaska, South Dakota, and Tennessee community property trusts have not been tested in any court opinion, but as discussed above, at least the Alaska trusts should work well under the existing law, and the South Dakota and Tennessee trusts have a good argument for working well under existing law.

b) Situs Issues

All three states make it quite easy for a trust to adopt those states as the relevant situs, but the importance of assuring that the chosen state's laws apply suggests that practitioners should urge their clients to do more than the minimum required to create an Alaska, South Dakota, or Tennessee community property trust. In particular, it is suggested that taxpayers do the following:

- Give the situs (Alaska, South Dakota, or Tennessee) trustee actual possession and control over the trust assets, rather than over a portion of the trust assets. If securities are held in certificate form, the trustee should hold the certificate. Otherwise, the brokerage account should be opened with a brokerage that has an office in the situs state. Tangible assets should be held in the situs state or held by an LLC or corporation created under the laws of the situs state.

- The situs trustee should have all duties with respect to management and administration of the trust assets. Distribution authority may be held by a co-trustee.

- The governing instrument should not only declare that the situs law applies but should prevent the trustee from changing the trust's situs until the first spouse has died.

c) Integrating the Community Property Trust into the Estate Plan

The easiest way to integrate the community property trust into the parties' estate plan is to provide that, when the first spouse dies or, if earlier, the §share to the husband's separate revocable trust (or, if there is none, to the husband or the personal representative of his estate), and one share to the wife's separate revocable trust (or to her or the personal representative of her estate). See Zaritsky, *Tax Planning for Family Wealth Transfers at Death*, ¶¶ 4.08[11] and 4.08[12] (Thomson-Reuters/WG&L, 2014, Supp. 2018-2), for sample forms for Alaska, Tennessee, and South Dakota community property trusts.

d) Notes on the Uniform Disposition of Community Property Rights at Death Act (UDCPRDA) and the Basis Adjustment Rules

(1) General Overview

The Uniform Disposition of Community Property Rights at Death Act ("UDCPRDA") was drafted by the National Conference of Commissioners of Uniform State Law in 1971 and sent to the American Bar Association, who approved it on February 7, 1972.

Sixteen non-community property states have adopted the statute. AS §§ 13-41-5 *et seq.*; Ark. Code Ann. §§ 28-12-101 *et seq.*; Conn. Gen. Stat. §§ 45-298a *et seq.*; Fl. Stat. §§ 732.216 *et seq.*; HRS §§ 510-23 *et seq.*; KRS §§ 391.210 *et seq.*; MCLS Ch. 557, §§ 261 *et seq.*; Minn. Stat §§ 591A.01 *et seq.*; MCA §§72-9-107 *et seq.*, N.C Gen. Stat. § 31C-1 *et seq.*, NY CLS EPTL, Art. 6, §§ 6.1 *et seq.*; ORS §§ 112.705 *et seq.*; Utah Code Ann. § 75-2b-101 *et seq.*; Va. Code Ann. §§ 64.2-315 *et seq.*; and Wyo. Stat. §§ 2-7-720 *et seq.*

(2) NCCUSL's Explanation of the Proposed Statute

In most cases when uniform laws are promulgated, there are prefatory notes, which generally gives the purpose and intent of the proposed law. UDCPRDA is no exception; its prefatory note states as follows:

> *"Frequently spouses, who have been domiciled in a jurisdiction which has a type of community property regime, move to a jurisdiction which has no such system of marital rights. As a matter of policy, and probably as a matter of constitutional law, the move should not be deemed (in and of itself) to deprive the spouses of any preexisting property rights. A common law state may, of course, prescribe the dispositive rights of its domiciliaries both as to personal property and real property located in the state. California's development of its "quasicommunity property" laws illustrates the distinction.*
>
> *The common law states, as contrasted to California, have not developed a statutory pattern for disposition of estates consisting of both separate property of spouses and property which was community property (or derived from community property) in which both spouses have an interest. In these states there have been relatively few reported cases (although the number has been increasing in recent*

years); the decisions to date show no consistent pattern and the increasing importance of the questions posed suggests the desirability of uniform legislation to minimize potential litigation and to facilitate the planning of estates.

This Act has a very limited scope. If enacted by a common law state, it will only define the dispositive rights, at death, of a married person as to his interests at death in property "subject to the Act" and is limited to real property, located in the enacting state, and personal property of a person domiciled in the enacting state. The purpose of the Act is to preserve the rights of each spouse in property which was community property prior to change of domicile, as well as in property substituted therefor where the spouses have not indicated an intention to sever or alter their "community" rights. It thus follows the typical pattern of community property which permits the deceased spouse to dispose of "his half" of the community property, while confirming the title of the surviving spouse in "her half."

It is intended to have no effect on the rights of creditors who became such before the death of a spouse; neither does it affect the rights of spouses or other persons prior to the death of a spouse. While problems may arise prior to the death of a spouse they are believed to be of relatively less importance than the delineation of dispositive rights (and the correlative effect on planning of estates). The prescription of uniform treatment in other contexts poses somewhat greater difficulties; thus this act is designed solely to cover dispositive rights at death, as an initial step.

The key operative section of the Act is Section 3 which sets forth the dispositive rights in that property defined in Section 1, which is subject to the Act. Section 2 follows Section 1's definition of covered property and is designed to provide aid, through a limited number of rebuttable presumptions in determining whether property is subject to the Act.

No negative implications were intended to be raised by lack of inclusion of other presumptions in Section 2; areas not covered were simply left to the

normal process of ascertainment of rights in property.

The first three sections form the heart of the Act; the succeeding sections might almost be described as precatory and have been added to clarify situations which would probably follow from the first three sections but which might raise questions. Thus, Section 8 makes it clear that nothing in the Act prevents the spouses from severing any interest in community property or creating any other form of ownership of property during their joint lives; and, such action on their part will effectively remove any property from classification as property subject to this Act. Similarly, Section 9 makes it clear that the Act confers no rights upon a spouse where, by virtue of the property interests existing during the joint lives of the spouses, that spouse had no right to dispose of such property at death. By way of illustration, in at least one community property jurisdiction, the wife has no right to dispose of any part of the community property if she predeceases her husband. If the law of that jurisdiction is construed so as to treat this as a rule of property, then the move to the common law state should not alter the "property interest" of the spouses by conferring a right on the wife which she did not previously possess. On the other hand, if the provision is treated as simply establishing a pattern of dispositive rights on death of a wife who predeceases her husband, rather than a property right, the common law state of new domicile could prescribe an alternative pattern of dispositive rights. The Act does not resolve this question; rather it simply makes clear that it does not affect existing "property rights," leaving to the courts the interpretation of the effect of the community property state's law."

(a) Observations on NCCUSL's Comments

In reviewing the prefatory note, it is interesting that nowhere does it mention that a purpose of this provision had anything to do with income taxes, tax basis or any similar provision. Rather, the purpose of this law was to provide upon the death of the first spouse to die of a couple who once lived in a community property state and owned community property, assuming that the couple did nothing to affirmatively destroy any property rights that they may have had in their "community property", that the surviving spouse will have certain

community property "rights" with respect to such property. What is more interesting is that the uniform law does not state that the property continues to be community property (the act is silent), rather the uniform act focuses on the surviving spouse's "rights" in the property. The goal of the statute is to provide certain rights to the surviving spouse in the property that such would be akin to what the survivor would have received had the property been community property. Thus, the subtlety of the statute is the focus on the survivor's rights, and not defining the property as "community property" or some other type of property.

(b) States Implementing UDCPRDA

There are sixteen common law states that have adopted UDCPRDA. Interestingly, even though Alaska has the Community Property Trust act, they have also kept their version of UDCPRDA. With respect to opt-in community property states, keeping the UDCPRDA would be relevant for those who choose not to opt into the community property system.

(3) Does the Survivor's Interest in Property Covered Under UDCPRDA obtain a Date of Death Basis Adjustment Under Section 1014(b)(6)?

(a) Careful Reading of Section1014(b)(6)

Section 1014(b)(6) states:

> *"(6) In the case of decedents dying after December 31, 1947, property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate under chapter 11 of subtitle B (section 2001 and following, relating to estate tax) or section 811 of the Internal Revenue Code of 1939 … "*

(b) Analysis of Section 1014(b)(6)

This statue applies only to "community property held by the decedent and the surviving spouse under the community

property laws of any State, or possession of the United States or any foreign country."

The question then becomes, if a decedent dies a resident of a non-community property state, can that decedent own "community property"? This situation arises where a couple live in a community property state, acquire community property assets, move to a non-community property state and one spouse dies while a resident of the non-community property state.

The key question is whether the state in which the decedent spouse was a resident at the time of death recognized the property as "community property" at the time of the decedent's death. One could initially say that those states that adopted UDCPRDA appear to categorize property as community property, but this is not necessarily the case.

The title to the statute gives the reader a key to this. The statute is called the Uniform Disposition of Community Property *Rights* at Death Act (emphasis supplied). The statute is not a uniform statute on the disposition of community property; it is a statute that is designed to address community property rights. Nowhere in the statute does it say that the property is community property, it simply provides certain presumptions, how the property will be distributed at death, how title is perfected by the surviving spouse and the decedent's fiduciary, heirs, or devisee, how to deal with purchasers for value and creditors and certain other aspects and rights with respect to the property that was once community property when the decedent lived in a community property state.

XV. BASIS PLANNING: THE GRANTOR RETAINED INTEREST STEP-UP TRUST ("GRI-SUT")

A. Generally

In an article in *Journal of Taxation*, Austin W. Bramwell, Brad Dillon, and Leah Socash described a series of ingenious trusts that seek to adjust the traditional qualified personal residence trust (QPRT), grantor retained annuity trust (GRAT), or grantor retained unitrust (GRUT), in order to assure that there is a basis adjustment for the trust assets when the first spouse dies, regardless of which spouse dies first or how title to the property is held before it is transferred to the trust. Austin W. Bramwell, Brad Dillon, and Leah Socash, *The New Estate Planning Lexicon: Sugrits and Other Grantor-Retained Interest Step-Up Trusts*, 123 J. Tax'n 196 (Nov. 2015). The following is this pair of authors' explanation of these techniques.

Any errors are solely our responsibility. Messrs. Bramwell and Dillon and Ms. Socash share none of the responsibility for our mistakes. Their work was excellent. Ours is yet to be judged.

B. The Step-Up Personal Residence Trust ("SUPRT")

1. Generally

Clients who have an appreciated personal residence and who no longer need significant estate tax savings can modify the traditional qualified personal residence trust to provide a basis step-up for the residence at the death of whichever spouse dies first. This basis step-up would not be available merely by holding the property as joint tenants, tenants in common, or tenants by the entirety. IRC § 2040.

2. Structure of the SUPRT

A SUPRT is a qualified personal residence trust (QPRT) created by one spouse (the donor-spouse), that provides a reserved use period that continues until the death of the first to die of the donor-spouse and the other spouse (the donee-spouse). If the donor-spouse dies first, the trust assets pass to the donee-spouse or his or her estate. If the donee-spouse dies first, his or her will or revocable trust disposes of the assets of the trust. It is presumed that the donee-spouse leaves these assets to or in trust for the donor-spouse, though there should be no clear prearrangement for a retransfer. For more on the rules for an ordinary QPRT, see R. Aucutt & H. Zaritsky, *Structuring Estate Freezes After Chapter 14*, ¶ 3.04, ¶ 10.05 (Thomson Reuters/Tax & Accounting, 2d ed.1997 & Supp. 2018-2); H. Zaritsky, *Tax Planning for Family Wealth Transfers During Life*, ¶ 10.09 (Thomson Reuters/Tax & Accounting, 5th ed. 2013 & Supp. 2018-3).

3. Tax Results of the SUPRT

a) Residence Included in First Deceased Spouse's Gross Estate

If the donor-spouse dies first, the trust assets are included in his or her gross estate under IRC § 2036(a), because the donor-spouse will have retained the rent-free use of the property for a term that does not end before his or her death.

If the donee-spouse dies first, the trust ends and the residence passes to the donee-spouse's estate. Thus, the value of the residence will be included in his or her gross estate under IRC § 2033.

(1) No Estate Tax Savings

There is no estate tax savings from the SUPRT, because the property merely passes from one spouse to the other. The point of this trust is to assure a full basis adjustment up to the fair market value of the residence at the first spouse's death, regardless of which spouse dies first.

(2) Estate Tax Marital Deduction

When the first spouse dies and the property is included in his or her gross estate under Section 2033 (donee-spouse dies first) or Section 2036 (donor-spouse dies first), the property passing outright to the surviving spouse should qualify for the estate tax marital deduction.

b) No Taxable Gift

(1) Completed Gift to Donee-Spouse

The donor-spouse's gift on the creation of the trust is the value of the donee-spouse's remainder interest, which is possessory upon the death of the earlier of the two spouses to die. This can be determined under the standard IRS actuarial tables. See Publication 1457 at p.8, www.irs.gov/ pub/irs-pdf/p1457.pdf. The present value of the donee-spouse's remainder interest is the value of the trust assets, less the value of the grantor's lifetime reserved interest. Section 2702 permits the subtraction of the value of the donor-spouse's lifetime personal use interest in the trust because the trust holds only an interest in a personal residence and meets the other requirements of a QPRT. The fact that the reserved use term is not a fixed number of years does not disqualify the trust as a QPRT – it merely changes the value of the remainder interest.

(2) Gift Qualifies for the Gift Tax Marital Deduction

The taxable gift, however, is zero, because the gift of the remainder interest to the donee-spouse or his or her estate qualifies for the gift tax marital deduction. See Rev. Rul. 54-470, 1954-2 C.B. 320 (A gift of a vested indefeasible remainder interest such as would be includible in the gross estate of the donee spouse at death under the 1939 predecessor to Section 2033 qualifies for the gift tax marital deduction.).

c) Probable Basis Adjustment at Each Spouse's Death under Section 1014

(1) Generally

The value of the residence and other assets of the SUPRT should receive a basis adjustment up to the fair market value of the property on the date of the first spouse's death, under IRC §§ 1014(a), 1014(b)(1), and 1014(b)(9). The trust assets then pass to the surviving spouse, either under the trust instrument or the first spouse's will, so they should, if retained by the surviving spouse until his or her later death, receive another basis adjustment at that time.

(2) Basis Adjustment May be Lost if Donee-Spouse Dies Within One Year of Gift of Remainder Interest

If the donee-spouse dies within one year of the gift of the remainder interest to him or her, Section 1014(e) should apply and deny the basis increase. This rule should not apply, however, if the donor-spouse dies within one year of having given the spouse the remainder interest, because there is no gift from the surviving spouse to the first deceased spouse, as required under Section 1014(e).

Section 1014(e) would not apply, however, if the donee-spouse leaves the property to someone other than the donor-spouse, at the former's death within one year of the funding of the trust. Leaving the property in trust for the donor-spouse, however, even if there are other beneficiaries, may result in the loss of all or part of the basis increase. See discussion at IV, E, 3, above.

C. The Step-Up Grantor Retained Income Trust ("SUGRIT")

1. Generally

A donor who has sufficient applicable exclusion amount to assure that current gifts and the assets of his or her estate will not be subject to gift or estate taxes may want to consider a variation on the SUPRT that may hold diverse investment assets, ra-

ther than being restricted to holding the grantor's personal residence. Such a variation is the step-up grantor retained income trust, or SUGRIT, which resembles the SUPRT except that; (a) it is not restricted to a personal residence – it may hold various types of investment or tangible assets; and (b) the gift of the remainder interest is likely to be a taxable gift.

2. Structure of the SUGRIT

A SUGRIT is an irrevocable trust created by the donor-spouse that provides a reserved income interest for a period that continues until the first spouse's death. If the donor-spouse dies first, the trust assets pass to the surviving donee-spouse or his or her estate. If the donee-spouse dies first, his or her last will leaves his or her interest in the trust to or in trust for the donor-spouse.

3. Tax Results of the SUGRIT

a) Assets Included in First Deceased Spouse's Gross Estate

As with a SUPRT, if the donor-spouse dies first, the trust assets are included in his or her gross estate under Section 2036(a), because the donor-spouse will have retained the right to the income from the trust assets for a term that does not end before his or her death.

If the donee-spouse dies first, the trust ends and the assets pass to the donee-spouse's estate. Thus, the value of the assets will be included in his or her gross estate under Section 2033.

(1) No Estate Tax Savings

There is no estate tax savings from the SUGRIT, because the trust assets merely pass from one spouse to the other. The point of this trust, like the SUPRT, is to assure a full basis adjustment up to the fair market value of the trust assets at the first spouse's death, regardless of which spouse dies first.

(2) Estate Tax Marital Deduction

When the first spouse dies and the property is included in his or her gross estate under Section 2033 (donee-spouse dies first) or Section 2036 (donor-spouse dies first), the property passing outright to the surviving spouse should qualify for the estate tax marital deduction.

b) Substantial Taxable Gift under Section 2702

(1) Gift to Donee-Spouse Enlarged Under Section 2702

The donor-spouse's gift on the creation of the trust is the value of the donee-spouse's remainder interest, which is possessory upon the death of the earlier of the two spouses to die. Under Section 2702(a), however, the gift tax value of this transfer must be determined without subtracting the present value of the donor-spouse's reserved income interest. The exceptions for trusts holding only a personal residence and for reserved qualified interests (annuities and unitrust interest) do not apply. The value of the gift, therefore, is the entire value of the transferred assets.

(2) Not All of the Gift Qualifies for the Gift Tax Marital Deduction

Section 2702(a)(1) applies "Solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), . . ." The increase in the value of the gift appears not to be reflected in the calculation of the gift tax marital deduction. Therefore, the taxable gift is the full value of the transferred assets, reduced only by the actuarial value of the donee-spouse's remainder interest.

(3) Gift Tax Limits, But Does Not Eliminate, the Appeal of the SUGRIT

The fact that Section 2702 produces a taxable gift on the creation of a SUGRIT only means that this technique should be reserved to couples who are unlikely to utilize all of their applicable exclusion amount. The goal of the SUGRIT is to obtain a full basis adjustment on the trust assets at the death of each spouse; it is not to reduce wealth transfer taxes.

Note, however, that if the donor-spouse dies first, his or her gift to the SUGRIT is not part of his or her lifetime adjusted taxable gifts, and so his or her applicable exclusion amount is adjusted for estate tax purposes, to recover the prior taxable gift. Section 2001(b) defines "adjusted taxable gifts" for estate tax purposes as "the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent." This clearly excludes from the adjusted taxable gifts the donor-spouse's transfers to the SUGRIT. The real cost of the additional taxable gift under Section 2702, therefore, occurs only if the donee-spouse dies first.

There is also a fair argument that the donor-spouse's applicable exclusion amount should be restored even if the donee-spouse dies first, if the donee-spouse transfers the trust assets to the donor-spouse. The above-quoted portion of Section 2001(b) excludes from a decedent's "adjusted taxable gifts" transfers that are "includible in the gross estate of the decedent." One could construe this as including the transfer to the SUGRIT if it is returned to the donor-spouse's gross estate by a subsequent transfer from the donee-spouse's estate. There is, however, no authority supporting this interpretation at this time.

c) Probable Basis Adjustment at Each Spouse's Death under Section 1014

(1) Generally

The value of the assets of the SUGRIT should receive a basis adjustment up to their fair market value on the date of the first spouse's death, under IRC §§ 1014(a), 1014(b)(1), and 1014(b)(9). The trust assets then pass to the surviving spouse, either under the trust instrument or the first spouse's will, so they should, if retained by the surviving spouse until his or her later death, receive another basis adjustment at that time.

(2) Basis Adjustment May be Lost if Donee-Spouse Dies Within One Year of Gift of Remainder Interest

As with the SUPRT, if the donee-spouse dies within one year of the gift of the remainder interest to him or her, Section 1014(e) should apply and deny the basis increase. Again, this rule should not apply if the donor-spouse dies within one year of having given the spouse the remainder interest, because there is no gift from the surviving spouse to the first deceased spouse, as required under Section 1014(e). Leaving the property in trust for the donor-spouse, however, even if there are other beneficiaries, may result in the loss of all or part of the basis increase.

D. The Tangibles SUGRIT

1. Generally

Yet another possibility is to create a SUGRIT and fund it entirely with non-depreciable tangible property. This transaction has the potential of achieving both income and wealth transfer tax benefits.

2. Structure

A Tangibles SUGRIT, like a regular SUGRIT, is an irrevocable trust created by the grantor-spouse that provides a reserved income interest for a period that continues until the first spouse's death. If the donor-spouse dies first, the trust assets pass to the surviving donee-spouse or his or her estate. If the donee-spouse dies first, his or her last will leaves his or her interest in the trust to or in trust for the donor-spouse. The Tangibles SUGRIT differs from the regular SUGRIT in that; (a) it holds only non-depreciable tangible property; and (b) the gift of the remainder interest should not be a taxable gift.

3. Regulations' Exception for Tangibles Trusts

a) Generally

Reg. § 25.2702-2(c)(2)(i) states, in part, that the valuation rules of Section 2702 does not apply to a transfer in trust of tangible property:

> *"(A) For which no deduction for depreciation or depletion would be allowable if the property were used in a trade or business or held for the production of income; and*
> *(B) As to which the failure to exercise any rights under the term interest would not increase the value of the property passing at the end of the term interest."*

Non-depreciable tangible property could include artwork, antiques, jewelry, or unimproved land.

b) Establishing Gift Tax Value

Section 2702 does not apply to a transfer in trust of tangible property, so the value of the gift is determined by conventional gift tax rules. Reg. § 25.2702-2(c)(2)(ii), however, states that the best evidence of the value of a transfer to a Tangibles SUGRIT:

> *"is actual sales or rentals that are comparable both as to the nature and character of the property and the duration of the term interest. Little weight is accorded appraisals in the absence of such evidence. Amounts determined under section*

7520 are not evidence of what a willing buyer would pay a willing seller for the interest."

As with other assets for which there is no established market, the practitioner will need to secure expert appraisals to establish the fair rental value of assets transferred to a Tangibles SUGRIT.

The regulations recognize that it is often impractical to transfer such nondepreciable assets without also transferring a small amount of depreciable property that has been added as an improvement. This is particularly true of ranch or farm land, which will almost always include a certain amount of fencing and other minor improvements. Thus, the regulations provide that a Tangibles SUGRIT will not be disqualified merely because there is also held by the trust depreciable improvements on otherwise acceptable nondepreciable tangible property, as long as the improvements do not increase the fair market value of the nondepreciable property by more than 5 percent. Reg. § 25.2702-2(c)(2)(ii).

For more on the requirements for a valid tangibles GRIT under the regulations, see also R. Aucutt & H. Zaritsky, *Structuring Estate Freezes After Chapter 14* ¶ 3.05, ¶ 10.06 (Thomson Reuters/Tax & Accounting, 2d ed.1997 & Supp. 2018-2); H. Zaritsky, *Tax Planning for Family Wealth Transfers During Life*, ¶ 10.10 (Thomson Reuters/Tax & Accounting, 5th ed. 2013 & Supp. 2018-3).

4. Tax Results of the Tangibles SUGRIT

a) Assets Included in First Deceased Spouse's Gross Estate

As with a SUGRIT or SUPRT, if the donor-spouse dies first, the assets of a Tangibles SUGRIT are included in his or her gross estate under Section 2036(a), because the donor-spouse will have retained the right to the income from the trust assets for a term that does not end before his or her death.

If the donee-spouse dies first, the trust ends and the assets pass to the donee-spouse's estate. Thus, the value of the assets of the Tangibles SUGRIT will be included in his or her gross estate under Section 2033.

(1) No Estate Tax Savings

There is no estate tax savings from the Tangibles SUGRIT, because the tangibles merely pass from one spouse to the other. The point of this trust is to assure a full basis adjustment up to the fair market value of the trust assets at the first spouse's death, regardless of which spouse dies first.

(2) Estate Tax Marital Deduction

When the first spouse dies and the property of the Tangibles SUGRIT is included in his or her gross estate under Section 2033 (donee-spouse dies first) or Section 2036 (donor-spouse dies first), the property passing outright to the surviving spouse should qualify for the estate tax marital deduction, as with a SUPRT or a SUGRIT.

b) No Taxable Gift

(1) Completed Gift to Donee-Spouse

The donor-spouse's gift on the creation of a Tangibles SUGRIT is the value of the donee-spouse's remainder interest, which is possessory upon the death of the earlier of the two spouses to die. Unlike a SUPRT, however, the value of the reserved use interest in a Tangibles SUGRIT is not determined under the IRS actuarial tables. Reg. § 25.2702-2(c)(1).

The regulations state that the best evidence of the value of a term interest in a Tangibles SUGRIT is actual sales or rentals of property that is comparable "both as to the nature and character of the property and the duration of the term interest" and that little weight will be given to appraisals that do not include evidence of actual comparable sales or rentals. Reg. § 25.2702-2(c)(3). This means that the grantor must search for rentals of comparable property, consider the length of the lease, and determine whether the lessee is required to pay the maintenance expenses on such leases. Then, the overall value of the leased property can be compared with the rents to determine the actual return on investment from the use of such assets.

Then, the present value of the donee-spouse's remainder interest, after subtracting the value of the grantor's lifetime reserved interest. Section 2702 permits the subtraction of the value of the donor-spouse's lifetime personal use interest in the trust because the trust holds only an interest in a personal residence and meets the other requirements of a Tangibles GRIT under the regulations. The fact that the reserved use term is not a fixed number of years does not disqualify the trust as a Tangibles GRIT – it merely changes the value of the remainder interest.

(2) Gift Qualifies for the Gift Tax Marital Deduction – But at What Value?

As with a SUPRT or SUGRIT, the value of the remainder interest given to the donee-spouse or his or her estate qualifies for the gift tax marital deduction. See Rev. Rul. 54-470, 1954-2 C.B. 320. As

with a SUGRIT, however, there appears to be a difference between the gift tax value of the remainder interest (based on comparable rentals) and the marital deduction value (based on the actuarial tables under Section 7520. For a Tangibles SUGRIT, however, it is not clear whether the remainder interest under the actuarial tables will be worth more or less than that valued on the basis of comparable rentals. If the comparable rentals value is at equal to or greater than the value based on the IRS actuarial tables, there should be no taxable gift.

c) Probable Basis Adjustment at Each Spouse's Death under Section 1014

(1) Generally

The value of the assets of a Tangibles SUGRIT should receive a basis adjustment up to the fair market value of the property on the date of the first spouse's death, under IRC §§ 1014(a), 1014(b)(1), and 1014(b)(9). The trust assets then pass to the surviving spouse, either under the trust instrument or the first spouse's will, so they should, if retained by the surviving spouse until his or her later death, receive another basis adjustment at that time.

(2) Basis Adjustment May be Lost if Donee-Spouse Dies Within One Year of Gift of Remainder Interest

As with a SUPRT or SUGRIT, if the donee-spouse dies within one year of the gift of the remainder interest to him or her, Section 1014(e) should apply and deny the basis increase. This rule should not apply, however, if the donor-spouse dies within one year of having given the spouse the remainder interest, because there is no gift from the surviving spouse to the first deceased spouse, as required under Section 1014(e).

Section 1014(e) would not apply, however, if the donee-spouse leaves the property to someone other than the donor-spouse, at the former's death within one year of the funding of the trust. Leaving the property in trust for the donor-spouse, however, even if there are other beneficiaries, may result in the loss of all or part of the basis increase. See discussion at IV, E, 3, above.

E. Step-Up Grantor Retained Annuity Trust ("SUGRAT") or Unitrust ("SU-GRUT")

1. Generally

A SUGRAT or SUGRUT is a qualified grantor retained annuity or unitrust created by the donor-spouse, that provides a reserved annuity or unitrust interest use period

that continues until the death of the first to die of the donor spouse and the donee-spouse. If the donor-spouse dies first, the trust assets pass to the surviving donee-spouse or his or her estate. If the donee-spouse dies first, his or her last will leaves his or her interest in the trust to or in trust for the donor-spouse. For more on the rules for GRATs and GRUTs generally, see also R. Aucutt & H. Zaritsky, *Structuring Estate Freezes After Chapter 14*, ¶ 3.03, ch. 11 (Thomson Reuters/Tax & Accounting, 2d ed.1997 & Supp. 2018-2); H. Zaritsky, *Tax Planning for Family Wealth Transfers During Life*, ¶ 12.06 (Thomson Reuters/Tax & Accounting, 5th ed. 2013 & Supp. 2018-3).

The rules and treatment of a SUGRAT or SUGRUT would be similar to that of a SUPRT, except that: (a) there would be no restriction on the type of assets that a SUGRAT or SUGRUT may hold; and (b) the interest retained by the donor-spouse would be either an annuity or unitrust interest, rather than the personal use of the asset; and (c) in some situations, the entire trust fund might not be included in the donor-grantor's gross estate if he or she dies first.

Unfortunately, the SUGRAT or SUGRUT does not appear to work under the present regulations, though some believe that there are legitimate arguments in their favor. The key problem is that Regulation Section 25.2702-3(d)(4) states:

> **(4)** ***Term of the annuity or unitrust interest.*** The governing instrument must fix the term of the annuity or unitrust and the term of the interest must be fixed and ascertainable at the creation of the trust. The term must be for the life of the holder, for a specified term of years, or for the shorter (but not the longer) of those periods. Successive term interests for the benefit of the same individual are treated as the same term interest. (emphasis supplied)

Clearly, a SUGRAT or SUGRUT uses a term that is not the life of the holder, a specified term of years, or the shorter of the two. It is, rather, the shorter of the lives of the holder and the holder's spouse. Reading the regulations literally, they unambiguously appear to preclude this approach.

There is no logical policy reason why the regulations would not permit a SUGRAT or SUGRUT. The retained interest in a SUGRAT or SUGRUT would certainly are fixed and ascertainable at the time the trust is created. Nonetheless, there appears to be no logical way to construe the regulations as permitting a SUGRAT or SUGRUT.

F. Reciprocal GRISUTS

1. Generally

Spouses may each own assets that they desire to have included in the estate of the first spouse to die, in order to obtain a basis adjustment. This, of course, raises questions under the reciprocal trust doctrine, in which the Supreme Court stated

that reciprocal trusts would be treated as created by their respective beneficiaries, rather than their respective settlors, "if they are 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." *United States v. Estate of Grace*, 395 U.S. 316, 324 (1969).

2. The Reciprocal Trust Doctrine

The Supreme Court's decision in *Estate of Grace* involved estate taxation, which would seem to render it applicable to determining what portion of the trust assets are includible in the gross estate of the first spouse to die. For those who would argue that the real issue is income taxation, rather than estate taxation, it is noteworthy that the Tax Court and the Sixth Circuit have applied the reciprocal trust doctrine for income tax purposes, as well. See *Krause v. Comm'r*, 57 T.C. 890 (1973), *aff'd*, 497 F.2d 1109 (6th Cir. 1974), *cert. denied*, 419 U.S. 1108 (1975). Other courts applied the pre–*Estate of Grace* version of the doctrine to income tax cases, as well. See *Estate of Newberry v. Comm'r*, 17 T.C. 597 (1951), *rev'd*, 201 F.2d 874 (3d Cir. 1953); *Tobin v. Comm'r*, 11 T.C. 928 (1948), *rev'd in part*, 183 F.2d 919 (5th Cir. 1950); *Haldeman v. Comm'r*, 6 T.C. 345 (1946); *Wieboldt v. Comm'r*, 5 T.C. 946 (1945); *Whiteley v. Comm'r*, 42 BTA 316 (1940), *aff'd*, 120 F.2d 782 (3d Cir. 1941), *cert. denied*, 314 U.S. 657 (1941).

3. Results of Reciprocal Trust Doctrine Application to GRISUTs

If spouses create reciprocal GRISUTs, the doctrine could result in the inclusion of the trust fund only in the gross estate of the donor-spouse, because the donor would be treated as if he or she had retained the remainder interest in his or her own trust.

It should be noted, however, that while the reciprocal trust doctrine has been used to cause inclusion of a trust in an individual's gross estate, it has never been used to cause exclusion of a trust fund from an individual's gross estate. Nonetheless, there is no reason why it could not be so used. See also See Slade, *The Evolution of the Reciprocal Trust Doctrine Since Grace and Its Current Application in Estate Planning*, 17 Tax Mgmt. Est. Gifts & Tr. J. 71 (1992).

4. Avoiding the Reciprocal Trust Doctrine

There is no bright-line test for what makes trusts reciprocal. The standard established in *Estate of Grace* is merely that the reciprocity "leaves the settlors in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries." *United States v. Estate of Grace*, 395 U.S. 316, 324 (1969). Thus, one must take as many steps as possible to avoid leaving the two spouses in such reciprocal situations. The following steps are suggested:

- *Different retained interests.* Spouses should attempt not to create the same types of trusts for each other. For example, one spouse could create a SU-PRT for the other spouse, and the other spouse could create a Tangible SUGRIT for the first spouse. This leaves each with reciprocal value (to the extent of equivalent value), but arguably not comparable economic positions.

- *Different creation dates.* It is helpful if the trusts are not created within a relatively close period of time. In *Estate of Lueders v. Commissioner*, 164 F.2d 128 (3d Cir. 1947), for example, the court held that the doctrine did not apply to similar trusts established by a spouse under instruments created 15 months apart. The court noted there was no evidence of any agreement, express or implied, or even an "understanding" to make reciprocal transfers of property at the time the husband's trust was created. See also PLR 9735025 (reciprocal trust doctrine does not apply when one trust was modified to become reciprocal 26 years after the other was created, and then only because the taxpayer's brother resigned as trustee.

- *Different trustees.* The trusts should have different trustees. This may not avoid having equivalent economic benefits, but it does avoid the argument that there are reciprocal powers. Compare *Bischoff v. Comm'r*, 69 T.C. 32 (1977) (reciprocal powers created estate taxation); with *Estate of Green v. United States*, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine does not apply to reciprocal powers, because they do not create an identical economic interest).

- *Different wills.* One element of differentiation may be for the donee-spouses to make different dispositions of the trust funds if the donee-spouse dies first. One spouse could leave assets outright to the other, and the other spouse leave assets to a QTIP or other marital trust. This can be further enhanced if one spouse leaves his or her GRISUT assets to other family members, which will eliminate the estate tax marital deduction for this disposition but will also negate the possible application of Section 1015(e).

XVI. PROBLEM BASIS SITUATIONS: BASIS AND BARGAIN SALES (PART-SALE/PART-GIFTS)

A. Generally

A part-sale/part-gift is a bargain sale, usually between family members or a donor and a charity. A bargain sale involves the transfer of property by one family member to another for less than full and adequate consideration in money or money's worth. The buyer may pay all cash or give the seller an installment note, in which case any gain on the sales portion of the bargain sale may be reported under the installment sales rules.

B. Two, Two, Two Transactions in One

A bargain sale is actually two transactions for tax purposes—a taxable gift and a sale.

1. Gift Portion

A bargain sale is a taxable gift to the extent that the fair market value of the property sold exceeds the consideration received. Reg. § 1.1001-1(e).

2. Sale Portion

a) Gain Transaction

A bargain sale is a sale to the extent that the consideration received exceeds the transferor's adjusted basis in the property. Reg. § 1.1001-1(e).

Example XVI-1

Son wishes to buy Mom's closely held stock that has a fair market value of $200,000. However, Son has only $150,000 to spend. Mom agrees to sell the stock to Son for $150,000. Mom's adjusted basis in the stock is $50,000.

The transfer is a $50,000 taxable gift, determined by the difference between the stock's fair market value and the amount of consideration paid by Son ($200,000 - $150,000 = $50,000).

The transfer is also a sale on which Mom recognizes a $100,000 gain, determined by the difference between the purchase price and Parent's adjusted basis ($150,000 - $50,000 = $100,000).

See Example XVI-3 below to determine how basis is determined in Son's hands.

b) No Loss - Loss Transaction

In a bargain sale transaction, the regulations provide that no loss is sustained in a sale to the extent that the consideration is less than the adjusted basis. Reg. § 1.1001-1(e).

Example XVI-2

Daughter wishes to buy Dad's closely held stock that has a fair market value of $300,000. However, Child has only $150,000 to spend. Dad agrees to sell the stock to Child for $150,000. Dad's adjusted basis in the stock is $200,000.

The transfer is a $150,000 taxable gift, determined by the difference between the stock's fair market value and the amount of consideration paid by Daughter ($300,000 - $150,000 = $150,000).

Even though the adjusted basis (of $200,000) was greater than the consideration received, there will be no loss because of Reg. § 1.1001-1(e).

See Example XVI-4 below to determine how basis is determined in Daughter's hands.

3. Basis in a Non-Charitable Bargain Sale

The transferor's adjusted basis in a non-charitable bargain sale property is allocated entirely to the sales portion of the transaction. Reg. § 1.1001-1(e)(1).

The transferee's basis in the bargain sale property is the greater of:

- the consideration paid by the transferee (i.e., the donee); or
- the transferor's adjusted basis at the time of the transfer, plus any gift taxes paid on gift.

Reg. §1.1015-4.

Example XVI-3

This is the same fact pattern as Example XVI-1, except here we discuss Son's basis in the stock. Recall that Son purchased the stock with a fair market value of $200,000 and adjusted basis in Mom's hands of $50,000 for $150,000. Son's basis would be $150,000, calculated as follows:

Greater of:

Consideration paid by Son	$150,000
or	
Mom's basis, plus gift taxes paid	50,000
Son's basis	$150,000

Example XVI-4

This is the same fact pattern as Example XVI-2, except here we discuss Daughter's basis in the stock. Recall that Daughter purchased the stock with a fair market value of $300,000 and adjusted basis in Dad's hands of $200,000 for $150,000. Daughter's basis would be $200,000, calculated as follows:

Greater of:

Consideration paid by Daughter	$150,000
or	
Dad's basis, plus gift taxes paid	200,000
Daughter's basis	$ 200,000

4. Holding Period in non-charitable transaction

As discussed above, even though there are two separate transactions, the holding period of the entire basis of the property will be tacked under the theory that the language "in whole or in part" under Section 1223(2) would apply. See, *Citizens Nat'l Bank of Waco v. United States*, 417 F.2d 675 (5th Cir. 1969).

Thus, in each of the four examples, the donee (i.e., Son in Examples XVI-1 and XVI-3, and Daughter in Examples XVI-2 and XVI-4) will tack the donor's holding period.

C. Basis in a Charitable Bargain Sale

1. Charitable Bargain Sale Defined

A charitable bargain sale is a bargain sale in which all or part of the gift portion is deductible for income tax purposes under Section 170. IRC § 1011(b); Reg. § 1.1011-2(a)(1).

2. Apportionment of Basis

For purposes of determining gain on a charitable bargain sale, the adjusted basis of the transferred property that is deemed to have been sold or exchanged is that portion of the adjusted basis of the entire property that bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the entire property. Reg. § 1.1011-2(b). See also generally Lichter, *The Federal Tax Rules and Theory of Bargain Sale Gifts to Charity*, 12 Tax Mgmt. Est., Gifts & Tr. J. 172 (1987) and 13 Tax Mgmt. Est., Gifts & Tr. J. 23 (1988); Weber & Stevenson, *Charitable Bargain Sales and the Allowability Test—A Tax Trap*, 56 Taxes 101 (1978).

Example XVI-5

Donor sells to Church certain publicly-traded stock that Donor has held for more than one year, and so qualifies as long-term capital gain property. Church pays Donor $400,000. The fair market value of the stock is $1 million. Donor's adjusted basis in the stock is $300,000. Donor's adjusted basis for determining gain on the bargain sale is $120,000, determined as follows:

$300,000 adjusted basis × ($400,000 amount realized ÷ $1 million value of property)

Donor realizes a long-term capital gain of $280,000 ($400,000 amount realized - $120,000 adjusted basis) on the bargain sale. See Reg. § 1.1011-2(c), Ex. 1.

3. Encumbered Property

The tax effects of a charitable gift of encumbered property are identical to those of a traditional bargain sale to a charity for cash. The amount of the debt assumed or taken subject to by the charity is included in the transferor-donor's amount realized for purposes of determining the transferor-donor's gain recognized on the transfer. Thus, the donor recognizes gain if the amount of the debt exceeds the share of his or her adjusted income tax basis allocated to the sale portion of the transfer. The excess of the value of the property over the amount of the encumbrance is deductible as a charitable contribution. Reg. § 1.1011-2(a)(3); see also Rev. Rul. 75-194, 1975-1 C.B. 80; and Rev. Rul. 81-163, 1981-1 CB 433. The part-sale result occurs even if there is no purchase, but rather the transfer of property that is subject to a nonrecourse mortgage. *Ebben v. Comm'r*, 783 F.2d 906 (9th Cir. 1986); *Guest v.*

Comm'r, 77 T.C. 9 (1981). See also Woodburn, Jr., *Handling Charitable Gifts of Debt-Encumbered Property*, 21 Est. Plan. 287 (Sept./Oct. 1994).

4. Income Tax Deduction

With respect to the gift part, the excess of the allocable value of the property over the amount received is a deductible gift to the charity. IRC § 1011(b).

a) Reduction for Non-Long-Term Capital Gain

Under Section 170(e)(1)(A), the deductible amount of a gift of appreciated ordinary income property is reduced by that part of the gain that would not qualify as long-term capital gain upon the sale of the property.

b) *Bullard* and the Charitable Bargain Sale

IRS previously stated that when the charitable contribution arises from a bargain sale, the non-long-term capital gain inherent in the entire property reduces the charitable deduction, and not just the non-long-term capital gain allocable to the charitable gift portion. The Tax Court rejected this position in *Estate of Bullard v. Comm'r,* 87 T.C. 261 (1986).

c) Regulations Revised

After *Bullard*, the IRS amended the regulations to state that only the non-long-term capital gain inherent in the portion of the property contributed to charity reduces the deduction for the charitable gift. Reg. §§ 1.170A-4(c), 1.1011-2, as amended by T.D. 8176, 53 Fed. Reg. 5568 (Feb. 25, 1988).

XVII. PROBLEM BASIS SITUATIONS: BASIS OF PARTNERSHIP (AND LLC INTERESTS) AND THE SECTION 754 ELECTION

A. Background on Partnership Taxation

1. In general

Limited partnerships (LPs) and limited liability companies (LLCs) are used extensively today in estate planning. The choice of entity is primarily determined by the client's needs and goals, the practitioner and the state in which the entity is to be formed.

For federal income tax purposes, LPs are generally taxed as partnerships under Subchapter K of the Internal Revenue Code. LLCs, by comparison may choose to be taxed as corporations (whether C or S), partnerships (if there are two or more members) or disregarded entities (where there is a single member). See generally, Reg. § 301.7701-1; -2; -3 and -4.

For purposes of this paper, we will discuss those LPs and LLCs that choose to be taxed as partnerships under Subchapter K, and often will refer to LLCs and LPs as "partnerships". This part of the paper is designed to be an overview of partnership law as it affects basis inside and outside of the partnership. For comprehensive treatise on partnership tax, see, W.S. McKee, W.F. Nelson & R.L. Whitmire, *Federal Taxation of Partnership and Partners* (Thomson Reuters/Tax & Accounting, 4th Ed. 2007 & Supp. through 2018-1).

