Recent Wealth Transfer Developments

Professor Jeffrey N. Pennell
Emory University School of Law
Atlanta

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1. Interim Changes and Adjustments

Every year the Treasury Department is required to update certain figures that are indexed for inflation. For year 2016 the indexed figure for

- the §1(e) point at which an estate or trust enters the highest marginal bracket is $12,400,
- the annual exclusion remains at $14,000,
- the §6601(j) 2% portion increased to $1,480,000 (a $10,000 increase),
- the §2032A special use value maximum reduction also increased $10,000 to $1,110,000,
- the §2523(i)(2) noncitizen spouse annual exclusion increased $1,000 to $148,000, and
- the basic exclusion amount is $5,450,000.

2. Legislation

Extenders Enacted. The Protecting Americans from Tax Hikes (PATH) Act of 2015 made permanent a number of provisions or benefits of interest to estate planners (and added new extensions for several others), including:

§111 deletes §§170(b)(1)(E)(vi) and (b)(2)(B)(iii), which permanently extends the charitable deduction for contributions of real property for conservation purposes.

§112 deletes §408(d)(8)(F), which permanently extends the ability of an IRA owner who is over age 70½ to annually exclude from gross income up to $100,000 by distribution to most qualified charities (not including donor advised funds, and a few other exclusions).

§115 deletes the last sentence of the flush language in §1367(b)(2), which permanently extends the basis adjustment for S Corporations that make charitable contributions of stock.

§126 amends §1202(a)(4), which extends the temporary exclusion of gain on certain small business stock held for over five years, and also permanently extends a rule eliminating that gain as an AMT preference item.

§127 permanently extends the §1374(d)(7)(A) provision reducing from ten to five years the period for which an S Corporation must hold assets following conversion from a C Corporation to avoid the BIG (built-in gain) tax.

§151 extends for just 2016 the §108(a)(1)(E) exclusion from gross income of discharged qualified personal residence indebtedness.

§302 expands the definition of qualified higher education expenses in §529(e)(3)(A)(iii) for which plan distributions can be made to include “computer or peripheral equipment” and “computer software or Internet access and related services” used primarily by the plan beneficiary while enrolled in school.

§344 clarifies the valuation rules in §664(e) for early termination of a CRUT by assuming that the larger of the stated percentage distribution or 5% will be made each year, meaning that a net-income limitation in a NICRUT or a NIMCRUT must be ignored for valuation of the charitable remainder.

§408 provides that transfers to qualified §501(c)(4) (civic league), (c)(5) (labor, agricultural, or horticultural organization), or (c)(6) (business league, chamber of commerce, real-estate board, or professional football league) are not subject to gift tax; the critical aspect for most taxpayers likely is making contributions to a §501(c)(4) lobbying organization or political action committee.

Legislative Agenda. On Tax Day 2015 the House of Representatives passed H.R. 1105, which would have repealed the estate and generation-skipping transfer taxes and amended the gift tax to provide a 35% maximum rate and retain the current $5 million exclusion amount (indexed after 2010 for inflation). A transfer in trust would be treated as a completed gift (subject to gift tax) "unless the trust is treated as wholly owned by the donor or the donor's spouse" under the grantor trust rules. This appeared to confirm that the gist of the gift tax would be to preclude income shifting – a goal that likely could be accomplished under existing assignment of income doctrine. In any event, the provision was tone-deaf, in terms of what taxpayers seek through intentionally defective grantor trusts (e.g., paying income tax on income paid to a natural object of the taxpayer's bounty, with no gift tax liability upon satisfying that tax obligation). This provision might have turned on the complex and frequently overlooked "portion rules" found in Treas. Reg. §1.671-3.

Voting virtually along party lines (only 3 Republicans voted no and 7 Democrats voted yes), the Bill was mirrored in the Senate by S. 860. As promised, President Obama will veto any Act that comes to his desk that is not paid for (these Bills were scored as losing $269 billion over 10 years), so the intriguing question is whether Congress in 2016 might be serious enough about this endeavor to adopt a form of pay-back for repeal. The Obama administration previously suggested that Congress adopt a form of capital gain realization at death (similar to the Canadian AET – appreciation estate tax – which was adopted when Canada repealed its estate tax 40 years ago), which actually might be worse for many taxpayers than the current wealth transfer taxes. The Obama proposal was *not* in lieu of the existing taxes, so it like the Bills that Obama vetoed are political theatre or posturing. The most likely outcome – but not likely in 2016 – might be restoration of carryover basis in exchange for repeal of the two taxes. There is virtually no commentary discussing why or even whether retention of the gift tax is sensible or necessary.