2. Underlying Theories for Subchapter K

In general, federal partnership tax law wrestles with two underlying theories that set the stage for its taxation: Aggregate Theory and Entity Theory.

a) Aggregate Theory

Under the aggregate theory, one would basically look through the partnership and tax the partner with respect to his/her ratable share of partnership items. According to Professors McKee, Nelson and Whitmire, if subchapter K was based only on aggregate theory, subchapter K would be generally unnecessary, because other sections of the Code would be able to adequately tax the partnership and its partners.

b) Entity Theory

The entity concept treats the partnership as a separate entity, and thus transactions between the partnership and third parties, as well as transactions between the partnership and its partners are at arm's length.

For a detailed discussion of the aggregate and entity theories, see W.S. McKee, W.F. Nelson & R.L. Whitmire, *Federal Taxation of Partnership*

and Partners ¶1.02 (Thomson Reuters/Tax & Accounting, 4th Ed. 2007 & Supp. through 2018-1); and B. I. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts,* ¶ 86.1 (Thomson Reuters/Tax & Accounting, 2nd/3rd Ed., 1993 - 2014, 2013 & 2018 Cum. Supp. N. 1).

c) Which Theory Applies?

The simple answer is – both.

Both theories apply in partnership tax, and as it applies to basis, we generally understand that a partner has a basis in his partnership interest, sometimes called "outside basis") separate and apart from the partnership's basis in the assets that it holds, sometimes called "inside basis"), thus, with regard to basis, it appears that an entity approach is adopted. However, as with most of the partnership tax law, there is often a blending of the aggregate and entity theory.

The 754 Election (discussed below) is a perfect example. On the one hand the basis of assets inside the partnership is generally determined on an entity theory, but when there is a shift in ownership of the partner's interests, that inside basis may be adjusted because of an outside basis shift.

From time to time, the tax lawyer tries to take advantage of some of the nuances and gaps that arise because of the application of one theory or the other to a particular partnership tax provision. When this happens, generally the issue is brought to light and then there are revenue rulings, regulatory and/or statutory changes that address the particular issue. These rulings and changes generally leads more of a blending of the aggregate and entity theories underpinning the existing partnership tax law, which could then further the complication and lead to more confusion.

B. Initial Basis

Generally, a partner's initial basis is established when a person (defined broadly to include individuals, trusts, estates, corporations, etc.,): (a) contributes assets into a partnership in exchange for a partnership interest, (b) purchases a partnership interest from an existing partner, or (c) a combination (a) and (b).

1. Contributions

In general, most contributions are non-recognition events, however, there are some that cause gain to be recognized on contribution. Note: Losses are never recognized on contribution.

a) Tax Free Contributions – General Rule

(1) No Gain Recognition

When partners contribute assets to the partnership in exchange for partnership interests, generally neither the partnership nor its partners recognize gain. IRC §721(a).

(a) Inside Basis - Basis of Partnership's Assets

When there is no gain recognition, the partnership's basis of the assets transferred to the partnership (i.e., the "inside basis") will be a transferred basis. IRC § 723; Reg. § 1.723-1

(b) Outside Basis – The Partner's Basis in its Partnership Interest

When there is no gain recognition, the partner's basis in the partnership interest (i.e., the "outside basis") is equal to the basis of the property contributed to the partnership. IRC § 722; Reg. § 1.722-1

Example XVII-1

Richard owns Blackacre (raw land) which he purchased for $100,000 in 2001. George owns Whiteacre (raw land) that abuts Blackacre. George purchased Whiteacre for $200,000 in 2004. In January 2015, each of Blackacre and Whiteacre has a fair market value of $500,000, on the day that Richard and George enter a partnership by contributing Blackacre and Whiteacre in exchange for a 50% interest in RGLP. Richard will be the general partner and George will be the silent limited partner.

Richard's outside basis will be $100,000 (i.e., the basis of Blackacre before contribution).

George's outside basis will be $200,000 (i.e., the basis of Whiteacre before contribution).

RGLP's inside basis will be $100,000 for Blackacre and $200,000 for Whiteacre.

(2) Holding Period

(a) For the Partnership

If no gain is recognized, the holding period of the property received by the partnership would be a tacked holding period. IRC § 1223(2); Reg. § 1.723-1.

(b) For the Partner

(i) The Rules

Unlike the holding period for the partnership, the holding period for the partner is a bit more complicated. If no gain is recognized, then for purposes of determining the holding period, one looks to the assets contributed to determine the holding period.

If the contributed assets are capital and Section 1231 type assets, then the holding period is a tacked holding period. IRC § 1223(1).

If the contributed assets are cash, a non-capital asset or non-§1231 type of asset, then the holding period begins on the date of contribution. IRC § 1223(1); Reg. § 1.1223-1(a).

If there is a mix of assets contributed (e.g., some cash, some capital assets), then, only for purposes of holding period, the partnership interest is bifurcated, and the rules (i.e., tacking and date of contribution) would apply pro-rata based on the fair market values of the assets contributed. Reg. §1.1223-3(b)(1). For an example, see also Reg. § 1.1223-3(f) Example 1.

(ii) The Aberration – Subsequent Contributions

In light of the bifurcation rule set forth in Reg. § 1.1223-3(b)(1), it should be noted that every time a partner makes a contribution of cash, a non-capital asset, or a non-Section 1231(b) type asset to the partnership, the holding period for the outside basis has to be bifurcated. That bifurcation lasts for only one year and a day (because after that one year and a day period, any gain from the sale or exchange would be a capital asset).

As a practical matter, this only comes into play when there are cash calls and a sale or exchange will occur within a year of such cash call.

Example XVII-2

Assume the same facts as Example XVII-1, and that both Blackacre and Whiteacre are capital assets.

As to Richard's outside basis, he would have a tacked holding period back to 2001.

As to George's outside basis, he would have a tacked holding period back to 2004.

As to RGLP's inside basis, Blackacre's holding period would be 2001 and Whiteacre's holding period would be 2004.

Example XVII-3

Assume the same facts as Example XVII-1, except that Richard contributed cash of $500,000 instead of Blackacre, and that Whiteacre is a capital asset.

As to Richard's outside basis, he would have a new holding period as of the date of contribution.

As to George's outside basis, he would have a tacked holding period back to 2004.

As to RGLP's inside basis, the cash will have a date of contribution holding period and Whiteacre's holding period would be 2004.

Example XVII-4

Assume the same facts as Example XVII-1, except that Richard contributed cash of $200,000 and Greenacre (which had a FVM of $300,000 and a $100,000 adjusted basis and was bought in 2001), instead of Blackacre, and that both Greenacre and Whiteacre are capital assets.

As to Richard's outside basis, he would have a bifurcated basis for holding period purposes. As to two-fifths (2/5), his holding period would be a new holding period as of the date of contribution (i.e., related

to the cash) and as to three-fifths (3/5), he would have a tacked holding period going back to 2001 (i.e., related to Greenacre).

As to George's outside basis, he would have a tacked holding period back to 2004.

As to RGLP's inside basis, the cash will have a date of contribution holding period, Greenacre's holding period would be 2001, and Whiteacre's holding period would be 2004.

b) Taxable Contributions – The Exceptions

In general, gain could be recognized when "boot" is received by the partner and gain is recognized when an "investment partnership" is formed.

(1) Receipt of Boot

"Boot" comes in various forms. It could occur when a partner receives cash or other property in conjunction with the partnership interest in exchange for the assets given up, or it could be that the partnership assumed debt or took assets subject to debt from the partner.

Section 721(a) is silent on how to treat receipt of boot by the partner (which is in stark contrast to the formation rules for corporations under Section 351). However, the regulations provide that the assumption of debt would be treated as a constructive distribution and the rules under Section 731 would apply. If the net assumed debt exceeds the partner's basis in the property given up, then gain will be recognized under Section 731(a).

(2) Investment Partnerships

Unlike the statutory gap for receipt of boot, Section 721(b) provides that a partnership recognizes gain (and not loss) if the contributions would be considered made to a partnership that, if it had been incorporated, it would be treated as an investment company, as such term is defined in Section 351(e) (hereinafter, "investment partnerships").

(3) Basis - Gain is Recognized

(a) Outside Basis

When gain is recognized on the contribution, the partner's outside basis is equal to the sum of (1) amount of cash contributed, (2) the adjusted basis of the other assets contributed, and (3) the gain recognized on the transfer. IRC § 722; Reg. §§ 1.722-1 and 721-1(b).

(b) Inside Basis

Further, in determining the partnership's inside basis, such basis is equal to the basis of the assets in the hand of the partner (immediately before the transfer), plus any gain recognized by the partner. IRC § 723; Reg. § 1.723-1.

(c) Holding Period

The holding period rules discussed above would apply equally in this situation.

c) Assumption of Liabilities/Relief of Debt – And Basis

When assets are contributed to a partnership and the partnership assumes the debt or the contributed assets are subject to the debt, there are three transactions that occur:

- First, the contributing partner is being relieved of debt.
- Second, the partnership assumes the debt.
- Third, the assumed debt by the partnership is deemed to be assumed by all of the partners based on their pro rata shares.

A partner's basis increases by the amount of such partner's share of the partnership's debt or the amount of any partnership liability that such partner assumes. IRC § 722; Reg. §§ 1.722-1 and 1.752-1. The assumption of debt is treated as a contribution by the partner to the partnership.

Conversely, a partner's basis decreases by the amount such partner's share of the debt that is relieved or that such partner assumes. IRC § 722; Reg. §§ 1.722-1 and 1.752-1.

d) Basis of Partner's Contribution of Partner's Own Note

(1) To a Partnership

If a partner contributes his/her own note in exchange for a partnership interest, the partnership basis is not increased by the face amount of the note. This is true whether the note is a recourse or non-recourse note. The basis of the note is zero and the basis in the partnership interest exchanged for the note is also zero. See *Vision Software LLC v. Comm'r*, T.C. Memo 2014-182; *Dakotah Hills Offices Ltd. P'ship. v. Comm'r*, T.C. Memo 1998-134; *Gemini Twin Fund III v. Comm'r*, T.C. Memo 119-315; *Oden v. Comm'r,* 679 F.2d 885 (4th Cir. 1983), *aff'g*, T.C. Memo 1981-184; and Rev. Rul. 80-235, 1980-2 C.B. 229.

As the notes are paid off, then the basis is increased by the note payments. Thus, if the note is never paid off, then the partner would not have any basis in the partnership with regard to that note. *Vision Software, LLC. v. Comm'r, supra.*

(2) To a Subchapter C Corporation – A Different Rule

It should be noted that in *Peracchi v. Comm'r*, 143 F.3d, 487 (9th Cir. 1998) in the context of subchapter C corporations, the Tax Court held that the taxpayer Donald Peracchi had a basis equal to the face value of his note (in this case, $1.06 million), and on contribution, the basis in the stock he received in exchange for such note would be equal to that amount. It is interesting to note in Footnote 16 that the court was mindful of the difference between pass through entities, such as S corporation and partnerships) and said that in such a context, the note would have a zero basis. In a similar case, instead of holding that the note had a value equal to its face value, the Second Circuit held that the note had a zero value, but on contribution to a corporation, the basis of the stock in the hands of the shareholder was equal to the face value of the note (i.e., creating basis upon contribution). *Lessinger v. Comm'r*, 872 F.2d 519 (2nd Cir. 1989).

The troubling part of these cases is that if the taxpayer did nothing, the note would have a zero basis (based on existing case law other than in the subchapter C corporation context), and by contributing to a subchapter C corporation the note had a basis immediately before contribution (*Peracchi*), or the stock received a basis on contribution (*Lessinger*). Both of these cases are limited to subchapter C corporations and should be so limited.

QUERY: What would happen if the subchapter C corporation made an S election and converted to a subchapter S corporation? Would that election eliminate the basis? How much of the basis of the note

would be eliminated? What if the note was partially paid before the election? After the election?

2. Basis of Interest Acquired other than by Contribution

a) Purchase

In general, if a partner acquires his/her interest other than by contribution, the acquiring partner's initial outside basis is determined under the general basis rules (i.e., cost basis). IRC §§ 742 and 1012.

b) Gift

In the case of an *inter vivos* gift, the initial basis of a partnership interest in the case follows the general gift rules of a transferred basis plus any gift taxes paid attributable to the gift. IRC §§ 1015(a) and (d).

c) Inheritance

The initial basis of a partnership interest from a decedent follows the general rules of fair market value on the date of death or alternate valuation under Section§ 1014(a) and 2032.

C. Basis Adjustments – Distributive Share of Income, Gains, Deductions and Losses

After the partner begins as a partner, his/her initial basis is continuously adjusted based on activities of the partnership and activities of the partner. The partnership's activities can be divided into those activities from the normal course of business (i.e., activities that generate income/loss) and other activities that related directly to the partner, such as additional contributions from the partner or distributions from the partnership.

In this section we address the impact of the day-to-day activities that affect basis. In general, with respect to such day-to-day activities, the Code provides a systematic way of adjusting basis. First, the Code (and the regulations thereunder) sets forth the manner in which items of income, gains, deductions, losses, credits, etc., are to be determined (Sections 702 and 703). Second, the Code (and in particular the regulations) explains how those items will be allocated among the partners (Section 704). Finally, the Code (and regulations) determines how those allocated items will increase and decrease the partner's outside basis (Section 705).

1. Section 702 – Separately Stated Items

Each partner is to take into consideration such partner's "distributive share" of a list of separately stated items, including but not limited to net taxable income (or loss), charitable contributions, short- and long-term gains (or losses), to determine such partner's income tax. IRC § 702.

2. Section 703

The partnership's net taxable income (or loss) is computed in a manner similar to that of an individual, except that certain items are to be separately stated, and there are certain items that are not allowed as deductions (e.g., personal exemptions).

3. Section 704 – Distributed Share Calculation

Section 704, and particularly the regulations thereunder, provides some of the most complex rules in tax law on how the "distributive share" is calculated for each partner. See, IRC § 704; Reg. § 1.704-1; Prop. Reg. § 1.704-1; Reg. § 1.704-1; Reg. § 1.704-1T; Reg. 1.704-2; Prop. Reg. § 1.704-2; Reg. 1.704-3; Prop. Reg. § 1.704-3; Reg. 1.704-4; and Prop. Reg. § 1.704-4.

In general, for most LPs (or LLCs) created for estate planning purposes, the partner's (or member's) distributive share is determined by his or her interest in the LP (or LLC). Thus, if a partner is a 20% partner, he or she will generally share in 20% of the separately stated items. Importantly, the so-called, special allocation rules, under Section 704(b), would generally not be in play. The allocations are generally simple and easy to understand.

4. Section 705 - Basis Adjustment

A partner's outside basis is adjusted (i.e., increased and decreased) by a number of transactions. Generally, with respect to the day-to-day activities, the partner's outside basis is from his or her distributable share of taxable and non-taxable income and expenses of the partnership. IRC § 705(a); Reg. § 1.705-1. The basis is also affected by contributions (whether actual or deemed) and distributions (whether actual or deemed).

a) Basis Increases

In general, the partner's initial outside basis is increased by the sum of such partner's distributive share of taxable income, tax exempt interest, and excess of the deduction for depletion over basis of property subject to the depletion. IRC § 705(a)(1); Reg. § 1.705-1(a)(2)(i) – (iii).

b) Basis Decreases

In general, the partner's initial outside basis is decreased by the sum of such partner's distributive share of taxable loss (including capital losses), partnership expenditures which are not deductible in computing partnership taxable income or loss and which are not capital expenditures. IRC § 705(a)(2); Reg. § 1.705-1(a)(3)(i) & (ii). There are other reductions related to depletion and disposition of oil and gas interests. IRC § 705(a)(2); Reg. § 1.705-1(a)(4) & (5).

c) Don't Forget Other Transactions Affect Basis Too!

Recall, the partner's outside basis is also adjusted for non-day-to-day activities, such as subsequent contributions to and distributions from the partnership. IRC § 705(a)(1) and (2). We discuss distributions below in the next subsection.

D. Inside Basis

The inside basis of contributed assets take a transferred basis and are adjusted for any gains recognized on the contribution. IRC § 723; Reg. § 1.723-1. The holding period for such assets is determined under the rules of Section 1223(2).

1. General Rule

The general rule is that the inside basis is generally adjusted for sales and other disposition under the normal basis rules.

2. Exception –754 Election

However, if an election is made under Section 754 ("754 Election") (discussed below), then such inside basis may be adjusted when there is a shift in the partner's ownership of the partnership (e.g., partner's sales of the partnership interest and termination of an interest due to death).

E. Basis for Distributions

Partnership distributions fall into two general categories: (1) cash distributions (which includes relief of a partner's share of liabilities); and (2) property (other than cash) distributions.

Distributions are further characterized as liquidating or current distributions. Liquidating distributions are those distributions that liquidate or terminate a partner's entire interest (whether in one or a series of distributions). IRC § 761, Reg. § 1.761-1(d). Current distributions are defined to be distributions that are not liquidating distributions.

When distributions are made, the distributed property's basis in the partner's hands must be determined. Additionally, if the distribution is a current distribution, it will affect the outside basis of the partnership (and possibly the inside basis), and if the distribution is a liquidating distribution, the basis before distribution determines the amount of gain or loss on liquidation.

1. Current Distributions

a) Non-Recognition Transactions

(1) Generally

Current distribution of cash, marketable securities, or other property will generally not trigger gain to the partner. IRC § 731(a)(1).

A partner will never recognize a loss from a current distribution. Section 731(a)(2). However, a partner can recognize a loss from a liquidating distribution, as discussed below.

(2) Outside Basis

If no gain is recognized, the partner's outside basis is reduced by the amount of money and the adjusted basis of the property distributed from the partnership. IRC § 733.

For consistency purposes, that reduction of basis is transferred to the money and other property.

The term "money" is defined to include marketable securities. IRC §§ 731(c) and 737(e).

(a) Basis for Cash

Regardless of whether gain or loss is recognized, the outside basis for cash is always its face value.

(b) Basis for Property Other Than Cash

If no gain or loss is recognized on the distribution, the basis of the property received in the partner's hands is the pre-distribution basis of such property (i.e., a transferred basis) (reduced any cash that may have been received in the same transaction). IRC § 732(a)(1); Reg. § 1.732-1(a). To the extent that a 754 Election is in effect, any basis adjustments from such election would be reflected in the partner's hands.

(c) Holding Period

(i) General Rule

In general, the holding period of property other than cash will be a tacked holding period of the partnership's distributed asset. IRC §§ 735(b); 1223(2), and Reg. § 1.735-1(b).

It should be noted that the basis in the assets is derived from the partner's partnership interest (i.e., the outside basis is derived from the basis of the asset received), but the holding period is not the holding period of the partnership interest, rather it is the distributed asset's holding period.

(ii) Exception

Section 735(b) only applies in cases where there has been a distribution of property to the partner. If the property was deemed to have been sold to or exchanged with (and not distributed) the partner, then tacking under Section 735(b) is not permitted, rather the holding period would start on the date of the deemed sale or exchange. See, *McCauslen v. Comm'r*, 45 T.C. 588 (1966).

Example XVII-5

Janet has an outside basis of $100,000 in JL,LP on January 1, 2015. On that day, JL,LP distributes cash of $5,000 and a parcel of land to Janet where the fair market value of such land was $15,000 and its inside basis was $5,000 and acquisition date of December 1, 2001. Janet's outside basis will be $90,000 (i.e., $100,000 minus $5,000 (cash) and $5,000 (inside basis of land)). Janet's basis in the cash will be $5,000 (its face value) and the adjusted basis in the land will be $5,000, and its holding period begins December 1, 2001.

(3) Impact to the Partnership

(a) Gain/Loss

Generally, for current distributions, the partnership does not recognize gain or loss on a distribution of property, including money. IRC § 731(b).

(b) Basis

(i) General Rule

If no gain or loss is recognized, then generally the basis is not affected as a result of the distribution. IRC §§ 734(a) and 743(a).

(ii) Exception – Section 734(b)

A partnership's inside basis may be adjusted as a result of an existing 754 Election or if there was a "substantial basis reduction" with respect to that distribution. IRC § 734(b).

A discussion of the intricacies of this rule is beyond the scope of this paper. See, W.S. McKee, W.F. Nelson & R.L. Whitmire, *Federal Taxation of Partnership and Partners, ch. 25* (Thomson Reuters/Tax & Accounting, 4th Ed. 2007 & Supp. through 2018-1).

Example XVII-6

Assume the same facts of Example XVII-5, with regard to the partnership, no gain was recognized on its transfer of the cash (of $5,000) or the property (with a fair market value of $15,000 and inside basis of $5,000) to Janet.

When Janet later sells the property, assuming the same fair market value and adjusted basis, the gain will be recognized. The gain is simply deferred by the distribution from the partnership to the partners. This is consistent with the aggregate theory.

b) Exceptions to Gain Recognition

Generally, there are three exceptions to the non-gain-recognition rule for current distributions:

- First, if the distribution consists of "money" where the fair market value of such money in excess of the distributee-partner's outside basis, then gain will be recognized. IRC § 731(a). Note: The term "money" means both cash and marketable securities. IRC § 731(c) and § 737(e).

- Second, if the partnership distributes property to a partner who contributed property within 7 years of the distribution, gain may be recognized under Section 737.

- Third, if there is a distribution to the partner and Section 751(b) is triggered, then gain may be recognized. IRC §§ 741 and 751.

If gain is recognized, then such gain is treated as gain from the sale or exchange of the partner's interest. If Section 741 applies to that gain, it receives capital gain treatment, and if § 751 applies to that gain, it receives ordinary income treatment.

For a complete discussion of the intricacies of W.S. McKee, W.F. Nelson & R.L. Whitmire, *Federal Taxation of Partnership and Partners*, chs. 19-21 (Thomson Reuters/Tax & Accounting, 4th Ed. 2007 & Supp. through 2018-1).

c) Effect on Basis

(1) Inside Basis

In general, if gain has been recognized on the distribution of an asset, the inside basis of the remaining assets are generally not affected.

(2) Outside Basis

In general, the outside basis is reduced (but not below zero) by the amount of money and basis of the distributed property (other than money) in the distributee-partner's hands. IRC § 733.

The term "money" is defined to include marketable securities. IRC §§ 731(c) and 737(e).

(3) Basis of Property Received by Distributee-Partner

The basis of the property (other than money) received by the distributee-partner shall be the inside basis immediately before the distribution. IRC § 732(a)(1); Reg. § 1.732-1(b). Provided, however, that if the inside basis of such property exceeds the outside basis, the basis of the distributed property in the hands of the partner would be the partner's outside basis. IRC § 732(a)(2); Reg. § 1.732-1(a).

When both money (defined as cash and marketable securities) and non-money assets are received, the money first uses up the distributee-partner's outside basis. Thereafter, the basis of the distributed asset in the hands of the partner will be the lesser of the outside basis

(after adjustment for the money received) or the inside basis (immediately before the distribution). IRC §§ 732(a)(1) and (2); Reg. § 1.732-1(a)

Example XVII-7

X is a partner with an outside basis of $20,000, receives in a current distribution in non-money property having an adjusted basis of $12,000 to the partnership immediately before distribution, and $3,000 cash. The basis of the non-money property in X's hands will be $12,000. Under Sections 733 and 705, X's outside basis will be reduced by the distribution to $5,000 ($20,000 less $3,000 cash, less $12,000, the basis of the distributed non-money property to X).

Example XVII-8

Y is a partner with an outside basis of $20,000. Y receives a current distribution of $12,000 cash and non-money property with an inside basis of $16,000. The basis of the distributed non-money property to Y is limited to $8,000 (i.e., $10,000, Y's outside basis, reduced by $12,000, the cash distributed).

(4) Holding Period of Property Received by Distributee-Partner

In general, the holding period rule is the same for current as it is for liquidating distributions. That is, the holding period of the property in the partner's hands (other than money) will be a tacked holding period of the partnership's distributed asset. IRC §§ 735(b); 1223(2), and Reg. § 1.735-1(b).

Note that the basis in the assets is derived from the partner's partnership interest (i.e., the outside basis become the basis of the asset received), but the holding period is not the holding period of the partnership interest, rather it is the distributed asset's holding period.

2. Liquidating Distributions

a) Generally

Liquidating distributions are one or more distributions that terminate a partner's entire interest in a partnership. IRC § 761; Reg. § 1.761-1(d). A partner's interest is not liquidated until the final distribution is received. Reg. § 1.761-1(d).

(1) No Gain/No Loss

In general liquidation of a partner's interest is a non-recognition event to both the partner and the partnership. However, it is possible to trigger gain or loss, as described below.

(a) Basis

(i) Outside Basis

The outside basis will disappear as a result of the liquidating distributions to the liquidating partner.

(ii) Basis of Assets Received by the Liquidating Partner

If no gain or loss is recognized on the liquidation, the basis of the property (other than money) received by the liquidating partner in liquidation of such partner's interest shall be an amount equal to such partner's outside basis (reduced by any money received in the same transaction). IRC § 732(b); Reg. § 1.732-1(b).

Thus, when both money (defined as cash and marketable securities) and non-money assets are received in liquidation, the money first uses up the liquidating partner's outside basis, and any remaining outside basis is allocated to the non-money assets.

(iii) Inside Basis

The inside basis of any assets remaining will generally stay the same as a result of the liquidation of the liquidating partner's distribution.

Example XVII-9

Z is a partner with an outside basis of $20,000 before his interest will be fully liquidated. Upon liquidation, Z receives cash of $8,000, and raw land with an inside basis of $10,000 (immediately before the liquidating distribution) and a fair market value of $21,000. Z's basis in the raw land after the liquidation is $12,000 (i.e., Z's outside basis of $20,000, reduced by $8,000, the cash distributed).

(2) Exceptions to No Gain/No Loss Rule

As with current distributions, liquidating distributions have exceptions to the current rules.

Gain can be recognized when the money distributed exceeds the outside basis immediately before distribution. IRC §§ 731(a)(1), (a)(2) and (c).

Additionally, loss may be recognized to the extent that the outside basis before the liquidating distribution is less than the sum of: (a) cash, (b) the fair market value of marketable securities distributed; and (c) the pre-distribution adjusted basis of any "unrealized receivables" (defined in Section 751(c) and "inventory" (defined in Section 751(d)). IRC §§ 731(a)(1), (a)(2), and (c).

F. When is Basis Determination Important?

Determining a partner's basis is typically an annual event. This is especially true when there are losses from the partnership, because such losses are generally limited to the extent of basis under Section 704(d). Additionally, annual determination is important in years where there is a partnership's liquidation or disposition of a partner's interest (to determine gain or loss under Section 732(b)), and when distributions (non-liquidating) are made from the partnership (to determine if gain or loss may be recognized under Sections 732(a)(2) and 731(a)(1)).

G. A Few Words on the Term "Negative Basis"

There is no such thing as "negative basis." Quite often the term is confused with the term "negative capital account." The tax laws allow the basis to go to zero, but not below. For an interesting discussion on the implications of "negative basis" (or as the author sometimes calls it "subzero basis") and the overriding considerations for tax laws not to incorporate "negative basis." See, Cooper, *Negative Basis*, 75 Harv. L. Rev. 1352 (1961-1962), see also, *Wilhelm v. Comm'r*, 46 T.C. Memo. 1983-234 (rejecting argument possibility of a negative basis in a depreciated automobile and citing *Hall v. Comm'r*, 595 F.2d 1059 (5th Cir. 1979), in which the court agreed with the IRS position that an asset cannot have a negative basis).

H. Basis for Shifting Interests

The typical planning structure with LPs is to have the senior generation create the LP. Thereafter, typical planning strategies include:

- Making *inter vivos* gifts of the LP interests to the junior generation (whether in trust or otherwise);

- Selling LP interests to irrevocable grantor trusts; and
- Keeping the interests until death and having the interests pass to the children.

Typically, the strategies rely on discounting of the LP interests to achieve minimization of the impact of estate and gift (and sometimes GST) taxes.

We address how basis is impacted by *inter vivos* and testamentary transfers, below.

1. *Inter Vivos* Transfers

a) Transfers to Irrevocable Grantor Trusts

Generally, transfers to irrevocable grantor trusts occur during the donor's life. When these transfers are made, under the theory of Rev. Rul. 85-13, 1985-1 C.B. 184, there is no transfer for federal income tax purposes, accordingly, there is no gain and no loss, and basis and holding period for the partner and the partnership are unaffected.

See discussion below entitled, *Basis and Grantor Trusts – Lots of Questions Not so Many Answers*, for more about basis and grantor trusts.

b) Transfers to Non-Grantor Trusts

When the partner makes a lifetime or testamentary transfer to a person, other than to such partner's grantor trust (i.e., to a non-grantor trust), outside and inside basis may be affected.

(1) Outside Basis

A donee-partner's outside basis is generally the donor's outside basis adjusted by any gift tax paid. IRC § 1015(a).

(a) Suspended 704(c)(1)(C) Basis Adjustments Lost

If the contributing partner originally contributed property with a basis in excess of its fair market value on the date of contribution ("loss property") an Section 704(c)(1)(C) basis adjustment (for pre-contribution loss) is created. If the donor-partner then makes a gift of his/her partnership interest, the basis adjustment related to that portion of the gifted partnership interest is eliminated. Prop. Reg. §§ 1.704-3(f)(3)(iii)(B)(2); 1.704-3(f)(3)(iii)(C), Ex. 5. In other words, the donee-partner does not succeed in the donor-partner's Section 704(c)(1)(C) allocation; the basis adjustment is lost.

(b) Suspended Losses – Lost?

Unlike the provision that the Section 704(c)(1)(C) (pre-contribution loss) is eliminated, neither the statute or the regulations give guidance on what happens to suspended losses if the partnership interest is given away. It is unclear in the context of a gift, whether the suspended loss (which is in effect an adjustment to basis), is conveyed to the donee-partner, or whether it is lost. The better reasoning is that it is not lost, however, there is no statutory or regulatory guidance (to date).

(2) Inside Basis

By definition, inside basis only changes upon the sale, exchange of death of the partner. Thus, inside basis is generally not affected by gifs.

However, if the gift it to a charity and basis is determined by reason of assumption of the partnership's liabilities, and the gift is considered a part-sale/part-gift, then it is possible for the basis to be adjusted as a result of the "sale part" of the transaction.

2. Testamentary Transfers

a) Outside Basis

The outside basis of property acquired from a deceased partner is the sum of the fair market value of the decedent's partnership interest at date of death or the alternate valuation date and the share of the inheriting partner's partnership liabilities, less the inheriting partner's share of the partnership's income in respect of a decedent (IRD). This can be viewed mathematically by the following formula:

+ Fair market value of the partnership interest at date of death or alternate valuation date

+ Partner's share of partnership liabilities assumed

- Share of partnership's IRD

= Inheriting Partner's new outside basis

b) Inside Basis

(1) Generally

In general, the inside basis is not adjusted as a result of a transfer of a partnership interest. IRC § 743(a).

(2) Exceptions

When a partner dies, then the inside basis may be adjusted if the partnership elects or had already made a 754 Election, and must be adjusted when there is substantial built-in loss. IRC § 743(a). A substantial built-in loss happens when at the time of death, the inside basis exceeds the partnership's fair market value by more than $250,000. IRC § 743(d)(1). Certain investment partnership are entitled to elect out of the mandatory substantial built-in loss rule. IRC § 743(e).

If a 754 Election is in effect, then upon the decedent-partner's death, the inside basis of assets is adjusted as to that particular deceased partner.

I. Special Rules with *Inter Vivos* and Testamentary Transfers that Affect Basis and Holding Period

1. Gift to Charity

When a partnership interest is given to charity, if the partnership's liabilities are included in the outside basis, the gift may be treated as a part-gift/part-sale transaction.

2. Allocation of Income to Donee Partner's Interest

When a partnership interest is gifted on a date other than the first or last day of the year, then the partner's distributive share of income, gains, loss, deduction, or credit shall be determined based on the varying interests of the donor and donee partners. IRC § 706(d)(2)(A).

3. Holding Period

a) Inside Basis Assets

(1) Generally

In general, the inside basis is not affected by transfers of partnership interests, whether by lifetime gift or testamentary transfer. IRC § 735(a).

(2) 754 Election Exception

If a 754 Election is in effect, inside basis will be affected in the case of a testamentary transfer, as discussed below, and may be affected by *inter vivos* gifts, if the gifts are recharacterized as a part-gift/part-sale as a result of relief of partnership debt, as discussed above.

b) Outside Basis

(1) *Inter Vivos* Gifts

In the case of *inter vivos* gifts, the donee-partner's outside basis is determined "in whole or in part" under Section 1015(a) (and perhaps Section 1015(d) for gift tax paid) by reference to the donor-partner's outside basis. If this is the case, then donee-partner's holding period is tacked. IRC § 1223(2).

(2) Testamentary Transfers

In the case of testamentary transfers, the inheriting-partner will have a holding period that starts on the decedent-partner's date of death, but if the partnership interest is sold, the property will be deemed to have been held for more than one year. IRC § 1223(9).

J. The 754 Election

1. Rationale Behind the Election

The rules for determining a partner's outside basis are separate from the rules that determine a partner's inside basis. At the inception of a partnership, generally the aggregate of the partner's outside bases is equal to the partnership's inside bases for its assets. During the operation of the partnership, however, with changes in ownership, increases in partnership borrowings, and distributions, often times there is a divergence between inside and outside bases, which may cause potential timing differences in the recognition of income (which could unfairly affect some of the partners).

Specifically, when a sale, exchange or death of a partner occurs, a disparity generally arises between the inside and outside bases. This disparity occurs because the general rule of Section 743(a) mandates that the inside basis is not to be adjusted on the happening of those events. However, Sections 743(a) and (b) provide that adjustments may be made to the inside basis of asses if a 754 Election is in effect.

Thus, the 754 Election is designed to mitigate some of those timing differences and disparities.

2. Mechanics of the Election

The partnership makes the 754 Election; the partners do not make the election. There is no required form; a written statement, signed by any partner that includes the partnership's name and address and a statement saying that the election is being made to adjust the basis under Sections 734(b) and 743(a) is all that is necessary.

The statement must be attached to a timely-filed return for the year in which the partnership made a distribution or there is a change in the partner's interests in the partnership. IRC § 754; Reg. §§ 1.754-1(a) and (b). If the statement is not timely filed, discretionary relief may be obtained under Reg. § 301.9100-2. Reg. § 1.754-1(b).

The election may be revoked by application by the partnership at the discretion of the Secretary. IRC § 754; Reg. § 1.754-1(c).

3. 754 Election is a Basis Adjustment

a) Only Applies to a Transferee Partner

The 754 Election affects only the transferee partner. When an adjustment under Section 743(b), is made it is made with respect to that partner.

Logistically, the 754 Election does not change the inside basis of the partnership assets. Rather, a separate "special basis" account is set up to keep track of all of the assets with respect to that particular partner. Every time there is an event that affects the basis of assets respect to that particular partner, the separate special account is adjusted, and it is also reflected in the pass-through income, gain, expense, loss, etc., to such partner.

The adjustments that arise under the election only affect taxable income (and basis), they do not affect the partner's capital accounts. Thus the 754 Election is not a book entry that affects capital.

b) Either Up or Down or Up and Down

The 754 Election is commonly referred to as the "754 basis step- up", like the basis adjustment at death of an individual under Section 1014. But, like the general basis provision under Section 1014, the 754 Election "adjusts"

inside basis; thus, it can have a net "increase" or "decrease" with respect to the particular transferee-partner.

If there is only one asset in the partnership (which would be highly unusual), then the net increase or decrease would apply to that asset. However, if there is more than one asset in a partnership (which is typically the case), then the net increase or decrease is directed to be allocated between two groups of assets. IRC § 755; Reg. § 1.755-1. The allocation is a five (5) step process.

- Step 1: Determine the total Section 754 adjustment (the "754 Adjustment"). This is generally the transferee-partner's share of the aggregate difference between the fair market value and adjusted basis of each of the partnership's assets.

- Step 2: Divide all assets into two classes: (1) capital assets and Section 1231(b) type assets (Class 1) – these assets generally trigger capital gain or loss on sale or disposition); and (2) all other property (Class 2) – these assets will generally trigger ordinary income property on sale or disposition).

- Step 3: Determine the 754 Adjustment for only the Class 1 assets (i.e., capital and § 1231(b) assets).

- Step 4: Determine the 754 Adjustment for the Class 2 assets (i.e., the assets other than Class 1 assets, or generally the ordinary income assets). To determine this amount, simply take the difference between the 754 Adjustment for all of the assets and subtract the Class 1 754 Adjustment. This difference may be positive or negative.

- Step 5: Allocate the Class 1 754 Adjustment among the Class 1 assets; and Allocate the Class 2 754 Adjustment among the Class 2 assets.

It is entirely possible to have a positive 754 Election for all of the assets and have a positive Class 1 754 Election while having a negative Class 2 754 Election. Thus, the adjustment may be up for one class of assets and down for the other.

Determining the 754 Adjustment lends itself well to a spreadsheet, which will be used every time there is a shift in the interest due to sale, exchange and or death of a partner, and each time an asset is sold and each year that assets have to provide for depreciation, depletion, amortization or some similar expense.

4. Effect on Basis for Lifetime Transfers

A 754 Adjustment only occurs when Sections 743 (sales, exchanges and deaths of partners) and 734 (partnership distributions) are triggered. Thus, during the partner's lifetime, only sales, exchanges and partnership distributions would trigger an adjustment.

It should be noted even though there may not be an event that triggers an adjustment under Sections 743 or 734, the separate special basis account is continuously being adjusted because of transactions happening in the partnership. Because the 754 Adjustment may be allocated to assets that are depreciable, by example, each year, inclusive of the normal depreciation, the 754 Adjustment allocable to a parcel of improved real estate would also have to be depreciated, too.

5. Effect on Basis for Testamentary Transfers

Upon the death of a partner, if there has been no 754 Election, the partnership has an opportunity to determine whether an election should be warranted. If it is warranted, then the election can be made.

If a 754 Election is in effect, the partnership determines the 754 Adjustment, and allocates it to the transferee-partners of the decedent-partner.

6. Practical Pointers About the Election

Although the 754 Election generally remedies some of the ill effects of inside and outside basis differentials upon the sale, exchange and death of a partner, it requires much effort to determine the 754 Adjustment and to maintain such adjustment on the partnership's books.

Calculating the adjustment may be time consuming, because it requires the partnership to value each asset in the partnership. And, if there are hard to value assets (e.g., real estate, private equity, etc.) in the partnership then typically, an appraisal would be necessary.

Each time an event happens that triggers a basis adjustment, the 754 Adjustment must be calculated, and depending upon the situation, it may require prior adjustments to be adjusted or even eliminated (e.g., where a partner dies and his or her interest initially created a 754 Adjustment for such now-deceased partner).

If there are multiple partners and/or multiple sales and exchanges, the administrative cost of the 754 Election could be quite costly.

Because of the tremendous amount of data and recordkeeping, quite often clients are reluctant to make the 754 Election, despite the tax benefit it may offer (by rectifying timing differences) over time.

7. Will Transfers from Estates and Trusts Trigger a 754 Adjustment?

We assume for this section that a 754 Election is in effect.[10]

The question posed is whether distributions from estates and trusts will trigger a 754 Adjustment. By its terms, Section 743, applies to "a transfer of an interest in a partnership by sale or exchange or upon the death of a partner." Clearly when a partner dies, and his interest goes to his estate, then there will be a 754 Adjustment. But what happens, at the end of the estate administration when assets have to be funded into trusts or distributed outright to beneficiaries, will that distribution trigger another adjustment?

In 1984, Section 761(e) was added to the Code to provide that:

> *"Except as provided in regulations, for purposes of … section 743 (relating to optional adjustment of basis of partnership property) any distribution of an interest in a partnership (not otherwise treated as an exchange) shall be treated as an exchange."*

There has been no regulatory guidance under Section 761 on this particular issue.

Read literally, if an estate or trust makes a distribution of a partnership interest to its beneficiary(ies), such distribution would trigger a 754 Adjustment.

Does this make sense? The purpose of the 754 Election was to ameliorate the tax burden arising from an adjustment to the outside basis resulting of a sale or exchange (i.e., a taxable transaction) or a death (a transaction that triggers basis adjustment because of Section 1014), but no correlative adjustment to the inside basis.

The problem with distributions from estates and trusts is that some are taxable events and others are not. That is, some are treated as sales or exchanges for purposes of Section 1001, while others are not.

The problem the authors see is that read literally, every time there is an estate or trust distribution, Section 761 says that there is an exchange thus a 754 Adjustment, however, it seems to fly in the face of the purpose of Section 754.

Let's explore this some more …

a) Transfers from Estates

When an estate is to make a distribution to its beneficiaries, Section 761 provides that such distribution is an "exchange" triggering a 754 Adjustment.

[10] Even if a 754 Election is not in effect, the transfer could be considered a transfer that would allow a 754 Election to be made. Thus, in order not to confuse the issue, we simply assume that a 754 Election is in effect.

If the distribution is a taxable event, such as the distribution to satisfy a pecuniary bequest, then under *Kenan v. Comm'*r, 114 F.2d. 217 (1940), there should be a deemed sale, and thus a 754 Adjustment should be warranted. If the distribution is not a taxable event, such as a distribution of the residue to the residuary beneficiaries, then typically gain is not recognized, and a 754 Adjustment should not be warranted.

In Example 3 of Reg. § 1.706-1(c)(3)(vi), H (husband), dies and his partnership interest passes into his estate. When the administration of the estate is completed, the partnership interest is distributed to W (wife). The example concludes that "[s]uch distribution by the estate is not a sale or exchange of H's partnership interest." Perhaps the writers of the regulations meant to say, since this was not a taxable transaction, it was not a sale or exchange, but they did not say that, they merely concluded that it was not a "sale or exchange."

However, what happens if the beneficiaries wish to trigger gain under Section 643 ("643 Election")?

Note: Example 3 was written before Section 643 was enacted. Arguably, an Section 643 election would change the result. IRC § 643(e)(3)(A)(ii) provides that if the election is made, gain or loss shall be recognized "as if such property had been sold to the distributee at its fair market value." Thus, using the theory for why the 754 Election was made part of subchapter K, it appears that a 754 Adjustment would be warranted.

b) Transfers from Trusts

Distributions from a trust to its beneficiaries should be treated the same as distributions from estates, as set forth in the section above.

There is an additional scenario which regularly occurs in trusts that does not occur in estates that is worth exploring. This is when a life income beneficiary of a trust dies. The question raised is, "Should there be a 754 Adjustment?" Again, assume that a 754 Election is in place.

There is no statutory or regulatory guidance on this issue. However, the authors' analysis looks to the theory of the imposition of the 754 Election in subchapter K for guidance.

Let's look at three examples to see how one would analyze whether a 754 Adjustment would be warranted.

- GST Trust Example: Jordan is the life income beneficiary of a GST Exempt Trust created in Delaware. Upon Jordan's death, the balance of the trust estate is directed to be distributed into lifetime trusts (with the same provisions as Jordan's) for his then living descendants, per stirpes. The descendants' trusts have the same provisions

in perpetuity. Jordan has many descendants and those descendants have many descendants, too. There is nothing else that would cause inclusion in any beneficiary's estate upon a beneficiary's death.

- Non-GST Trust with Contingent General Power of Appointment Example: Jordan is also a life income beneficiary of a Non-GST Exempt Trust with the same provisions as the GST Trust. There is, however, a contingent general power of appointment that allows inclusion in the beneficiary's estate for Federal estate tax purpose.

- Non-GST Trust Example: Jordan is also a life income beneficiary of a Non-GST Exempt Trust with the same provisions as the GST Trust (i.e., there is no contingent general power of appointment).

In the GST Trust Example, notwithstanding the literal language of Section 761(e) (i.e., the distribution from the GST Trust for the benefit of Jordan to the trust for the benefit of his descendants, would mandate a 754 Adjustment), it does not appear appropriate to have a 754 Adjustment. The reason is that there will be no triggering of either an estate tax or a GST tax upon Jordan's death. Thus, there will be no basis adjustment under either Sections 1014 or 2654(a). Therefore, the inside and outside basis will remain the same and there should be no need for the 754 Election. The better analysis in this case is that a 754 Adjustment should not be made.

In the Non-GST Trust with Contingent general power of appointment Example, the trust's assets to the extent that the trust's assets (i.e., the partnership interest) will be included in Jordan's estate and therefore it would receive an outside basis adjustment under Section 1014, a 754 Adjustment should be warranted.

In the Non-GST Trust Example even though there is no estate tax inclusion, there will be a taxable termination, thus, under Section 2654(a)(2) there will be a date of death adjustment to the asset's fair market value. Thus, since the outside basis is adjusted, a 754 Adjustment appears to be warranted. See the discussion in section titled "Basis and the GST Tax."

XVIII. PROBLEM BASIS SITUATIONS: BASIS AND PASSIVE ACTIVITY ASSETS – SECTION 469

A. Brief Overview of Passive Activity Loss Rules

The passive activity rules (relating to the limitations on deductions for passive activity losses and passive activity credits (passive activity credits)) were added to the Code, as Section 469, as part of the Tax Reform Act of 1986. Pub. L. 99-514, 99th Cong., 2d Sess. (Oct. 22, 1986), 100 Stat 2085. Those passive activity loss/passive activity credit rules, combined with the at-risk rules, under Section 465, were designed to limit the perceived ill-effects of individuals participating in "tax shelters." The term "tax shelter" generally describes investments in passive-type activities used primarily (if not solely) for the purpose of taking losses and credits from those activities to offset other unrelated income.

The passive activity loss and passive activity credit rules were designed to apply primarily to individuals. However, to back-stop individuals from using entities to bypass Section 469, the rules were extended to estates, trusts, closely held C corporations and personal service corporations. The limitations do not apply to flow-through entities (i.e., entities taxed as partnerships (under subchapter K) or S corporations (under subchapter K)), because those entities are non-taxpaying entities, rather they are merely conduits (i.e., where their income, gains, deductions, losses, credits, etc., flow through to the owners).

In general, the passive activity loss/passive activity credit rules are applied on an activity-by-activity basis. An example of "activity" could be holding rental real estate.

When activities are held in a pass-through entity (i.e., a partnership or S corporation) such entity must segregate all such activities and report them separately to the owners.

The passive activity loss/passive activity credit limitations apply at the ultimate owner's level. Generally, an owner's passive activity losses from all passive activities can be offset from passive activity income from other passive activities, however, if there is a net loss, such net passive activity losses cannot be used against other income, instead those net passive activity losses are suspended. The aggregation, netting and then allocation of the passive activity losses are very complex and beyond the scope of this paper. For details see, B. I. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts*, ¶86.1 (Thomson Reuters/Tax & Accounting, 2nd/3rd Ed., 1993 - 2014, 2018 Cum. Supp. N. 1); and Shaviro, 549-2nd T.M., *Passive Loss Rules*. Additionally, see the same resources for the rules of determining if an activity is a passive activity.

When a particular activity's losses/credits are limited by Section 469, they will generally only be used against future passive activity income, or for a particular activity, any suspended passive activity losses may be used when such activity is sold or exchanged.

When the activity is given away during life or at death, in general part or all of the losses are added to basis and are not able to be used by the subsequent owner, until the activity is sold or otherwise disposed. We discuss this in detail below.

B. Suspended Losses

Passive activity losses and passive activity credits may not be deducted. IRC § 469(a). However, disallowed passive activity losses and passive activity credits for any year may be carried forward (indefinitely, at least until used and/or death). IRC 469(b).

There are four ways in which one can release the suspended losses:

- First, if the passive activities generate income, generally the suspended passive activity losses can be used to the extent of such income.
- Second, if there is an entire disposition (i.e., sale, exchange or abandonment) of the entire interest of the passive activity, the suspended passive activity losses/passive activity credits are able to be used. IRC § 469(g)(1)(A).
- Third, if the activity is given away during life. IRC § 469(j)(6).
- Fourth, if the activity is given away at death. IRC § 469(g)(2).

We discuss the *inter vivos* and testamentary transfers below.

C. Disposition of Passive Activity by Gift

If any interest in a passive activity is transferred by gift, the basis of such interest immediately before the transfer is increased by the amount of any suspended passive activity losses allocable to such interest. IRC § 469(j)(6)(A). Under this rule, the suspended passive activity losses are merely added to basis and the donee is unable able to use the suspended losses. IRC § 469(j)(6)(B).

There are four things to note. First, there is no need to dispose of the entire interest in order for the suspended losses to be used. Second, in the year of the gift, the income/loss from the given interest is prorated through the date of the gift, thus, the suspended passive activity loss would be adjusted as of the date of the gift. IRC § 469(j)(4). Third, even though the suspended losses are used, they are only added to basis, and they cannot be used by the donee against the donee's income, they may only be used to offset gains from future sales. Fourth, after giving effect to Section 469(j)(6), if the basis is greater than the fair market value of such property, the rules about "gifts of depreciated property" under Section 1015(a) would apply, so that the basis (after adjustment) would be limited to the fair market value on the date of gift.

If the transferred asset becomes a passive activity in the donee's hands, then from the date of gift forward the passive activity loss rules will apply to that transferred interest.

D. Disposition of Passive Activity by Death

1. Generally

When the owner of a passive activity dies, his or her death is treated similarly to a sale or exchange of his / her entire interest in the activity, where suspended passive activity losses can offset income. In death, however, some of the suspended passive activity losses may be non-deductible.

2. Three Step Process

There is a three-step process to determine the amount of the allowable passive activity loss:

First, determine the amount of the passive activity loss attributable to the decedent's interest through the date of death. IRC § 469(b) and (j)(4).

Second, determine if (1) the estate's date-of-death adjusted basis (i.e., the Section 1014 basis in the hands of the estate / beneficiary, which is generally the fair market value at date of death or alternate valuation date) is greater or less than (2) the decedent's adjusted basis immediately before death. IRC § 469(g)(2)(A). If the estate's adjusted basis is less than or equal to the decedent's adjusted basis, then the passive activity loss is fully deductible. If the estate's basis is greater than the decedent's basis, determine this excess and continue to the third step. IRC § 469(g)(2)(B).

Third, the passive activity loss is deductible to the extent it is greater than the excess (determined in the second step). The rationale for this rule is to prevent passive activity losses from exceeding true economic loss. Death eliminates any built-in-gains because of the basis adjustment under Section 1014. By disallowing passive activity losses equal to built-in gains, one prevents losses from exceeding the economic loss.

The deductible passive activity loss is used as follows: first, offset income from the particular passive activity; second, offset income of other passive activities; and finally, offset non-passive activity income. IRC § 469(g)(1).

Example XVIII-1 – Fully Utilized Passive Activity Losses

X dies on July 1, 2014, with a passive activity that he leaves to B. X's suspended passive activity loss with respect to passive activity was $235,000 immediately before his death. X's basis immediately before death was $250,000. B's Section 1014 basis is $100,000 (i.e., passive activity's date of death adjusted basis).

The results will be as follows:

First, X's passive activity loss attributable to passive activity was $235,000.

Second, there is no excess. X's adjusted pre-death basis (of $250,000) is less than the B's date-of-death adjusted basis (or $100,000).

Third, the deductible passive activity loss is $235,000 to be used to offset X's income on his final income tax return.

In this case, there is no built-in gain (i.e., the value of the property is less than the adjusted basis in the hands of the decedent immediately before death); thus, the passive activity loss could be fully utilized to offset the decedent's income.

Example XVIII-2 – Partially Utilized Passive Activity Losses

Assume the same facts as Example XVIII-1, except B's Section 1014 basis is $350,000. The results will be as follows:

First, X's passive activity loss attributable to passive activity was $235,000.

Second, the excess is $100,000 (i.e., B's basis of $350,000 minus X's basis of $250,000).

Third, the deductible passive activity loss is $135,000 (i.e., the passive activity loss is deductible to the extent of the excess).

Example XVIII-3 – Totally Non-Deductible Passive Activity Losses

Assume the same facts as Example XVIII-1, except B's Section 1014 basis is $510,000. The results will be as follows:

First, X's passive activity loss attributable to PA was $235,000.

Second, the excess will be $260,000 (i.e., B's basis of $510,000 less the decedent's basis of $250,000).

Third, since the excess (of $260,000) is greater than the passive activity loss (of $235,000), there is no deductible passive activity loss.

In this case, there was a built-in-gain at the time of death (i.e., the fair market value at death was greater than the decedent's basis immediately before death). Thus, since that built in gain was eliminated because of the date of death adjustment (under Section 1014), and such built-in-gain exceed the passive activity loss, the passive activity loss will be non-deductible.

E. Passive Activity and Section 1022 Election

For decedents dying in 2010, if an Section 1022 election was made, Rev. Proc. 2011-41, 2011-2 C.B. 1988, addressed the issue of the impact of the election on passive activity assets that passed from a decedent to beneficiaries. Section 4.06 of Rev. Proc. 2011-41 provided that if the election was made, the transfer would be treated as if a gift were made.

XIX. PROBLEM BASIS SITUATIONS: BASIS AND GRANTOR TRUSTS – LOTS OF QUESTIONS, NOT MANY ANSWERS

A. Sale to an Intentional Grantor Trust

1. Generally

The assets of a grantor trust are deemed to be owned directly by the grantor (or other deemed owner), which makes a determination of the basis of the assets dependent upon what that basis would have been had the grantor, rather than the trustee, owned the asset directly. Treating the grantor as the owner of the underlying assets of the trust is at the heart of determining the adjusted basis of the assets of the trust and of any debt obligations issued by the trust.

2. Background

A full understanding of the background of this principle is essential to determining the basis of the assets held by a grantor trust and the basis of debt instruments issued by the trust.

a) *Rothstein*

The nature of the grantor's relationship with the grantor trust began to seriously considered in *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984), *rev'g* 574 F.Supp. 19 (D. Conn. 1983), *nonacq*. Rev. Rul. 1985-13, 1985-1 C.B. 184.

(1) Facts

Alexander Rothstein created an irrevocable trust for his three children, naming his wife Reba as the trustee. He funded the trust with shares in a closely held corporation. Seven years later, Alexander bought some of the shares back from the trust for an installment note bearing an adequate rate of interest but no security. This caused the trust to be a grantor trust under Section 675(3). The stock was later transferred back to the corporation as part of a liquidation following several years of business reversals. The amount paid to Alexander for the stock was less than he had paid the trust for the shares.

(a) Interest and Loss Deductions Claimed

Alexander claimed an income tax deduction for the interest he paid on the installment note and for the loss he recognized on the sale of the stock to the corporation. He asserted that he was entitled to a new cost basis when he bought shares of stock from the trusts, and that he was entitled to a deduction for interest paid to the trustee on the promissory note used to purchase the stock. The Commissioner contended that the

step-up in basis and the interest deduction should be disallowed because the grantor had, in effect, bought the stock from himself and had paid interest to himself.

(b) Deductions Disallowed

The IRS disallowed both deductions.

(2) District Court

The District Court held for the Commissioner.

(3) Second Circuit Reverses and Holds for Taxpayer

The Second Circuit disagreed with the IRS. Judge Friendly, writing for the court, stated that the trust was a grantor trust, but disagreed with the IRS regarding disallowance of the interest deductions and the basis of the stock in the hands of Alexander. The court stated that the grantor trust rules require only that the grantor who is treated as the owner of the trust include the trust's "items of income, deduction, and credits" in his or her own computation of taxable income. The rules do not, the court stated, require that the grantor's basis in property bought from the trust be computed under rules different from those applicable to transactions between unrelated parties. Under the majority opinion, therefore, Alexander received a step-up in basis and a capital loss on an exchange of assets with the trust.

(4) Dissent

Judge Oakes dissented from the majority. He agreed that the trust was a grantor trust, but stated that Alexander was entitled to neither an interest deduction nor an increased adjusted basis in the purchased stock. Judge Oakes argued that treating Alexander as the owner of the trust under Section 671 meant that there was never a genuine installment sale.

b) Rev. Rul. 85-13

The IRS nonacquiesced in Rothstein in Rev. Rul. 85-13, 1985-1 C.B. 184.

(1) Facts

The IRS posited a grantor who created a nongrantor irrevocable trust, and then bought the corpus of the trust in exchange for the grantor's unsecured, interest-bearing promissory note.

(2) Grantor Trust Status

The ruling agreed with the Second Circuit that the grantor was considered to have borrowed the corpus of the trust and, as a result, owns the trust under Section 675(3). The ruling disagreed, however, regarding the effect of grantor trust status.

(3) Result of Trust Ownership

The IRS stated that, because the grantor is treated as the owner of the trust, the grantor is deemed the owner of the trust assets for federal income tax purposes.

(a) Rationale

The IRS stated:

> *"[i]t is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of the trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor."*

(b) No Gain Realized

In addition, because the grantor is considered to own the purported consideration both before and after the transaction, the exchange of a promissory note for the trust assets is not recognized as a sale for federal income tax purposes.

(c) No True Debt Created for Income Tax Purposes

The grantor owns the trust assets and thus cannot have a sale to himself or herself; nor can there be a valid debt obligation running between the grantor and himself or herself.

(4) IRS Reaffirms This Position

For several years after intentional grantor trusts became popular, there was concern that the IRS might change its mind and revoke Rev. Rul. 85-13. The IRS has made the principles of Rev. Rul. 85-13 the foundation upon which it has built its approach to all grantor trusts, and it now appears virtually impossible for the IRS to revoke Rev. Rul. 85-13.

(a) How Deep is the IRS Hole?

The IRS has relied on this ruling as the basis for no fewer than five other revenue rulings, two notices, and over 125 private letter rulings, chief counsel advisories, field service advice and technical advice memoranda. See Rev. Rul. 2007-13, 2007-11 I.R.B. 684 (Feb. 16, 2007); Rev. Rul. 2004-86, 2004-2 C.B. 191; Rev. Rul. 90-7, 1990-1 C.B. 153; Rev. Rul. 88-103, 1988-2 C.B. 304; Rev. Rul. 87-61, 1987-2 C.B. 219; Notice 97-34, 1997-1 C.B. 422; Notice 97-24, 1997-1 C.B. 409; Notice 90-1, 1990-2 C.B. 297.

(b) A Sobering Thought

As one of the leading practitioners pointed out in an article about installment sales to intentional grantor trusts:

> *"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."*

Aucutt, *Installment Sales to Grantor Trusts*, 2 Bus. Entities 28 (April/May 2002).

3. Initial Basis in Typical Grantor Trust Arrangements

The IRS has not actually addressed directly the question of the basis either of the assets given or sold by a grantor to a wholly-owned grantor trust, or the basis of any debt instrument issued by the trustee in satisfaction of such a transfer, but a reasonable analysis of Rev. Rul. 85-13 can reveal the correct answer to at least some of these questions.

a) Assets Given to the Trust

(1) Generally – Carryover Basis

A gift by the grantor to the trustee of a wholly-owned grantor trust is not a gift for income tax purposes, because there is no change in the owner for income tax purposes. The grantor owned the asset before the transfer, and the grantor owns the asset after the transfer. Clearly, therefore, the grantor's adjusted basis in the asset before the transfer becomes the trustee's adjusted basis in the asset after the transfer.

(2) Depreciated Property

The grantor, for income tax purposes, continues to own the assets of the grantor trust. The trustee, therefore, does not actually have a carryover basis; rather, the trustee continues to represent the grantor as owner of the property. This can be important if the assets are thereafter sold at a loss, because the loss should still be realized by the grantor. See above discussion of gifts of depreciated property.

b) Basis Adjustment for Gift Tax Paid

It is difficult to determine whether there is a basis adjustment under Section 1015(d) for the gift tax paid by the grantor on the net appreciation in the value of a gift to a grantor trust. However, see discussion below where we conclude based on a mathematical analysis that there should be a basis adjustment.

(1) What the Code and Rulings Suggest

The transaction is not a gift at all for income tax purposes, and basis is strictly an income tax concept. The transfer is, however, a gift for gift tax purposes, and a gift tax may be imposed and paid on the net appreciation.

(2) PLR 9109027 – Basis Increased by Gift Tax

The only ruling on point appears to be PLR 9109027, in which the donor made gifts to two grantor trusts. The trusts would be grantor trusts for 10 years less one day. The IRS expressly considered whether the gift tax on the net appreciation was added to basis, and it concluded that the basis increase was allowed.

The IRS discussed *Post v. Comm'r*, 26 T.C. 1055 (1956), *acq*., 1958-1 C.B. 5, in which the Tax court held that the date of the gift to beneficiaries was the date that the grantor transferred the property into the trust under the predecessor of Section 1015(a), despite the grantor's retained powers over and interests in the trust. On the ruling facts, the IRS stated that when the grantor transfers property to a grantor trust, the trust initially takes the grantor's basis. The ruling is not absolutely clear, but it appears that the basis at that point is not increased by the gift taxes paid. When the trust ceases to be a grantor trust, the basis is increased by the gift tax paid on the net appreciation. The IRS stated:

> *"In general, under section 1015(a), the basis of the stock transferred by gift in the hands of the donee, here the children, is the basis in the hands of the do-*

nor, here Settlor adjusted by any gain or loss resulting from the transfer since the gift occurred after December 31, 1920. However, since the transfer also occurred after December 31, 1976, the basis in the hands of the donee is the basis in the hands of the donor under section 1015(a) of the Code but increased not by the entire amount of gift tax paid to the extent of the fair market value of the stock as required in section 1015(d)(1)(A) of the Code, but instead the basis is increased by a percentage of the gift tax paid as it relates to the net appreciation of the property as defined by section 1015(d)(6)(B) of the Code. See, section 1015(d)(6)(A) of the Code."

c) Debt Assumed or Taken Subject to by the Trustee

Again, there is no real authority on point, but because the trustee and the grantor are deemed to be a single taxpayer for income tax purposes, and neither gain nor loss is realized on a transfer of encumbered property to a wholly-owned grantor trust, there ought to be no basis adjustment for any debt assumed by the trustee or to which the transferred property is received subject. The debt should increase basis if it still exceeds basis when the trust ceases to be a grantor trust during the grantor's lifetime, because gain is then recognized.

4. Promissory Note Given by the Trustee

The trustee of a wholly-owned grantor trust may buy assets from the grantor in exchange for an installment obligation. The IRS views this obligation as nonexistent, because it is, in effect and for income tax purposes (though not wealth transfer tax purposes), an obligation of the grantor to pay money to himself or herself. Thus, there can be no basis in the promissory note given to the grantor. This could be significant if the grantor sells the note to a third-party, because the entire amount paid by the transferee would appear to be taxable as a gain. See discussion above on basis of promissory notes contributed by a partner to a partnership and a shareholder to a C corporation.

5. Effect on Basis of Termination of Grantor Trust Status During Grantor's Lifetime

a) Generally

The mere termination of grantor trust status does not, in itself, constitute a taxable event for income tax purposes. See CCA 200937028. Termination of grantor trust status during the grantor's lifetime, however, can result in the recognition of gain and, logically, the increase in the basis of assets held

by the now-nongrantor trust. See Rev. Rul, 77-402, 1977-2 C.B. 222 (discussed below).

b) Encumbered Assets

The termination of grantor trust status during the grantor's lifetime is a constructive transfer of the property from one taxpayer to another, and if the property is subject to debt in excess of its basis, gain may be realized. This has been addressed in a key ruling, regulation, and case, and there appears to be little doubt about the validity of these consistent precedents.

(1) Rev. Rul. 77-402

In Rev. Rul. 77-402, G established a grantor trust funded with a contribution of money that the trustees used to acquire a limited partnership interest in a real estate investment partnership. During the first few years of the trust, the partnership generated losses and G, as owner of the entire trust, deducted the distributive share of partnership losses attributable to the partnership interest held by the trust. When the basis of the partnership interest had been significantly reduced, G renounced the powers that caused the grantor to be treated as the owner of the trust.

(a) Analysis

The IRS ruled that G recognized gain upon the renunciation of powers to the extent that the share of partnership liabilities attributable to the partnership interest exceeded the adjusted basis of that interest. The ruling explains that during the period that G was treated as the owner of the trust, G was considered to be the owner of all the trust property for federal income tax purposes, including the partnership interest. Consequently, when G renounced the grantor trust powers, G was considered to have transferred the partnership interest to the trust.

(b) GCM

See also GCM 37228, discussing in greater detail the reasoning behind this ruling.

(2) Reg. § 1.1001-2(c)

(a) Generally

Example 5 of Reg. § 1.1001-2(c) closely parallels the facts and holding of Rev. Rul. 77-402.

(b) Facts

In that Example, C, an individual, creates an irrevocable wholly-owned grantor trust. The trustee bought an interest in a partnership. C deducted the distributive share of partnership losses attributable to the partnership interest held by the trust. In 1978, when the adjusted basis of the partnership interest held by the trust was $1,200, C renounced the grantor trust powers. The trust then ceased to be a grantor trust and C ceased to be the owner of the trust. At the time of the renunciation all of the partnership's liabilities are nonrecourse liabilities on which none of the partners have assumed any personal liability. The trust's proportionate share of the partnership liabilities was $11,000.

(c) Conclusion

The regulations explain that, since prior to the renunciation of the grantor trust powers, C was the owner of the entire trust, C was considered the owner of all the trust property (including the partnership interest) for Federal income tax purposes. C, and not the trust, was considered to be the partner in the partnership during the time the trust was a "grantor trust," because C was considered to be the owner of the partnership interest. When C renounced the grantor trust powers, the trust no longer qualified as a grantor trust, with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C was considered to have transferred ownership of the partnership interest to the trust, which was now a separate taxable entity, independent of C. On the transfer, C's share of partnership liabilities ($11,000) was treated as money received; C's amount realized was $11,000; C's gain realized was $9,800 ($11,000 - $1,200)

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(3) Madorin

The Tax Court followed Reg. § 1.1001-2(c), Ex. 5 in *Madorin v. Comm'r*, 84 T.C. 667 (1985).

(a) Facts

Bernard Madorin was the grantor of four trusts. The trustee of each of the four trusts had the power to sprinkle income and principal among a class of beneficiaries, and the power to add charitable beneficiaries. The four trusts were, therefore, grantor trusts pursuant to Section 674(a). The trusts bought limited partnership interests in Metro Investment

Co., a limited partnership, which in turn purchased a partnership interest in Saintly Associates. Bernard recognized on his joint income tax return the losses generated by Saintly Associates. When Saintly Associates began generating income, the trustee renounced his power to add beneficiaries and the trusts ceased to be grantor trusts. The grantor argued that he should be treated as the owner of the trust only to attribute to him items of income, deductions, and credits – the *Rothstein* position.

(b) IRS Position

The IRS disagreed with the taxpayer and assessed a deficiency. The IRS based its position on Reg. § 1.1001-2(c), Ex. 5, contending that the grantor was the owner of the partnership interests and when the trusts ceased to be grantor trusts there was a disposition of the trusts' assets (the partnership interests) on which gain would be recognized to the extent that the underlying debt from which the trust was released exceeded the taxpayer's basis in the partnership interests.

(c) Tax Court Holds for IRS

The Tax Court rejected the *Rothstein* rationale and upheld the validity of the regulations. The court stated that defining the "owner * * * of a trust" under Section 671 as the owner of the trust's assets was consistent with the usual, ordinary and everyday meaning of the word "owner." 84 T.C. at 671.

(i) Code Requires Deemed Ownership of Assets.

The taxpayer argued that the legislative history of the 1954 codification showed that the grantor trust rules were designed only to cause the grantor to include in income the trust's items of income, deduction, credit, gain and loss. The Tax Court found no such requirement in the legislative history and noted that the grantor trust rules treat the grantor as if he or she were the owner in cases where the grantor has reserved some of the powers normally attendant to outright ownership. 84 T.C. at 674-675.

(ii) Code Also Requires Recognition of Gain

The taxpayer argued that the plain language of Section 671 limited the attributes of ownership to the imputation of income, deductions, and credits only, but

the Tax Court agreed with the IRS that this list was not necessarily exclusive. 84 T.C. at 672. The court stated that the combination of Section 671 and the partnership provisions of subchapter K, along with the recognition of gain or loss provisions of Section 1001, required the recognition of gain upon the sale or disposition of a partnership interest where the amount realized exceeds the adjusted basis of the partnership interest, and that the basis of a partnership interest includes the partner's share of partnership liabilities. The partner's share of the liabilities is also included in the amount realized if the assets are transferred. *Crane v. Comm'r*, 331 U.S. 1 (1947).

(d) Effects on Basis

Logically, the grantor realizes gain equal to the excess of the indebtedness to which the property is subject over the carryover adjusted basis, so the trustee should increase its basis in the encumbered assets by the amount of the realized gain. In effect, the termination of the grantor trust status has caused the debt to become a *bona fide* indebtedness between two different taxpayers, and basis in the trustee's assets should be increased to reflect this change.

6. Effect on Basis of Termination of Grantor Trust Status at Grantor's Death

a) Generally

There is no case, regulation or ruling that directly addresses the income tax treatment of the termination of grantor trust status at the grantor's death, but the IRS's own rulings suggest that the grantor's death should not be a recognition event for income tax purposes, even when the trust holds encumbered property with a debt in excess of its adjusted basis. Although this conclusion seems correct, there are several practitioners who take a different view.

b) Why Gain Should Not be Recognized

(1) Generally

The income tax law has long viewed death as not a recognition event.

(a) *Crane*

The Supreme Court held in *Crane v. Comm'r, supra.*, that the assumption of a mortgage, or taking property subject to a mortgage, in connection with the acquisition of property to

which the mortgage relates, is treated for purposes of determining the basis of such property as though the purchaser had paid cash in the amount of the mortgage. The taxpayer had inherited property that was encumbered by a liability exactly equal to its fair market value, but in excess of the decedent's basis in the property on the date of death. The court treated the transaction as one in which the basis in the assets was increased under the predecessor to Section 1014. Thus, it treated the transaction as a devise, rather than a sale.

(b) Rev. Rul. 73-183

In Rev. Rul. 73-183, 1973-1 C.B. 364, updating and restating O.D. 219, 1 C.B. 180 (1918), the IRS stated that no loss is recognized on the decedent's final income tax return as a result of the transfer of the stock to the executor of the decedent's estate, even though the stock had an adjusted basis in excess of its fair market value at the date of the decedent's death. The IRS stated that, if the fair market value of the stock at the date of the decedent's death was in excess of the adjusted basis of the stock, no gain is recognized on the decedent's final income tax return as a result of the transfer of such stock to the executor of the decedent's estate.

(c) 1954 Legislative History

The House and Senate committee reports on the re-codification of the tax law in 1954 also stated:

> *"The mere passing of property to an executor or administrator on the death of the decedent does not constitute a taxable realization of income even though the property may have appreciated in value since the decedent acquired it."*

See also H. Rep. No. 1337, 83rd Cong., 2d Sess., 1954 U.S.C.A.N. 4017, 4331 (1954) and S. Rep. No. 1622, 83rd Cong., 2d Sess., 1954 U.S.C.A.N. 4621, 4981 (1954).

(d) Legislative History of 2001 Act

In the Conference Committee negotiations on the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16 § 542(a),107th Cong., 1st Sess., 115 Stat. 38 (2001), a proposal was made and rejected to impose gain at death in situations where debt exceeded basis. The Conference Committee Report states:

> *"The bill clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property."*

H. R. Rep. No. 107-84, 107th Cong., 1st Sess. 113 (2001). See also F. L. Boyle & J. G. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* § 4:8.2 (PLI 15th ed.); and 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).

(2) No Gain Under Rev. Rul. 85-13

Rev. Rul. 85-13 and *Madorin* treat the grantor as the owner of the grantor trust's assets for income tax purposes, as if the trust did not exist. The death of an individual is not itself a recognition event, and 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. See Aucutt, *Installment Sales to Grantor Trusts*, 2 Bus. Entities 28 (April/May 2002); F. L. Boyle & J. G. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* § 4:8.2 (PLI 15th ed.); 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); Hatcher, *Buffaloed by Bongard? Struggling with Strangi? Tormented by Turner/Thompson? Confused by Kimbell? Reeling from Rosen? Freezing and Bridging the Increasingly Troubled Waters of FLPs*, SM093 ALI-ABA 95 (2007); Manning & Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Estates, Gifts & Tr. J. 3 (1999).

(3) Basis of Installment Obligation

The promissory note should take a basis in the hands of the grantor's estate equal to its fair market value on the date of death. The grantor is deemed to own the installment obligation on the date of death, even though the note is not actually a debt obligation under Rev. Rul. 85-13. Therefore, the note should receive a basis adjustment under Section 1014(b)(1) and 1014(b)(9).

The only applicable exception to this rule might be if the note is an item of income in respect of a decedent ("IRD") under Section 691, which would not receive a basis adjustment under Section 1014(c).

(a) Definition of IRD

IRD is defined as amounts of gross income that were not properly includible in computing the decedent's taxable income for the taxable year ending with the date of his death (or a previous taxable year), under the decedent's accounting method. Reg. § 1.691-1(b).

(b) Character of IRD

The fact of an item of IRD and the amount and character of the IRD are all determined as if "the decedent had lived and received such amount." IRC § 691(a)(3). As the decedent would not have realized any income had he received the note payments during life under Rev. Rul. 85-13, there is arguably no IRD associated with the note. Thus, the note receives a stepped-up basis and the subsequent principal payments on the note are not taxed. See Aucutt, *Installment Sales to Grantor Trusts*, 2 Bus. Entities 28 (April/May 2002); Manning & Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt. Estates, Gifts & Tr. J. 3 (1999).

(4) Basis of Trust Assets

The trust assets are not included in the grantor's gross estate for estate tax purposes, and thus do not appear to receive a basis adjustment under Section 1014(b)(9). In CCA 200937028, an e-mail response, an attorney in the IRS Chief Counsel's Office stated:

> *"In this case, the taxpayer transferred assets into a trust and reserved the power to substitute assets. Section 1014(b)(1)-(10) describes the circumstances under which property is treated as having been acquired from the decedent for purposes of the section 1014 step-up basis rule. Since the decedent transferred the property into trust, section 1014(b)(1) does not apply. Sections 1014(b)(2) and (b)(3) apply to transfers in trust, but do not apply here, because the decedent did not reserve the right to revoke or amend the trust. None of the other provisions appear to apply at all in this case."*

Quoting from section 1.1014-1(a) of the Regulations:

> *"The purpose of section 1014 is, in general, to provide a basis for property acquired from a decedent*

which is equal to the value placed upon such property for purposes of the Federal estate tax. Accordingly, the general rule is that the basis of property acquired from a decedent is the fair market value of such property at the date of the decedent's death. . . . Property acquired from the decedent includes, principally . . . property required to be included in determining the value of the decedent's gross estate under any provision of the [Internal Revenue Code.]"

Based on a literal reading of the statute and the regulations, it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to Section 1014, unless the property is included in the gross estate for federal estate tax purposes as per Section 1014(b)(9).

It may be argued, however, that the assets of a grantor trust receive a date-of-death value basis adjustment under Section 1014(b)(1), as property "in the hands of a person [the trust] acquiring the property from a decedent or to whom the property passed from a decedent." This would be the analysis most consistent with Rev. Rul. 85-13 and *Madorin*, which say that the grantor is deemed to own the trust assets for all income tax purposes, which should include determination of basis. 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). Unfortunately, a court may be reluctant to give a basis increase without a concomitant estate or income tax, and a practitioner must ponder whether the basis increase is a position on which the practitioner may reasonably believe there to be a more-than-50% chance of success.

c) Possible Contrary Views

The IRS may well argue that the same rule that applied to the termination of grantor trust status during the grantor's lifetime in Reg. § 1.1001-2(c), Ex. 5, Rev. Rul. 77-402, and *Madorin*, should apply equally to termination of grantor trust status on account of the grantor's death. Of course, there are no cases, regulations or rulings that directly support (or directly contradict) this point. See, Aucutt, *Installment Sales to Grantor Trusts*, 2 Bus. Entities 28 (April/May 2002); Cantrell, *Gain Is Realized at Death*, 149 Tr. & Est. 20 (Feb. 2010); Hodge, *On the Death of Dr. Jekyll -- the Disposition of Mr. Hyde: the Proper Treatment of an Intentionally Defective Grantor Trust at the Grantor's Death*, 29 Est., Gifts & Tr. J. 275 (Nov. 11, 2004).

(1) IRS Precedents Are Not on Point

The IRS will likely rely on Reg. § 1.1001-2(c), Ex. 5, Rev. Rul. 77-402, and *Madorin* for the proposition that the termination of the

grantor trust status of a trust that holds encumbered assets is a recognition event, but all of these precedents involved a lifetime termination of grantor trust status. Lifetime transfers of encumbered assets, even between unrelated individuals, are taxable events, but there is no reason why the same rule must apply to testamentary transfers. See also, CCA 200923024 ("Regulation 1.1001-2(c), Ex. 5, *Madorin*, and Rev. Rul. 77-402 are silent regarding the income tax consequences to the party who receives trust assets (the 'transferee'). . . . [T]he rule set forth in these authorities is narrow, insofar as it only affects *inter vivos* lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event.") and Blattmachr & Gans, *No Gain at Death*, 149 Tr. & Est. 34 (Feb. 2010).

(2) When Gain Recognized Under IRS Argument

A specific critique of the IRS argument will depend upon when the IRS deems the constructive transfer of the installment obligation to have occurred. There is a significant difference in tax results between an analysis that (a) perceives a transfer to have occurred at the moment before death, and (b) one that perceives it to have occurred at the moment after death.

(a) Moment-Before Analysis

The IRS seems likely to adopt the analysis that results in gain recognized at the moment before the grantor's death, because this analysis is closer to that of Rev. Rul. 77-402 and because it results in a more certain recognition of gain.

(i) Gain Recognized on Grantor's Final Income Tax Return

The grantor would recognize the difference between the adjusted basis in the assets on the date of death (before adjustments under Section 1014) and the outstanding balance on the note. This gain would be reported on the grantor's final income tax return, because the deemed disposition of the encumbered assets occurred before the grantor's death. See also, Reg. § 1.684-2(e), Ex. 2 (the termination of grantor trust status at the death of the U.S. grantor of a foreign trust is treated as if the grantor had transferred the assets to the trust at the moment before death).

(ii) Decedent's Basis in the Assets

The grantor's adjusted basis in the assets would be their adjusted basis on the moment before death.

(b) Part Gift/Part Sale?

The transfer of property deemed to occur would likely be a part-sale/part-gift. It would be a sale to the extent that the remaining balance on the note exceeds the grantor's adjusted basis in the transferred assets, and a gift to the extent that the value of the property on the date of death exceeds the outstanding balance on the note.

In a noncharitable part-sale/part-gift, the grantor is not required to allocate any portion of the basis to the gift component. Cf. IRC § 1011(b) (in a charitable part-sale/part-gift, basis must be apportioned between the sale and gift components). Therefore, all of the grantor's adjusted basis would be allocated to the sale portion of the transfer. See discussion above of part-gift/part-sale with charities.

(i) Installment Reporting

The grantor's executor should be able either to report any recognized gain under the installment sales rules of Section 453 or elect out of installment reporting under Section 453(d). The entire gain would not have to be recognized immediately.

(ii) IRD

If gain is recognized as if the property were sold at the moment before death in exchange for an installment obligation, and if the personal representative of the decedent's estate does not elect out of installment reporting, the promissory note should be an item of IRD under Section 691(a)(4).

As noted above, IRD means gross income that was not properly includible in the decedent's taxable income for the taxable year ending with the date of his or her death under the decedent's accounting method. Reg. § 1.691-1(b).

Rev. Rul. 85-13 states that there would have been no amount includible in gross income had the decedent not died, suggesting that there was no IRD. If sale is

deemed to occur immediately before death, however, the application of Rev. Rul. 85-13 would have to be deemed terminated immediately before death, too. This means that the grantor trust would be entitled to an income tax deduction for any federal (but not state) estate taxes attributable to the net appreciation in the note on the date of death. IRC § 691(c).

(iii) Trust's Basis in Its Assets

Under the moment-before analysis, the trust should take an adjusted basis in the property it bought equal to the amount of the debt on the date of the grantor's death. IRC § 1012. The trust assets would not be entitled to a basis adjustment under Section 1014.

(c) Moment-After Analysis

It seems more logical that, if gain must be recognized, it should be deemed to occur at the moment after death, because the trust remains a grantor trust until the grantor's death and not until the moment before the grantor's death.

If the IRS deems a transfer to have occurred on the moment after the date of death, the grantor would not report any gain on the grantor's final income tax return; the trust would report any gain on its own income tax return. See Hodge, *On the Death of Dr. Jekyll -- the Disposition of Mr. Hyde: the Proper Treatment of an Intentionally Defective Grantor Trust at the Grantor's Death*, 29 Est., Gifts & Tr. J. 275 (Nov. 11, 2004).

(i) *Frane* Analogy

One should consider the relevance, by analogy, of *Frane v. Comm'r*, 998 F.2d 567 (8th Cir. 1993), *aff'g in part, rev'g in part* 98 T.C. 341 (1992), in which the decedent sold assets for a self-canceling installment obligation and died while the debt was outstanding.

The Tax Court held that the decedent's gross estate included no portion of the note, and that gain was recognized by the decedent immediately before death.

The Eighth Circuit affirmed in part and reversed in part, holding that the decedent's death effected a cancellation of installment obligation under Sections 453B and 691(a)(5), and that gain was recognized immediately after death.

The IRS might cite the appellate opinion in *Frane* for the proposition that the grantor's death should cause recognition of gain, but *Frane* is really inapplicable. The *Frane* analysis is based on Section 453B, which applies only if there is a sale in exchange for an installment obligation. Rev. Rul. 85-13 negates the existence of either a sale or an installment obligation, and no election could be made under Section 453 in the absence of a sale.

(ii) Basis in Assets

In a moment-after analysis, the decedent is deemed to have owned the underlying assets on the date of death. The property seems clearly to be "property acquired by . . . the decedent's estate from the decedent," and so it should take a basis increase to its fair market value on the date of death. IRC § 1014(b)(1). Section 1014(b)(9) grants a basis adjustment for property that is included in the decedent's gross estate for Federal estate tax purposes. The fact that Section 1014(b)(9) does not apply to assets in an Intentional grantor trust does not preclude the application of Section 1014(b)(1).

(iii) IRD

The promissory note would be deemed received by the decedent's estate after the date of death, and thus should not be an item of IRD.

(d) Does the IRS Really Believe This?

In CCA 200923024, however, the IRS Chief Counsel suggested that the IRS might not take this position at all.

(i) Facts

A married couple (the parents) and their three adult children (the "taxpayers" or the "family") owned low-basis stock of an S corporation. The corporation filed a Form S-1 with the SEC to register securities

in anticipation of an initial public offering. The Form S-1 stated that the family intended to sell all of their shares (except for one of the spouses who intended to sell one-half of his or her shares).

(a) Formation of Partnership and Trusts

Each taxpayer transferred his or her shares of stock to a partnership, and also formed an irrevocable nongrantor trust, funded with $100,000 in cash. Each taxpayer sold his or her partnership interests to his or her trust, in exchange for unsecured private annuity promises to pay a fixed annual sum to the seller for the rest of his or her life.

(b) Terms of the Trusts

The terms of each trust directed that the principal and income would be distributed, in the trustee's discretion, for the benefit of the grantor's then-living issue. The trustee of each trust was one of the parents, together with an independent trustee and an independent corporate trustee, neither of which was related or subordinate to the grantor. The trustees acted by majority vote. The trusts continued until the grantor's death, upon which time the trustees would distribute the trust funds to the grantor's then-living issue, outright. None of the trusts were grantor trusts, in part because no more than one-half of the trustees were related or subordinate to the grantor of the trust. IRC § 674(c).

(c) Sale of Partnership Interests for Private Annuities

The parents and their adult children then sold their partnership interests to their respective trusts in exchange for unsecured private annuities. The partnership then made a 754 Election to increase its inside basis in the stock to be equal to the outside basis taken by the trust. This would be the present value of the private annuity obligation, which represented the fair market value of the stock on the date of the sale.

(d) Partnership Goes Public

The partnership then sold the shares in an initial public offering, receiving an amount approximately equal to the partnership's inside basis in the stock. The partnership distributed to the trusts amounts sufficient to pay the annuity due that year, but otherwise retained the rest of the cash for reinvestment. The individual taxpayers continued to pay the capital gains tax on the sale of the stock to the trusts on a deferred basis, over their lifetimes, despite the fact that the partnership had received the entire value of the shares in cash.

(e) Toggling Off Grantor Trust Status

Thereafter, the corporate trustee of each trust was removed by the trust adviser (a person who was neither related nor subordinate to the grantor), and replaced with an individual who was related or subordinate to the grantor of the trust, because that person was employed by a corporation in which the stock holdings of the family are significant from the viewpoint of voting control and/or a subordinate employee of a corporation in which the family are executives. This left, as trustee, one independent party and two related or subordinate persons, causing the trusts to become grantor trusts under Sections 674(a) and 674(c).

(ii) Taxpayers' Argument

The family contended that, as of the date that the trusts converted to grantor trust status, and although the family directly held partnership interests, the family members would report no further annuity income, because, as grantor-owners of the trusts, they were both payors and payees on the annuities. Rev. Rul. 85-13.

(iii) IRS' Argument

The IRS agent auditing the transaction sought to make the taxpayers recognize the gain on the sale under one of two theories.

(a) Deemed Disposition

First, the agent argued that the taxpayers should recognize gain on the on the conversion of the trust from nongrantor trust to grantor trust, because, the agent argued, ownership of a trust's assets is deemed to change hands when the trust's separate tax existence disappears and it becomes a grantor trust. Therefore, the agent argued, the conversion of a nongrantor trust into a grantor trust should result in the recognition of any appreciation in the value of the trust assets, as if they had been transferred in a taxable exchange. The nongrantor trusts, therefore, would have only the modest gain on the initial public offering that they had reported, but the grantor trusts and their family member-owners would recognize taxable gain on the deemed exchange when the trusts became grantor trusts.

(b) Indirect Borrowing

Alternatively, the agent argued that the sale of the partnership interests to the trusts in exchange for private annuities should be treated as an indirect borrowing of the trust assets, causing the trusts to become grantor trusts on the date of the sale, rather than when the corporate trustee was removed. Thus, the sale of property to the trust would not be a taxable event, no gain would be recognized, and the partnership's Section 754 election would not increase its adjusted basis in the stock it held. Therefore, the partnership, and through it, the grantors, would recognize as gain the excess of the amount realized on the initial public offering over their original low basis in the stock.

(iv) Chief Counsel's Response

The IRS Chief Counsel agreed with the agent that the transactions were abusive but rejected both arguments under which the agent had sought to tax the gain realized in the transactions.