Looking forward, among *other* changes advocated by the Obama administration in the 2015 Greenbook, which might be considered if Congress ever undertakes serious piecemeal tax reform (which seems unlikely in advance of the 2016 election) include:

- Returning to 2009 levels for the maximum rate (45%) and exclusion amount ($3.5 million for estate and GST purposes; $1 million for gift tax – both with no inflation indexing – and with a clarification that reduction in the exclusion would not trigger a clawback problem).
- A requirement that §1014 basis must equal the federal estate tax value of included property. See *Van Alen v. Commissioner*, 106 T.C.M. (CCH) 427 (2013), dealing with this issue. Without any warning (other than inclusion in the Greenbook) new §1014(f) was enacted as §2004 of the Highway Act, H.R. 3236, at the end of July 2015. See page 26. This shows that any item in the Greenbook might be enacted by Congress piecemeal, as payback for changes that have nothing to do with tax reform.
- Amend §2702 with regard to GRATs to require a minimum term of 10 years and a maximum term of life of the annuitant plus ten years, prohibit any decline in the annuity amount during the term, and require that a remainder interest have a value equal to the greater of 25 percent of the value of the assets contributed to the GRAT or $500,000. The proposal also would preclude any tax free exchange of assets with the GRAT. (With the §7520 rate hovering only as high as 2.4% in 2014, and an effective date for such a change that promises to be prospective only, it still is an opportune time to create a GRAT (or a CLAT — the economics being exactly the same), if the assets used to fund the trust are likely to perform at a higher rate than the assumed annual rate.

- Limit GST exempt trusts to a 90 year period to preclude perpetual tax free dynasty trusts, and deny the §2611(b)(1) exclusion for so-called HEET (Health and Education Exclusion Trust) payments from a GST nonexempt trust.
- When a defective grantor trust ceases to be defective, impose estate or gift tax on property received by the trust in any transaction that was ignored for income tax purposes.
- Extend the §6324(a)(1) lien throughout any §6166 deferral period.
- Eliminate the present interest requirement for gift tax annual exclusion purposes but create a category of transfers that is limited to $50,000 per donor, per year, on transfers defined in this category (even if the total gifts to any individual donee did not exceed the current per-donee $14,000 annual exclusion amount). "The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in passthrough entities, transfers of interests subject to a prohibition on sale, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee." Reference to §2642(c) is to a "tax vested" right of withdrawal that does not lapse and therefore will cause estate tax inclusion to the powerholder at death. The change is scored to raise $2.9 billion over 10 years.
- Expand the definition of "executor" in §2203, currently limited in application to Chapter 11 of the Code (the estate tax) to apply for all tax purposes.

Two previous recommendations do not appear in this year's version of the wish list:

- Amend §2704 to eliminate certain additional valuation discounts.
- Refine special interest provisions for farmers and small business owners.

Many of the Obama Administrations proposals were included in a bill introduced by Senator Bernie Sanders, the Independent from Vermont who is running for the Democratic Presidential nomination. They are mirrored by a bill introduced by Representative Schakowsky, a Democrat from Illinois. Neither has any likelihood of being approved in 2016 by the Republican-controlled Congress. Clearly each is representative of the political theatre that surrounds the wealth transfer taxes on both sides of the aisle, in both houses of Congress.

Just prior to the 2015 State of the Union address the Obama administration released talking points of reform proposals that included one of interest to estate planners: a form of capital gain realization at death – an AET (appreciation estate tax) similar to that adopted in Canada 40 years ago. Unlike the Canadian AET, however, the Obama proposal would not replace of the estate tax – it would be in addition to it. Sprinkled with various exceptions (for example, an exclusion of a base amount of gain on a personal principal residence, special treatment of farmers and ranchers, closely held business owners, and a spousal unity rule), it too is not likely to receive serious consideration by the Republican-controlled Congress. So it likely is only a chip for negotiations, or a public relations gambit.

A good reminder is that any form of repeal will likely be coupled with something else, maybe much less desirable than current law. For example, in 2010 the one-year hiatus of the estate tax was in exchange for carryover of basis. Even as a replacement for the current estate tax, the Obama proposal would be worse than carryover, in the sense that it taxes gain immediately at a decedent's death. Proving the historic basis of an asset would still be an administrative difficulty, and the tax liability would be immediate. Another option in exchange for repeal would be ZBAT – Zero-Basis-After-Transfer – which would eliminate the need for records of a decedent's basis and would allow for deferral of gain until a realization event

occurred. It would, however, impose capital gain tax on the full date-of-death fair market value of an asset, rather than wealth transfer tax on full fair market value.

Another potential change in the law would be repeal of the wealth transfer taxes *and* §§101 and 102, which would treat an inheritance (or a gift) and the receipt of insurance proceeds as taxable ordinary income.

Note that, without more, the Obama AET proposal (and most others) would significantly favor investment in life insurance, the proceeds of which are received free of income tax, without a built-in capital gain. In judging various alternatives it makes sense to consider which industry groups are involved behind the scenes, and which are the most effective lobbyists in Washington.

3. Priority Guidance Plan

The Treasury Department's "business plan" announces projects that it intends to pursue during the next year. It usually is a good indication of what bothers Treasury. Guidance regarding decanting fell off the list in 2013, and guidance concerning adjustments to sample charitable remainder trust forms under section 664 and concerning private trust companies fell off the list in 2014. The following projects on the 2015-2016 Plan are likely of interest to most estate planners (in the government's own terms, and using their numbering [with my annotations in brackets]). To view the full document go to www.irs.gov/uac/Priority-Guidance-Plan:

GENERAL TAX ISSUES

1. Guidance relating to *Obergefell v. Hodges*. [Reported at page 15.]

32. Guidance regarding material participation by trusts and estates for purposes of section 469. [This is relevant in the context of the net investment income tax under §1411.]

35. Final regulations under section 1411 regarding issues related to the net investment income tax. Proposed regulations were published on December 2, 2013. [The proposed regulations are discussed at page 26.]

GIFTS AND ESTATES AND TRUSTS

1. Guidance on qualified contingencies of charitable remainder annuity trusts under §664. [This was new in 2015.]
2. Final regulations under §1014 regarding uniform basis of charitable remainder trusts. Proposed regulations were published on January 17, 2014. [The proposed regulations are discussed at page 25.]
3. Guidance on basis of grantor trust assets at death under §1014. [This was new in 2015 and likely related to Rev. Proc. 2015-37, reported at page 26.]
4. Revenue Procedure under §2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability.
5. Guidance on the valuation of promissory notes for transfer tax purposes under §§2013, 2033, 2512, and 7872. [This was new in 2015 and likely a reaction to the *Davidson* litigation reported at page 19.]
6. Final regulations under §2032(a) regarding imposition of restrictions on estate assets during the six month valuation period. Proposed regulations were published on November 18, 2011. [Released as a reaction to *Kohler*; the government's primary concern is that

taxpayers will try to manipulate value by postmortem creation and funding of FLPs. The proposed regulations are discussed at page 10.]

7. Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate. [This is an important follow up to the final §2053 regulations.]
8. Guidance on the gift tax effect of defined value formula clauses under §§2512 and 2511. [This was new in 2015.]
9. Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP.
10. Final regulations under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption. Proposed regulations were published on April 17, 2008. [See page 22 regarding the proposed regulations.]
11. Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships. [This has rolled over since the 2003-2004 plan. A government official speaking at the American Bar Association Tax Section's Spring meeting in May promised (threatened?) that these would be released before that body's "next meeting" on September 18, 2015, which did not happen. Today there is no guess when it might be released.]
12. Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates. [Proposed regulations were issued on September 11, 2015, and are reported at page 24.]
13. Guidance under §§1014(f) and 6035 regarding consistent basis reporting between estate and person acquiring property from decedent. [This responds to enactment of these new provisions as discussed at page 26, with a mandate that Treasury promulgate "such regulations as necessary to carry out [§6035], including regulations relating to — (1) the application of [§6035] to property with regard to which no estate tax return is required to be filed."]

TAX ADMINISTRATION

10. Regulations under §6166 regarding the furnishing of security in connection with an election to pay the estate tax in installments.