(a) No Deemed transfer

First, the IRS stated that the conversion of a nongrantor trust into a grantor trust is not a deemed transfer for income tax purposes and that gain is not recognized on the transaction.

The agent relied on Rev. Rul. 77-402, *Madorin*, and Reg. § 1.1001-2(c), Ex. 5, but the Chief Counsel stated that these authorities did not support the claim that the conversion of a trust from a nongrantor trust to a grantor trust is a taxable exchange, and that they do not even suggest that the termination of grantor trust status constitutes a taxable transfer of the trust assets. Even assuming that the transaction was abusive, the Chief Counsel added, asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations.

The Chief Counsel also stated:

> *"The authorities cited only discuss the application of § 1001 to the party who is considered to have transferred ownership (the "transferor") of trust assets. Regulation 1.1001-2(c), Example 5, Madorin, and Rev. Rul. 77-402 are silent regarding the income tax consequences to the party who receives trust assets (the "transferee"), which in these examples was the nongrantor trust. We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event."*

(v) Favorable Analysis

This is the most favorable statement that the IRS has ever made officially regarding the effect of the death of the grantor on encumbered assets held by a grantor trust. See Blattmachr & Gans, *No Gain at Death*, 149 Tr. & Est. 34 (Feb. 2010).

B. Tax Basis Adjustment for Gift Taxes Paid on Gifts to Irrevocable Grantor Trusts[11]

1. Does Section 1015(d)(6) Adjust Basis of a "Gift" to an IGT?

a) Gut Feeling v. Empirical Data/Studies

Though not empirically studied, it is the gut feeling, based on review of list serve chatter, conversations and review of various articles, a majority of planners probably believe that a gift of appreciated property to an IGT, which results in the payment of gift tax would enable the basis in the donated asset to be adjusted by the gift tax paid attributable to the appreciation under Section 1015(d)(6). However, some planners reach the opposite conclusion.

b) Historical Perspective – Transferred Basis Underpinning is Cost Basis

(1) Cost Basis

From an historical perspective, the general "cost basis" rule, currently in Section 1012, provides the basis is determined by looking at the property's cost (i.e., generally, the amount paid for the property). This historical rule, which still applies in many different situations today, was originally placed in the 1913 Code. However, when determining the basis of property acquired from a gift, the Revenue Act of 1921 replaced the traditional "cost basis" rule and introduced what is now in Section 1015.

In its original form, the rule was simple, when the donee received property from the donor, the donee received not only the property, but the donor's adjusted basis. In effect, the "cost basis" of the donor was transferred over to the donee. As the law matured, there were a number of modifications to what is now Section 1015. See Section discussion above of the history of Section 1015.

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[11] This section XIX.Bis based on Franklin and Law, *Extraordinary, Efficient, Elegant, Evolutionary: The Annual Taxable Gifts Approach and Testamentary CLAT Remainder*, 51st Heckerling Inst. (2017).

Of note, one of the theories why the basis should be 'transferred' from the donor to the donee, was that fact that property transferred in a gift was a non-taxable transaction. From 1913 to 1920, even though there was no recognition of income on gifts, taxpayers were using gifts as a way to "step-up" the basis, because before the Revenue Act of 1921, when the donee received the gift, the donee could adjust the basis to the donated property's fair market value. Thus, before 1921, the fair market value basis adjustment was effectively a 'non-recognition' provision, in that no gain was recognized at the time of the gift and the basis was adjusted to the donated property's fair market value.

(2) No Gain Recognized – The Other Side of The Coin

Today, the basis provision under Section 1015 is a deferral provision; upon making the gift, no gain is recognized under section 1001, and, as a corollary thereto, the basis is transferred from the donor to the done under Section 1015(a). Section 1015(a) now provides:

> *"If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor ..." [Emphasis Added]*

It is interesting to review the actual language of section 1001, which states as follows:

> *"The gain from the sale* ***or other disposition*** *of property shall be the excess of the amount realized therefrom over the adjusted basis ... and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized."* [Emphasis added]

Interestingly, technically, a 'gift' could, in normal parlance in the English language, be considered an 'other disposition', but for some reason, the tax laws have never considered a 'gift' as an 'other disposition'.

Over the years, Section 1015 has been modified from its original language. Of note is the provision related to gifts of appreciated property and the gift tax paid with respect to such property.

(a) The 1958 Change

Section 1015(d)(1)(A) was originally enacted, as part of The Small Business Tax Revision Act of 1958, to provide a wholesale adjustment for any gift taxes paid related to a gift, provided that the adjusted amount was limited to the donated

property's fair market value on the date of the gift, and later, in 1976 (to be effective January 1, 1977), the Tax Reform Act of 1976 added section 1015(d)(6) to further modify section 1015(d)(1)(A) to limit the basis adjustment to gift taxes paid that are attributable to the net appreciation in the donated property. (Section 1015(d)(6)(B) defines "net appreciation" as the difference between the fair market value and the basis of such gift on the date of the gift.)

(b) What was Congress Thinking in 1958?

Examining Congress' thinking at the time they were enacting the provision that provided the gift tax paid attributable to the entire donated property (and not just limited to the net appreciation) would increase basis; provided, however, the new basis would be limited to the property's fair market value at the time of the gift. The rationale, as explained in the Senate Finance Committee's report in 1958 was as follows:

> *"In general, carrying over the basis of property in the case of gifts is in accord with the general principle followed in determining basis; namely, setting the basis of the property at its "cost." In this case the "cost" is the cost of the property to the donor, adjusted for any subsequent depreciation, etc. However, this ignores the fact that in reality there is another "cost" incurred in transferring the property from the donor to the donee; namely, the gift tax, which must be paid in order to make this transfer. As a result, your committee has concluded that to properly reflect total "costs" incurred with respect to donated property, it is necessary to increase the basis of the property by the amount of any gift tax paid with respect to it."*

S. Rep. No. 1983, 85th Cong., 2d Sess., reprinted in 1958-3 CB 922, 991.

There are a few of things worth highlighting in this comment. First, Congress continued to indicate that the "cost basis" concept (originally set forth in the 1921 law) was still the theory on which the transferred basis relied upon. The Committee concluded that the new "cost" or carryover basis was the donor's basis, as it may have been adjusted for depreciation, etc. Second, Congress believed that the gift tax

was a "cost" incurred in transferring the property from the donor to the donee (i.e., the gift tax), and that "cost", even though borne by the transferor / donor as a result of the transaction / gift is a "cost" that is transferred over to the transferee / donee. As a result of the changes in 1976, which we discuss next, a third observation is warranted; section 1015(d)(1) only applies to gifts made between 1958 through December 31, 1976.

It should be noted, in income taxable transactions (e.g., sales), commonly the cost of the transferor / seller does not become a basis adjustment to the transferee / buyer. In the gift transaction, the primary liability for the gift tax is on the transferor / donor (and secondarily on the transferee / donee), what Congress appears to be saying, is since this is a "non-taxable" transaction for income tax purposes, passing that "cost" of the gift tax to the transferee / donee is reasonable. Note, as of 1977, the transfer of the gift tax "cost" is limited to the net appreciation.

(c) The 1976 Change

The 1977 modification, under the Tax Reform Act of 1976, added section 1015(d)(6). This modification, applicable to gifts made after December 31, 1976, limits the basis adjustment to the gift tax attributable to the net appreciation in the donated property.

(d) What was Congress Thinking in 1977?

In reviewing the efficacy of this provision, the House Ways & Means Committee stated as follows:

> "*The purpose of the increase in basis for gift taxes paid on the gift is to prevent a portion of the appreciation in the gift (equal to the gift tax imposed on the appreciation) from also being subject to income tax, that is, to prevent the imposition of a tax on a tax. However, [§ 1015(d)(1)] is too generous in that it permits the basis of the gift property to be increased by the full amount of the gift tax paid on the gift and not just the gift tax attributable to the appreciation at the time of the gift. Consequently, the bill provides that the increase in basis of property acquired by gift is limited to the gift tax attributable to the net appreciation on the gift*."

HR Rep. No. 1380, 94th Cong., 2d Sess., reprinted in 1976-3 CB (vol. 3) 735, 778.

The idea behind the new provision was to provide a way in which to minimize the "tax on the tax" only on the net appreciation. Understanding Congress' intention behind the basis adjustment for the net appreciation on the donated property, let's refocus our attention to the issue at hand — Should the basis of property donated to an IGT be adjusted?

c) The Initial Hypothesis – Was Congress Right?

Clearly, if a donor made an outright gift of appreciated assets to an individual donee (and not a trust) and a gift tax was paid, to the extent that the gift tax is attributable to the net appreciation, probably all agree that the adjustment under Section 1015(d)(6) is appropriate. The question is whether the same basis adjustment should be made if the asset were transferred to an IGT.

If the gift is made to a non-grantor trust, it seems as though the same result would apply as if given to an individual.

(1) What Does "Acquired by Gift" Mean?

Recall, Section 1015 is only triggered if property is "acquired by gift". There is no definition of what it meant by "acquired by gift" in the Code or its accompanying regulations.

By analogy, when looking at the basis adjustment provision for testamentary transfers, the Code specifically defines the term "acquired from or to have passed from the decedent". See IRC § 1014(b)(1) through (b)(10). Thus, there appears to be an anomaly between the two basis rules under Sections 1014 and 1015. One would have thought that there would have been a good definition of what Congress meant when they wanted to say that a property was acquired by gift, but they did not.

We know for gift tax purposes, it is clear, as long as dominion and control has been given up by the donor (in favor of the donee), which is usually the case for transfers to intentional grantor trusts, there is a completed gift. We also know, under the *Duberstein* case and its progeny, that the requirement for property transferred from one person to another to be treated as a gift for income tax purposes is slightly different. *Comm'r v. Duberstein*, 363 U.S. 278 (1960). For income tax purposes, donative intent (a subjective standard) is required. The distinction between the income and gift tax definitions of a gift is probably not relevant in the case where property has been

donated to an IGT, since it appears that it would be considered a "gift" under either definition.

(2) Impact on Rev. Rul. 85-13

(a) In General

What, however, is relevant is whether the purported transfer is respected for purposes of Section 1015. The crux of the matter turns on the IRS' own ruling -- Rev. Rul. 85-13.

Recall that under the terms of Rev. Rul. 85-13, there has been no "transfer" for income tax purposes. And some (maybe just a few) may argue, if there is no transfer for income tax purposes then perhaps there was no "gift", which is a pre-condition for the application of Section 1015(d)(6). This is the argument that is made why Section 1015(d)(6) should not adjust basis, at least during the time that the trust is a grantor trust. We revisit this argument later.

(b) A Close Review of Rev. Rul. 85-13 – What did the IRS really mean?

Others will say that section 1015 is operational, regardless of Rev. Rul. 85-13. Perhaps we ought to look at Rev. Rul. 85-13 with a critical eye. Recall that the two issues under Rev. Rul. 85-13 were:

> *"(1) Whether a grantor's receipt of the entire corpus of an irrevocable trust in exchange for an unsecured promissory note given to the trustee, the grantor's spouse, constituted an indirect borrowing of the trust corpus which caused the grantor to be the owner of the entire trust under section 675(3) of the Internal Revenue Code.*"

and

> "*(2) To the extent that a grantor is treated as the owner of a trust, whether the trust will be recognized as a separate taxpayer capable of entering into a sales transaction with the grantor.*"

With respect to the first issue, the Service concluded:

> *"(1) A's receipt of the entire corpus of the trust in exchange for A's unsecured promissory note constituted an indirect borrowing of the trust corpus which caused A to be the owner of the entire trust under section 675(3) of the Code." [Emphasis added]*

Further, with respect to the second issue, the Service concluded (in part):

> *"(2) At the time A became the owner of the trust, A became the owner of the trust property. As a result, the transfer of trust assets to A was not a sale for federal income tax purposes and A did not acquire a cost basis in those assets..." [Emphasis added]*

In their analysis, the Service stated that their holding is contrary to the *Rothstei*n holding [*Rothstein v. United States,* 735 F.2d 704, 2nd DCA (1984)], stating that:

> *"It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain its vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust, or, as in this case, by dealing with the trust property for the grantor's benefit, the grantor has treated the trust property as though it were the grantor's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor." [Emphasis added]*

The IRS' theory is if the trust is considered a grantor trust under the grantor trust rules (contained in section 671 *et seq*.,), the grantor is treated as the "owner of the trust's assets". Further, in its second holding, it is interesting to note the Service's thought that the grantor did not acquire a new

cost basis in the assets, rather, the Service concluded that the grantor continued to hold onto those assets (keeping its old cost basis).

(3) Analyzing Section 1015(b)(6) and How it Relates to Rev. Rul. 85-13.

So, how does the rationale behind Rev. Rul. 85-13 square with the theory behind Section 1015(d)(6)? The Congressional rationale behind Section 1015(d) (before 1977) and Section1015(d)(6) (after 1977) was to give the donee a basis adjustment so that the donee does not suffer a tax on the tax (i.e., an income tax on the gift tax paid attributable to the gain) when the assets are later sold. If the assets are in an IGT and the assets are sold during the grantor's lifetime, then, with respect to the donee, the Congressional intent is not violated, since the donee is not liable for the tax in any event. However, when examining the impact to the donor, when the property is sold, is the donor worse off by having paid the income tax, without a basis adjustment?

(4) Using Examples to Analyze the Theory

To understand the impact to the donor, consider the following examples:

(a) Basic Fact Pattern for All Examples

- The donor (D) has consumed all of D's applicable exclusion amount.

- D had two assets before the gift: Cash of $3,500,000, and C corporation stock in P, Inc., with a fair market value of $100,000 with an adjusted basis of $0 (P stock). Thus, the total fair market value is $3.6 million and total adjusted basis is $3.5 million.

- The income derived from the investment of the cash will generate just enough every year to pay taxes, living expenses, other gifts, etc. so that at any given time, D will have $3.5 million, except that the effect of the gift, sale, or other disposition of P stock will have a direct impact on D's cash. By example, when D makes a gift of P stock and pays $40,000 of taxes, D's cash would reduce to $3.46 million (i.e., $3.5 million less $40,000).

- D's income, gift and estate tax rates are 25%, 40% and 40% respectively.

- The donee's (E's) income tax rate is also 25%.

- D donates all of the P stock to a trustee (T) to hold in trust for E's benefit for life, then upon D's death to E (outright and free of trust), if E is alive, or if not to E's then living descendants, per stirpes. E will survive D.

- The fair market value of all assets stays the same through D's date of death.

- The trust is a grantor trust as to D during D's entire lifetime.

- D dies more than three years after the gift was made to T (to avoid and Section 2035(b) issues).

- D consumed all of D's applicable exclusion at the date of death (having made gifts of the increasing applicable exclusion amount each year), and D had only cash at death, which was adjusted for the gifts, taxes, living expenses, etc.

(b) Different Assumptions for Examples 1 – 6

Let's look at six different examples to see the net result to D and E.

- **Example 1**, D sells P stock before making the gift and gives the net proceeds of $80 to T (for E's benefit).

- **Example 2**, D makes the gift of P stock to T. Section 1015(d)(6) adds the gift tax to the basis.

- **Example 3**, D makes a gift of P stock to T. There is no adjustment for the gift tax to the basis.

- **Example 4**, D makes a gift of P stock to T on day 1. Section1015(d)(6) adds the gift tax to the basis. T sells P stock on day 5. (D pays the income tax).

- **Example 5**, D makes a gift of P stock to T on day 1. There is no adjustment for the gift tax to the basis. T sells P stock on day 5 (D pays the income tax).

- **Example 6**, D does not make a gift, D holds onto P stock until death.

(c) The Results of the Six Examples

The results of the examples can be viewed in the next table.

They start at the same place, where the fair market value is $3.6 million and the adjusted basis is $3.5 million. The difference between the fair market value and the adjusted basis is $100,000, which is attributable to P stock having a zero basis.

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
Fair market value of all of D's assets before the gift	$3,600,000	$3,600,000	$3,600,000	$3,600,000	$3,600,000	$3,600,000
Basis of all of D's assets before the gift	3,500,000	3,500,000	3,500,000	3,500,000	3,500,000	3,500,000

After the gift of D to T, the income and gift tax ramifications (if any) are as follows:

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
Income Tax Paid before the transfer	25,000	-	-	-	-	-
Fair market value of gift on date of transfer	75,000	100,000	100,000	100,000	100,000	-
Gift Tax Paid by D	30,000	40,000	40,000	40,000	40,000	-

The resulting fair market value and basis of the assets are as follows immediately after the gift from D to T:

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
Fair market value of all of D's assets immediately after the gift (excludes P stock, if given)	3,470,000	3,460,000	3,460,000	3,460,000	3,460,000	3,600,000
Fair market value of P stock in T's	-	100,000	100,000	100,000	100,000	-

hands as trustee for E						
Fair market value of cash in T's hands as trustee for E	75,000	-	-	-	-	-
Adjusted basis of P stock in T's hands	-	40,000	-	40,000	-	-

Note, in Examples 2 and 4 Section 1015(d)(6) applies. Thus, the donor's basis (i.e., $0) is increased by the amount of the gift taxes paid which is attributable to the net appreciation (i.e., $40,000). In this case, since the donor's basis (before the transfer) was $0 and the fair market value was $100,000, the net appreciation was $100,000, or in percentage terms, the net appreciation was 100% (i.e., $100,000 ÷ $100,000). Thus, since the gift tax paid in those examples was $40,000, 100% of the gift tax would adjust the basis (from $0 to $40,000). In Examples 3 and 5, however, Section 1015(d)(6) does not apply. Thus, the basis of those assets would be $0 (i.e., the donor's basis). In Example 1, P was sold and cash was given, thus there is no basis in P stock. In Example 6, the donor did not make a gift.

Five days after the gift (in Examples 4 and 5) P stock is sold, the results would be as follows:

	Example 1	**Example 2**	**Example 3**	**Example 4**	**Example 5**	**Example 6**
Gross sales proceeds after T sells P stock	-	-	-	100,000	100,000	-
Gain on sale of P stock after the gift	-	-	-	60,000	100,000	-
Income tax paid by D on sale of P stock after the gift	-	-	-	15,000	25,000	-

The difference between Examples 4 and 5 is in the former Section 1015(d)(6) is operative (thus, a higher basis and lower gain) and in the latter there is a lower basis (i.e. $0) and greater gain.

Upon D's death, the fair market value and basis of the assets in E's hands would be as follows:

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
Taxable estate when D dies	3,470,000	3,460,000	3,460,000	3,445,000	3,435,000	3,600,000
D's Estate tax liability (40%)	1,388,000	1,384,000	1,384,000	1,378,000	1,374,000	1,440,000
Net Estate passing to E at D's death	2,082,000	2,076,000	2,076,000	2,067,000	2,061,000	2,160,000

The resulting fair market value and adjusted basis of assets in D's hands (from D's estate and from T) is as follows:

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
Net estate passing to E at D's death	2,082,000	2,076,000	2,076,000	2,067,000	2,061,000	2,160,000
Add Value of assets in T for the benefit of E	75,000	100,000	100,000	100,000	100,000	-
Total fair market value of assets passing to E at D's death	2,157,000	2,176,000	2,176,000	2,167,000	2,161,000	2,160,000
Basis of assets in E's hands at D's death	2,157,000	2,116,000	2,076,000	2,167,000	2,161,000	2,160,000
Built in Gain	-	60,000	100,000	-	-	-
Possible income tax on Built in Gain	-	15,000	25,000	-	-	-

Based on the foregoing, the economic value (i.e., the value assuming that all assets were converted to cash) on D's death is as follows:

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
Economic Value of assets that passed to E upon E's death (this is the difference between the fair market value and the possible built in gains tax)	2,157,000	2,161,000	2,151,000	2,167,000	2,161,000	2,160,000

(d) Initial Conclusions About the Results

If Congress' goal was to try to equate the results, on its face it appears that they did a fairly poor job since there is disparity between the economic results. However, when we look deeper into the numbers and evaluate the difference, we see that perhaps the results are not too bad, or even good.

If one of Congress' goals was to try to have the net result of the different alternatives (i.e., Examples 2 through 6) be roughly equal to Example 1, where (a) the donor sells the assets, (b) recognizes the gain and pays the income tax, (c) gives away the net proceeds and (d) pays the gift tax, perhaps they accomplished what they set out to do. At first blush, the results seem to show disparity, but when we look at them closely, we see that maybe there is some sense to all of this.

(e) Comparing Examples 1 and 6

First, let's examine the results of the only two examples, where Section 1015(d)(6) would have been inapplicable, and see where the differences lie (i.e., examining Examples 1 and 6).

	Example 1	**Example 2**	**Example 3**	**Example 4**	**Example 5**	**Example 6**
Economic Value of assets that passed to E upon E's death	2,157,000	2,161,000	2,151,000	2,167,000	2,161,000	2,160,000

In comparing the Examples 1 and 6, there is difference of $3,000 (i.e., $2.16 million - $2.157 million). What makes up this economic difference?

There are two things, first, the *quid pro quo* for inclusion in the estate is that basis adjustment under Section 1014 (i.e., assets included in the gross estate are entitled to a basis adjustment to the fair market value) at the time of death.

In Example 6, P stock was retained until death, thus, achieving full basis step up. Thus, D avoided the income tax of $25,000, but since that $25,000 was include in D' estate at death, he suffered an estate tax of 40% of such savings, yielding a net benefit of $15,000. However, D had to pay the tax inclusive tax on the P stock, versus the tax exclusive tax.

By comparison, in Example 1, D's estate did not have to pay an estate tax on the gift tax paid, thus, there was an estate tax savings of 40% of the $30,000 of gift tax paid (or $12,000).

The difference between the benefits in Example 6 of $15,000 and in Example 1 of $12,000, is $3,000, which explains the difference between the net result to E in the same examples.

In this case, it is clear that the difference is not due to the gift tax basis adjustment, rather it is attributable the tax-free step-up rules and the tax inclusive and exclusive nature of the estate and gift taxes.

(f) Comparing Examples 1 and 2

Comparing Examples 1 and 2, where the basis adjustment under Section 1015(d)(6) comes into play in Example 2, we note the following:

	Example 1	**Example 2**	**Example 3**	**Example 4**	**Example 5**	**Example 6**
Economic Value of assets that passed to E upon E's death	2,157,000	2,161,000	2,151,000	2,167,000	2,161,000	2,160,000

The net after tax amount passing to the donee, E, in Examples 1 and 2 are $2.157 million and $2.161 million, respectively. The difference is $4,000. We note that the difference has nothing to do with the basis adjustment under Section 1015(d)(6), rather it has to do with the tax exclusive nature of the gift tax vis-à-vis the tax inclusive nature of the estate tax.

Recall, in Example 1, the asset was sold, income tax paid, the net proceeds given and the gift tax was paid, and in Example 2, the asset was not sold, thus, no income tax was paid, the asset was donated and the gift tax was paid, and the basis of the asset was increased by the gift taxes paid (since the net appreciation was 100%). In Example 1, D gave away the net proceeds of $75,000 (i.e., $100,000 gross proceeds from the sale of P stock less $25,000 of income taxes attributable to the sale), whereas in Example 2, D gave away P stock then valued at $100,000. The $25,000 difference in value (i.e., $100,000 (in Example 2) and $75,000 (in Example 1)) meant that there were less gift taxes paid in Example 1 than in Example 2, by an amount equal to the difference (of $25,000) multiplied by the gift tax rate (of 40%), which was $10,000.

When D died, that $10,000 was still there, and since the gift tax is exclusive (in that there is no estate tax paid on the gift tax paid) and the estate tax is tax inclusive, the $10,000 difference, when multiplied by the estate tax rate (of 40%) yields a tax effected difference of $4,000. Therefore, the difference between Examples 1 and 2 has nothing to do with

the basis adjustment, and everything to do with the tax exclusive nature of the gift tax.

(g) Comparing Examples 2 and 3

Now, let's compare Examples 2 and 3. The results, as stated above, are restated as follows:

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
Economic Value of assets that passed to E upon E's death	2,157,000	2,161,000	2,151,000	2,167,000	2,161,000	2,160,000

The difference between Examples 2 and 3 is that in Example 2, Section 1015(d)(6) was applied and in Example 3, it was not applied. Recall, that P stock was held through date of death. In reviewing the fair market value of the assets received at date of death, we note there was no difference between the results, to wit:

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
Total fair market value of assets passing to E at D's death	2,157,000	2,176,000	2,176,000	2,167,000	2,161,000	2,160,000

The difference only occurred when we looked at the 'economic value' of the assets (i.e., taking the value of P stock and hypothetically selling the stock for its value and paying the income tax attributable to the stock). In this case, the difference in 'economic value' is merely due to the fact that in Example 2, we had a tax basis of $40,000, whereas, in Example 3 we had zero basis. Thus, the hypothetical gain was $40,000 more in Example 3 and the resulting hypothetical income tax would be such hypothetical gain multiplied by the income tax rate of40%, which is $10,000 (i.e., the difference between $2.161 million (in Example 2) and $2.151 million (in Example 3). Thus, we see the difference between the examples is strictly in the assumption where the basis is adjusted in one scenario and not in the other.

(h) Comparing Examples 2 and 4

Comparing Examples 2 and 4, we note that there is a $6,000 difference, as follows:

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
Economic Value of assets that passed to E upon E's death	2,157,000	2,161,000	2,151,000	2,167,000	2,161,000	2,160,000

That $6,000 difference is attributed to the fact that in Example 2, the assets are sold after the estate tax is imposed, whereas, in Example 4, the assets are sold and income tax is paid before the estate tax is imposed. Thus, the difference between Examples 2 and 4 is attributed to the tax inclusive nature of the estate tax over the tax exclusive nature of the gift tax.

By paying the income tax before death (in Example 4), there is a benefit equal to the amount of the income tax adjusted by the estate tax. In this case, the income tax was $15,000, and the estate tax rate was 40%, thus, the product of the two is $6,000 (i.e., the difference between $2,167,000 and $2,161,000). Again, the difference has nothing to do with the basis adjustment, rather it has to do with the tax inclusive / tax exclusive natures of the estate and gift taxes, respectively.

(i) Comparing Examples 4 and 5

When comparing Examples 4 and 5, we note that there is also a $6,000 difference.

	Example 1	Example 2	Example 3	Example 4	Example 5	Example 6
Economic Value of assets that passed to E upon E's death	2,157,000	2,161,000	2,151,000	2,167,000	2,161,000	2,160,000

This $6,000 difference is directly related to the impact of the assumption that in one case the basis is $40,000 and in the other it is $0. With the basis adjustment in Example 4, D recognizes $40,000 less of gain, and thus pays $10,000 less of income tax (i.e., $40,000 x 25% income tax rate). Adjusting that difference for estate taxes of 40%, the net difference is $10,000 x (100% – 40%), or $6,000. Again, the difference in this case, as the difference when we compared Examples 2 and 3, had everything to do with the basis adjustment at death.

(5) Overall Comparison–How did Congress Do?

Examples 2 and 4 demonstrate that the client in parity with Example 1 (i.e., as if D had sold the property and gave the net proceed to the beneficiary). Thus, strictly from a mathematical standpoint, taking into consideration that Congress wanted to avoid a tax on tax, and tried to reach a fair result, on balance, it appears that it is fairer to add the gift tax paid on the net appreciation to the donor's basis.

(6) Revisiting the Rev. Rul. 85-13 "Nothing Happened" Argument

Notwithstanding the fairness of adding back the gift tax paid on the net appreciation, one could argue that under the theory of Rev. Rul. 85-13, nothing happened. Stated differently, since D was the owner of the assets before and after the "gift", for income tax purposes, and Section 1015 is an income tax provision, nothing happened. Thus, because there was no gift (because nothing happened) for income tax purposes, that there should be no basis adjustment, so long as the intentional grantor trust remains a grantor trust. This argument has merit, but as demonstrated from a pure mathematical standpoint, it appears that this may be not as strong of an argument considering the stated Congressional intent.

d) Squaring the Basis Adjustment Under Sections 1015 and 1014

Knowing now that the better argument appears to favor a basis adjustment during life even for a gift to an intentional grantor trust, for any gift tax paid, does it make sense that there should be a second adjustment at death to the intentional grantor trust assets because of the grantor's death and termination of grantor trust status? It's a red herring to argue that a basis adjustment during life under Section 1015(d)(6) prevents an adjustment to the same assets at death. There is no provision anywhere in the Code (or the regulations thereunder) that prohibits a basis adjustment under Section 1014 if there was a lifetime adjustment under Section 1015. Whether death is an event that triggers an adjustment to basis in a grantor trust not part of the grantor's taxable estate is another question not addressed herein.

C. GRATs and QPRTs

1. Trust's Initial Carryover Basis

Virtually all GRATs and QPRTs are wholly-owned grantor trusts, so as discussed above, the trustee should take the grantor's adjusted basis in the assets transferred to the GRAT. Any gain or loss on the sale of the trust assets while the trust remains a grantor trust should be measured by the carryover basis obtained by the trustee from the grantor, as discussed above.

2. Basis Adjustment for Gift Taxes Paid

It is unclear precisely whether and when the basis in property given to a wholly-owned GRAT or QPRT is increased to reflect the gift tax paid on the net appreciation. The best analysis, as discussed above, is that the trustee takes a pure carryover basis until grantor trust status ends, at which time there would be an adjustment for the gift tax payment.

3. Expiration of Retained Interest Term

At the end of the reserved annuity or use term, the asset passes to the remainder beneficiaries with no change in basis, unless the asset is encumbered by a debt in excess of basis and the trust then ceases to be a grantor trust. In that situation, gain should be recognized by the grantor and the basis of the underlying assets should be increased accordingly.

4. Death of the Remainder Beneficiary During Retained Interest Term

a) Uniform Basis

Reg. § 1.1014-8(a)(1) states that the death of the remainder beneficiary does not affect the uniform basis of property held in a trust. Therefore, the basis of the property in a GRAT or QPRT is unaffected by the death of the remainder owner before the termination of the retained interest term.

b) Basis to Heir, Legatee, or Devisee for the Remainder Interest

The remainder is, however, includible in the remainder beneficiary's gross estate under Section 2033, whether vested or contingent. Rev. Rul. 67-370, 1967-2 C.B. 324; Rev. Rul. 76-472, 1976-2 C.B. 264; *Estate of Williams v. Comm'r*, 62 T.C. 400 (1974). Reg. § 1.1014-8(a)(1) states that, if the remainder passes in fee, the basis increase under Section 1014 will be taken into account in calculating the basis of the remainder interest in the hands of the heir, legatee, or devisee for the remainder beneficiary. Reg. § 1.1014-8(a)(2) also takes it into account when the trust ends and its assets are distributed to the remainder beneficiary's heir, legatee, or devisee of the remainder interest. See also, Rev. Ruls. 69-239, 1969-1 C.B. 198 and 68-268, 1968-1 C.B. 349; and PLR 6906060320A.

XX. PROBLEM BASIS SITUATIONS: BASIS AND PRIVATE ANNUITIES

A. Generally

A private annuity is a sale of property by one family member to another in exchange for the buyer's unsecured promise to make specific, periodic payments to the seller for the rest of the seller's life. The seller is often referred to as the "annuitant" and the buyer as the "obligor," and the transferred property as the "annuity property." Private annuities may be an excellent tool for removing a significant asset from an individual's gross estate for estate tax purposes, while simultaneously providing that individual with a lifetime source of income. The value of the unpaid portion of a private annuity obligation should be excluded from the annuitant's gross state because the annuity represents an amount received in a bona fide sale for full and adequate consideration in money or money's worth. See *Fidelity Philadelphia Trust Co. v. Smith,* 356 U.S. 274 (1958); *Helvering v. Estate of Rhodes*, 117 F.2d 509 (8th Cir. 1941); *Estate of Zeitz v. Comm'r*, 34 T.C. 351 (1960); *Estate of Milner v. Comm'r*, 6 T.C. 874 (1946); *Estate of Bergan v. Comm'r*, 1 T.C. 543 (1943), *acq*. 1943 C.B. 2; Rev. Rul. 55-438, 1955-2 C.B. 601. On private annuities generally, see Hodges & Panarisi, *Planning Private Annuities*, 4 Rev. Tax'n Individuals 214, 225–226 (1980); Leimberg & Hodges, *The Income Tax and Estate Planning Advantages of Private Annuities*, 33 Est. Plan. 3 (Feb. 2006); Leimberg & Hodges, *Maximizing the Planning Opportunities of Private Annuities*, 33 Est. Plan. 13 (Mar. 2006); McGraph, *Private Annuity Sales and the Exhaustion Test*, 47 Tax Mgmt. Memo. 235 (June 12, 2006); Wojnaroski, Jr., *Tax Aspects of Private Annuities*, 22 Tax Mgmt. Est., Gifts & Tr. J. 119 (May/June 1997); Wojnaroski, Jr., *Tax Aspects of Private Annuities Part II—Income Tax Considerations*, 22 Tax Mgmt. Est., Gifts & Tr. J. 178 (July/Aug. 1997).

B. Income Taxation of Private Annuities

Understanding the basis issues for a private annuity is easier if one also understands how the seller (annuitant) is taxed.

1. Taxation of the Annuitant

The traditional income tax treatment of a private annuity sale is designed to return to the annuitant the same net income and gains that would have been recognized had the annuitant sold the property for an installment obligation with a term equal to the annuitant's life expectancy. Because the annuitant's actual life expectancy is unknown, the income tax treatment is based on the annuitant's actuarial life expectancy. Rev. Rul. 69-74, 1969-1 C.B. 43.

a) All Annuities Are Divided into Three Parts

Rev. Rul. 69-74, 1969-1 C.B.43 states that each annuity payment is divided into three components: (1) a return of capital (i.e., adjusted basis) component, (2) a gain (capital or ordinary) component, and (3) an annuity component.

(1) Return of Capital

The return of capital component is recovered from each annuity payment through application of an "exclusion ratio." The exclusion ratio is the result of dividing the annuitant's "investment in the contract" by the expected return on the annuity contract. IRC § 72(b); Reg. § 1.72-4(a)(4).

(a) IRS View of the Investment in the Contract

The annuitant's investment in the contract is his or her income tax basis in the annuity property. Rev. Rul. 69-74.

(b) Another View

Some commentators contend that the investment in the contract should be the fair market value of the annuity property, rather than the annuitant's adjusted basis. This is consistent with the computations used in the purchase of commercial annuities. IRC § 72(c)(1)(A). Also, Reg. § 1.1011-2(c), Ex. 8, issued after Rev. Rul. 69-74, says that the investment in a private annuity contract bought from a church that does not regularly sell private annuities is the value of the annuity property, and not its basis. See Stewart, *Private Annuities Revenue Rule 69-74 Partially Repudiated, Sub Silentio, by Reg. § 1.1001-2(c), Ex. (8)*, 24 Mercer L. Rev. 585 (1973). This argument has some validity since there seems to be no reason why a different rule should apply to private annuities bought from a charity and those bought from an individual. Furthermore, if the private annuity transaction fails to qualify for pro rata recognition of gain, the Tax Court has said that the investment in the contract is the entire value of the property. *212 Corp. v. Comm'r,* 70 T.C. 788 (1978); *Estate of Bell v. Comm'r*, 60 T.C. 469 (1973); *Comm'r v. John C. Moore Corp.*, 15 B.T.A. 1140 (1929), *nonacq*. VIII-2 CB 67, *aff'd*, 42 F.2d 186 (2d Cir. 1930). See also Croft & Hipple, *Planning Lifetime Property Transfers: Private Annuities, Installment Sales, and Gift-Leasebacks*, 11 Real Prop., Prob. & Tr. J. 253, 265–269 (1976); Magram, *The Use of Private Annuities Under the 1976 Tax Reform Act*, 30 S. Cal. Tax Inst. 655, 671–673 (1978). While the gain on this basis should probably be reported, the current IRS position is still that enunciated in Rev. Rul. 69-70.

(c) Exclusion Ratio is Permanent

The exclusion ratio, once established, applies to all payments received by the annuitant, until the annuitant recovers his or

her entire adjusted basis, after which the exclusion ratio is irrelevant.

(2) Return of Capital

The gain component of each annuity payment is the difference between the present value of the annuity promise on the date of the sale, and the annuitant's adjusted basis in the property, divided by the annuitant's life expectancy.

(3) Annuity Component

The balance of each annuity payment is the annuity component, which is taxed as ordinary income. If the annuitant lives longer than the actuarial life used to determine the annuity (as well as the value of the annuity for determining gain on the annuity sale), all annuity payments received thereafter are treated entirely as ordinary income (as derived solely from the annuity component). This is because, at this point in time, the annuitant-seller will have recovered from previously paid annuity payments both (a) his or her adjusted basis in the property exchanged for the annuity, and (b) all gain realized at the time of the annuity sale.

b) 2006 Proposed Regulations

In 2006, the Treasury Department and the IRS proposed regulations under Section§ 72 (concerning taxation of annuities and certain proceeds of endowment and life insurance contracts, Prop. Reg. § 1.72-6(e)) and 1001 (concerning the determination and recognition of gain or loss, Prop. Reg. § 1.1001-1(j)) that would dramatically alter the taxation of private annuity sales to the annuitant by eliminating the deferral of income taxes on such exchanges through requiring current realization of the fair market value of the annuity in the year of the exchange. 71 Fed. Reg. 61,441 (Oct. 18, 2006). See also Lederman, *Proposed Regulations on the Tax Treatment of Private Annuities Would Generally Make Them Unattractive*, 106 J. Tax'n 175 (March, 2007); and Leimberg, McGrath, & Zaritsky, *Deferral of Gain Eliminated in Sales of Appreciated Property for an Annuity—A Whole New Ballgame and the IRS Hits for the Fence!*, 33 Est. Plan. 3 (Feb. 2006). These regulations have not yet been finalized, but their finalization remains on the Treasury/IRS *Priority Guidance Plan for 2017-2018* (Updated May 9, 2018).

(1) Generally

The proposed regulations are relatively simple. They state that if an annuity contract is received in exchange for property (other than money), the following three results occur:

- The amount realized attributable to the annuity contract is its fair market value determined under Section 7520 at the time of the exchange. Prop. Reg. § 1.1001-1(j)(1);

- The entire amount of the gain or loss, if any, is recognized at the time of the exchange regardless of the taxpayer's method of accounting. Prop. Reg. § 1.1001-1(j)(1); and

- For purposes of determining the initial investment in the annuity contract under Section 72(c)(1), the aggregate amount of premiums or other consideration paid for the annuity contract equals the amount realized attributable to the annuity contract (i.e., the fair market value of the annuity contract). Prop. Reg. § 1.72-6(e)(1).

Thus, where the fair market value of the property exchanged equals the fair market value of the annuity contract received, the investment in the annuity contract will be the fair market value of the property exchanged for the contract.

The preamble explains that this rule, determining the investment in the annuity contract under Section 72(c)(1), is intended to ensure that none of the gain or loss on the exchange is duplicated or omitted by the application of Section 72 in the years after the exchange. The annuitant's investment in the contract would be reduced in subsequent years under Section 72(c)(1)(B) for amounts already received under the contract after the exchange and excluded from gross income when received as a return of the annuitant's investment in the contract. 71 Fed. Reg. 61,443.

Thus, if an unsecured private annuity promise or a commercial annuity contract is received by the transferor in exchange for property other than cash, the entire amount of the seller's realized gain or loss (if any) must be recognized at the time of the exchange, rather than ratably over the seller's life expectancy.

(2) Accounting Methods

This rule will apply regardless of the method of accounting used by the taxpayer, and regardless of whether the annuity is created in the exchange or is a pre-existing contract.

(3) Secured and Unsecured Agreements

The proposed regulations do not distinguish between secured and unsecured annuity contracts, nor between annuity contracts issued by an insurance company and those issued by a taxpayer who is not an insurance company. The same set of rules would apply to leave

the transferor and transferee in the same position before tax as if the transferor had sold the property for cash and used the proceeds to buy the annuity contract. 71 Fed. Reg. 61,443 (Oct. 18, 2006). Security of any type, directly or indirectly, has traditionally been held to preclude income tax deferral. *Estate of Bell v. Comm'r*, 60 T.C. 469 (1973), *acq. in part and nonacq. in part*, 1974 WL 36039 (Jan. 8, 1974), *acq.* AOD 1979-184 (Aug. 15, 1979), *aff'd per curiam*, 668 F.2d 448 (8th Cir. 1981); *212 Corp. v. Comm'r*, 70 T.C. 788 (1978).

(4) Gain or Loss Recognized

The same rules would apply whether the exchange produces a gain or loss. The preamble notes, however, that this does not prevent the application of other provisions, such as Section 267, to limit deductible losses in the case of related party exchanges. 71 Fed. Reg. 61,443.

(5) Effective Date

The proposed regulations generally apply to exchanges of property for an annuity contract after October 18, 2006 (the publication date of the proposed regulations.) The new regulations would not apply to amounts received after October 18, 2006, under annuity contracts that were received in exchange for property before that date. The effective date is delayed for six months (until April 18, 2007) for transactions that meet the following three requirements: (1) The issuer of the annuity contract must be an individual, rather than a corporation, partnership, trust, or other legal entity; (2) The obligations under the annuity contract cannot be secured, either directly or indirectly; and (3) The property transferred in the exchange cannot be sold or otherwise disposed of by the transferee during the two-year period beginning on the date of the exchange.

(6) Analysis

The new rules would significantly undermine the utility of traditional private annuity sales by requiring that all gain from the annuity sale be recognized on the date of the exchange, to the extent of the actuarial fair market value of the annuity contract.

(a) Unappreciated Assets

Obviously, this is relevant only with respect to the exchange of substantially appreciated assets for an annuity. Private annuities would still be valuable in exchange for assets with little or no appreciation because they would generate very little taxable gain, as purchases of a private annuity for cash

will generate no taxable gain and are expressly excluded from the operation of the proposed regulations.

(b) Installment Sales

The proposed regulations do not generally apply to installment sales agreements, the taxation of which is controlled by Section 453 rather than Sections 72 and 1001. Reg. § 1.1275-1(j)(6) states that an annuity with a maximum payout provision (i.e., an obligation to pay a stated amount each year, or more often, but in no event more than a fixed sum) is a debt instrument, rather than an annuity, for income tax purposes, unless "the period of time from the annuity starting date to the termination of the annuity is at least twice as long as the period of time from the annuity starting date to the expected date of the annuitant's death." Therefore, a private annuity could be brought out of the ambit of the proposed regulations and under the rules for installment sales if (1) it included a fixed maximum total dollar payment (as with an agreement to make periodic payments for the shorter of the annuitant's life or a set number of years), and (2) the set number of years is less than twice the annuitant's life expectancy.

(c) Annuity Sales to a Grantor Trust

The proposed regulations should not apply where a private annuity sale is made to a grantor trust. See Rev. Rul. 85-13, 1985-1 C.B. 184.

2. Taxation of the Obligor – Basis Rises

a) Generally

The annuity obligor is treated like the purchaser of the annuity property except that amounts paid in excess of the purchase price are nondeductible annuity payments, rather than deductible interest. See Rev. Rul. 55-119, 1955-1 C.B. 352; *Bell v. Comm'r*, 76 T.C. 232 (1980), *aff'd per curiam*, 668 F.2d 448 (8th Cir. 1981); *FA Gillespie & Sons v. Comm'r*, 154 F.2d 913 (10th Cir. 1946), *cert. denied*, 329 U.S. 781 (1946); *Kaufman's, Inc. v. Comm'r*, 28 T.C. 1179 (1957); *Reliable Incubator & Brooder Co. v. Comm'r*, 6 T.C 919 (1946). See also *Rye v. United States*, 25 Cl. Ct. 592 (1992) (reaffirming that a private annuity sale is not an installment sale under Section 453(b)(1) and that the annuity payments are not deductible as interest).

b) Open Basis Concept

The obligor's basis in the annuity property is computed using an open basis approach, under which the obligor's basis depends on when and for what purpose it is being computed.

(1) Basis During Annuitant's Lifetime for Depreciation and Sale at a Gain

The obligor's basis in the annuity property during the annuitant's lifetime, for purposes of depreciation and determining the gain recognized on a sale or exchange of the annuity property, is the amount of consideration paid for the property (assuming there was no gift feature). This is the present value of the annuity promise on the date of the agreement. An obligor who makes actual capital payments in excess of this amount may increase his or her adjusted income tax basis, for both subsequent depreciation as well as determining gain or loss on any subsequent sale or exchange, to reflect these additional payments. See Rev. Rul. 55-119, 1955-1 C.B. 352; Rev. Rul. 72-81, 1972-1 C.B. 98.

(2) Sale at a Loss

The obligor's basis in the annuity property for purposes of determining loss recognized on a sale or exchange of the annuity property during the annuitant's lifetime is equal to the amount of the payments actually made less any allowable depreciation. The present value of any annuity payments not yet made is disregarded for this purpose, and any additional annuity payments made after a sale at a loss are additional losses. *Id.*

(3) Sale Between Gain and Loss

A sale by the obligor during the annuitant's lifetime at a sales price that (1) exceeds the amounts actually paid by the obligor to that date but (2) is less than the present value of the promised annuity results in neither a gain nor a loss. Subsequent payments may ultimately cause the obligor to recognize a loss on such a sale if the total of actual annuity payments exceeds the sales price. *Id.*

(4) Basis After Annuitant's Death

The obligor's basis after the annuitant's death is the total of all of the annuity payments made by the obligor less any depreciation deductions allowable with respect to the annuity property. *Id.*

(5) Tax Benefit Recovery

The obligor's depreciation deductions during the annuitant's life are based on the present value of the annuity projected over the annuitant's actuarial life expectancy, so a combination of fast depreciation and a premature death by the annuitant can give the obligor a negative basis. A negative basis should be recaptured as ordinary income under the tax benefit rule. *Id*. On the tax benefit rule generally, see Bierman & Severin, *Effect of Deduction Phase-Out on Tax Benefit Rule*, 80 J. Tax'n 181 (Mar. 1994); Bittker & Kanner, *The Tax Benefit Rule*, 26 UCLA L. Rev. 265 (1978); Goldman, Tax *Benefit Rule Affects Trusts and their Beneficiaries*, 75 Pract. Tax Strat. 293 (Nov. 2005); Yin, *Supreme Court's Tax Benefit Rule Decision: Unanswered Questions Invite Future Litigation*, 59 J. Tax'n 130 (1983).

c) Proposed Regulations

The 2006 proposed regulations on private annuities state that the obligor's investment in the contract under Section 72(c)(1) would be the aggregate amount realized attributable to the annuity contract (i.e., the fair market value of the annuity contract). Prop. Reg. § 1.72-6(e)(1) (Oct. 18, 2006). Thus, where the annuitant had to recognize gain, the obligor would take a fair market value basis for all purposes.

XXI. PROBLEM BASIS SITUATIONS: BASIS AND SELF-CANCELLING INSTALLMENT NOTES (SCINS)

A. Generally

A self-cancelling installment note (SCIN) is a transaction where the seller ("transferor") sells property ("transferred property") to a buyer ("transferee") in exchange for a promissory note that generally expires upon the death of the transferor. The SCIN is structured like any other ordinary installment note (OIN), in that one payment is made on the date of sale and there is at least one other payment made in a later year (or years), thereby allowing the transferor to defer the gain. IRC § 453(b)(1).

Although the SCIN could be a transaction between unrelated individuals, it is most common between related individuals, and quite often it is between the transferor and his or her irrevocable grantor trust. When the latter strategy is used (i.e., sale to one's irrevocable grantor trust), gain recognition on the sale may not only be deferred, but may be eliminated, and the basis of the transferred property will likely be transferred basis from the transferor (i.e., there will be no step-up in basis under Section 1015). We discuss this in detail below.

SCINs, like private annuities, may be an effective planning tool for removing significant asset values from an individual's gross estate for estate tax purposes, while simultaneously providing that individual with a lifetime source of income. It is most favorable, from a gift and estate tax perspective, when the transferor dies before his or her life expectancy; if the transferor outlives his or her life expectancy, a SCIN may not be as effective.

For an in-depth discussion about SCINs, see, Wojnaroski, 805 3rd TM, *Private Annuities and Self-Cancelling Installment Notes*.

1. SCINs vs. Private Annuities

The Service, in GCM 39503 (May 7, 1986), distinguished a private annuity from a SCIN, and concluded that a transaction will be treated as an installment sale only if it is reasonably anticipated that the payments (including interest) for the transferred property will be received by the transferor before the expiration of the transferor's actuarial life expectancy. As a corollary, if the payments are not anticipated to be received before the life expectancy, the transaction would be taxed as an annuity (a private annuity) under Section 72 (discussed above).

2. SCINs Versus Ordinary Installment Notes (OINs)

SCINs are similar to OINs in that they both have the installment feature that defers the gain recognition, thus, deferring income tax liability. IRC § 453(b)(1). The regulations permit SCINs because it is anticipated that the selling price (plus interest) will be received by the transferor. Temp. Reg. § 15A.453-1(c)(2).

The contingency in a SCIN is not the sales price, which is generally known, but rather whether the transferor will survive the payment period.

SCINs and OINs are similar, in that both can be effective in freezing estate values, can convert illiquid assets into liquid assets, and can offer similar income tax treatment.

SCINs are different from OINs, in that the typical SCIN does not obligate the transferee to make any further payments after the transferor's death. To avoid adverse gift and estate tax results, the transferor/seller must be compensated for the chance that the entire purchase price will not be paid because of the transferor/seller's premature death, by a "risk premium."

B. Transfer Tax Consequences

1. Gift Tax

a) Common Issues

When there is a "sale" between related parties, the typical gift tax issue is whether the amounts exchanged represent full and adequate consideration. This is especially true when discounted assets (such as limited liability company or limited partnership interests) are sold. Some of the issues arising in sales of discounted assets can be mitigated by using formula allocation or defined value clauses. In this respect, sales involving SCINs are no different that sales of other assets.

b) Risk Premium

When a SCIN is used, in addition to determining the asset's fair market value (independent of the SCIN transaction), because there is a cancellation feature to the note, the transferee must pay a risk premium. The risk premium can be assessed by (a) increasing the interest rate, (b) increasing the purchase price, or (c) a combination of (a) and (b).

c) Mortality Tables

To determine the risk premium, and to determine the length of the annuity, one needs to use the mortality tables. It is currently unclear which mortality tables should be used in determining the interest rate. For a good discussion about which mortality tables should be used, see, Crotty, Hesch, Wojnaroski,& Gassman, *IRS Puts More Skin in the Game of Using SCINs*, Est. Plan. (Jan 2014).

See also, CCA 20133033 (Aug. 5, 2013), discussing the IRS' position on the use of SCINs (and other estate planning techniques) employed by William Davidson (former owner of the NBA's Detroit Pistons), now deceased. See also, H.M.Zaritsky & R. Aucutt, *Structuring Estate Freezes: Analysis with Forms* ¶ 12.02[3] (Thompson Reuters/ Tax & Accounting, 2nd ed. 1997 & Supp 2018-1).

d) Interest Rates

It is also unclear which interest rates should be used (e.g., the Section 7520 rate or the applicable Federal rate). The conservative planner generally uses the higher of the two rates based on the actual term of the note. In CCA 201320033, the IRS took the position that the Section 7520 rate did not apply to SCINs in the particular transaction that they reviewed. However, it appears that in *Dallas v. Comm'r,* T.C. Memo 2006-212, the IRS used the Section 7520 rate to determine the SCIN's value. See H. M. Zaritsky & R. Aucutt, *Structuring Estate Freezes: Analysis with Forms* ¶ 12.02[3] (Thompson Reuters/ Tax & Accounting, 2nd ed. 1997 & Supp 2018-1).

e) Inadequate Risk Premium

If it is determined that the risk premium is inadequate, then the sale may be re-characterized a part-gift/part-sale transaction. See *Dallas v. Comm'r*, T.C. Memo 2006-212.

For a more detailed discussions about the gift tax consequences, see, Malin, *Self-Cancelling Installment Note Maintain Planning Usefulness*, 65 Practical Tax Strategies 141 (Sept. 2000); Rapkin, *Freezing Estates with Private Annuities and Self-Cancelling Installment Notes*, 12 J Tax'n Investments, 22, 41 (1994); and H.M. Zaritsky & R. Aucutt, *Structuring Estate Freezes: Analysis with Forms*, ¶ 12.02[3] (Thompson Reuters/ Tax & Accounting, 2nd ed. 1997 & Supp 2018-1).

2. Estate Tax

a) General Rule - No Estate Tax Inclusion

Properly structured, the unpaid balance on a SCIN is not included in the transferor's gross estate. *Estate of Moss v. Comm'r*, 74 T.C. 1239 (1980). Technically, the note is cancelled at the moment of death and thus has no value at death.

b) Include Payments Received

The note is not included in the transferor's estate, but any payments received by the transferor from the time of the sale through his or her death (including any appreciation thereon) will be included in the transferor's estate, to the extent not expended or consumed.

c) Bona Fide Sale for Full and Adequate Consideration

In negotiating the SCIN transaction the sale must be a *bona fide* transaction for full and adequate consideration. To compensate the transferor/seller for

the contingency of death before full payment is received, the transferor must be paid a risk premium as part of the bargained for consideration.

(1) Non-*Bona Fide* Sales

If it determined that the sale was not *bona fide*, the SCIN could be ignored and the transfer may be considered a gift and have estate and/or estate tax consequences. *Estate of Musgrove v. United States*, 33 Fed. Cl. Ct. 657 (1995).

(2) Burden of Proof - Taxpayer

The burden is on the taxpayer (not the IRS) to demonstrate that the transaction was *bona fide*. *Estate of Costanza v. Comm'r*, 320 F.3d 595 (6th Cir. 2003), *rev'g*, T.C. Memo 2001-128.

C. Income Taxation – Individuals and Non-Grantor Trusts

In this section we assume that the transferor is an individual and the transferee is an individual or a non-grantor trust (i.e., for instance, the sale could be between an individual and his or her child, or between an individual and a non-grantor trust). For a discussion of the income tax issues for SCIN transactions between the transferor and his or her grantor trust, see the discussion below, and for a general discussion about sales between a grantor and his or her irrevocable grantor trust, see discussion above.

Generally, there is one income tax issue facing the transferor/seller -- the recognition of income. There are two income tax issues that affect the transferee/buyer -- (1) the deductibility of the interest paid by the transferee; and (2) the tax basis of the transferred property.

1. Transferor's Income Tax Implications

a) Date of Sale

(1) Amount Realized

The amount realized (as defined under Section 1001) on the sale will generally be (a) the fair market value of the property (had the property not been sold for a SCIN), plus (b) the risk premium (if assessed as a principal addition to the sale price).

(2) Gain Realized/Recognized

The gain realized will equal to the amount realized less the transferred property's adjusted basis. If a gain is realized, then it can be deferred under Section 453. It would be imprudent to have a sale where is loss is realized, since they will likely be denied the loss under Section 267.

Whether the gain is a capital gain, Section 1031 gain, recapture of ordinary income, or otherwise will be determined as it is normally determined on any other sale. The capital gain component can be deferred under Section 453.

(3) Interest Income

In general, there will be no interest income earned on the closing date. Interest is recognized as it is accrued and/or paid (depending on whether the seller is an accrual or cash basis taxpayer). Since most individuals are cash basis taxpayers, interest income will be recognized when collected (i.e., when payments are made by the transferee).

b) Future Payments

As payments are received periodically a portion of the payments will be a recovery of principal, a portion will be capital gain, and the balance will be interest income. Depending upon how the risk premium is computed (i.e., as an addition to principal or as an increased interest rate), the amount of capital gain and interest will differ.

2. Transferee's Income Tax Implications

a) Interest Expense

GCM 39503 (June 25, 1986) provides that the accrued or paid interest may be deductible by the transferee. Deductibility may be limited by some of the provisions of Section163, however. For instance, if the interest is characterized as investment interest expense, then the limitation rules under Section 163(d) would apply.

b) Transferee's Tax Basis

(1) GCM 35903

(a) Conclusions by General Counsel

In GCM 35903, General Counsel concluded, with regard to a SCIN, the transferee/buyer's basis in the transferred property is the fair market value of assets exchanged including the full face value of the note (i.e., the basis is generally be the purchase price for the transferred property).

(b) General Counsel's Analysis

In analyzing whether the buyer's basis would be increased to reflect contingent obligations, General Counsel cited to a number of cases which held that if the seller was no longer receiving payments (and the buyer was no longer obligated to make payments on the note), that such basis could only be increased to the extent that the buyer/transferee was "in fact required to make payments pursuant to the obligation."

However, General Counsel took the analysis further concluding since the transferor/seller (and/or his or her estate) has to recognize all of the income from the sale, even though the buyer/transferee's obligation terminated. The recognition of income by the seller supports the increase of basis to the extent of the full face value of the note.

GCM 35903 provides in the case of a SCIN, "the full face value of the note will in all events be realized by the seller or the seller's estate, whether or not the seller lives long enough to require payment of the face amount." In GCM 35903, ultimately, General Counsel concluded that Section 691(a)(5) would cause the recognition of income by reason of cancellation of the indebtedness upon the transferor's death. Therefore, it appears that General Counsel felt that there would be symmetry in the transaction (i.e., the transferor/seller would recognize gain, which supports the basis in the hands of the transferee/buyer).

3. Risk Premium - The Basis Game

As discussed above, when determining how to structure the risk premium, the parties could agree to an increased purchase price, an increased interest rate or some combination of the two.

If there is an increased purchase price, (compared to a higher interest rate), there will be more capital gain and less interest income to the transferor/seller, and a higher basis and less interest expense to the transferee/seller.

On the other hand, if the purchase price is not adjusted for the risk premium, and instead the interest rate is increased, the transferor/seller will recognize less capital gain, but will have to recognize more interest income over the term of the note. The transferee/seller will have a lower basis and more interest expense.

The planner should analyze which approach would be better for the family, by running the numbers for the buyer and seller, and taking into consideration the needs and desires of the parties.

a) *Estate of Frane*

(1) Tax Court Decision

In the Tax Court's decision in the *Estate of Frane v. Comm'r*, 98 T.C. 341 (1993), *aff'd in part, rev'd in part,* 998 F.2d 567 (8th Cir. 1993). the Tax Court held that upon the transferor's death, income would be recognized, and that it would be recognized by the decedent (i.e., on his final return) under Section 453B.

(2) Eighth Circuit Decision

Frane was appealed to the Eighth Circuit, which affirmed that in the case of a "death-terminating installment note", as they called it, that income would be recognized as a result of the "termination" or cancellation of the debt. The appeals court, however, disagreed with the Tax Court and held that the income would be recognized not by the decedent (on his final income tax return), but by the estate as income in respect of the decedent (IRD) under Section 691, by reason of Section 691(a)(5)(iii).

The appeals court's decision is consistent with General Counsel's conclusions in GCM 35903 (i.e., that the income after death is IRD in the hands of the transferor's estate).

What is unanswered at this point is what happens if income is not recognized by the transferor's estate upon death? Would the basis still be increased by the full-face value of the note? It is unclear at best.

(3) An Alternative Argument – Tax Court's Dissent

(a) Judge Halpern's Arguments

The Tax Court majority decision in *Frane* was met with a strong five-judge dissent, written by Judge Halpern, who took the position that there should be no recognition event. Judge Halpern, agreeing with the taxpayer, felt that there was no cancelation of the note, since there was no "obligation that came into being", thus, there can be no cancellation of something that never was. The dissent argues that the condition precedent for an obligation to arise is that the transferor/seller is to survive to the payment date, failure to survive does not cause an obligation to arise; thus, death does not cancel the obligation, rather life causes the obligation. Therefore, if the transferor dies, there is no obligation.

Judge Halpern argued that the majority's holding is inconsistent with *Estate of Moss v. Comm'r*, 74 T.C. 1239 (1980), in which the Tax Court held that since the decedent had "no interest in the notes" there could be no inclusion in the gross estate. Judge Halpern points out that, "when the decedent has no interest remaining and no right to collect, borrower has no obligation to pay"; thus, it is impossible to cancel something that does not exist in the first place.

The argument is compelling.

(b) *Frane's* Application

Under the rule established in *Golsen v. Comm'r*, 445 F.2d 995 (10th Cir.) (commonly referred to as the *Golsen* rule), *Frane* is precedent for the Eighth Circuit. If the taxpayer faces the same issue in a different circuit, one should consider using Judge Halpern's dissenting arguments.

(c) Planning

In light of the uncertainty when planning in jurisdictions outside of the Eighth Circuit, perhaps the planner could use a grantor trust as the transferee/buyer for the SCIN transaction. This is discussed below. For a recent article on planning with SCINs, see, Crotty, Hesch, Wojnaroski and Gassman, *IRS Position Puts More Skin in the Gam of Using Skins*, 41 Est. Plan. 3 (Jan. 2014).

D. SCINs and Grantor Trusts

Like ordinary installment sales, (commonly called "sales to defective grantor trusts", "sales to IDGTs", or simply, "sales to irrevocable grantor trusts"), SCINs can be used with grantor trusts.

If a transaction is structured so that the note is a SCIN and the transferee is a grantor trust with respect to the transferor's, Rev. Rul. 85-13, provides for income taxes there has been no sale. If there is no sale, there is no income recognized by the transferor at the time of the sale and the basis in the hands of the transferor passes to the transferee.

1. Rev. Rul. 85-13

In Rev. Rul. 85-13 the grantor acquired the corpus of a trust in exchange for the grantor's unsecured promissory note, resulting in the trust being a grantor trust for income tax purposes. The IRS ruled the exchange of a promissory note for the trust assets is not recognized as a sale for federal income tax purposes, because the gran-

tor is considered to own the purported consideration both before and after the transaction. The IRS also stated that since the grantor owns the trust assets, the grantor cannot have a sale to him or herself. Finally, the IRS confirmed that there cannot be a valid debt obligation running between the grantor and him or herself.

2. Is the SCIN a "Note" in a "Sale" to the Transferor's Grantor Trust?

Applying the logic and reasoning of Rev. Rul. 85-13 to a SCIN transaction involving a "sale" from a grantor to his/her irrevocable grantor trust, since there is no "sale", there is no note. And, since there is no note, there can be no obligation. And, using Judge Halpern's logic in the *Frane* dissent, if there is no obligation, there is nothing that can be cancelled. This is true so long as the trust remains a grantor trust during the grantor's lifetime.

3. Basis in the hands of the Transferor

a) Before the "Sale"

Immediately before the "sale" the basis in the hands of the transferor would be the adjusted basis of the transferred asset.

b) After the "Sale"

Immediately after the sale, the transferor would own a promissory note, with a cancellation provision (only for state law purposes, not for Federal income tax purposes), and the asset would be in the hands of the transferee

(1) Gain Recognition

(a) If the Trust Remains a Grantor Trust

Under Rev. Rul. 85-13, there would be no sale or exchange (as is contemplated under Section 1001); thus, no gain could be realized or recognized.

(b) If the Trust Ceases to be a Grantor Trust

If the trust ceases to be a grantor trust during the transferor's lifetime, and if the SCIN has not been fully paid, gain may be triggered at that point in time. See detailed discussion above in Section XIX.A.5 and Section XIX.A.6, regarding Reg. § 1.1001-2(c), Ex. 5; Rev. Rul. 77-402, 1977-2 C.B. 222; and *Madorin v. Comm'r, supra*.

4. Basis in the hands of the Transferee/Grantor Trust

a) After the Sale and before the Grantor's Death

For Federal income tax purposes there is no sale; however, there is a transfer, the transferee (i.e., the irrevocable grantor trust) would have a transferred basis in the transferred property. Therefore, the basis in the property immediately after the sale would be the basis in the hands of the transferor immediately before the sale. That basis could be adjusted after the transfer, for items that would normally adjust basis (e.g., depreciation for depreciable property).

b) After the Death of the Grantor

After the transferor dies, the Federal income tax basis in the hands of the transferee (i.e., the irrevocable grantor trust) should be a transferred basis (i.e., the same basis immediately before the sale).

See the full discussion about the impact on basis and whether gain should be recognized on the death of the transferor/grantor in the section titled, Effect on Basis of Termination of Grantor Trust Status at Grantor's Death, above.

XXII. PROBLEM BASIS SITUATIONS: BASIS AND SPECIAL USE VALUATION PROPERTY -- SECTION 2032A

A. Generally

Section 2032A permits the executor of a decedent's estate to value real estate and used in a closely-held business or family farm and certain personal property used in a family farm at its current use value, rather than its highest and best value. This valuation can reduce the estate tax value of the assets by up to $1,090,000 for estates of decedents dying in 2014 ($750,000, indexed for inflation after 1997) for estates of decedents dying in 2012. Rev. Proc. 2013-35 § 3.33, 2013-2 C.B. 537.

B. Value for Basis. Section1014(a)

The estate tax value of an asset for basis purposes of Section 1014(a) is its value under Section 2032A, if that section's benefit is validly elected by the executor. IRC § 1014(a)(3).

C. Adjustment to Basis for Recapture Tax. Section 1016(c)

1. Recapture Tax Generally

The estate tax savings from a Section 2032A election are recaptured as an additional estate tax, if the use of the property is changed from a family business or farm, or the property is disposed of outside of the decedent's family within ten years after the decedent's death. IRC § 2032A(c).

2. Recapture Tax Added to Basis

a) Full Recapture

If the recapture tax is imposed with respect to special use value property, the qualified heir can elect to increase the basis of the property by the amount of the estate tax value reduction allowed earlier by Section 2032A. IRC § 1016(c)(1).

b) Partial Dispositions

In the case of any partial disposition, the basis increase is proportionate, bearing the same to the total valuation adjustment as the amount of the recapture tax bears to the adjusted tax difference attributable to the entire interest. IRC § 1016(c)(2).

c) Time Adjustment Made

Any increase in the basis of property with respect to a recapture tax is deemed to occur immediately before the recapture disposition or cessation of use. IRC § 1016(c)(3).

d) Substituted Property

(1) Involuntary Conversions

Where special use valued real property is the subject of an involuntary conversion (such as a condemnation) under Section 1033, no recapture tax is imposed if the cost of the qualified replacement property equals or exceeds the amount realized on such conversion, in light of the reinvestment of the proceeds in "qualified replacement property." IRC § 2032A(h)(1). "Qualified replacement property" means real property into which the special use valued property is converted or in which the proceeds are reinvested under Section 1033. IRC § 2032A(h)(3). The basis increase for a recapture tax imposed with respect to "qualified replacement property" is made by reference to the involuntarily converted property. IRC § 1016(c)(4).

(2) Tax Free Exchange

Where special use valued real property is the subject of an like-kind exchange under Section 1031, no recapture tax is imposed if the cost of the qualified exchange property equals or exceeds the amount realized on such exchange, in light of the reinvestment of the proceeds in "qualified exchange property." IRC § 2032A(i). "Qualified exchange property" means real property for which the special use valued property is exchanged. IRC § 2032A(i)(3). The basis increase for a recapture tax imposed with respect to "qualified exchange property" is made by reference to the exchanged property. IRC § 1016(c)(4).

3. The Election

The election to increase basis by the recapture tax under Section 2032A(c) must be made as provided by regulations, and once made is irrevocable. IRC § 1016(c)(5)(A). There are no such regulations, but the Publication 551 and the instructions to Form 706-A state that the election is made by filing with Form 706-A (reporting the recapture event and paying the recapture tax) and

- Checking the box on line 7 of Part I,
- Entering on line 20 of Part II the amount of the interest being paid on the additional estate tax due;

- Filing a statement that:
- Contains your name, address, and taxpayer identification number and those of the estate;
- Identifies the election as an election under Section 1016(c); and
- Specifies the property for which the election is made.

4. Interest on Recaptured Amount

A taxpayer who elects to increase basis must pay interest on the recapture tax, running from the original estate tax return due date to the date the recapture tax is paid. Section 1016(c)(5)(B). The potential interest expense means that one must compare the benefit of the basis with the detriment of the interest.

XXIII. PROBLEM BASIS SITUATIONS: BASIS AND THE GST TAX

A. Basis for Taxable Terminations Generally

1. Section 2654(a)(2)

Section 2654(a)(2) states that the basis of property transferred in a taxable termination that occurs at the same time as, and as a result of, the death of an individual, is adjusted for the GST tax imposed in a manner similar to that provided under Section 1014(a). If the inclusion ratio with respect to such property is less than one, however, any basis adjustment is limited by multiplying the adjustments by the inclusion ratio.

2. Section 2654(a)(1)

Section 2654(a)(1) states that the basis of property transferred in a generation-skipping transfer other than a taxable termination that occurs at the same time as, and as a result of, the death of an individual, the basis of such property shall be increased (but not above the fair market value of such property) by an amount equal to that portion of the GST tax attributable to the appreciation in the value of the transferred asset immediately before the transfer. This rule is applied after any basis adjustment under Section 1015 with respect to the transfer. This rule applies to direct skip transfers, taxable distributions, and taxable terminations other than those occurring upon the death of and on account of the death of an individual.

B. Taxable Termination *Versus* Taxable Distribution

Whether a generation-skipping transfer is a taxable termination or a taxable distribution can affect the income tax basis of the property involved and determine who bears liability for the tax. IRC §§ 2654(a), 2603. Section 2612(b) provides that a transfer that meets the definitions of both “taxable termination” and “taxable distribution” is a taxable termination. For example, where the trustee has discretion to distribute trust funds to the grantor's children and grandchildren, a distribution of all of the trust assets to a grandchild is both a taxable distribution and a taxable termination. Under Section 2612(b), this is taxed exclusively as a taxable termination.

C. Certain Partial Terminations

Section 2612(a)(2) characterizes distributions to skip persons that occur on the death of a lineal descendant of the transferor as taxable terminations, rather than as taxable distributions. Reg. §§ 26.2612-1(b)(2) and 26.2612-1(f), Ex. 11. This rule is confusing and its purpose unclear. It can produce a favorable income tax result, however, because Section 2654(a) provides an increase in the adjusted income tax basis of an asset that is the subject of a taxable termination that occurs on an individual's death, but not for a taxable distribution occurring at such a time.

Example XXIII-1

Transferor creates an irrevocable trust to pay income to Child-1 and Child-2, in such shares as the trustee deems appropriate. When the first child dies, half of the trust fund is to be paid to Transferor's then-living grandchildren, and the balance of the trust fund will be paid to the then-living grandchildren when the later of the two children dies. Child-1 dies first, causing half of the trust fund to be paid to Transferor's grandchildren. This is a taxable termination as to one half of the trust fund, rather than a taxable distribution, because the distribution is a distribution of a portion of the trust that occurs as a result of the death of a lineal descendant of Transferor. That the rest of the trust continues to be held for the benefit of Child-2 and the grandchildren, and that Child-2 is not a skip person, does not change this result. Reg. § 26.2612-1(f), Ex. 11.

XXIV. PROBLEM BASIS SITUATIONS: BASIS IN TRUST OR ESTATE DISTRIBUTIONS

A. Generally

Section 643(e)(1) states that the basis of property received by a beneficiary in a distribution from an estate or trust is the adjusted basis of the property in the hands of the fiduciary immediately before the distribution, adjusted for any gain or loss recognized. The basis adjustment for the recognition of gain or loss, however, creates four possible options for the calculation of basis, depending upon the facts of the distribution.

B. Distribution of Property in Satisfaction of a Specific Gift – No Recognition of Gain or Loss and Carryover Basis

A fiduciary recognizes no gain or loss on a distribution in satisfaction of a specific gift of property, if the fiduciary delivers to the beneficiary the exact property described in the will or trust. The beneficiary receives a carryover of the fiduciary's adjusted basis. IRC § 643(e)(4).

C. Distribution of Property in Satisfaction of a Pecuniary Gift or of a Specific Gift of Other Property -- Recognition of Gain or Loss and New Basis

1. *Kenan* Rule

A fiduciary recognizes gain or loss on most distributions to a beneficiary in satisfaction of a right to a specific dollar amount or of a right to specific property other than the property that is actually distributed, and the beneficiary takes as a basis the fiduciary's adjusted basis, increased by the recognized gain. Reg. § 1.661(a)-2(f)(1). This is sometimes called the *Kenan* rule, after an early case that held that an estate recognized a gain when it distributed property in kind to satisfy a fixed dollar legacy. *Kenan v. Comm'r*, 114 F.2d 217 (2d Cir. 1940); see also *Suisman v. Eaton*, 15 F. Supp. 113 (D. Conn. 1935), *aff'd*, 83 F.2d 1019 (2d Cir.), *cert. denied*, 299 U.S. 621 (1936).

2. Distributions of Property in Satisfaction of a Right to Income

The *Kenan* rule applies equally to a distribution of property in satisfaction of a right to income, as defined in Section 643(b). Reg. §§ 1.651(a)-2(d) and 1.661(a)-2(f). This requires such recognition and fair market value basis on a distribution of traditional income or income defined as a unitrust amount.

3. Hybrid Gifts

a) Generally

The regulations distinguish between gifts of pecuniary amounts or specific property on the one hand, and other types of testamentary transfers on the

other; mandatory recognition of gain applies only to distributions of pecuniary amounts or specific property. Some instruments, however, provide for transfers that in form or substance, have characteristics of both types, and the question arises of which rule to apply to them.

b) Rev. Rul. 66-207

In Rev. Rul. 66-207, 1966-2 C.B. 243, a decedent's will provided for a pecuniary legacy of $250,000, but at distribution, the estate had assets worth only $200,000, in which the executor had a basis of $150,000. The IRS ruled that the gift was a pecuniary legacy, and gain had to be recognized on the distribution to the extent of the $50,000 accrued gain, even though the legatee received what was, in essence, a residuary distribution of the estate.

c) Rev. Rul. 72-295

In Rev. Rul. 72-295, 1972-1 C.B.197, the IRS concluded that a bequest of $100,000 worth of stock, but not more than all of the shares of such stock owned at the decedent's death, was neither a pecuniary legacy nor a gift of specific property distributed as such. The ruling states that the estate did not recognize gain on the distribution of shares in satisfaction of the legacy (which was actually less than the total number of shares outstanding), and that the distribution did carry out DNI. Rather, the distribution was treated as a residuary gift. Were these facts to occur today, the executor could elect to recognize gain on the distribution. It does seem that the beneficiary in this ruling was in much the same position as a pecuniary legatee whose gift is satisfied with appreciated property. The scope of extent this ruling is uncertain. For example, would it apply if a will provided for a gift of stock, and also for a contingent legacy of the difference between the value of that gift on the date of death and a set pecuniary amount.

d) Rev. Rul. 82-4

In Rev. Rul. 82-4, 1982-1 C.B. 99, a decedent's will provided for an equal division of the testator's estate between two children, after taking into account the value of an *inter vivos* gift that had been made to one of them. The *inter vivos* gift was shares of stock and the will directed that the date of death value of the shares be deducted from the share passing to that donee. The value of the entire estate at the time of distribution was less than the date of death value of the *inter vivos* gift, so the entire estate (which had appreciated since the date of death) was distributed to the other beneficiary. The IRS ruled that the will provided for a pecuniary legacy to the nondonee equal to the date of death value of the donated shares, in addition to a residuary gift of the excess to two beneficiaries, which abated the legacies entirely. The estate, therefore, was required to recognize gain on the distribution of its assets in satisfaction of a pecuniary bequest.

e) Rev. Rul. 83-75

In Rev. Rul. 83-75, 1983-1 C.B. 114, a charitable lead trust was required to recognize gain when it distributed appreciated assets to satisfy part of a charitable annuity. Gain was recognized to the extent of the excess of the value of the assets distributed in kind over the basis of those assets, even though the trustee did not have enough cash on hand from income or other sources to satisfy the required annuity payment in full.

D. Satisfaction of Pecuniary Gift with Loss Assets – Basis Adjusted for Disallowed Losses

Section 267 denies a fiduciary a deduction for a distribution of loss assets (those with an adjusted basis above their fair market value) in satisfaction of a pecuniary bequest. In such cases, the beneficiary does not include in gross income any gain realized on later sale or exchange of the distributed property, to the extent of the disallowed loss. Thus, in effect, the beneficiary gets a partial carryover of basis. IRC § 267(d). A fiduciary who wishes to dispose of a loss asset should usually sell the asset and distribute the proceeds, rather than distributing the asset in kind. The fiduciary can then deduct the recognized loss and use that loss to offset gains it may have or as the basis for a capital loss carryover. IRC § 1212.

E. Discretionary and Residuary Distributions – Elective Recognition of Gain and Carryover or New Basis

1. Generally

A fiduciary may elect to recognize a gain or loss on distributions of property not governed by one of the other three rules. IRC § 643(e). The distributions that fall into this category are discretionary distributions, whether charged to income or principal, and residuary distributions of principal. Generally, such distributions carry out distributable net income (DNI) equal to the adjusted basis of the distributed asset in the fiduciary's hands, and the beneficiary receives a basis equal to the basis in the fiduciary's hands. IRC § 643(e)(1). The fiduciary may, however, elect to recognize gain or loss on the distribution as though it had sold the property to the beneficiary for its fair market value; the fiduciary recognizes gain or loss and treat the amount distributed as the fair market value of the property. IRC § 643(e)(3). For more on the Section 643(e) election, see also R.T. Danforth, N. Lane, & H.M. Zaritsky, *Federal Income Taxation of Trusts and Estates* ¶ 4.11[1][d] (Thomson-Reuters/WG&L, 3d ed. 2001 & Supp. 2018 No. 1) (from which this discussion is largely derived); and also Acker, *The Impact of TRA '84 on Trust and Estate Distributions of Property*, 124 Tr. & Est. 54 (Jan. 1985); Aucutt, *Tax Planning for In-Kind Distributions Increased by New Special Elections*, 62 J. Tax'n 48 (Jan. 1985); Bolling, *Tax Planning and Pitfalls of the DRA's In-Kind Property Distribution Rules*, 16 Tax Adviser 730 (1985); Fields, *Tax Benefits of Property Distributions by Trusts and Use of Multiple Trusts Restricted*, 11 Est. Plan. 264 (1985); Freeland, Maxfield & Sawyer, *Estate and Trust Distributions of Property in Kind After the Tax Reform Act of 1984*, 40 Tax L. Rev. 449 (1985); Gerhart, *Trust and Estate*

Income Taxes Changed by Tax Reform Act, 124 Tr. & Est. 16 (Jan. 1985); Salzarulo, *When to Elect to Recognize Gain or Loss on Distributions of Estate or Trust Property*, 13 Est. Plan. 38 (1986); Vogel and Steinkamp, *Distributions of Income in Respect of a Decedent After the Tax Reform Act of 1984*, 10 Rev. Tax. Ind. 316 (Autumn 1986); Zeitlin, *Revised Distribution Rules Change Tax Planning for Estates and Trusts*, 14 Tax'n Law. 4 (July/Aug. 1985).

2. Nondeductibility of Elected Losses

Although Section 643(e)(3)(A)(II) states that the entity recognizes a gain or loss when it makes this election, Section 267 still precludes a deduction for the recognized loss. It is unclear what is the beneficiary's basis when a fiduciary elects to recognize loss on a distribution, which loss deduction is then disallowed by Section 267. The beneficiary's basis could be the fiduciary's basis for all purposes, or it could be, as Section 267(d) states, a basis for computing gain equal to the fiduciary's basis but a basis for computing loss equal only to the fair market value at the time of the distribution. Section 643(e)(1) states that the basis to the beneficiary is the adjusted basis to the estate or trust immediately before the distribution "adjusted for...any gain or loss recognized to the estate or trust on the distribution."

3. Timing of the Election

Section 643(e)(3)(B) requires the election to recognize gain or loss to be made on the fiduciary income tax return for the year in which the distribution is made. The IRS will, however, occasionally permit a fiduciary to make a late election or revocation. Rev. Proc. 92-85, 1992-2 CB 490, and Rev. Proc. 93-28, 1993-2 CB 344, set out the standards the IRS will use to determine whether to grant a discretionary extension under Reg. § 301.9100-1 of time to make an election when the due date of the election is fixed by regulation rather than by statute. On the discretionary extension rules generally, see also Gillett, *Substantial Compliance, the 9100 Regulations, and the Special Use Election*, 5 Prob. Prac. Rep. 1 (July 1993).

4. DNI and the Election to Recognize Gain

In the absence of an election to recognize gain, property distributed in kind is taken into account, for purposes of computing the distribution deduction under Section 661 and the amount included in the beneficiary's income under Section 662, at the lesser of its adjusted basis to the fiduciary or its fair market value at the time of distribution. When the fair market value limitation applies for purposes of computing the distributions deduction and the amount includable in the beneficiary's gross income, however, the trust's adjusted basis in the property still carries out to the beneficiary, unless the fiduciary elects to recognize loss. Fiduciaries should not elect to recognize loss, however, because the loss is disallowed under Section 267, and the beneficiary may get only a partial, rather than total, carryover of basis, as previously explained.

5. Consistent Elections

A fiduciary must make consistent elections for all distributions made during a single taxable year. No consistency is required between different taxable years. IRC § 643(e)(3)(B).

6. Revocation of Election

The Section 643(e) election, once made, may be revoked only with the consent of the Secretary. To date, this has been permitted only twice.

a) PLR 8822016

In PLR 8822016, a testamentary trust was to terminate when B turned 30, and when he did, trustee distributed to him a house in which B lived. Trust distributed to C, another beneficiary, ten acres of unimproved land. A vice president of Bank's trust department told C that the taxes had been taken care of and that, at most, C would have to pay a small capital gain of not more than $2,000. The property distributions were reflected on the trust's final tax return, which was prepared by Bank's tax department. During preparation a reviewer noticed that the basis of the property distributed to C exceeded the basis of the property distributed to B and became concerned that this difference would lead to a disproportionate sharing of DNI (which would have been about $4,000. Reviewer asked the return preparer to consider whether trust should make the Section 643(e)(3) election. The return preparer discussed the election with the trust's administrator and made the election, believing that it had been approved. The administrator, however, denied that the tax consequences were ever discussed and no one had any conversation with or considered the circumstances of B or C. The trustee mailed the final K-1s to B and C, each reflecting a capital gain exceeding $29,000 which was largely due to the Section 643(e) election. After C protested, Bank asked for consent to revoke the election. Both B and C joined in Bank's request and represented that: (1) retroactive tax planning was not the reason for seeking to revoke the election; and (2) the bases of the properties received will be the same in the hands of B and C as the hands of the trustee before the distributions. The IRS allowed the revocation, noting that (a) the trustee timely filed its final return; (b) the trustee was diligent in having that return prepared by Bank's tax department; (c) C was diligent in asking about the tax ramifications of the distributions; (d) C acted promptly when her K-1 did not comport with Bank's prior statements; (e) Bank promptly filed a request to revoke the Section 643(e) election after C's contact and after Bank's discovery of its error; (f) there was no evidence that B or C used a stepped-up basis (available only under the election) to calculate any gain, loss or deduction; and (g) there was no evidence that B, C, or the trust's administrator ever intended to have the election made.

b) PLR 9641018

In PLR 9641018, Bank was executor of A's estate and trustee of a testamentary trust. Bank prepared the estate's final Form 1041, reporting certain capital gains from the funding of the trust with appreciated assets. Bank made the Section 643(a)(3) election. When preparing the return, Bank was advised by its in-house accountants that the estate was required to recognize gains upon the funding of the trust, and that the Section 643(e)(3) election was made only because the gains were being reported, and not because the estate intended to recognize any gains that were not otherwise required to be reported. After filing the return, Bank discovered that, absent the Section 643(e)(3) election, the estate was not required to recognize gains upon the funding of the trust with appreciated assets. Immediately after this discovery, Bank submitted a request for permission to revoke the election. The IRS allowed the revocation, noting that: (a) the final income tax return for the estate was timely filed; (b) Bank was diligent in seeking advice from its accountants as to the appropriate treatment of funding the trust with appreciated assets; (c) the estate would not have made the election, but for Bank's mistaken understanding of the law; (d) the estate had no intent to recognize gain except to the extent required by law; (e) the bases of the assets transferred to the trust will be the same in the hands of the trustee as in the hands of the estate before funding the trust; and (f) Bank promptly filed a request to revoke the election after it discovered its error.

7. Planning with the Section 643(e) Election

The decision whether or not to make a Section 643(e)(3) election will often be difficult; many variables can affect its desirability. The fiduciary should consider the following factors:

- The respective current and probable future marginal tax rates of the entity and beneficiary;
- The likelihood of sale by the beneficiary in the near future;
- The trade-off between capital gain and higher basis for depreciation, if the appreciated asset is depreciable following its distribution to the beneficiary;
- The availability of capital loss carry-forwards to one party or both; and
- The requirement for consistent treatment of all distributions.

F. Combining a Deduction and a Basis Increase – Section 642(g)

1. Limit on Double Deductions Generally

Section 642(g) states that amounts allowable as estate tax deductions under Section 2053 or 2054 cannot also be allowed as an income tax deduction or as an offset against the sales price of property in determining gain or loss. If one wants to claim deductions on the Form 1041, one must also file, within the time and in the manner and form prescribed by the Secretary, a statement that the amounts have not been allowed as deductions under Sections 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under those sections. Similar rules apply to amounts taken into account under Sections 2621(a)(2) (expenses taken into account in calculating the amount of a taxable distribution) or 2622(b) (expenses taken into account in calculating the amount of a taxable termination).

2. Is Basis Increase a Double Deduction?

In *Long v. Comm'r*, 71 T.C. 724 (1980), *aff'd on other issues*, 660 F.2d 416 (10th Cir. 1981), the Tax Court held that an estate whose decedent was a member of a partnership could both deduct its share of partnership liabilities paid out of estate funds as a claim against the estate under Section 2053, and also increase its basis in the partnership interest by the liabilities so paid, thereby generating a larger capital loss on liquidation of the estate's partnership interest. The rationale of Long appears applicable despite the present Section 642(g) which was enacted in 1976. *Long* involved pre-1976 taxable years, and the court noted that Section 642(g) (as it then read) only barred deductions, and that an increase in basis is not the same as a deduction, though it may potentially increase future deductions.

XXV. PROBLEM BASIS SITUATIONS: BASIS FOR CERTAIN NON-CHARITABLE INTERESTS IN CHARITABLE REMAINDER TRUSTS – BEWARE THE PROPOSED REGULATIONS

A. Notice 2008-99 – Disposition of a Charitable Remainder Trust Annuity or Unitrust Interest

In Notice 2008-99, 2008-47 I.R.B. 1194 (Nov. 24, 2008), the IRS and Treasury described a transaction in which all of the interests in a charitable remainder trust are sold, after a contribution of appreciated assets to the trust and the reinvestment of those assets by the trustee.

1. The Claim

Promoters of this arrangement claimed that it results in the grantor or other noncharitable recipient receiving the value of that person's trust interest, with little or no taxable gain.

2. Primary Variation

In one variation of the transaction, the grantor funded a charitable remainder trust with appreciated assets, retaining the noncharitable interest and the right to designate the charitable remainder beneficiary. The trust then sold or liquidated the appreciated assets and reinvested the net proceeds in other assets, such as money market funds or marketable securities, often creating a diversified portfolio. No tax was due on the sale, because the trust was a charitable remainder trust. The trust's basis in the new assets is their purchase price. Next, the grantor and the charity would sell or otherwise dispose of their respective interests in the trust to an unrelated third party, for an amount that approximated the current fair market value of the trust assets. The promoters contended that this joint disposition is (a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons, as described in Section 1001(e)(3), and that the grantor and the charity each can apply their proportionate share of the trust's adjusted basis against the amount realized, to avoid taxable gain on the transaction. The trust then terminated, and the trust assets were distributed to the buyer.

Example XXV-1

Grantor, an individual, creates a charitable remainder unitrust on Date 1 and retains the unitrust interest. Grantor funds the trust with stock in which Grantor's basis is $10x. The trustee thereafter sells the stock for $100x, realizing a $90x long-term capital gain, which gain is exempt from income tax under Section 664(c)(1). The trustee applies the sales proceeds, $100x, to buy Y stock. The trustee thereafter sells the Y stock for $110x and applies the proceeds to buy Z stock. The trustee's basis in the Z stock is then $110x, and the trust's undistributed net capital gains are $100x.

The fair market value of trust's assets grows to $150x and the trust has no undistributed net ordinary income. Grantor and the remainder beneficiary jointly sell all of their interests in the trust to a third person, dividing the proceeds actuarially. Grantor receives $100x for the unitrust interest, and Charity receives $50x for the remainder interest. The entire interest in the trust was transferred to the third person, so Section 1001(e)(3) states that Grantor's gain is determined using as Grantor's basis Grantor's actuarial share of the $110x adjusted uniform basis -- $73 1/3x. Grantor receives $100x but pays capital gains tax on only $26 2/3x. Grantor's built-in gain on the creation of the trust had been $90x.

3. Other Variations

Some variations of this transaction used a net income charitable remainder unitrust with make-up provision (NIMCRUT) or a pre-existing charitable remainder unitrust or NIMCRUT (often holding the appreciated assets contributed to the trust). In some variations, the recipient and seller of the term interest would be the grantor and/or another person, or the grantor might contribute the appreciated assets to a partnership or other pass-through entity and then contribute the interest in the entity to the trust.

4. Transactions of Interest

The Notice classified these transactions as "transactions of interest," and added that:

> *"The IRS and Treasury Department are not concerned about the mere creation and funding of a charitable remainder trust and/or the trust's reinvestment of the contributed appreciated property, and such events alone do not constitute the transaction subject to this notice.*
>
> *However, the IRS and Treasury Department are concerned about the manipulation of the uniform basis rules to avoid tax on gain from the sale or other disposition of appreciated assets."*

B. New Regulations Offer a Solution

In 2017, Treasury amended the income tax regulations to add a special rule for the sale or other disposition of a unitrust or annuity interest in a charitable remainder trust, where the entire trust is being disposed of. Reg. § 1.1014-5(b). The regulations state:

> "***(b) Sale or other disposition of certain term interests****—(1) In general. In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001-1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent), section 1015 (relating to the basis of property acquired by gift or by*

a transfer in trust), or section 1022 (relating to the basis of property acquired from certain decedents who died in 2010), that part of the adjusted uniform basis assignable under the rules of paragraph (a) of this section to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and § 1.1001-1(f). reduce the Grantor's basis by a share of the trust's undistributed net ordinary income and its undistributed net capital gains."

82 Fed. Reg. 6235 (Jan. 19, 2017). The regulations apply to sales and other dispositions of interests in charitable remainder trusts after January 19, 2017. Reg. § 1.1014-5(b)(2).

Example XXV-2

Assume the same facts as in the prior example, except that the proposed regulations have been finalized. Grantor's adjusted basis will be reduced by Grantor's share of the undistributed net ordinary income ($0) and Grantor's share of the undistributed net capital gain ($100x). Grantor's adjusted basis will be 2/3 x ($110x - $100x), or $6.67x, and Grantor will recognize a $93.33x gain on the sale of the annuity or unitrust interest. Reg. § 1.1014-5(d), Ex. 7.

XXVI. PROBLEM BASIS SITUATIONS: BASIS AND LIFE INSURANCE POLICIES

A. Generally

Generally, an insured's basis in the contract is the total premiums the insured had paid, reduced by the "cost of insurance protection" provided throughout the date of the sale, and nontaxable dividends the insured has received under the contract. Rev. Rul. 70-38, 1970-1 C.B. 11. The premiums paid, less the "cost of insurance protection," are equal to those portions of the premiums paid that increase the cash surrender value of the policy. See *e.g.*, *London Shoe Co. v. Comm'r*, 80 F.2d 230 (2d Cir. 1935); *Century Wood Preserving Co. v. Comm'r*, 69 F.2d 967 (3d Cir. 1934); *Keystone Consol. Publ'g. Co. v. Comm'r*, 26 B.T.A. 1210 (1934). See also PLR 9443020 (Oct. 28, 1994) (amounts paid to a dying individual by a viatical settlement company on the assignment of his life insurance contract was a sale of the policy, but the gain was limited to the excess of the amount paid over the insured's basis in the policy, including the total premiums the insured had paid, reduced by the "cost of insurance protection" provided throughout the date of the sale and nontaxable dividends he received under the contract. The IRS also stated that, absent proof to the contrary, the cost of insurance protection is essentially the difference between the total amount of premiums paid and the policy's cash value (after any surrender charges)).

B. ILS 200504001 – Policy Basis in a Strange Context

1. Facts

In Internal Legal Memorandum 200504001, the taxpayer owned two life insurance policies issued by the same insurer. One policy insured the taxpayer's own life, and the other insured the life of her ex-husband. The insurer reduced the death benefit payable under the policy insuring the taxpayer's ex-husband's life, after the taxpayer had paid premiums for five years. The taxpayer later surrendered the policy on her own life. The taxpayer claimed that the insurer made several misrepresentations to encourage her to convert the policy on her ex-husband's life. Primarily, the insurer claimed that no additional premiums would be necessary if the taxpayer used the policy's cash surrender value to pay for a new policy. The insurer lied.

The taxpayer was a member of a class of policyholders that sued the insurer, claiming that it had "fraudulently induced class members to surrender, borrow against or otherwise withdraw values from their existing policies in order to purchase new policies." The class also claimed that the insurer had "misrepresented the true financial effect of the transaction and uniformly failed to disclose to class members that the switch was against the best interests of the class members."

The taxpayer and the class won their court case, and in 2001, the taxpayer received an award. Part of the award represented interest, which the taxpayer agreed was ordinary taxable income. None of the award represented punitive damages, which would also have been ordinary taxable income.

2. Taxpayer's Arguments

The taxpayer contended that the balance of the award (above the interest portion) was a tax-free recovery of the premiums and costs she had paid with respect to the policy. She had paid these amounts with after-tax dollars, so the recovery should be tax-free, she claimed.

3. IRS Agent and Area Counsel Arguments

The IRS revenue agent and the IRS Area Counsel claimed that not all of the non-interest damages were tax-free, because the taxpayer had, for five years, received the benefit of the original policy through present insurance coverage on the life of her ex-husband. The taxpayer now had the benefit of the replacement life insurance policy. Thus, the revenue agent and area counsel argued, no portion of the taxpayer's payments for the life insurance policy on her ex-husband's life could offset the taxable portion of the award.

4. National Office Analysis and Rulings

The IRS National Office agreed that the taxpayer was not taxable on that portion of the award that merely compensated her for a loss of pre-tax dollars, because she would have no economic gain that could be taxed. The question, they said, was how much was the taxpayer's basis in the policy on her ex-husband's life, because that would be the measurement of her loss. The IRS relied primarily on the 1934 Third Circuit decision in *Century Wood Preserving Co. v. Comm'r*, *supra*., and Rev. Rul. 70-38, 1970-1 C.B. 11, and stated that the taxpayer had already had the benefit of the annual insurance protection, and that her basis included only the excess premiums that increased the policy's cash surrender value. The IRS stated that the basis of the taxpayer's former policy on the life of her ex-husband was the premiums she had paid, less:

> 1. The cost of insurance protection provided through the date of sale (e.g., loading, expense, and mortality charges, and administrative fees); and
>
> 2. Amounts received under the contract that have not been included in the taxpayer's gross income.

The IRS stated, in part, that the taxpayer's taxable income from the award should not be reduced for the cost of the benefit provided for five years, or the value of the replacement policy that the taxpayer received. Those benefits were separately provided to the taxpayer and should not be deemed to increase her loss.

C. Rev. Ruls. 2009-13 and 2009-14

The IRS addressed the calculation of the adjusted basis in life insurance policies in two revenue rulings issued in 2009. See also Gorin, *IRS Takes Formal Position on Income Taxation of Certain Transfers of Life Insurance Policies*, 34 Tax Mgmt. Estates, Gifts &

Tr. J. 17 (July 2009); and Leimberg & Zaritsky, *IRS Finally Explains the Income Taxation of the Sale of a Life Insurance Policy*, 21 Prob. Pract. Rep. 1 (June 2009).

1. Rev. Rul. 2009-13

Rev. Rul. 2009-13, 2009-1 C.B. 1029 involved the income tax treatment of the surrender of a cash value life insurance policy.

a) Situation 2. Sale of a Cash Value Life Insurance Policy

(1) Facts

In Situation 2, A, a cash method, calendar year individual who bought and owned an insurance contract on A's own life. The policy had cash values and the named beneficiary was a member of A's family. A had the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value. The contract was a capital asset in A's hands. On June 15 of Year 8, A sold the contract to B, an unrelated person, for $80,000. B would suffer no economic or personal loss upon A's death.

(2) IRS Analysis and Ruling

(a) Gain Realized

The IRS ruled that A's gain on the sale was the excess of the amount realized by A on the sale, over A's adjusted basis in the contract. IRC §§ 1011 and 1012. A realized $80,000 -- the sum received on the sale.

(b) Adjusted Basis

A's adjusted basis in the insurance contract was its cost, adjusted to reflect expenditures, receipts, losses, or other items properly chargeable to capital account. IRC § 1016(a)(1). The IRS reduced A's basis by the cost of the pure life insurance protection prior to the sale. *London Shoe Co. v. Comm'r, supra*.; *Century Wood Preserving Co. v. Comm'r, supra*.; and *Keystone Publishing Co. v. Comm'r*, 26 B.T.A. 1210 (1932). The IRS measured the cost of insurance by the $10,000 by which the insurer reduced the cash surrender value to reflect cost-of-insurance charges. Thus, A's adjusted basis in the contract was $54,000 ($64,000 premiums - $10,000 cost of insurance), and A recognized a $26,000 gain ($80,000 - $54,000).

(c) Character of Gain

The IRS applied the "substitute for ordinary income doctrine," which convert s part of the gain on a sale into ordinary income, because neither "property" nor "capital asset" includes "property representing income items or accretions to the value of a capital asset themselves properly attributable to income." *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965); *Comm'r v. P.G. Lake, Inc.*, 356 U.S. 260 (1958); *Arkansas Best Corp. v. Comm'r*, 485 U.S. 212, 217, n.5 (1988); *Prebola v. Comm'r*, 482 F.3d 610 (2d Cir. 2007); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004); *Davis v. Comm'r*, 119 T.C. 1 (2002). This doctrine is limited to the amount that would be recognized as ordinary income if the contract were surrendered, which the IRS said was the inside build-up under the contract -- the excess of the cash surrender value over the premiums paid. Capital gains treatment is afforded the excess of the gain realized over the inside build-up. *Comm'r v. Phillips*, 275 F.2d 33, 36 n. 3 (4th Cir. 1960). Here, the inside build-up under A's life insurance contract immediately prior to the sale was $14,000 ($78,000 cash surrender value less $64,000 aggregate premiums paid). A must recognize $26,000 of gain, of which $14,000 is ordinary income and $12,000 is capital gain.

b) Situation 3. Sale of Term Life Insurance Policy

(1) Facts

The facts in Situation 3 were identical to those in Situation 2, except that the contract was a level premium fifteen-year term life insurance contract with no cash surrender value. The monthly premium was $500 and A paid a total of $45,000 in premiums through the date of sale. A sold the policy to B for $20,000.

(2) IRS Analysis and Rulings

The IRS applied the same rules that it used in Situation 2, noting that the amount realized from the sale was the $20,000 that A received from B.

(a) Basis

The IRS stated that, absent any other proof, the cost of the pure life insurance protection would be presumed to be equal to the entire premium paid. Therefore, $44,750 of the total premium payments was attributable to pure life insurance protection and was not included in A's adjusted basis. A's

adjusted basis was $250 (the unexpired portion of the last premium), and A would recognize a gain of $19,750 on the sale ($20,000 amount realized - $250 basis).

(b) Character of Gain

The IRS explained, further, that the entire gain would be capital gain, because there was no investment component to which the substitution for income doctrine could apply.

c) The Tax Cuts and Jobs Act of 2017

The 2017 TCJA overruled Rev. Rul. 2009-13 with respect to the basis of a cash value life insurance contract. The 2017 TCJA provides that, in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as "cost of insurance"). This reverses the position taken regarding basis in Rev. Rul. 2009-13. 2017 TCJA § 13521(a). This change applies to transactions entered into after August 25, 2009. 2017 TCJA § 13521(b).

2. Rev. Rul. 2009-14

In Rev. Rul. 2009-14, 2009-1 C.B. 1031, the IRS also issued this ruling addressing the income tax consequences to the third-party buyer of a life insurance contract, regarding the collection of the death benefit or the resale of the policy. This ruling also posited three situations.

a) Situation 1: Receipt of Death Benefit by Third Party Purchaser

(1) Facts

B, a cash basis, calendar year, U.S. taxpayer bought a life insurance contract on the life of A. The sale occurred on June 15, 2008 and the sales price was $20,000. The contract originally issued to A on January 1, 2001, by a domestic insurer, and, was a level premium fifteen-year term life insurance contract with no cash surrender value. At the time of purchase, the remaining term of the contract was 7 years, 6 months, and 15 days. The monthly premium was $500, payable on the first day of each month. After the purchase, B continued to pay the premiums. B had paid $9,000 of premiums by December 31, 2009, when A died. The insurer paid a $100,000 death benefit to B. B had no insurable interest in A's life and B bought the contract with a view to profit, promptly naming itself beneficiary. The contract in B's hands was a capital asset. The likelihood that B would allow the contract to lapse by failing to pay any of the remaining premiums was remote.

(2) IRS Analysis and Rulings

(a) Basis and Realization of Gain

The IRS ruled that B must recognize $71,000 of ordinary income on the receipt of death benefits. The amount realized was $71,000 ($100,000 death benefit - $20,000 sales price - $9,000 premiums), and B can exclude from gross income the $20,000 B paid for the policy and the $9,000 of premiums B paid after the sale.

(b) Character of Gain

The IRS stated that the gain on the receipt of the death benefit is ordinary income, because although the policy might be a capital asset in B's hands, neither the surrender of a life insurance contract nor the receipt of a death benefit from the issuer under the terms of the contract is a sale or exchange. Therefore, all realized gain must be taxed as ordinary income.

b) Situation 2: Resale of the Contract by the Buyer

(1) Facts

The facts in Situation 2 were identical to those of Situation 1, except that B resold the policy to C, a person unrelated to A or B. The sale occurred on December 31, 2009, and the sales price was $30,000.

(2) IRS Analysis and Rulings

(a) Basis and Realization of Gain

The IRS ruled that B should recognize a $1,000 capital gain on this sale. The IRS stated that B's gain on the resale of the contract would be the amount realized by B on the resale ($30,000) over B's adjusted basis in the contract ($29,000).

As in Situation 1, B's adjusted basis in the contract included both the amount B paid to A for the contract ($20,000) and the premiums B paid after the purchase to maintain the policy in force ($9,000).

The IRS explicitly stated that "B is not required to reduce its basis in the life insurance contract by any cost of insurance charges that may have been imposed," because B is wholly unrelated to A, the policy was not bought to protect B against any economic loss upon A's death, B bought the policy

solely with a view to profit, and the additional premiums were paid solely to prevent the loss of B's financial investment. Thus, B's basis for a resale is computed differently from A's basis on the initial sale.

(b) Character of Gain

The IRS stated that the gain on the resale was a capital gain, because the policy was property owned by B and was not described in any of the exceptions from the definition of a capital asset under Section 1221(a), and because there was a sale or exchange. Assuming that B meets the holding period requirements, B's gain on the resale is taxable as a long-term capital gain. The substitute for ordinary income doctrine will not apply, because the contract was a term contract with no cash value.

(3) Effective Date.

While Rev. Rul. 2009-13 stated that it was not retroactive, Rev. Rul. 2009-14 contains no such representation. Therefore, this ruling should be applied retroactively.

South Carolina Bar
Continuing Legal Education Division

The Intersection of Probate Law & Family Law

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Introduction

Family Court Jurisdiction: "Notwithstanding another provision of law, the family court and the probate court have concurrent jurisdiction to hear and determine matters relating to paternity, common-law marriage, and interpretation of marital agreements; except that the concurrent jurisdiction of the probate court extends only to matters dealing with the estate, trust, and guardianship and conservatorship actions before the probate court." S.C. Code Ann. § 63-3-530.

Probate Court Jurisdiction: "To the full extent permitted by the Constitution, and except as otherwise specifically provided, the probate court has exclusive original jurisdiction over all subject matter related to:

(1) estates of decedents, including the contest of wills, construction of wills, determination of property in which the estate of a decedent or a protected person has an interest, and determination of heirs and successors of decedents and estates of protected persons, except that the circuit court also has jurisdiction to determine heirs and successors as necessary to resolve real estate matters, including partition, quiet title, and other actions pending in the circuit court;

(2) subject to Part 7, Article 5:

(i) protective proceedings and guardianship proceedings under Article 5;

(ii) gifts made pursuant to the South Carolina Uniform Gifts to Minors Act under Article 5, Chapter 5, Title 63;

(iii) matters involving the establishment, administration, or termination of a special needs trust for disabled individuals;

(3) trusts, inter vivos or testamentary, including the appointment of successor trustees;

(4) the issuance of marriage licenses, in form as provided by the Bureau of Vital Statistics of the Department of Health and Environmental Control; record, index, and dispose of copies of marriage certificates; and issue certified copies of the licenses and certificates . . .

(c) The probate court has jurisdiction to hear and determine issues relating to paternity, common-law marriage, and interpretation of marital agreements in connection with estate, trust, guardianship, and conservatorship actions pending before it, concurrent with that of the family court pursuant to Section 63-3-530.

I. Tax Cuts and Jobs Act of 2017

A. Alimony. Effective January 1, 2019, all **new** alimony orders or separation agreement that are not modifications of pre-2019 orders or agreements will have alimony as nontaxable to the payee and nondeductible by the payor. This is a **permanent** change and is not scheduled to revert back to prior law in 2026. (see alimony material attached)

B. Transfer Taxes. The Act (temporarily) increases the exemption level for estate, gift and generation skipping transfer taxes from $5,000,000 to $10,000,000. The exemption is indexed for inflation and, for 2019, the exemption level is $11,400,000 per individual. For married couples, the combined exemption amount for transfer taxes is $22,800,000. On January 1, 2026, the exemption level is scheduled to return to $5,000,000, indexed for inflation.

II. Validity of Marriage

A. Common Law Marriage.

i. S.C. Code Ann. § 20-1-360 (1976) states "Nothing contained in this article shall render illegal any marriage contracted without the issuance of a license."

ii. Common Law marriage requires an informal (but mutually understood) agreement of a man and woman to be married, both having the capacity to marry, without obtaining statutory marriage license, accompanied or followed by cohabitation, the couple publicly representing themselves to be married. No fixed time period of cohabitation is required to establish common law married in South Carolina. *Rodgers v. Herron*, 226 S.C. 317, 85 S.E.2d 104 (1954).

1. The South Caroline Supreme Court in *Bell v. Progressive Direct Insurance Company* 407 S.C. 565, 757 S.E.2d 399, 408 (2014) stated: "A common-law marriage is formed when two parties contract to be married." However, "[n]o express contract is necessary;" instead, "the agreement may be inferred from the circumstances." Therefore, [t]he fact finder is to look for mutual assent: the intent of each party to be married to the other and a mutual understanding of each party's intent. Consideration is the participation in the marriage. If these factual elements are present, then the court should find as a matter of law that a common-law marriage exists. Moreover, "when the proponent proves that the parties participated in 'apparently matrimonial' cohabitation, and that while cohabitating the parties had a reputation in the community as being married, a rebuttable presumption arises that a common-law marriage was created." "A party may overcome the presumption by presenting "'strong, cogent'" evidence that the parties in fact never agreed to marry." (internal citations omitted).

iii. Once a valid common law marriage has been established nothing less than death or a judgment of divorce can dissolve the relation.

iv. Family court and probate court have "concurrent" jurisdiction to determine issues relating to common-law marriage. 62-3-530(B); 62-1-302(c). However, the Supreme Court has drawn the distinction of whether the ultimate issue relates to heirship (exclusive jurisdiction probate court) or existence of common law marriage (exclusive jurisdiction family court) *Thomas v. McGriff* 629 S.E.2d 359, 360 (2006).

v. Further, while both parties are alive, the determination of a common-law marriage is determined by a "preponderance of the evidence." *Callen v. Callen* 365 S.C. 618, 620 S.E.2d 59, 62 (2005). If the determination occurs after the death of a party, the court requires "clear and convincing evidence" S.C. Code Ann. § 62-2-802(b)(4).

B. Same Sex Couples

i. The Federal Court has established that same sex marriage is a fundamental right inherent in the liberty of the person, under the equal Protection Clauses of the 14th Amendment and that same sex couples have this right. Obergefell ordered that States must recognize lawful same-sex marriages performed in other states. *Obergefell v. Hodges*, 135 S.Ct. 2584, 2599 (2015)

ii. *Condon v. Wilson*, 21 F.Supp.3d 572, 587 (D.S.C.2014) - Held that S.C. Code Ann. § 20-1-10(B)-(C), S.C. Code Ann. § 20-1-15 and S.C. Constitution art. XVII, § 15, to the extent they seek to prohibit the marriage of same sex couples who otherwise meet all other requirements for marriage in South Carolina, unconstitutionally infringe on the rights of Plaintiffs under the Due Process Clause and Equal Protection Clause of the Fourteenth Amendment of the United States Constitution and are invalid as a matter of law." In the *Condon* order, Judge Gergel also issued a permanent injunction, enjoining Defendant and Charleston County Probate Judge Irvin G. Condon and "their officers, agents, servants and employees" from enforcing the provisions, from "interfering in any manner with Plaintiffs' fundamental right to marry or in the issuance of a marriage license to Plaintiffs," and from "refusing to issue Plaintiffs a marriage license if, but for their sex, they are otherwise qualified to marry under the laws of South Carolina." Id.

III. Paternity

A. Legal Parent, Biological Parent, Psychological Parent, De Facto Parent

i. S.C. Code 1976 § 63- 17-790 Establishment of Paternity.

ii. S.C. Code 1976 § 63- 17-60 for Admissibility of Paternity.

iii. **Legal Parent** - a legal parent's fundamental right to custody and control of a child may be infringed upon by the state if the parent endangers the health or safety of the child. *V.C. v. M.J.B.*, 163 N.J. 200, 218, 748 A.2d 539, 548 (2000)

iv. **Biological Parent** - parent to child by blood

v. **Psychological Parent** - a psychological parent can be granted visitation with a child, even when a fit biological parent opposes it. In order to demonstrate the existence of a psychological parent-child relationship the petition must show:

1. That the biological or adoptive parents consented to, and fostered, the petitioner's formation and establishment of a parent-like relationship with the child;
2. That the petitioner and the child lived together in the same household;
3. That the petitioner assumed obligations of parenthood by taking significant responsibility for the child's care, education and development, including contributing towards the child's support, without expectation of financial compensation; and
4. That the petitioner has been in a parental role for a length of time sufficient to have established with the child a bonded, dependent relationship parental in nature.
5. A "psychological parent," who has greater protection under the law in a child custody proceeding than would ordinarily be afforded to one who is not the biological or adoptive parent of the child, is a person who, on a continuing day-to-day basis, through interaction, companionship, interplay, and mutuality, fulfills a child's psychological and physical needs for a parent and provides for the child's emotional and financial support. *Middleton v. Johnson*, 369 S.C. 585, 596, 633 S.E.2d 162, 168 (Ct. App. 2006).

B. **De Facto Parent** - "de facto custodian" means, unless the context requires otherwise, a person who has been shown by clear and convincing evidence to have been the primary caregiver for and financial supporter of a child who: (1) has resided with the person for a period of six months or more if the child is under three years of age; or (2) has resided with the person for a period of one year or more if the child is three years of age or older. S.C. Code 1976 § 63-15-60.

i. *De facto* parent is defined as a person who has been found by the court to have assumed, on a day-to-day basis, the role of parent, fulfilling both the child's physical and psychological needs for care and affection, and who has assumed that role for a substantial period. *Middleton v. Johnson,* 369 S.C. at 595, 633 S.E.2d at 168 (*Marquez v. Caudill*, 376 S.C. 229, 241, 656 S.E.2d 737, 743 (2008).

C. Intestacy - Parent Child Relationship

i. S.C. Code Ann. §62-2-109 defines a parent child relationship for intestacy purposes. An adopted person is the child of an adopting parent. If there is no formal adoption, a person born out of wedlock is a child of the mother. That person is also a child of the father in two scenarios:

1. **Marriage Ceremony**. If the natural parents participate in a marriage ceremony before or after birth of child, even though attempted marriage is void, then the person is a child of the father.

2. **Legal Adjudication**. Paternity of the father may also be established by an adjudication commenced before the death of the father or within the later of 8 months after death of father or 6 months after the initial appointment of a personal representative of the father's estate. If the adjudications occurs after death, clear and convincing proof is required. Father cannot inherit from deceased child unless the father has openly treated the child as his and has not refused to support child.

IV. Children

A. Guardians

i. Family Law

1. "Guardian ad Litem" (GAL) has role of investigating the issue related to children.
2. Under SC Code Ann. § 63-3-810 (2009), GAL is appointed when the facts of the case and there is substantial dispute which necessitates a guardian ad litem; or
3. Both parties consent to the appointment of the GAL who is approved by the court.
4. The court has complete discretion in determining who will be appointed as GAL in each case. GAL must be appointed by the court.
5. SC Code Ann. § 63-3-820 (2009), contains the qualifications that are required of a GAL.
6. SC Code Ann. § 63-1-810 (2009) contains the responsibilities and duties of a GAL.

ii. Probate Law

1. S.C. Code Ann. §21-21-25 provides: The father of any child under the age of twenty-one years and not married, if the mother is dead, or the mother of any such child, the father being dead, whether the father or mother is <u>under the age of twenty-one years</u>, or of full age, may by deed executed and recorded according to law or <u>by last will and testament, made and probated according to law</u>, dispose of the <u>custody</u> and tuition of the child while he remains under the age of twenty-one years to any other person, in possession or remainder. No deed is valid unless signed by both father and mother, if both are living and no such deed, except a deed to an agency or department of this State authorized by law to receive or place the custody of children, is effective unless approved upon petition by a family court or family court judge of this State. Nothing in this section may be construed to abrogate, lessen, or interfere with the right and duty of a <u>court of competent jurisdiction</u> at any time to transfer and assign the <u>custody</u> of a child for its <u>best interest</u>.

B. Custody/Child Support.

i. **Jurisdiction to Decide Custody.** Family Court has the jurisdiction to decide custody. S.C. Code Ann. § 63-3-530.

ii. **Family Court until 18**

1. S.C. Code Ann. § 63-3-510, whenever the court has acquired the jurisdiction of any child under eighteen years of age, jurisdiction continues so long as, in the judgment of the court, it may be necessary to retain jurisdiction for the correction or education of the child, but jurisdiction shall terminate when the child attains the age of twenty-two years. Any child who has been adjudicated delinquent and placed on probation by the court remains under the authority of the court only until the expiration of the specified term of his probation. This specified term of probation may expire before but not after the twentieth birthday of the child.

iii. **Child Support after 18**

1. To make all orders for support run until further order of the court, except that orders for child support run until the child turns eighteen years of age or until the child is married or becomes self-supporting, as determined by the court, whichever occurs first, or past the age of eighteen years if the child is enrolled and still attending high school, not to exceed high school graduation or the end of the school year after the child reaches nineteen years of age, whichever is later; or in accordance with a preexisting agreement or order to provide for child support past the age of eighteen years; or in the discretion of the court, to provide for child support past age eighteen when there are physical or mental disabilities of the child or other exceptional circumstances that warrant the continuation of child support beyond age eighteen for as long as the physical or mental disabilities or exceptional circumstances continue. When child support is terminated due to the child turning eighteen years of age, graduating from high school, or reaching the end of the school year when the child is nineteen, no arrearage may be incurred as to that child after the date of the child's eighteenth birthday, the date of the child's graduation from high school, or the last day of the school year when the child is nineteen, whichever date terminated the child support obligation.

2. S.C. Code Ann. § 20-7-420 Once child turns 18, a parent's obligation to pay child support generally ends by operation of law.

3. Where a disability prevents a child from becoming emancipated, the presumption of emancipation upon reaching majority is inapplicable, for child support purposes. *Riggs v. Riggs*, 353 S.C. 230, 578 S.E.2d 3.

4. For purposes of statute governing Family Court's jurisdiction to provide child support past age of 18, legislature intended that a noncustodial parent share burden of supporting a child who cannot be deemed emancipated because of a disability that arose before majority but was diagnosed only after child turned 18. *Riggs v. Riggs*, 353 S.C. 230, 578 S.E.2d 3.

5. *Thelma Louellen Frazier Risinger vs. Harvey Maxey Risinger*, 273 S.C. 36, 253 S.E.2d 652.

    a. *Risinger* is the criminal case that provides divorced parents may be required to contributed to the College expenses for their children.

    b. Overturned by *Webb v. Sowell*, 387 S.C. 328, 692 S.E.2d 543 (2010), overruled by *McLeod v. Starnes*, 396 S.C. 647, 723 S.E.2d 198 (2012)

V. Marital Agreements

A. Antenuptial Agreements

i. Family Law

1. **General.** Agreements between prospective spouses made in contemplation of marriage. They become effective only upon marriage. *South Carolina Loan &Trust Co. v. Lawton*, 69 S.C. 345, 48 S.E. 282 (1904).

    a. May deal with two types of issues

        i. Regulations of affairs between spouses on and during the marriage or the steps the parties will take in the event of separation or divorce. SC-MARLIT 14(C)(2)(a).

    b. In *Hardee v. Hardee*, 355 S.C. 382, 585 S.E.2d 501 (2003), the Supreme Court held that parties are free to contractually alter the obligations which would otherwise attach to marriage.

    c. Premarital contracts may be altered, rescinded, or revoked by the parties until they become part of a court order. SC-MARLIT 14(C)(2)(a).

    d. The Family Court may also disregard premarital agreements if they are unconscionable or it would be unfair or unreasonable to enforce the contract due to changed circumstances. SC-MARLIT 14(C)(2)(a).

2. **Specific Issues:**

    a. S.C. Code Ann. § 20-3-630

        (A)The term "marital property" as used in this article means all real and personal property which has been acquired by the parties during the marriage and which is

owned as of the date of filing or commencement of marital litigation as provided in Section 20-3-620 regardless of how legal title is held, except the following, which constitute nonmarital property:

1. property acquired by either party by inheritance, devise, bequest, or gift from a party other than the spouse;
2. property acquired by either party before the marriage and property acquired after the happening of the earliest of:
    a. entry of a pendente lite order in a divorce or separate maintenance action;
    b. formal signing of a written property or marital settlement agreement; or
    c. entry of a permanent order of separate maintenance and support or of a permanent order approving a property or marital settlement agreement between the parties;
3. property acquired by either party in exchange for property described in items (1) and (2) of this section;
4. property excluded by written contract of the parties. "Written contract" includes any antenuptial agreement of the parties which must be considered presumptively fair and equitable so long as it was voluntarily executed with both parties separately represented by counsel and pursuant to the full financial disclosure to each other that is mandated by the rules of the family court as to income, debts, and assets;
5. any increase in value in nonmarital property, except to the extent that the increase resulted directly or indirectly from efforts of the other spouse during marriage.

ii. Interspousal gifts of property, including gifts of property from one spouse to the other made indirectly by way of a third party, are marital property which is subject to division.

(B) The court does not have jurisdiction or authority to apportion nonmarital property.

b. Separate Property vs. Marital Property

i. *Bowman vs. Bowman*, 357 S.C. 146, 591 S.E.2d 564.

1. For property to be included within the term "marital property," two factors must exist: property must be (1) "acquired ... during the marriage" and (2) "owned as of the date of filing or commencement of marital litigation." S.C. Code Ann. § 20–7–473 (Supp.2002). The "acquired during marriage" component is generally established by showing that the property relates to compensation earned or effort expended during the marriage.

2. Once the Family Court determines that property is nonmarital, it has no jurisdiction to address its ownership or to deal with the property in any way. The Family Court determined that the parties' prenuptial agreement was enforceable. The agreement provided that property that was nonmarital before the marriage would remain nonmarital property.

c. Alimony.

i. Generally, a waiver of spousal support in a premarital agreement will be enforced unless the court finds the waiver unconscionable. We find the majority position best comports with the language in Stork and hold that antenuptial provisions waiving alimony and attorney fees are not per se void as against public policy. *Hudson v. Hudson*, 408 S.C. 76, 757 S.E.2d 727.

ii. Probate/Tax Law

1. Elective Share. South Carolina law provides that a surviving spouse has a right of election to take an elective share of one-third (1/3rd) of the decedent's probate estate, reduced by funeral and administration expenses and enforceable claims. For purposes of determining the elective share, the assets of a revocable trust are included. Surviving spouse is defined in §62-2-802. The elective share right can be waived, wholly or partially, before or after marriage, by a written contract, agreement or waiver voluntarily signed by waiving party after fair and reasonable disclosures of the other party's property and financial obligations S.C. Code Ann. §§ 62-2-201, 62-2-202, 62-2-204.

2. **Deceased Spouse Unused Exclusion ("DSUE").** The executor of a deceased spouse can make an election on the decedent's federal estate tax return to provide the surviving spouse with the ability to use the decedent spouse's "unused exclusion" from federal estate taxes. At a 40% estate tax rate, the 2019 exemption from federal estate taxes has a value of up to $4,560,000 to a surviving spouse that otherwise has a taxable estate. I.R.C. §2010(c)(4), §2010(c)(5).

    a. **Costs of Filing Return**

    b. **Not Applicable to GST Exemption**

3. **Retirement Accounts.** Subchapter D (Deferred Compensation) of Chapter 1 of the Internal Revenue Code sets forth certain rules relating to the taxation, operation and governance of deferred compensation arrangements. Specifically, certain types of deferred compensation arrangements are required to provide benefits in the form of a "qualified joint and survivor annuity" payable to the participant and the participant's spouse. Section 417 of the I.R.C. provides that a plan participant may waive the "qualified joint and survivor annuity" form of benefit provided that the participant's spouse consents "in writing to such election, (ii) such election designates a beneficiary (or a form of benefits) which may not be changed without spousal consent (or the consent of the spouse expressly permits designations by the participant without any requirement of further consent by the spouse), and (iii) the spouse's consent acknowledges the effect of such election and is witnessed by a plan representative or a notary public." Although the parties may contractually agree to the disposition of deferred compensation in a prenuptial agreement, upon consummation of the marriage, it may be necessary to have the "spouse" sign another written consent.

VI. Divorce

A. Can Divorce Survive Death? Divorce, by its unique nature as a personal cause of action, does not survive the death of a party. To the extent the action affects property rights, however, it survives to the personal representative. *Stone v. Guaranty Bank & Trust Co.*, 270 S. C. 331, 242 S. E. 2d 404 (1978)

i. Equitable Distribution is still an issue to be decided by the Family Court after the death of one or both of the parties.

1. When a spouse dies, equitable division goes forward; however the spouse must be a "surviving spouse" to gain from the equitable distribution. S.C. Code Ann. §62-2-802 excludes from the definition of "surviving spouse" the following individuals:

    a. an individual who obtains or consents to a final decree or judgment of divorce from the decedent or an annulment of their

marriage, which decree or judgment is not recognized as valid in this State, unless they subsequently participate in a marriage ceremony purporting to marry each to the other, or live together as husband and wife at the time of the decedent's death;

b. an individual who, following an invalid decree or judgment of divorce or annulment obtained by the decedent, participates in a marriage ceremony with a third person;

c. an individual who was a party to a valid proceeding concluded by an order purporting to terminate all marital property rights or confirming equitable distribution between spouses unless they are living together as husband and wife at the time of the decedent's death; or

d. an individual claiming to be a common law spouse who has not been established to be a common law spouse by an adjudication commenced before the death of the decedent or within the later of eight months after the death of the decedent or six months after the initial appointment of a personal representative; if the action is commenced after the death of the decedent, proof must be by clear and convincing evidence.

2. A divorce or annulment is not final until signed by the court and filed in the office of the clerk of court.

B. Pending Divorce

i. S.C. Code § 1976 § 62-2-507. Revocation by Divorce, Annulment, and Order Terminating Marital Property Rights

1. (a) In this section:

a. "Disposition or appointment of property" includes a transfer of an item of property or any other benefit to a beneficiary designated in a governing instrument.

b. "Divorce or annulment" means any divorce or annulment or declaration of invalidity of a marriage or other event that would exclude the spouse as a surviving spouse in accordance with Section 62-2-802. It also includes a court order purporting to terminate all marital property rights or confirming equitable distribution between spouses unless they are living together as husband and wife at the time of the decedent's death. A decree of separate maintenance that does not terminate the status of husband and wife is not a divorce for purposes of this section.

c. "Divorced individual" includes an individual whose marriage has been annulled.

d. "Governing instrument" means an instrument executed by the divorced individual before the divorce or annulment of the individual's marriage to the individual's former spouse including, but not limited to wills, revocable inter vivos trusts, powers of attorney, life insurance beneficiary designations, annuity beneficiary designations, retirement plan beneficiary designations and transfer on death accounts. "Governing instrument" does not include a beneficiary designation made in connection with a governmental employee benefit plan established or maintained for employees of the government of the State or a political subdivision thereof, or by an agency or instrumentality of any of the foregoing.

e. "Revocable" with respect to a disposition, appointment, provision, or nomination, means one under which the divorced individual, at the time of the divorce or annulment, was alone empowered, by law or under the governing instrument, to cancel the designation in favor of the divorced individual's former spouse, whether or not the divorced individual was then empowered to designate the divorced individual in place of the divorced individual's former spouse and whether or not the divorced individual then had the capacity to exercise the power.

f. No change of circumstances other than those described in this section and in Section 62-2-803 effects a revocation.

g. Except as provided by the express terms of a governing instrument, a court order, or a contract relating to the division of the marital estate made between the divorced individuals before or after the marriage, divorce or annulment, the divorce or annulment of a marriage:

   i. revokes any revocable:

      1. disposition or appointment of property or beneficiary designation made by a divorced individual to the divorced individual's former spouse in a governing instrument;

      2. provision in a governing instrument conferring a general or nongeneral power of appointment on the divorced individual's former spouse; or

      3. nomination in a governing instrument, nominating a divorced individual's former spouse to serve in any fiduciary or representative capacity, including a personal

representative, trustee, conservator, agent, attorney in fact or guardian;

ii. severs the interests of the former spouses in property held by them at the time of the divorce or annulment as joint tenants with the right of survivorship so that the share of the decedent passes as the decedent's property and the former spouse has no rights by survivorship. This provision applies to joint tenancies in real and personal property, joint and multiple-party accounts in banks, savings and loan associations, credit unions, and other institutions, and any other form of co-ownership with survivorship incidents.

h. A severance under subsection (c)(2) does not affect any third-party interest in property acquired for value and in good faith reliance on an apparent title by survivorship in the survivor of the former spouses unless a writing declaring the severance has been noted, registered, filed, or recorded in records appropriate to the kind and location of the property which are relied upon, in the ordinary course of transactions involving the property, as evidence of ownership.

i. Provisions of a governing instrument and nomination in a fiduciary or representative capacity that are revoked by this section are given effect as if the former spouse predeceased the decedent.

j. Provisions revoked solely by this section are revived by the divorced individual's remarriage to the former spouse or by a nullification of the divorce or annulment.

k. A payor or other third party is not liable for having made a payment or transferred an item of property or any other benefit to a beneficiary designated in a governing instrument affected by a divorce, annulment, or remarriage, or for having taken any other action in good faith reliance on the validity of the governing instrument, before the payor or other third party received written notice of the divorce, annulment, or remarriage. A payor or other third party is liable for a payment made or other action taken after the payor or other third party received written notice of a claimed forfeiture or revocation under this section. (2) Written notice of the divorce, annulment, or remarriage under subsection (g)(1) must be mailed to the payor's or other third party's main office or home by registered or certified mail, return receipt requested, or served upon the payor or other third party in the same manner as a summons in a civil action. Upon receipt

of written notice of the divorce, annulment, or remarriage, a payor or other third party may pay any amount owed or transfer or deposit any item of property held by it to or with the court having jurisdiction. The court shall hold the funds or item of property and, upon its determination under this section, shall order disbursement or transfer in accordance with the determination. Payments, transfers, or deposits made to or with the court discharge the payor or other third party from all claims for the value of amounts paid to or items of property transferred to or deposited with the court.

l. A person who purchases property from a former spouse or any other person for value and without notice, or who receives from a former spouse or any other person a payment or other item of property in partial or full satisfaction of a legally enforceable obligation, is neither obligated under this section to return the payment, item of property, or benefit nor is liable under this section for the amount of the payment or the value of the item of property or benefit. However, a person who, not for value, receives a payment, item of property, or any other benefit to which that person is not entitled under this section is obligated to return the payment, item of property, or benefit, or is personally liable for the amount of the payment or the value of the item of property or benefit, to the person who is entitled to it under this section. (2) If this section or any part of this section is preempted by federal law with respect to a payment, an item of property, or any other benefit covered by this section, a person who, not for value, receives a payment, item of property, or any other benefit to which that person is not entitled under this section is obligated to return that payment, item of property, or benefit, or is personally liable for the amount of the payment or the value of the item of property or benefit, to the person who would have been entitled to it were this section or part of this section not preempted.

ii. Probate Law

1. **QTIP Marital Trust with Elective Share Amount**. The South Carolina Probate Code provides that the elective share can be satisfied through a number of different methods, including non-probate transfers (e.g., life insurance, individual retirement accounts) and beneficial interests that flow into trust for the benefit of the surviving spouse. If the trust for the benefit of surviving spouse qualifies for the federal estate tax marital deduction (I.R.C. §2056), then the value of the electing spouse's beneficial interest in such trust property is computed at the "full value." For purposes of I.R.C. § 2056, if the surviving spouse has a "qualifying

income interest for life", then the trust qualifies for the marital deduction. In other words, while divorce is pending, consider revising estate planning documents to provide that an elective share amount flow into a qualifying marital trust for the benefit of surviving spouse with mandatory distributions of income and no principal distributions. S.C. Code Ann. §62-2-207.

2. **Remove Spouse as Fiduciary; Sever Jointly Owned Property.** While divorce is pending, counsel should advise their clients to consider revoking or modifying any instrument in which the spouse is named in a fiduciary capacity and severing jointly owned property. Divorce or annulment of a marriage operates to revoke any revocable (1) disposition of appointment of property or beneficiary designation, (2) the granting of a general or nongeneral power of appointment, (3) nomination of former spouse in any fiduciary or representative capacity. Divorce and annulment also operates to sever any property held as joint tenants with rights of survivorship.

C. Divorce Decree

i. Family Law

1. Equitable Division of Marital Property; Non-Marital Property

a. S.C. Code Ann. § 20-3-630, The term "marital property" as used in this article means all real and personal property which has been acquired by the parties during the marriage and which is owned as of the date of filing or commencement of marital litigation as provided in Section 20-3-620 regardless of how legal title is held, except the following, which constitute non-marital property:

i. Property acquired by either party by inheritance, devise, bequest, or gift from a party other than the spouse;

ii. Property acquired by either party before the marriage and property acquired after the happening of the earliest of:

1. Entry of a pendente lite order in a divorce or separate maintenance action;

2. Formal signing of a written property or marital settlement agreement; or

3. Entry of a permanent order of separate maintenance and support or of a permanent order approving a property or marital settlement agreement between the parties;

iii. property acquired by either party in exchange for property described in items (1) and (2) of this section;

iv. Property excluded by written contract of the parties. "Written contract" includes any antenuptial agreement of the parties which must be considered presumptively fair and equitable so long as it was voluntarily executed with both parties separately represented by counsel and pursuant to the full financial disclosure to each other that is mandated by the rules of the Family Court as to income, debts, and assets;

v. any increase in value in non-marital property, except to the extent that the increase resulted directly or indirectly from efforts of the other spouse during marriage.

vi. Interspousal gifts of property, including gifts of property from one spouse to the other made indirectly by way of a third party, are marital property which is subject to division.

vii. The court does not have jurisdiction or authority to apportion non-marital property.

b. S.C. Code Ann. § 20-3-630, lays out the apportionment factors for how the court would proceed through disbursing the marital assets in court.

i. Tax characteristics of marital assets is important. Consider income tax consequences of receiving zero basis capital assets or receiving tax deferred retirement benefits and whether to “tax affect” those assets when dividing marital assets.

2. Alimony S.C. Code Ann. § 20-3-130: Alimony and separate maintenance and support awards may be granted pendente lite and permanently in such amounts and for periods of time subject to conditions as the court considers just including, but not limited to:

a. **Periodic Alimony**. Periodic alimony to be paid but terminating on the remarriage or continued cohabitation of the supported spouse or upon the death of either spouse (except as secured in subsection (D)) and terminable and modifiable based upon changed circumstances occurring in the future. The purpose of this form of support may include, but is not limited to, circumstances where the court finds it appropriate to order the payment of alimony on an ongoing basis where it is desirable to make a current determination and requirement for the ongoing

support of a spouse to be reviewed and revised as circumstances may dictate in the future.

b. **Lump-sum alimony**. Lump-sum alimony in a finite total sum to be paid in one installment, or periodically over a period of time, terminating only upon the death of the supported spouse, but not terminable or modifiable based upon remarriage or changed circumstances in the future. The purpose of this form of support may include, but not be limited to, circumstances where the court finds alimony appropriate but determines that such an award be of a finite and nonmodifiable nature.

c. **Rehabilitative alimony** Rehabilitative alimony in a finite sum to be paid in one installment or periodically, terminable upon the remarriage or continued cohabitation of the supported spouse, the death of either spouse (except as secured in subsection (D)) or the occurrence of a specific event to occur in the future, or modifiable based upon unforeseen events frustrating the good faith efforts of the supported spouse to become self-supporting or the ability of the supporting spouse to pay the rehabilitative alimony. The purpose of this form of support may include, but is not limited to, circumstances where the court finds it appropriate to provide for the rehabilitation of the supported spouse, but to provide modifiable ending dates coinciding with events considered appropriate by the court such as the completion of job training or education and the like, and to require rehabilitative efforts by the supported spouse.

d. **Reimbursement alimony**. Reimbursement alimony to be paid in a finite sum, to be paid in one installment or periodically, terminable on the remarriage or continued cohabitation of the supported spouse, or upon the death of either spouse (except as secured in subsection (D)) but not terminable or modifiable based upon changed circumstances in the future. The purpose of this form of support may include, but is not limited to, circumstances where the court finds it necessary and desirable to reimburse the supported spouse from the future earnings of the payor spouse based upon circumstances or events that occurred during the marriage.

e. **Separate maintenance and support**. Separate maintenance and support to be paid periodically, but terminating upon the continued cohabitation of the supported spouse, upon the divorce of the parties, or upon the death of either spouse (except as secured in subsection (D)) and terminable and modifiable based upon changed circumstances in the future. The purpose of this form of support may include, but is not limited to,

circumstances where a divorce is not sought, but it is necessary to provide for support of the supported spouse by way of separate maintenance and support when the parties are living separate and apart.

f. Such other form of spousal support, under terms and conditions as the court may consider just, as appropriate under the circumstances without limitation to grant more than one form of support.

3. Life insurance obligations

a. The Family Court may order the payor spouse to obtain life insurance as security for an alimony obligation if the support spouse can demonstrate the existence of special circumstances with reference to her need for security and the payor's spouse ability to provide it. *Stoney v. Stoney*, 425 S.C. 47, 819 S.E.2d 201 (2018). See also *Smith v. Smith*, 386 S.C. 251, 264, 687 S.E.2d 720, 727 (Ct. App. 2009). *Wooten v. Wooten*, 364 S.C. 532, 553, 615 S.E.2d 98, 109.

4. Provisions for minor children

a. Family court in divorce action has legal authority to require a supporting spouse to maintain life policy naming child as beneficiary to ensure continued support of the minor child; however, this imposition must be based on justice, equity and compelling reasons. Code 1976, § 20–3–160.

ii. Probate/Tax Issues in Divorce

1. **Income Tax Consequences.** In general, the disposition of property is a taxable event under I.R.C. § 1001. § 1001 provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 1011 for determining gain; the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

a. **Property Transfers**. Section 1041 of the Internal Revenue Code provides an exception to this general rule: no gain or loss is recognized on a transfer of property from an individual to a former spouse, but only if the transfer is "incident to the divorce." A transfer of property is "incident to the divorce" if such transfer occurs within 1 year after the date on which the marriage ceases or is related to the cessation of the marriage. The transferee of the property pursuant to Section 1041 is treated as having acquired the property by gift and has the same basis the transferor had in the property prior to the transfer.

b. **Transfers Not More than One Year After Divorce.** If the transfer between former spouses occurs within one year of the date that the marriage ceases, the general rule of 1041 applies regardless of whether the transfer was related to the cessation of the marriage.

c. **Transfers Related to Cessation of Marriage (Six Year Period)**. If the transfer occurs after the one year mark but not later than six years after the date on which the marriage ceases and transfer is pursuant to divorce decree or separation award, Treasury Reg. § 1.1041-1T(b) provides that the transfer is deemed to be "incident to divorce."

   i. **Rebuttable presumption if after six year period.**

      Treasury Reg. § 1.1041-1T(b), Q&A 7: Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

d. **Sale of Marital Home.** What are the tax consequences relating to the sale of a marital home? I.R.C. § 121 of the Internal Revenue Code provides an exclusion from gross income for certain gains that result from the sale or exchange of property "owned" and "used" as a taxpayer's principal residence for at least two years or more out of the five year period ending on the date of the sale/exchange. An individual is able to exclude $250,000 of gain. A husband and wife who make a joint return may exclude $500,000 of gain provided that both spouses use such property as a principal residence for 2 of the 5 years.

   i. **Surviving Spouse Rule.** I.R.C. § 121(b)(4) provides that an "unmarried individual whose spouse is deceased on the date of such sale" is entitled to $500,000 of capital

gains exclusion if the sale occurs not later than 2 years after the death of such spouse and the ownership and use requirements set forth in (2)(A) are satisfied.

ii. **Rules related to Divorced Spouses.** I.R.C. § 121(d)(3) provides special rules for separate and divorced taxpayers. First, the selling taxpayer is entitled to use the former spouse's holding period with respect to the principal residence. Second, the selling taxpayer is treated as "using" the property as an individual's principal residence during any period of ownership while such individual's spouse or former spouse is granted use of the property under a divorce or separation instrument.

2. Gift Tax Consequences

a. **General rule**: A tax is imposed for each calendar year on the transfer of property by gift during such calendar year by any individual or nonresident. If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift. If property is transferred for less than "adequate and full consideration", then the gift is the excess of the amount by which the value of the property exceeded the value of the consideration. I.R.C. §§ 2501, 2512.

b. **Exceptions**:

i. **Property Settlement Agreement**. Where a husband and wife enter into a written agreement relative to their marital and property rights and divorce occurs within the three (3) year period beginning on the date one (1) year before such agreement is entered into, any transfer of property or interests in property made pursuant to such agreement (1) to either spouse in settlement of his/her marital property rights, or (2) to provide a reasonable allowance for the support of issue of the marriage during minority, shall be deemed to be transfers made for a full and adequate consideration in money or money's worth. I.R.C. § 2516.

1. **Timing Issues**: For I.R.C. § 2516 to apply, the divorce must occur not later than 2 years after execution of agreement and no earlier than one year before execution of agreement. If the divorce related transfer occurs outside of the relevant time periods, the transfer will be a taxable gift.

2. Payments for adult children are not included in I.R.C. § 2516

3. A release of marital property rights (e.g., elective share) is not considered adequate consideration for purposes of determining whether a gift has been made. Unless I.R.C. § 2516 applies, transfer of property for release of marital property rights is a gift. Treasury Reg. § 25.2512-8

4. Release of support rights by a spouse in return for a transfer of property to a third party; adequate consideration to transferor but release of support right by spouse is a gift. *Rev. Rul.* 77-314.

ii. **Annual Exclusion Gifts**. During any calendar year, the first $10,000, indexed for inflation (2019: $15,000), of gifts made to any person by a donor is not included in the total amount of gifts made during such year. I.R.C. § 2503(b)

iii. **Medical/Education Payments**. Any amount paid on behalf of an individual (A) as tuition to an educational organizational for the education or training of such individual or (B) to any person who provides medical care with respect to such individual as payment for such medical care is not treated as a transfer of property by gift for gift tax purposes. I.R.C. § 2503(e)

3. Estate Tax Consequences.

a. General Principles: A tax is imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States. The taxable estate is calculated by determining the "gross estate" (I.R.C. § 2031) and reducing it by certain deduction permitted by the Internal Revenue Code (I.R.C. § 2053, *et seq.*). For purposes of determining the estate tax base, "adjusted taxable gifts", which are the "total amount of the taxable gifts made by the decedent other than gifts which are included in the decedent's gross estate, are included. A "completed" gift during the decedent's lifetime is includible as an adjusted taxable gift; an "incomplete" gift is included as part of the decedent's taxable estate pursuant to Sections 2036 through 2042.

b. Implications of Divorce Related Transfers. Divorce related transfers could be completed gifts, incomplete gifts, or lifetime

transfers for adequate consideration (not a gift). Since gifts, whether completed or incomplete, are included in the decedent's taxable estate for estate tax purposes under general principles, the estate taxability of a divorce related transfer turns on whether adequate consideration was given in exchange for the divorce related transfer.

i. Adequate consideration in money or money's worth

1. **Release of marital property rights.** A release of marital property rights in connection with establishment of a trust for benefit of spouse and minor children in which settlor retains an interest or power is not adequate consideration. Thus, I.R.C. § 2036 through 2038 would apply to cause estate tax inclusion of the retained value in the Settlor's estate.

2. **Release of support rights.** Release of support rights of a spouse and minor children is adequate consideration for purposes of Section 2053. "The claim for payment after the death of the decedent, to the extent that it is based on such release [of marital property rights], is deductible by the estate under section 2053(a)(3) of the Code as a claim based upon an adequate and full consideration in money or money's worth to the extent of the value of the postponed support rights" *Rev. Rul.* 71-67.

3. **Court ordered transfers.** The United States Supreme Court in *Harris v. Commissioner* 340 U.S. 106 (1950) ruled that divorce related transfers of cash and property pursuant to a court decree/judgment in exchange for release of marital property rights were "involuntary" transfers that are not taxable gifts. In other words, the court's decree validates the transfers as being for adequate consideration for purposes of Section 2036 through 2038 and, therefore, not includable in the decedent's estate for estate tax purposes.

c. Divorce Related Obligations/Payments that Continue Post-Death. In certain cases, the spouse's divorce related payments and obligations continue after the spouse's death. I.R.C. § 2053 permits an estate tax deduction for the value of "claims against

the estate" (personal obligations of the decedent) that are founded on a promise or agreement. I.R.C. § 2053(c)(1) limits the deduction for claims only to the extent the claims were "contracted bona fide and for an adequate and full consideration in money or money's worth."

i. **Obligations Founded on Decree of Judgment.** If the divorce related transfers of cash and property are founded on a court decree or judgment, under *Harris v. Commissioner*, those obligations are not taxable gifts and are deemed to be for adequate consideration. Thus, court ordered obligations are deductible under I.R.C. § 2053.

ii. **Obligations Founded Upon Promise or Agreement.** I.R.C. § 2516 provides that transfers pursuant to a property settlement agreement that is entered into within certain time parameters are deemed to be transfers made for a full and adequate consideration in money or money's worth and therefore are deductible under I.R.C. § 2053. See *Rev. Rul*. 71-67.

VII. **Estate Planning Considerations for Blended Families**. When a divorced client is considering remarriage, it is prudent for counsel to advise the client to consider entering into a prenuptial agreement, especially if there are children from the first marriage.

A. **Prenuptial Agreements**. Hopefully, prior to entering into the marriage, your client considered entering into a prenuptial agreement to define the rights of the spouses. The prenuptial agreement should address how assets are devised to the surviving spouse. Preferably, assets are left in trust for the surviving spouse with the children from the first marriage as the remainder beneficiaries. Trustee selection is critical as there could be a natural tension between the surviving spouse (oftentimes, close in age to the adult children!) and the children from the first marriage. Support issues may be very important as the spouses age.

B. **Disinheritance of children from first marriage**. If there is no prenuptial agreement and no waiver of the elective share, the surviving spouse has a right to at least one-third of the decedent's probate estate. If the decedent did not have a valid Last Will and Testament, the surviving spouse is entitled to 50% of the probate estate. S.C. Code Ann. § 62-2-102.

i. **Contract to make a Will.** A contract to make a will or devise, or to revoke a will or devise, or not to revoke a will or devise, or to die intestate, if executed after the effective date of this act, can be established only by (1) provisions of a will of the decedent stating material provisions of the contract; (2) an express reference in a will of the decedent to a contract and extrinsic evidence proving the terms of the contract; or (3) a writing signed by the decedent evidencing the contract and extrinsic evidence proving the terms of the contract. The execution of a joint will

or mutual wills does not create a presumption of a contract not to revoke the will or wills. S.C. Code Ann. § 62-2-701.

C. Options to Protect Children from First Marriage.

i. **Don't Remarry!**

ii. **Premarital Agreements.** Define the rights of each of the spouses so that the remaining property can be devised to the children.

iii. **Waiver of Elective Share.** If there is no premarital agreement that waives the elective share, consider having the spouses waive his or her right to claim an elective share amount. Although prudence would suggest following the same disclosure formalities for a prenuptial agreement, the statute only requires "fair and reasonable" disclosures of the other party's property and financial obligations.

iv. **If No Prenuptial Agreement and No Waiver of Elective Share?** Consider whether it may be appropriate to have certain financial accounts titled with one or more of the children as joint tenants with rights of survivorship. Non-probate assets are not considered part of the "probate estate" for purposes of determining the elective share amount.

v. **Life Insurance**. Consider purchasing life insurance on your life and designating children as the beneficiaries.

vi. **Non-Probate Property Regimes.** Consider minimizing or avoiding owning assets as "joint tenants with rights of survivorship" with your spouse and carefully consider beneficiary designations on financial assets. These forms of ownership provide that the assets pass to the surviving spouse automatically upon death and do not pass under the estate planning provisions of the decedent's testamentary plan.

vii. **Long Term Care Policies.** Consider the purchase of long term care policies to help defray the costs or to provide liquidity for expenses relating to aging.

viii. **Time Value of Money**. Depending on the relative ages of the spouses, the children from the first marriage may not receive inheritance until the much younger spouse passes away. If the second spouse is the same age as the children, actuarial tables would suggest similar life expectancies. Thus, the children from the first marriage may not be alive to receive anything upon the surviving spouse's demise.

ix. **Parents should coordinate plans.** Don't assume that the divorced spouse will make testamentary provisions for the children.

Alimony and the Road Ahead

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The most significant change to Alimony in the past thirty (30) years did not come from the South Carolina Supreme Court or South Carolina Legislature, but rather from the Tax Cuts and Jobs Act of 2017 (the "Act") which was signed into law by the President of the United States on December 22, 2017.

Effective January 1, 2019, all **new** alimony orders or separation agreements that are not modifications of pre-2019 orders or agreements will have alimony as nontaxable to the payee and nondeductible by the payor. The Act repeals the deductible nature of alimony by the payor. This is a permanent change to the tax code and does not end in 2025 like other modifications that are a part of the Act. Any orders or agreements in place before January 1, 2019 are grandfathered under the old law and may remain taxable to the payee and tax deductible by the payor. (The South Carolina Family Court has the authority to make modifications to pre-January 1, 2019 orders nontaxable and nondeductible, if expressly stated in the modification order; otherwise, they may remain taxable/deductible.)

The Act essentially eliminates the most effective tool in settling alimony claims. Some individuals argue the change eliminates the alimony tax loophole, but it unquestionably makes the jobs of lawyers and judges in the Family Court more difficult. There is rarely too much money in a Family Court case and this change means there will be even less. Under the old law, the payor may pay $10,000.00 a month in alimony, but it may only cost him/her $6,500.00 after he/she deducts the payment. The receipt pays taxes on the $10,000.00 but still nets $8,000.00 essentially creating an extra $1,500.00 per month. (I have used rounded numbers for the ease of reference.)

Under the example, the old method creates an extra $18,000.00 a year or $180,000.00 over ten years or $360,000.00 over twenty years. One of the only real benefit from the change will be that judges and lawyers will no longer need to worry about the complicated alimony recapture rule allowing the award of alimony upfront without worrying about adverse tax consequences. The change also simplifies the details and an accountant may not be necessary to evaluate the tax consequences of alimony.

In addition to essentially shrinking the money available, the Act has left lawyers and judges with unanswerable questions. I will explore two questions below:

1. Do temporary orders prior to January 1, 2019 that award alimony grandfather the litigants under the old method of taxable/deductible alimony?

2. Would a prenuptial agreement signed prior to January 1, 2019 allow alimony payments to be taxable/deductible?

Disclaimer: No one knows the answers to these questions with certainty. The following is information to assist with these questions.

1. Temporary Orders entered prior to the January 1, 2019 may preserve the taxable/deductible nature of alimony. (See Attachment A)

> 71(b)(2) Divorce or Separation Instrument
> The term "divorce or separation instrument" means –
> - (A) a decree of divorce or separate maintenance or a written instrument incident to such a decree;
> - (B) a written separation agreement, or
> - (C) a decree (not described in (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

The key question becomes the interpretation of 26 U.S.C.A. §71(b)(2). Two cases provide some insight into this question. Landreth v. Comm'r of Internal Revenue, T.C. Memo. 1997-169 and Peterson v. Comm'r of Internal Revenue, T.C. Memo. 1998-27. In

Landreth, the Court states, "[a] decree for support includes any type of court order or decree, including an interlocutory decree of divorce or a decree of alimony pendente lite, requiring one spouse to make payments for the other spouse's support or maintenance. Sec. 1.71-(1)(b)(3). [Landreth, at *2]" The Court went on to state, "[a] review of the relevant Missouri statutes and procedural rules reveals that the terms "order" and "judgment", rather than "decree", are used. We are satisfied that an order or judgement that is issued by a Missouri court constitutes a decree. Id. at*2."

The Peterson opinion states, "[f]or purposes relevant to the present dispute, the term 'divorce or separation instrument' underscored above means a decree requiring a spouse to pay for the support or maintenance of the other spouse. Sec. 71(b)(2)(C). Such a decree must be enforceable at the time it is issued. [Peterson, at*3]" The Court continued "[h]owever, a judgement is not the only type of decree sufficient for purposes of section 71(b)(2)(C). A decree for support under section 71(b)(2)(C) includes '*any type* of court order or decree, including an interlocutory decree of divorce or a decree of alimony pendente lite', requiring one spouse to make payments for the other's spouse's support or maintenance. Id. at*4."

When Landreth and Peterson are applied to our current situation, a Temporary Order/Pendente Lite Order may preserve the taxable/deductible nature of alimony. In cases with a significant difference between the actual cost to the payor and net benefit to the payee, preserving the taxable/deductible method is likely a benefit to both parties. With that said, draft and send a letter to the client explaining the risk.

In Tom Traxler's presentation at the Bench Bar CLE on December 7, 2018, he opines, "there is a good chance that the alimony will still be taxed/deducted as it was under

the Temporary Order, if the Final Order incorporates or adopts the prior Temporary Order without changing the payment terms or adding/deleting any contingency or condition." (See Attachment B included with the permission of Tom Traxler) Tom Traxler's theory is supported by IRS Publication 504 (2017) on page fifteen which is included in Attachment A.

Although acknowledging Tom Traxler's greatness, this opinion is clearly a conservative view of the issue. The Landreth and Peterson decisions read in conjunction with the modification language of the Act may allow changes and/or conditions to the Temporary Order that would remain taxable/deductible. Depending on the situation and facts of your case, it may be worth arguing this position. For example, the Court could include a termination of the alimony at some time in the future or alter the amount while preserving the taxable/deductible nature of the award. Once again, the answer is unknown so cover the risks with your client.

2. Prenuptial Agreements executed prior to January 1, 2019 may preserve the taxable/deductible nature of alimony. As indicated in 26 U.S.C.A. §71(B)(2), the possible number of documents that qualify as a "divorce or separation instrument" appears broad. A prenuptial agreement which specifies the amount and/or duration of alimony in the event of divorce may very well qualify. If the prenuptial agreement expressly states the alimony is taxable/deductible, strong weight exists that the intention of the parties was to make the alimony taxable/deductible. 26 USCA 71(b)(2) identifies three distinct classification of instruments that qualify as "Divorce or Separation Instruments." It seems very plausible that a Prenuptial Agreement may fit under one of them. Furthermore, accepting a Prenuptial

Agreement as a Divorce or Separation Agreement allows the Court to meet the intentions of the parties.

The last topic of these materials will provide examples and comparisons of the new reality of nontaxable/nondeductible alimony as follows:

Example A: Husband and Wife are married for thirty (30) years. Husband earns $10,000.00 per month and Wife earns $1,500.00 per month. (No children) Applying the Dickert approach (23% of the difference between the parties' incomes), Husband owes Wife alimony of $1,955.00. Under the old tax laws using Tom Traxler's Alimony calculator, it cost Husband $1,302.00 per month and nets Wife $1,539.00 per month generating an additional $237.00 per month or $2,844.00 per year. Under the Rock Hill formula (the difference between the parties' incomes multiplied by the length of marriage as a decimal point), Husband owes Wife alimony of $2,550.00. Under the old tax law, it cost Husband $1,706.00 per month and nets Wife $1,990.00 per month generating an additional $284.00 per month or $3,408.00 per year.

Example B: Husband and Wife are married for thirty (30) years. Husband earns $20,000.00 per month and Wife earns $1,500.00 per month. (No children) Applying the Dickert approach, Husband owes Wife alimony of $4,255.00. Under the old tax laws, it cost Husband $2,629.00 and nets Wife $3,149.00 generating an extra $520.00 per month or $6,240.00 per year. Under the Rock Hill formula, Husband owes Wife alimony of $5,550.00. Under the old tax law, it cost Husband $3,496.00 and nets Wife $4,030.00 generating an extra $534.00 per month and $6,408.00 per year.

Under the Act, Judges inclined to use the Dickert approach may be inclined to award alimony in the $1,300.00 to $1,540.00 range per month under Example A (15% to 18% of the difference between the parties' incomes). Under Example B, those same Judges may be inclined

to award $2,630.00 to $3,150.00 in monthly alimony (14% to 17%). The higher the payor's income or the greater the difference between the parties' incomes, the lower the percentage needs to be to account for the change in the taxable/deductible nature of alimony.

Turning to the Rock Hill formula, those Judges may be inclined to award alimony from $1,700.00 to $1,990.00 (20% to 23.5%) per month in Example A. Under Example B, those same Judges may be inclined to award $3,500.00 to $4,030.00 (18% to 22%) per month in alimony.

	Example A1- Dickert Approach	**Example A2- Rock Hill Formula**	**Example B1- Dickert Approach**	**Example B2- Rock Hill Formula**
Husband's Gross Monthly Income	$10,000.00	$10,000.00	$20,000.00	$20,000.00
Wife's Gross Monthly Income	$1,500.00	$1,500.00	$1,500.00	$1,500.00
Amount of Alimony	**$1,955.00**	**$2,550.00**	**$4,255.00**	**$5,550.00**
Net Cost of Alimony	-$1,302.00	-$1,706.00	-$2,629.00	-$3,496.00
Net Benefit of Alimony	$1,539.00	$1,990.00	$3,149.00	$4,030.00

	Example A1- Dickert Approach	**Example A2- Rock Hill Formula**	**Example B1- Dickert Approach**	**Example B2- Rock Hill Formula**
Alimony Award Range	$1,300.00 to $1,540.00	$1,700.00 to $1,900.00	$2,630.00 to $3,150.00	$3,500.00 to $4,030.00
Percentage	15% to 18%	20% to 23.5%	14% to 17%	18% to 22%

Conclusion

The Act has changed the approach to alimony moving forward. We will all struggle with this change until new norms and unwritten formula(s) emerge. Working together, I am confident we can achieve fair and reasonable results for all litigants.

Several other presentations on Alimony and the Act have included suggestions that agreements and orders should include language that if the alimony payments are intended to be

taxable/deductible and are ultimately determined to be nontaxable/nondeductible, then the court has the authority to modify the alimony. Although this is likely to be best practice, the fact that alimony payments were contemplated to be one way and are then determined to be another should surely constitute a material and substantial change in circumstance to give the Family Court the authority to modify the alimony.

Extra Alimony Thoughts

Attachment C contains a summary of alimony cases for the past thirty plus (30+) years in descending order of Husband's income. Last, I have included a brief for Sweeny v. Sweeny, 420 S.C. 69, 800 S.E.2d 148 (Ct. App. 2017). (See Attachment D) In Sweeny, the Family Court awarded Wife taxable/deductible monthly periodic alimony of $5,000.00 or approximately 15% of the difference between Husband and Wife's incomes. The award was confirmed by the Court of Appeals. This is a recent alimony decision that could signify the lowering of alimony awards. On the other hand, it may just be an example of a payor spouse benefiting from a frugal conservative lifestyle. If it is the later, the case calls into question the public policy implications of awarding more alimony to litigants who live beyond their means. Regardless, maybe it is time to explore a total review of the alimony law to provide better tools to address the alimony questions coming before the Court? The South Carolina General Assembly appears to be taking a step in that direction. As I was finishing these materials, changes to the alimony statutes have been submitted in H3787. (See Attachment E)

South Carolina Bar

Continuing Legal Education Division

Attorneys as Fiduciaries: Ethical & Practical Considerations for Estate Planning Attorneys

Frederick W. Faircloth, IV

ATTORNEYS AS FIDUCIARIES: ETHICAL AND PRACTICAL CONSIDERATIONS FOR ESTATE PLANNING ATTORNEYS

AL TODD ESTATE PLANNING WORKSHOP

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ATTORNEYS AS FIDUCIARIES: ETHICAL AND PRACTICAL CONSIDERATIONS FOR ESTATE PLANNING ATTORNEYS

By: Frederick W. Faircloth, IV

One of the challenges estate planning attorneys face is advising clients on the appointment of fiduciaries, especially with respect to personal representatives and trustees but increasingly with respect to new types of fiduciary roles such as trust protectors and trust investment advisors. This task involves two primary undertakings. The first task deals with the attorney's responsibility to explain to the client the "job description" the specific fiduciary will be called upon to fulfill so that the client reasonably understands it. The second, overlapping and often more complicated task is assisting the client in identifying the person or entity that best fits that description.

For an estate planning attorney, these tasks can take on another layer of complexity because the attorney may well be one of the candidates to serve in the fiduciary role(s) he is explaining to his clients. The attorney may even be one of the best choices to serve, especially where the estate planning attorney has a significant history with the client or where family members or corporate fiduciaries are not appropriate. Further, the potential fees received by the attorney for such services may be very attractive to the attorney. This revenue stream may be especially attractive to estate planning attorneys in a high estate tax exemption environment where the need for sophisticated estate planning is not as great as it once was.

This manuscript will focus on the ethical and practical decisions faced by a drafting attorney who desires and/or is asked to serve as a fiduciary under the documents he is preparing, focusing specifically on wills and trust instruments. Part I will review the general considerations the drafting attorney must address before being appointed fiduciary in the documents he prepares. Part II addresses more specific issues the drafting attorney will need to consider.

I. Drafting Attorney Serving as Fiduciary--General

An attorney is not prohibited from serving as fiduciary, including under documents the attorney prepares. This is true in South Carolina[1] and generally across the rest of the country.[2] Rule[3] 1.8(c) provides that "a lawyer shall not solicit any substantive gift from a client . . . or prepare on behalf of a client an instrument giving the lawyer or a person related to the lawyer any substantial gift unless the lawyer or other recipient is related to the client." However, Comment [8] to Rule 1.8 explains that the rule does not prohibit an attorney from "seeking to have the lawyer or a partner or associate of the lawyer named as executor of the client's estate or to another potentially lucrative fiduciary position." The attorney's designation and service as fiduciary is not a gift from the client since the attorney would be compensated for his services;[4]

[1] S.C. Ethics Advisory Opinion 91-07.
[2] ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 02-426 (2002) (hereinafter, "ABA Formal Opinion 02-426").
[3] "Rule" as used herein generally refers both to the South Carolina Rules of Professional Conduct ("SCRPC") and the Model Rules of Professional Conduct promulgated by the American Bar Association (the "Model Rules"). The portions of the SCRPC discussed herein have adopted the same portions of the Model Rules.
[4] ABA Formal Opinion 02-426, n. 7.

however, a fee structure that is not reasonable or customary for fiduciaries generally may violate Rule 1.8(c).[5]

While an attorney is not prohibited from serving as a fiduciary under documents he prepares, determining whether the attorney may serve in a particular situation requires the attorney to consider a number of issues that will affect his ability to serve.

A. Competency.

A baseline requirement for all attorneys is that they are required to provide competent representation. Rule 1.1 provides that competent representation "requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation." For an attorney who would serve as a fiduciary, this competency requirement is layered on top of the duty of care that subjects all fiduciaries to potential civil liability.

The American College of Trust and Estate Counsel (ACTEC) promulgated Commentaries on the Model Rules of Professional Conduct[6] to provide guidance on the application of the Rules to trusts and estates lawyers. The ACTEC Commentaries on Rule 1.1 note that competency also requires the attorney to consider the adequacy, training and oversight of his staff to ensure that the undertaking of any matter can be handled appropriately.

B. Communication.

In assisting a client with designating fiduciaries, the estate planning attorney's first responsibility is explaining the nature and function of the fiduciary role(s) to be filled. Rule 1.4(b) provides that "[a] lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."

The ACTEC Commentaries on Rule 1.4 indicate that attorneys should meet personally with clients at the outset of representation, or communicate "as directly as possible with the client."[7]

ABA Formal Opinion 02-426 provides an illustrative list of items that need to be explained to, and understood by, the client:

- The tasks to be performed by the fiduciary;
- The fiduciary's desired skills;
- The kinds of individuals or entities likely to serve most effectively, such as professionals, corporate fiduciaries, and family members; and
- The benefits and detriments of using each, including relative costs.

As discussed in more detail below, adequate communication is a prerequisite for obtaining the informed consent generally necessary to permit a drafting attorney to serve

[5] S.C. Ethics Advisory Opinion 91-07.
[6] ACTEC Commentaries on Model Rules of Professional Conduct (5th Ed. 2016) (available at https://www.actec.org/professionals/publications-and-videos-for-estate-planning-professionals/) (the "ACTEC Commentaries").
[7] *Id*. at 61.

as a fiduciary. Because informed consent is required to be confirmed in writing, and because clients can have selective memories, the prudent attorney will document as much of these communications as possible in writing, even (and perhaps especially) where much of the original communication and consent is oral.

C. Conflicts of Interest.

Many parts of the Rules can seem foreign to estate planning practitioners given that the Rules are general in nature and in many ways drafted with an eye towards adversarial relationships that often do not exist in the estate planning context. As the Reporter's Note to the Second Edition of the ACTEC Commentaries explains, the Rules "are composed largely of general, litigation-based rules that do not address many of the difficult problems that arise in specific areas of practice."

Determining whether an attorney has a real or potential conflict of interest and, if there is conflict, whether it is waivable can be thorny. In situations where an attorney is asked to serve as a fiduciary or, alternatively, solicits appointment, the task may become even more complicated. In such situations the attorney must determine the Rules' effect on his ability to serve as fiduciary and then address the more typical questions related to other conflicts of interest that might either preclude the representation or require informed consent.

1. Issues Related to Service as Fiduciary.

As referenced above Rule 1.8(c), regarding an attorney's solicitation of gifts from a client, does not apply to an attorney's service as a fiduciary. However, while Rule 1.8(c) is inapplicable, Rule 1.7 and 1.8(a) still lurk and must be addressed. In addition to addressing whether the attorney can serve as fiduciary, the application of one or both rules can have a significant effect on the manner in which the attorney is required to address the issue with a client.

2. Rule 1.7.

SCRPC Rule 1.7(a) prohibits an attorney from representing a client if there is a concurrent conflict of interest. However, Rule 1.7(b) provides a reprieve from this prohibition if:

> (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
> (2) the representation is not prohibited by law;
> (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
> (4) each affected client gives informed consent, confirmed in writing. (Emphasis added.)

The significance of Rule 1.7(b) here is that if the drafting attorney is not otherwise precluded from serving as fiduciary, he may do so if he receives informed consent confirmed in writing.[8]

Rule 1.7(a)(2) addresses the portion of Rule 1.7(a) most applicable to the issue of attorney as fiduciary and provides that a concurrent conflict of interest exists if "there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer." (Emphasis added.)

As confirmed by ABA Formal Opinion 02-426, Rule 1.7(a)(2) does not necessarily require informed consent confirmed in writing in all situations in which an attorney will be designated as fiduciary. Instead, the attorney must determine if the particular circumstances are such that informed consent confirmed in writing is warranted. If the attorney reasonably determines that there is not a significant risk of material limitation to the representation, arguably no concurrent conflict of interest exists.

As a practical matter, one wonders how narrow a gap exists such that the attorney could determine that he can serve as fiduciary in a document he drafts without obtaining from the client informed consent confirmed in writing. There seem to be any number of factors, from the amount of potential fees[9] to "information asymmetry"[10] between the attorney and client, that militate in favor of informed consent confirmed in writing, especially given that communicating the various pros and cons of potential fiduciaries is required in any event.[11]

As an interesting comparison, the Supreme Court of Georgia, based on that state's precursor to Rule 1.7, has taken the position that an attorney who is to be designated as a fiduciary in documents he is drafting must obtain informed consent confirmed in writing.[12] In FAO 91-1, the court noted that

> the risk that some lawyers may take advantage of the lawyer-client relationship to benefit themselves in a manner not in the client's best interest . . . creates the need for restrictions that offer assurance that the naming of the lawyer as executor or trustee is the informed decision of the testator or settlor.

As if trying to illustrate how easy it is to obtain informed consent in writing, or at least to make it easier for attorneys in Georgia, FAO 91-1 goes so far as to

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[8] The application of this Rule with which most estate planning clients are familiar may be the joint representation of a husband and wife when drafting estate planning documents.

[9] ABA Formal Opinion 02-426 at 4-5.

[10] *See* Paula A. Monopoli, *Drafting Attorneys as Fiduciaries: Fashioning an Optimal Ethical Rule for Conflicts of Interest*, 66 U. PITT. L. REV. 411, 415 (2005) (arguing that informed consent confirmed in writing should be the default requirement).

[11] *See* Part I.B above.

[12] State Bar of Georgia Formal Advisory Opinion No. 91-1 (Sept. 13, 1991). The relevant rule required "written consent or written notice to [the] client after full disclosure. *Id.* (citing Standard 30 of former State Bar Rule 4-102(d)). This appears to be the equivalent of informed consent confirmed in writing required under the Rules.

provide a "Form Notification and Consent Letter." Unfortunately, at least one attorney ran afoul of this opinion. In In re Estate of Peterson,[13] the Georgia Court of Appeals disqualified an attorney from serving as executor under a will the attorney drafted because of the failure to obtain written consent or provide the necessary written notice, despite finding that the attorney hadn't consciously influenced the testator's decision and had made all the necessary disclosures (including about potential conflicts of interest).

3. Rule 1.8(a).

Another question may be whether Rule 1.8(a) may apply. Rule 1.8(a) provides:

> (a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:
>
> (1) the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;
>
> (2) the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and
>
> "(3) the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer's role in the transaction, including whether the lawyer is representing the client in the transaction. (Emphasis added.)

There are two distinctions to be made between the application of Rule 1.7 and Rule 1.8(a). One is that Rule 1.8(a) requires the informed consent to be in a writing "signed by the client," thus requiring the additional step of obtaining such a signature. As discussed in Part II.A below, this may be a distinction without a difference for those prudent attorneys who obtain signed engagement letters as a matter of course.

The more practical distinction is the requirement in Rule 1.8(a)(2) that the client be "advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction."

S.C. Ethics Advisory Opinion 91-07 is silent on the issue, which might be taken as an implicit acknowledgment that Rule 1.8(a) is inapplicable. ABA Formal Opinion 02-426, in taking the same position as S.C. Ethics Advisory Opinion 91-07 relative to Rule 1.8(c), further relies on comment [8] to Rule 1.8for the proposition that "because appointing a fiduciary is not a 'business transaction

[13] 565 S.E.2d 524 (Ga. Ct. App. 2002).

with a client,' Rule 1.8(a) does not apply to require the client to give her signed, informed consent to the essential terms of the arrangement after receiving the lawyer's written advice to seek independent legal advice."

At least one commentator believes that Rule 1.8(a), or at least its provisions related to informed consent in a writing signed by client, should apply when an attorney is asked to, or seeks to, be named as a fiduciary, especially with respect to disclosure and informed consent if not necessarily to the desirability and opportunity to seek independent legal counsel.[14]

Interestingly, at least one state bar's ethics advisory committee has taken the position that Rule 1.8(a) "may" apply if the attorney actively solicits appointment as a fiduciary.[15] The New Hampshire Bar Association's Ethics Committee, in dealing with a number of questions related to an attorney's service as a fiduciary, noted that ABA Opinion 02-426 permits an attorney to "'disclose his own ability to serve as a fiduciary' when discussing fiduciary options." However, it went on to distinguish disclosure from solicitation:

> This question, however, presumes a greater level of solicitation of services by the drafting attorney. Such a determination will depend upon the specific facts involved in any given situation. For example, if the lawyer (1) advertises fiduciary services, and (2) actively solicits its clients consider selecting the lawyer as the fiduciary in the documents drafted by the lawyer, it would be difficult to argue that such solicitation does not transform the fiduciary selection by the client into a "business transaction with a client." If such practice is determined to involve a "business transaction with a client," then compliance with Rule 1.8 (a) would be required.[16]

Both S.C. Ethics Advisory 91-07 and ABA Formal Opinion 02-426 address situations where the drafting attorney has been <u>asked</u> to serve as personal representative or trustee. Query whether active solicitation of such an appointment would change the analysis in South Carolina.

4. <u>Rule 1.7 in General</u>

The above discussion of Rule 1.7 focuses on concurrent conflicts of interests brought about by the pecuniary interest a drafting attorney has in naming himself as fiduciary. However, the attorney must still consider the full range of relationships affected by his service as fiduciary. These considerations should be broad and go beyond more obvious situations, such as whether the attorney also represents a beneficiary or creditor. Illustrations from Restatement (Third) of the Law Governing Lawyers demonstrate how delicate such considerations can be:

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[14] *See* Monopoli, *supra* n. 10.
[15] New Hampshire Bar Association Ethics Committee Advisory Opinion #2008-09/01 (May 13, 2009).
[16] *Id.*

> 1. Lawyer is outside counsel to Company, a business corporation. Lawyer is also executor of the estate of Boss, the former president of Company. From examining Boss's papers, Lawyer knows that Company has plausible claims against the estate for the return of Company assets taken by Boss for personal use. Lawyer may not represent Company in seeking compensation for the assets because Lawyer's obligation as executor would be to resist the claims of Company. Whether Lawyer may inform Company of the existence of the claims depends on whether the law applicable to executors imposes a duty of confidentiality on Lawyer as executor.
>
> 2. The same facts as in Illustration 1, except that Company through another lawyer asserts the claim against Boss's estate. Because of the antagonistic positions between Company and Lawyer as executor, Lawyer must withdraw from representing Company on unrelated matters, unless Company gives informed consent to Lawyer's continued representation (see § 122 & § 128, Comment e). Whether, due to Lawyer's relationship with Company, Lawyer may continue as executor after Company asserts its claim is determined under the law governing executors.[17]

II. Drafting Attorney as Fiduciary—Specific Issues.

The drafting attorney's determination that he has the competency to serve as fiduciary and is not otherwise barred by a conflict is only part of the equation. There are a number of other, more specific issues the drafting attorney will need to contemplate. This Part II covers some of those specific items.

A. Informed Consent in Writing; Engagement Letters.

Rule 1.0(g) defines "informed consent" as "the agreement by a person to a proposed course of conduct after the lawyer has communicated reasonably adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct."

Rule 1.0(b) provides that "confirmed in writing" in the context of informed consent means such consent that "is given in writing by the person or a writing that a lawyer promptly transmits to the person confirming an oral informed consent." Rule 1.0(b) further provides that if obtaining or transmitting the necessary writing is not feasible at the time the person gives informed consent, it must be obtained within "a reasonable time thereafter."

Three important concepts can be pulled from the above definitions. The first, perhaps self-evident, concept is that informed consent necessarily requires communication about relevant information and material risks. What constitutes adequate information will vary. As explained by comment [6] to Rule 1.0,

[17] RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYER, § 135 (2000).

> [t]he lawyer must make reasonable efforts to ensure that the client or other person possesses information reasonably adequate to make an informed decision. Ordinarily, this will require communication that includes a disclosure of the facts and circumstances giving rise to the situation, any explanation reasonably necessary to inform the client or other person of the material advantages and disadvantages of the proposed course of conduct and a discussion of the client's or other person's options and alternatives. In some circumstances it may be appropriate for a lawyer to advise a client or other person to seek the advice of other counsel. A lawyer need not inform a client or other person of facts or implications already known to the client or other person; nevertheless, a lawyer who does not personally inform the client or other person assumes the risk that the client or other person is inadequately informed and the consent is invalid. In determining whether the information and explanation provided are reasonably adequate, relevant factors include whether the client or other person is experienced in legal matters generally and in making decisions of the type involved, and whether the client or other person is independently represented by other counsel in giving the consent. Normally, such persons need less information and explanation than others, and generally a client or other person who is independently represented by other counsel in giving the consent should be assumed to have given informed consent.

The second concept is that informed consent must be obtained <u>before</u> a course of action is taken. The drafting attorney has not obtained informed consent if the relevant risks and alternatives are explained after a document is executed naming the drafting attorney as fiduciary.

The final point is that confirmation in writing does not mean that the writing must be signed by the client so long as the confirmation is transmitted to the client in written form. Comment [1] to Rule 1.0 provides that an attorney may reasonably rely on informed verbal consent provided that confirmation in writing is obtained or given within a reasonable time thereafter. Execution of the relevant documents, without more, would not constitute informed consent confirmed in writing.

As a practical matter the prudent drafting attorney will want to obtain informed consent confirmed in writing by providing the relevant disclosure in an engagement letter that is signed by the client before any estate planning documents are executed. ACTEC has promulgated a collection of form engagement letters,[18] one of which relates specifically to attorneys serving as fiduciaries and which covers substantially all of the issues addressed herein.[19] This free resource is highly recommended.

B. <u>Attorney as Fiduciary and Attorney for Fiduciary</u>.

Absent a conflict of interest under Rule 1.7, there is no prohibition against an attorney (including the drafting attorney) who serves as a fiduciary from also serving as

[18] ACTEC Engagement Letters: A Guide for Practitioners (3d Ed. 2017) (available for free at https://www.actec.org/professionals/publications-and-videos-for-estate-planning-professionals/)
[19] *Id*. at 60-65.

attorney for the fiduciary.[20] In such cases the "obligations of the lawyer as fiduciary do not differ materially from the obligations of the lawyer as fiduciary."[21]

While noting that it may be permissible, the ACTEC Commentaries caution attorneys taking on both roles:

> A lawyer undertaking to serve in both capacities should attempt to ameliorate any disadvantages that may come from dual service, including the potential loss of the benefits that are obtained by having a separate fiduciary and lawyer, such as the checks and balances that a separate fiduciary might provide upon the amount of fees sought by the lawyer and vice versa.[22]

While dual representation generally is permissible, two issues deserve special attention. The first relates to the general rule under South Carolina law that an attorney for a fiduciary represents the fiduciary and not beneficiaries.[23] As most estate planning attorneys likely have experienced, this rule is not always understood and generally warrants specific disclosure to beneficiaries and other interested parties. ABA Formal Opinion 02-426 provides that such "clarification is particularly called for as a matter of good practice" when the attorney wears both hats. S.C. Ethics Opinion 91-07 similarly provides that "[s]ervice in such dual capacities should be fully disclosed to the Probate Court and any other court where an action is pending involving the Estate; and such disclosure should also be made to all beneficiaries and other parties having an interest in the Estate (e.g., bondsmen)."

Second, where the attorney is serving in dual roles, compensation issues must also be addressed. As discussed in Part II.C below, a number of factors go into the determination of compensation. Where the attorney serves in dual roles, his compensation as a fiduciary is relevant in determining his reasonable compensation as attorney for the fiduciary. Generally, attorneys cannot be compensated for the same work twice, once as the fiduciary and secondarily as the attorney.[24]

C. <u>Compensation</u>.

Regardless of who serves as the fiduciary, that person's compensation is an important topic that must be discussed with the client. This is especially true where the drafting attorney will be the one receiving the compensation.

With respect to personal representative commissions in South Carolina, the default statutory commission (5% of personal property plus 5% of real estate sold in the normal course plus 5% of income) may whipsaw the fiduciary or the client and the

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[20] S.C. Ethics Opinion 91-07; ABA Formal Opinion 04-426. *See also* S.C. CODE ANN. § 62-3-715(19).
[21] ABA Formal Opinion 04-426 at 5.
[22] ACTEC Commentaries at 40 (Commentary on Rule 1.2).
[23] *See* S.C. CODE ANN. § 62-1-109.
[24] S.C. Ethics Advisory Opinion 91-07 ("In determining what a reasonable fee should be, the attorney should consider, inter alia, if any portion of the legal services duplicate or overlap services being performed in any other capacity."). ABA Forma Opinion 02-426, n. 18 ("When the lawyer and his firm are fully compensated for his time and labor through fiduciary compensation, the same time and labor cannot properly be given full weight under Rule 1.5(a)(1).")

client's beneficiaries depending on the circumstances.[25] In any event the statutory commission would be subject to adjustment by the Probate Court.

With respect to trustees, unless the trust instrument provides otherwise, the South Carolina Trust Code requires that trustee commission be "reasonable under the circumstances." [26] The comments to South Carolina Trust Code § 62-7-708 notes that relevant factors include:

- The custom of the community;
- The trustee's skill, experience, and facilities;
- The time devoted to trust duties;
- The amount and character of the trust property;
- The degree of difficulty, responsibility and risk assumed in administering The trust, including in making discretionary distributions;
- The nature and costs of services rendered by others; and
- The quality of the trustee's performance.

These factors largely correspond to Rule 1.5, which provides factors relative to an attorney's compensation as such.

The comments to South Carolina Trust Code § 62-7-708 further expand on the effect of delegating duties to others:

> In setting compensation, the services actually performed and responsibilities assumed by the trustee should be closely examined. A downward adjustment of fees may be appropriate if a trustee has delegated significant duties to agents, such as the delegation of investment authority to outside managers. . . . On the other hand, a trustee with special skills, such as those of a real estate agent, may be entitled to extra compensation for performing services that would ordinarily be delegated.

Where the drafting attorney will serve as fiduciary (and likely also as attorney for the fiduciary), this author submits that a best practice may be to provide that fiduciary compensation, as well as compensation for truly legal services, will be compensated at the attorney's (and his staff's) regular billing rates as in effect from time to time. Much the same as a corporate fiduciary may reference its fee schedule, using billing rates has the benefit of providing clarity for all parties about how compensation is computed. Further, doing so should also alleviate some of the concern of double billing where the attorney is wearing dual hats as fiduciary and attorney.

Regardless of how compensation is computed, the drafting attorney should obtain from the client informed consent confirmed in writing, which will best be accomplished with a signed engagement letter.

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[25] Consider two separate estates one with $1,000,000 of real property and one with $1,000,000 in investment assets. The statutory fee for the former would be the $50 minimum commission, while the fee for the latter would be $50,000 (even without regard to income).
[26] S.C. Code Ann. § 62-7-708.

D. Limitations on Liability; Indemnification.

It is not uncommon for exculpatory provisions limiting fiduciary liability to be drafted into estate planning documents, especially in instances where family members are named. Generally, such provisions are permissible subject to certain restrictions. For example, South Carolina Trust Code § 62-7-1008 permits exculpatory provisions unless

(a) it relieves the trustee of liability for a breach of trust committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the beneficiaries; or
(b) was inserted as the result of an abuse by the trustee of a fiduciary or confidential relationship to the settlor.

Interestingly, the South Carolina Trust Code does not adopt a provision in the Uniform Trust Code providing a default rule that "an exculpatory term drafted or caused to be drafted by the trustee is [such an abuse] unless the trustee proves that the exculpatory term is fair under the circumstances and that its existence and contents were adequately communicated to the settlor." The comments to Uniform Trust Code § 1008 provides that the default presumption could be overcome if the client was represented by independent counsel.

The comments to South Carolina Trust Code § 62-7-1008 do not explain why the UTC default presumption was not adopted in South Carolina. However, its exclusion may be of limited consequence. That is because Rule 1.8(h)(1) provides that "[a] lawyer may not make and agreement prospectively limiting the lawyer's liability to a client for malpractice unless the client is independently represented in making the agreement." Comment [11] provides that this rule is put in place because such agreements are likely to undermine competent and diligent representation." The ACTEC Commentaries to Rule 1.8 reiterate this point.[27]

While the drafting attorney is precluded from inserting an exculpatory provision that may exculpate that same attorney in a fiduciary capacity, the Restatement (Third) of Trusts notes that

> [e]xculpatory clauses are to be distinguished from trust provisions that modify a trustee's powers and duties; modifications may affect the question of whether certain conduct by the trustee constitutes a breach, whereas an exculpatory clause may eliminated or limit a trustee's liability when a breach of trust does occur.[28]

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[27] Those comments provide as follows:

> Under some circumstances and at the client's request, a lawyer may properly include an exculpatory provision in a document drafted by the lawyer for the client that appoints the lawyer to a fiduciary office. (An exculpatory provision is one that exonerates a fiduciary from liability for certain acts and omissions affecting the fiduciary estate.) The lawyer should not include an exculpatory clause without the informed consent of an unrelated client. An exculpatory clause is often desired by a client who wishes to appoint an individual nonprofessional or family member as fiduciary.

[28] RESTATEMENT (THIRD) OF TRUSTS § 96, cmt. a (Tentative Draft No. 5, 2009).

This distinction is important given that drafting attorneys often use trust terms to expand the scope of what fiduciaries are permitted to do. One example of such a provision is the inclusion of terms that allow (and perhaps even encourage) a personal representative or trustee to maintain a closely-held business. While the drafting attorney would not appear to need to have the client obtain outside counsel to review such powers, there seems little doubt that Rule 1.4 and common sense dictate that the drafting attorney explain these provisions to the client.

E. Removal.

While there are statutory mechanisms for removing fiduciaries, it is common practice for a drafting attorney to provide a specific mechanism allowing an individual or group of individuals the opportunity to remove and replace the fiduciary, especially where the fiduciary is not a family member. One typical example is the ability of some group to remove a corporate fiduciary and replace it with another corporate fiduciary. Similar provisions are also common where other individual professionals (e.g., accountants) are serving. As always, these provisions should be discussed clearly with the client, who would need to make informed decisions on the matter.

Where the drafting attorney is to be named as a fiduciary, it is probably best practice for a drafting attorney being appointed as a fiduciary to be sure to provide a removal mechanism.[29] Doing so at the very least reduces the likelihood that the drafting attorney overreached in accepting or seeking an appointment.

F. Delegation; Directed Trustees.

While an attorney's particular skills may make him an appropriate choice to serve as fiduciary, it is doubtful that the attorney's "tool box" will cover the full range of skills necessary to handle every aspect of fiduciary administration. Just as other fiduciaries may, the attorney/fiduciary can looks to others to assist in areas where the attorney needs help.

1. Delegation.

Personal Representatives and Trustees generally are permitted to delegate their authority to other fiduciaries or agents,[30] and this should be the case as well for attorneys serving as fiduciaries. Generally, delegation to a co-fiduciary does not reduce a fiduciary's liability for actions taken by the co-fiduciary. On the other hand a fiduciary who exercises reasonable care may employee agents, such as attorneys, investment advisor, and real estate and other professionals, and avoid liability for actions of the agent.

Whether specific tasks are delegable depends on the terms of the relevant documents and whether a prudent fiduciary would delegate the task in similar circumstances. If the drafting attorney will be named as fiduciary, he will

[29] *See* Amy K. Kanyuk, *Perils and Potential Profit of a Lawyer Serving as Trustee*, EST. PLANNING J. (Feb. 2014).

[30] See S.C. CODE ANN. §§ 62-3-7-715(19) (personal representative's authority to employee others), 62-3-717 (delegation among co-personal representatives), 62-7-703 (dealing with co-trustees generally), and 62-7-807 (trustee's ability to delegate to co-trustee and agents).

want to discuss any limitations on his ability to delegate his powers, keeping in mind that the factors that lead to the attorney's selection as fiduciary may be indicative of the types of tasks a client would reasonably expect the attorney to do himself.

The ability to delegate should be clearly explained to the client, especially as that ability materially impacts the selection of a fiduciary.

2. Directed Trustee.

Instead of relying on a trustee's determinations about delegation, a client may desire to expressly empower others to make certain determinations. For example, South Carolina Trust Code § 62-7-819 provides that a trust instrument may designate one or more "trust investment advisors" whose directions a trustee is required to follow. In exchange, the trustee generally has no duties with respect to the trust investment advisor's conduct.

One wonders whether the ability to segregate functions in a way that effectively absolves the directed trustee from actions in certain parts of the trust administration will affect an attorneys' willingness to serve as a trustee.

G. Trust Protectors.

With the addition of South Carolina Trust Code § 62-7-818, the inclusion of trust protectors in trust instruments is likely to increase. Trust protectors can be given broad powers to amend trust terms, remove or replace trustees and other advisors, change trust situs or even terminate a trust. Before including such provisions in a trust instrument, the drafting attorney will need to discuss the pros and cons of providing for a trust protector and what specific powers the trust protector will have.

Even for drafting attorneys who as a matter of course decline to serve as personal representatives or trustees, the attorney may be willing, and it may be appropriate, to name the drafting attorney as trust protector. In such instances the drafting attorney should consider all of the same factors relative to the appointment of any other fiduciary.

H. Safekeeping Assets.

One of the primary duties of personal representatives and trustees is safekeeping assets for the benefit of heirs, devisees and beneficiaries (not to mention creditors). Any attorney preparing to serve as fiduciary needs to be prepared to take those actions necessary to maintain and safekeep the assets under his control.

For financial assets, this might mean creating custodial or similar accounts or taking possession of bonds and stock certificates and placing them in a safe deposit box or vault. For tangible property, real and personal, the efforts may be more involved and require at least making sure that adequate hazard and liability insurance is maintained but may also demand making regular efforts to observe and review the property in person (or engage others to do so).

I. Fiduciary Bonds.

Fiduciaries may be required to post a bond covering their appointment, either as a default requirement or at the request of a court or interested party, although under South Carolina law trustees may not be required to post bond if the trust instrument excuses the trustee from doing so.[31]

While it is common for wills and trust instruments to waive bond for fiduciaries named therein, a drafting attorney who will be named as a fiduciary will need to discuss with his client whether it is appropriate to waive the bond requirement in those documents instead of relying on general statutory requirements and exceptions. Even where a client may otherwise be comfortable waiving bond, the attorney himself may consider whether posting a bond is appropriate, especially where the attorney's malpractice coverage would not cover the attorney's actions as fiduciary.

J. Professional Liability and Other Insurance.

Before serving as a personal representative, trustee or other fiduciary, an attorney should closely examine his firm's malpractice coverage to determine whether and to what extent actions taken (or not taken) in such fiduciary capacity(s) are covered under such policies. In doing so care should be taken in reviewing the "professional services" that are covered and any specific exclusion applicable to the policy. For example, a malpractice policy may define professional services to include services rendered as a personal representative or trustee but specifically exclude such services provided to an estate or trust of which the attorney is also an heir, devisee, or beneficiary.

Where insurance coverage is not available under a general malpractice insurance policy, the attorney should consider obtaining a fiduciary bond or other specific liability insurance. Further, the attorney should consider possible sources of liability, such when the attorney as fiduciary has taken possession and control of estate or trust assets and/or hires outside contractors to maintain such asset, and seek to obtain coverage as appropriate.

III. Conclusion.

A drafting attorney's service as fiduciary may be an appropriate solution to a client's unique personal situation. Further, serving as a fiduciary may also be personally and financially rewarding to a drafting attorney. However, drafting attorneys should be circumspect about the many issues that arise in such situations. Failing to do so can be a trap for the attorney and detrimental to the client.

[31] *See* S.C. CODE ANN. §§ 62-3-603 (dealing with personal representatives) and 62-7-702 (dealing with trustees).

Resources

ACTEC Commentaries on Model Rules of Professional Conduct (5th Ed. 2016) (available at https://www.actec.org/professionals/publications-and-videos-for-estate-planning-professionals/)

ACTEC Engagement Letters: A Guide for Practitioners (3d Ed. 2017) (available at https://www.actec.org/professionals/publications-and-videos-for-estate-planning-professionals/)

South Carolina Bar

Continuing Legal Education Division

Retirement Benefits Payable to Trusts

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Retirement Benefits Payable to Trusts

Al Todd Estate Planning Workshop
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Retirement Benefits Payable to Trusts[1]

I. OVERVIEW AND GENERAL TERMS

A. Read the Plan. The rules that are discussed in this outline may or may not be available based on a participant's specific retirement plan. Due to the complexity and length of qualified retirement plan documents, the Summary Plan Description (SPD) may be the best place to start prior to making a participant's account in a retirement plan payable to a trust.

B. Qualified Retirement Plans ("QRP"). QRPs are subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). Examples include, but are not limited to, 401(k) and 403(b) plans. Non-qualified plans are beyond the scope of this outline. Non-qualified plans are exempt from most of ERISA's requirements and are sometimes used by employers in conjunction with QRPs.

1. This outline uses the terms "participant" and "owner" interchangeably to refer to a QRP account holder. ERISA uses the term "employee."

C. Individual Retirement Account ("IRA").

1. Traditional
2. Roth
3. SEP – IRA for small business owners and self-employed people
4. SIMPLE – Employer must match or make non-elective contributions

D. Required Beginning Date ("RBD"). The date that the participant of the plan is required to withdraw funds from the retirement account. This represents the starting date that Required Minimum Distributions must be withdrawn from the retirement account. Generally, the RBD is the April 1 of the year following the year the participant turns 70½ (or, in some instances, when the participant retires, if it is a later date). Note that the ½ year is counted in months and not days.[2]

1. Example 1: Don was born on June 30, 1950. Don turns 70 on June 30, 2020. Don turns 70½ on December 30, 2020. Don's RBD is April 1, 2021.
2. Example 2: Betty was born on July 1, 1950. Betty turns 70 on July 1, 2020. Betty turns 70½ on January 1, 2021. Betty's RBD is April 1, 2022.
3. Exception: Roth IRAs do not have a RBD during the account owner's lifetime.

E. Applicable Distribution Period ("ADP"). The period over which a participant or beneficiary takes RMD payments or distributions from the account. Life expectancy factor provided by IRS tables.

1. Tables used during owner's life:

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[1] These materials are based in large part on David A. Thompson's outline which was presented at Probate & Pumpernickel in Greenville, South Carolina in May 2019.
[2] Treas. Reg. §1.401(a)(9)-2, A-3.

a. Uniform Lifetime Table/Joint – assumes owner and spouse exactly ten (10) years younger
b. Joint and Last Survivor Table – used if spouse is more than ten (10) years younger than owner

2. Tables used after owner's death:
   a. Single Life Table (life-expectancy minus 1)
3. 5-year payout method

F. Required Minimum Distribution ("RMD"). The amount required to be withdrawn by the participant from the retirement account by December 31st each year.

1. A participant's RMD is computed by dividing the year-end account balance by an actuarially determined annually declining life expectancy factor. There are three (3) life expectancy tables that are used to calculate RMDs.[3]
2. These RMD rules apply to 401(a) qualified plans (e.g., 401(k) plans), 403(b) plans, IRAs, SEP-IRAs, SIMPLE IRAs, 457 plans, Keogh plans, governmental plans, church plans, and Roth 401(k) plans.
   a. Exception: Roth IRAs are subject to the RMD rules only after the participant's death. Roth IRA owners are never required to take RMDs during their lifetimes.
3. During the owner's lifetime the RMD is recalculated every year by referring to the applicable IRS chart
4. Penalties – 50% excise tax on amount that was not distributed.
   a. Failure to properly establish "see-through" trust status and accurately calculate RMDs results in the excise tax.
   b. The trustee is main party responsible for the calculation and distribution of RMDs; secondarily responsible party is a plan administrator, if applicable.

G. Designated Beneficiary ("DB"). The valuable income tax deferring life expectancy payout method (i.e., the "stretch" payout method) is only available to Designated Beneficiaries.

1. Any individual designated as a beneficiary of the retirement benefits by the owner or participant.[4]
   a. Can be a class of individuals, as long as the oldest member of the group is identifiable.
2. The estate of the participant is not a DB.
3. If a participant fails to fill out a beneficiary designation or if the beneficiaries (primary and contingent) named by the participant fail to survive him, then the "default beneficiary" under the plan document takes.
   a. Under these circumstances, the plan documents may direct payment of the benefits to the participant's estate or to the participant's spouse.
4. Trusts may be a DB if they qualify as a "see-through" trust.

H. Beneficiary Designation Date ("BDD"). The designated beneficiaries for purposes of RMD calculation are the beneficiaries remaining as of September 30 of the calendar year

[3] Exception: The life expectancy tables will not be used in situation where the post-death 5-year payout rule applies.
[4] I.R.C § 401(a)(9)(E).

following the participant's death. Means by which a DB may be removed prior to the BDD:

1. Distribution
2. Qualified Disclaimer
3. Post-death trust amendments (i.e., "switch" trust)?
4. Death of trust beneficiary? – does the estate of the beneficiary still have a claim to the retirement benefits?

I. Rollovers and Trustee-to-Trustee Transfers. Means for allowing retirement plan assets to be moved from one plan or account to another one.

1. Trustee-to-Trustee rollovers/transfers
2. Spousal rollover:
   a. Additional opportunity for income tax deferral
   b. Availability of rollover through estates and trusts

II. CONSIDERATIONS REGARDING THE USE OF TRUSTS

A. In most cases, it makes sense for the participant to name an individual as the beneficiary of their retirement accounts, and for married couples, that individual is typically the participant's surviving spouse because of the opportunity for additional income tax deferral. However, sometimes income tax deferral may not be the client's primary goal.

B. Identify the participant's goals. Certain situations where it may be advisable to name a trust as the beneficiary of a retirement plan account include:

1. Beneficiary is a special needs child/person and relies on government benefits;
   a. Beneficiary is a second spouse or participant wants beneficiary to have limited access;
   b. Beneficiary is a minor (avoid conservatorship);
   c. Beneficiary is a spendthrift or has an addiction or compulsive disorder;
   d. Asset/divorce protection; or
   e. Using estate and GST tax exemptions (depending on the amount of the participant's estate).

III. "SEE-THROUGH" TRUSTS - TRUSTS AS DESIGNATED BENEFICIARIES

A. Other than the special spousal election, most optimal form of post-death retirement benefit payout is over the life expectancy of the beneficiary. Only DBs qualify for life expectancy payout.

B. Importance of trusts as DBs: Ability to qualify for "stretch" payout.

1. If trust is not a DB (i.e., cannot qualify as a "see-through" trust):
   a. Death of participant prior to RBD – 5-year payout period
   b. Death of participant after RBD – participant's remaining life expectancy from the single life IRS chart

C. RMD Trust Rules. The four (4) requirements to qualify a trust as a DB are:

1. The trust must be valid under state law.[5]
2. The trust is irrevocable or will be irrevocable upon the owner's death.[6]
3. Beneficiaries of the trust who are beneficiaries with respect to retirement benefits are identifiable from the trust instrument.[7]
4. Certain documentation must be provided to the plan administrator or account custodian by October 31st of the year following the owner's death.[8]
5. Note: The "Fifth" RMD rule that all trust beneficiaries must be individuals.[9]

D. Rule 1: Valid under state law. No PLR or IRS guidance that provides an example of a trust that fails under this requirement.

1. Testamentary trusts meet this requirement – this rule does not require that the trust be in existence or funded with assets prior to the owner's death.[10]

E. Rule 2: Irrevocability.

1. Including a statement of irrevocability in a testamentary trust or living trust is technically not required but is best practice.
2. There has been no IRS guidance on when a trustee's powers to amend provisions of a trust constitute a power to "revoke."

F. Rule 3: Beneficiaries must be identifiable. A DB need not be specified by name by the account holder. Members of a class of beneficiaries will be treated as identifiable "if it is possible to identify the class member with the shortest life expectancy."[11]

1. Must be possible to identify the OLDEST trust beneficiary because that person's life expectancy is determinative upon the owner's death.
   a. Consider: Trust beneficiaries are "my descendants living from time to time" – adoption?[12]
2. The mere possibility that an older trust beneficiary could be added means that the trust flunks this requirement.
   a. Example 3: Pete leaves his IRA to a trust that is to pay income to his only daughter, Tammy, and after her death is to pay income to her widower (if any) for life, with remainder to Pete's then living descendants.
      i. Potential to marry an older beneficiary means the trust's beneficiaries cannot be treated as DBs.
3. "Identifiability" of beneficiaries is determined as of the date of the owner's death.

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[5] Treas. Reg. §1.401(a)(9)-4, A-5(b)(1).
[6] Treas. Reg. §1.401(a)(9)-4, A-5(b)(2).
[7] Treas. Reg. §1.401(a)(9)-4, A-5(b)(3).
[8] Treas. Reg. §1.401(a)(9)-4, A-5(b)(4); Generally, a trust that satisfies all four RMD Trust rules will ensure that the beneficiaries of the trust are treated as the designated beneficiaries for RMD calculation purposes.
[9] *See* Natalie B. Choate, *Life and Death Planning for Retirement Benefits*, 413 (8th ed. 2019)
[10] Treas. Reg. §1.401(a)(9)-5, A-7(c)(3), Examples 1 and 2.
[11] Treas. Reg. §1.401(a)(9)-4, A-1.
[12] *See* PLR 201203033.

a. Everyone born in the same year has the same life expectancy (male and females).[13]
b. "The identity of the beneficiaries can be determined by perusing the trust's terms"[14] – unclear what IRS means by this

G. Rule 4: Documentation to Plan Administrator. Trustee responsible to provide certain documents to plan administrator (or IRA trustee/custodian).

1. Provide either:
   a. Summary containing:
      i. Final list of trust beneficiaries (including contingents and remaindermen with description of conditions on their entitlement) as of September 30th of the calendar year after the calendar year of the owner's death;
      ii. Certify that to trustee's knowledge the list is accurate and complete;
      iii. Trust's terms satisfy the "see-through" requirements; and
      iv. Agreement to provide a copy upon request
   b. Provide a copy of the trust document.
2. Failure to provide documentation or provision of improper documentation is not disqualifying for trust to be DB.
   a. May expose the account holder to the 50% excise tax for failure to take an RMD should it have been greater than was provided under the documentation to the plan administrator.[15]

H. Rule 5: All trust beneficiaries are individuals.

1. Greatest risk: Participant's estate.[16]
   a. Provision requiring payments to participant's estate for expenses or taxes?
      i. Best practice: Provision that forbids to any non-individual after the BDD.
      ii. Post-mortem – removal of the estate as a beneficiary prior to the BDD.[17]
      iii. No PLR has disqualified a trust based on a clause allowing payment to the estate or because of actual payments.
2. Another potential risk is charities.
3. Determining which beneficiaries count for purposes of the RMD rules:
   a. Disregard any beneficiary who predeceases the owner.
   b. Determine whether beneficiaries may be disregarded because they will not receive any retirement benefits under the trust (i.e., they will receive other income or principal).
   c. Determine which beneficiaries can be removed prior to the BDD or disregarded as "mere potential successors."
4. Sub-trusts – Can we disregard beneficiaries of shares or sub-trusts that do not receive any portion of the retirement benefits?

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[13] *See* PLR 200235038.
[14] PLR 200620026.
[15] Treas. Reg. §1.401(a)(9)-4, A-6(c)(2).
[16] Note that a §645 election will not cause a trust to fail this requirement even though under a 645 election the trust and the estate are treated as one entity for income tax purposes; *See* Treas. Reg. §1.645-1(e)(2)(i).
[17] *See* PLR 200432027 (Trustee had already withdrawn money to pay taxes prior to the BDD; even though the IRA is still subject to contingent liability on estate taxes).

a. The IRS has confused the question of who counts for beneficiary purposes under a sub-trust with the issue of "separate accounts" treatment.[18]
b. If the beneficiary designation directly names one or more of the particular sub-trusts and not the funding trust, then only the sub-trust's beneficiaries will "count for" "see-through" status.[19]
c. Trust instrument mandates allocation? – it is less clear, but there is some PLR support that you can disregard the other sub-trust beneficiaries
d. Trustee's discretionary allocation of assets – unclear; old PLRs say its okay

5. "Mere Potential Successors" – "A person will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy… *merely because the person could become the successor* to the interest of one of the [owner's] beneficiaries after that beneficiary's death."[20]

IV. CONDUIT TRUSTS AS SAFE HARBORS & ACCUMULATION TRUSTS

A. Conduit Trusts. Type of "see-through" trust with specific guidance from the IRS. Key concept: This type of "see-through" trust has NO power to accumulate retirement benefit distributions in trust.

1. After death of the owner, the trustee is required to distribute all distributions from the retirement account to the beneficiary during such beneficiary's life.
2. Benefit – The remainder beneficiaries are not counted for RMD calculation purposes.
3. All distributions – not just RMDs
4. Trust provisions should limit payment of distributions to only retirement accounts that qualify for the "stretch" payout.
5. Conduit provisions must come into effect upon the participant's death.
6. Conduit trust for one individual beneficiary is a safe harbor.[21]
7. No example in regulation provides for a conduit trust with a group of collective beneficiaries.
   a. Example 4: Don dies leaving his IRA to a trust for his three children, Sally, Bobby, and Eugene. All of Don's children are under 30. The trust provides that all retirement benefit distributions must be paid out in proportions as in trustee's discretion for the children's HEMS. The trust terminates when no living child is under 30 and is distributed to Don's then living children or to charity, as applicable. Unclear – some IRS support.[22]
      i. Oldest child of Don would be determinative of the ADP.

B. Additional Considerations with Conduit Trusts. Conduit trusts intuitively defeat the purpose of putting assets in trust.

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[18] *See* PLR 199903050.
[19] *See* PLR 200537044, PLR 200607031.
[20] Treas. Reg. §1.401(a)(9)-5, A-7(c).
[21] Treas. Reg. §1.401(a)(9)-5, A-7(c)(3), Example 2 (support for safe harbor whether the remainder beneficiaries are charities, an estate, or older individuals, even potential appointees under a POA are ignored).
[22] *See* PLR 200329048.

1. Conduit trust with Grantor trust – Beneficiary has the right to demand immediate payment? IRS has not taken a position on this; however, on its face it seems to violate the requirements of the regulations.
2. Switch trust – Provides a trust protector the power to amend the trust to change from a conduit to an accumulation (i.e., remove beneficiaries as needed and change distribution standards)
   a. Operates in a narrow time window between participant's death and BDD.
   b. Limited IRS guidance on the topic.[23]
3. IRS has permitted payment of expenses associated with the administration of the trust from retirement benefits held in a "conduit trust."[24]
4. Tracing requirement for RMDs

C. Accumulation Trusts. Any trust that is a "see-through" trust but is not a conduit trust. A true conduit trust is a safe harbor "see-through" trust.

1. Count beneficiaries as of the death of the participant until you find one entitled to immediate and outright receipt of the retirement benefits held in trust.
2. IRS is at best inconsistent in how it applies "see-through" trust rules to accumulation trusts.
3. Example 5: Roger dies leaving his retirement benefits payable to a trust for the benefit of his spouse, Jane, for her life. Upon Jane's death to be divided among Roger's "lineal descendants then living," with each descendant's share to be distributed outright at 30 or in trust until such descendant attained 30.
   a. If all children had already attained 30?[25]
4. Example 6: Harry dies leaving his IRA payable to a trust for his daughter, Beatrice. Pursuant to the terms of the trust, Beatrice is to receive all of the benefits and trust property no later than age 30. If Beatrice dies before 30, then the trust would pass to Beatrice's descendants, if any, otherwise to Harry's "heirs-at-law." At Harry's death Beatrice has no descendants. Harry's heir-at-law at the date of his death is his wife, Jennifer.[26]
5. Circle trust – draft around the issue of finding a younger beneficiary entitled to immediate and outright distribution.
   a. Note that simultaneous death situations are ignored for purposes of "see-through" status.[27]

D. Powers of Appointment ("POA").

1. Beneficiary's POA – Unless the POA applies only to "mere potential successor" beneficiaries then they are counted for purposes of a trust's compliance with the "see-through" rules.
   a. Not relevant for conduit trusts.
   b. A beneficiary's POA should be limited to individuals who are younger than the intended-to-be oldest beneficiary of the trust (or other ignorable trusts).

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[23] *See* PLR 200537044.
[24] *See* PLR 200432027. *See also* PLR 200620026 (IRS support for payment of "asset management fees").
[25] *See* PLR 200438044, PLR 200520012, PLR 200608032.
[26] *See* PLR 200843042.
[27] Treas. Reg. §1.401(a)(9)-5, A-7(c)(3); *See* PLR 201203033.

c. POA to beneficiary's spouse creates a non-identifiable beneficiary problem.
d. POA to a charity would cause a trust to fail "see-through" status.

2. Trusts as beneficiaries – payment to new trusts count as beneficiaries and the very possibility of payment or decanting to a non-compliant trust may prevent "see-through" trust status
   a. Should include a provision prohibiting decanting into non-qualifying trusts
   b. No PLR or IRS guidance yet out discuss decanting in this context

E. Outlier IRS Rulings.

1. There are rulings where the IRS does not "count" through all the possible beneficiaries and instead ignores potential appointees or the potential that a beneficiary may die prematurely.
   a. Example 7: Ken died leaving his retirement benefits payable to a trust. The trust provided that the funds would be paid out to his son, Edward, when Edward reached 35. If Edward died prematurely, then to Edward's issue, otherwise to Ken's other descendants. At Ken's death he has no other descendants and Edward has no issue.[28]
      i. If Edward is over 35?
      ii. If we don't know Edward's age? IRS – the trust passes because no other "beneficiaries" are named in the instrument.
   b. Back-up Trust – what about back-up trusts for young or minor beneficiaries?
   c. Example 8: Gene died leaving his IRA to a trust. The trust paid all income to his daughter, Elizabeth, for her life and also provided for principal distributions. Trust would terminate and distribute to Elizabeth at 50. If Elizabeth died before 50 it would be held for the benefit of her children Sally and Bobby, to be distributed outright at age 21. If Sally and Bobby died before reaching 21 then it would pass to their estates. Sally and Bobby are under 21 and Betty is under 50 at the time of Gene's death.
   d. PLR 201633025 – ignores the fact that nobody is an immediate outright beneficiary
      i. Back-up trusts are a staple of estate planning, so many have argued that this is the proper outcome, but it flies in the face of previous IRS rulings.
      ii. Note that all back-up trusts where there is no immediate outright beneficiary rely on this PLR.

V. DRAFTING CONSIDERATIONS, MISCELLANEOUS CONCERNS & FINAL THOUGHTS

A. Trust Accounting Income. Normally, retirement account distributions are gross income to the trust for federal income tax purposes, but such retirement account distributions may be principal for trust accounting purposes.

1. 10% Rule: Unless the trust has its own definition – RMDs are 10% income and 90% principal; any additional distribution is all principal

[28] *See* PLR 201320021.

2. Marital Deduction Trusts – the IRS has described two acceptable methods for determination of retirement account "income" that is payable to a marital deduction trust:
   a. "Trust-within-a-trust" approach – Trustee shall treat each "separate fund" (i.e., retirement account) held by the trust as if it were a trust itself and calculate the income for each "separate fund" under the UPIA. Surviving Spouse can request all internal income.[29]
   b. If internal income of the "separate funds" is not determinable, then Trustee should use the "Unitrust" approach. IRS provided a 3-5% annual guideline.[30] South Carolina's trust code uses 4%.[31]
3. Consider drafting the definition of income so that it does not matter or in the case of a conduit trust provide for specific payment of RMDs in conjunction with other income.
4. Example Provision for a Marital Trust:

   If distributions from the Plan to a Marital Trust for any distribution calendar year (as defined in the Internal Revenue Code, as amended) total less than that which is required by section 401(a)(9) of the Internal Revenue Code, as amended, for such distribution calendar year, Trustee shall demand additional distributions from the Plan so that the minimum distribution requirements of section 401(a)(9) of the Internal Revenue Code, as amended, are satisfied. Trustee may require the Plan to make distributions to a Marital Trust in excess of the minimum amounts otherwise required to be distributed.

5. Define "Plan" – can be an IRA, QRPs, or more as needed; should not be so broad as to include accounts/plans that are not eligible for "stretch" payout.
6. Define "Marital Trust" – trust created for which the martial deduction is allowed in Grantor's federal estate tax proceedings.

B. Separate Account Treatment.

1. Separate account treatment is not available for purposes of determining the ADP for benefits paid to multiple beneficiaries through a single trust.
2. This is not to be confused with the fact that the IRS has allowed separate account treatment for inherited retirement accounts paid to a single trust for RMD purposes, just not for calculation of the ADP.
3. Drafting Tips.
   a. The participant must cause a separate trust to be established for each beneficiary; "separate shares" under a single funding trust is not sufficient.[32]
   b. The beneficiary designation must name each separate trust directly as a beneficiary of his retirement account.
   c. Owner may do this by either establishing separate accounts during his life or paying to each separate trust at death.

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[29] Rev. Rul. 2006-26, 2006-1 CB 939. *See also*, S.C. Code Ann. §62-7-918(F) for South Carolina's similar "trust-within-a-trust" approach.
[30] Rev. Rul. 2006-26, 2006-1 CB 939.
[31] S.C. Code Ann. §62-7-918(G).
[32] *See* Natalie B. Choate, *Life and Death Planning for Retirement Benefits*, 432 (8th ed. 2019)

d. Example Provision:
Each share so provided for a living child of mine shall be distributed to the Trustee of the separate trust created under Paragraph (X) of my Last Will and Testament.

C. Provisions for "See-Through" Trusts.

1. RMD withdrawal provision for conduits
   a. Example Provision:
   Each year, beginning with the year of my death, and during the lifetime of my wife, my Trustee shall withdraw from any Deferrable Retirement Benefit (as hereinafter defined) the Minimum Required Distribution for such Deferrable Retirement Benefit for such year, plus such additional amount or amounts as my Trustee deems necessary or advisable for the health, support and maintenance of my wife. All amounts so withdrawn (net of expenses properly charged thereto) shall be promptly paid directly to my wife upon receipt by my Trustee and shall not be accumulated in this trust.
   b. Define deferrable retirement benefit: (1) subject to the RMD rules and (2) a plan that allows for "stretch" payout method.
   c. Define RMD as its meaning under the Code.
   d. Marital Deduction Trust – see above income definition.
2. Prohibit the payment of debts, expenses, or taxes, or prohibit payment of such after the BDD.
   a. Example Provision:
   Notwithstanding anything in this Agreement to the contrary, Grantor directs that no Deferrable Retirement Benefit may be used or applied after the BDD for payment of Grantor's debts, taxes, expenses of administration, or other claims against Grantor's estate; nor for payment of estate, inheritance or similar transfer taxes due on account of Grantors death.

3. Provide that the trust is irrevocable upon death – again not technically required, but good practice.
4. Accumulation trusts should prohibit exercise of a POA that would flunk "see-through" trust rules.
   a. Example Provision:
   Notwithstanding anything herein or in the law to the contrary, after the death of Grantor, no exercise of a power of appointment granted in this Agreement shall be made which would cause a trust created under this Agreement that owns or is the beneficiary of a Plan asset to use a life expectancy calculation with respect to such Plan asset that is shorter than the life expectancy of (a) Grantor's wife, if Grantor's wife survives Grantor, or (b) Grantor's oldest descendant who survives Grantor if Grantor's wife does not survive Grantor.

5. Prohibit decanting into a non-"see-through" trust.
   a. Example Provision:
   Notwithstanding anything herein or in the law to the contrary, after the death of Grantor no modification, reformation, amendment or decanting of a trust created under this Agreement that owns or is the beneficiary of a Plan asset

to use a life expectancy calculation with respect to such Plan asset that is shorter than the life expectancy of (a) Grantor's wife, if Grantor's wife survives Grantor, or (b) Grantor's oldest descendant who survives Grantor if Grantor's wife does not survive Grantor.

D. Heirs-at-law provision/wipe-out provision. Some practitioners provide for an "ultimate" beneficiary with language such as "heirs-at-law" and limit such "heirs" to individuals younger than the oldest trust beneficiary.
   1. IRS's position on these types of clauses is unclear.
      a. What happens if there is no "heir-at-law" that meets the requirement? Does that mean it's the estate? Or the actual heirs-at-law?

E. Naming a separate trust for retirement benefits?
   1. Consider: tracing requirements with a pot trust.
   2. Separate trust is often impracticable for smaller estate plans.

F. GST Trusts and Dynasty Trusts.

   1. Naming a GST-trust means participant is "wasting" GST exemption paying income taxes.
      a. Exception: Roth
   2. What about naming the nonexempt GST share?
      a. General power of appointment for estate inclusion means you have introduced an estate (i.e., a non-individual) into the countable chain of beneficiaries.
         i. What if it is conduit trust?

G. Transferability of an IRA.

   1. IRAs are transferable.[33] Not the same as whether such transfer is a taxable event.
   2. This should theoretically be applicable to other QRPs.
      a. Anti-alienation restraints on QRPs?
   3. A trust can transfer an IRA to its beneficiaries regardless of whether the trust qualifies as a "see-through" trust.
   4. Transferring an IRA out of an estate or trust to the beneficiaries solely for the purposes of allowing the trust or estate to terminate is permitted.
      a. Generally, transfer has no impact on ADP.
   5. Example 9: Greg leaves his IRA payable to his testamentary trust. The trust provides income to Greg's wife, Joan, for her life. After Joan's death, the trust is to terminate and pass to Greg and Joan's son, Kevin. ADP for Joan is 20 years. Joan dies in year 10. Trustee has IRA provider retitle the IRA. After Joan's death the account would be held as "Kevin, as successor beneficiary of Greg, deceased."

VI. SECURE ACT

A. Setting Every Community Up for Retirement Enhancement ("SECURE") Act of 2019.
   1. The SECURE Act passed the House of Representatives on May 23, 2019.

[33] *See Generally* I.R.C § 408.

2. The SECURE Act would be the first major retirement legislation since 2006.
3. The Senate currently has a similar version of the SECURE Act called the Retirement Enhancement Securities Act ("RESA") on track for a vote. As such, due to differences only some parts of each may be passed and others will be modified prior to being signed into law.
4. The SECURE Act includes provisions that are beyond the scope of these materials. Some of these provisions include but are not limited to: (i) seeking to allow smaller employer's to set up 401(k) plans with less fiduciary liability concern and least cost, (ii) increases annuity options inside retirement plans, and (iii) penalty free distributions for birth of child or adoption.

B. Important Potential Changes.

1. Increases the RMD age for most retirement accounts.
   a. The SECURE Act would delay the RMD age to 72 for most retirement accounts.
   b. The RESA Act (the Senate version) would delay the RMD age even further to 75.
2. The SECURE Act removes the age limitation on IRA contributions. Under current law after age 70.5, you can no longer contribute to an IRA (but could still to contribute to a Roth IRA).
3. Removal of "Stretch" Inherited IRA Provisions
   a. Included in bill, because it is scored as a tax-generating provision.
   b. Except for spouses, most inherited retirement account beneficiaries would be required to distribute the account over a ten (10) year period instead of their life expectancy.
   c. The RESA Act's version of this provision is significantly different but would end the stretch provision for the portion of an inherited IRA exceeding $450,000.

C. It appears likely that some version of SECURE/RESA Act will pass at some time in the near future. The provisions in the final law will likely be different in some contexts, but some form of the Act is likely to pass.