4. Portability

Final Portability Regulations. T.D. 9725 promulgated final portability regulations with an effective date of 12 June 2015. These replace proposed and temporary regulations that were retroactively applicable to decedents dying after 2010. The timing is such that taxpayers may rely on them for all purposes, which generally is favorable because many positions in these pronouncements are taxpayer-friendly.

The final regulations clarify the concept of the §2010(c)(2)(B) and 2010(c)(4) deceased spousal unused exclusion (DSUE) amount and the §2010(c)(5)(A) portability election, with very few additions or changes from the proposed and temporary version. Among the items that are new, only the following three are likely to be significant to most taxpayers:

I. No extension of the time to file a late portability electing return can be granted under Treas. Reg. §301.9100-3 if the estate is larger than the decedent's basic exclusion amount,

because the time when those estates must file is established by §6018. But discretion to grant relief for tardy filing is available for smaller estates because the deadline for them to file is established by these regulations. See item 2 below, and **Private Letter Rulings 201601006, 201552010, 201551008, 201550032, 201549022, 201548004, 201544017, 201544003, 201544001, 201539021, 201537012, 201537010, 201536005, 201535004,** and **201532002,** which appear to be the first rulings actually granting such relief. All of these PLRs recount that the estates were below the §6018 filing threshold – only two say that a professional advisor was involved and none establish whether the estates placed reasonable reliance on that qualified tax professional – which gives the impression that all an estate must do is pay the filing fee to request the PLR and ask for relief – *if* the estate was below the exclusion amount. Note that PLR 201544017 *did* say that the taxpayer acted reasonably and in good faith "because, after exercising reasonable diligence (taking into account the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election." Which is a odd, given that filing a return is a deemed election. See item 1 below.

II. The portable DSUE amount allowable to a noncitizen surviving spouse beneficiary of a qualified domestic trust (QDOT) is no longer subject to adjustment after the spouse becomes a United States citizen, if §2056A(b)(1) is precluded from application because the §2056A(b)(12) requirements are met. See Treas. Reg. §§20.2010-2(c)(4)(ii), -2(c)(5) Example 4, and 25.2505-2(d)(3)(ii), and discussion item 11 below.

III. An estate's eligibility for any of the credits under §§2012-2015 does not affect the DSUE amount. Instead, Treas. Reg. §20.2010-2(c)(3) mandates application of the §2010 unified credit before any of those other credits, meaning that those credits do not preserve unified credit for portability.

Otherwise unchanged are positions that (as originally proposed and now made final) address the following important concepts (among many others).

1. Because nontaxable estates are not otherwise required to file an estate tax return, Treas. Reg. §§20.2010-2(a)(2) and -2(b) provide that merely filing an estate tax Form 706 for a nontaxable estate constitutes the requisite §2010(c)(5)(A) portability election (unless the executor affirmatively opts out of this presumed election – which would be unexpected). As explained by the preamble to the release of the final regulations, this eliminates the need for a "protective" election if, for example, the amount of a §2053 deduction might be increased during estate administration and that increase would reduce the amount of unified credit consumed, which could make unused exclusion amount available, for which an election might be desired.

2. Also because nontaxable estates are not otherwise required to file a return, Treas. Reg. §20.2010-2(a)(1) declares that the same return filing due date (including extensions) for *taxable* estates will apply for these purposes. Then, because that filing due date is pursuant to regulation and not the statute, it is susceptible to due date extension relief, as noted in item I above.

3. Treas. Reg. §20.2010-2(a)(4) makes the election by an appointed executor revocable until the return filing due date passes. Thus, the normal 15 month (nine months plus an automatic six month extension, if sought) filing deadline applies, during which an executor can have a change of mind about whether to make the election. The last timely filed return is the one that counts.

4. Notwithstanding that an election normally is not irrevocable until after the filing deadline, Treas. Reg. §§20.2010-3(c)(1) and 25.2505-2(d)(1) provide that the election relates back to the date of the decedent's death. This means that the surviving spouse can use that DSUE amount before the decedent's return is filed, and before the DSUE amount is known with certainty.

However, the amount is subject to audit at any time until the statute of limitation runs out on the surviving spouse's own estate tax return.

5. Portability requires the filing of a "complete and properly-prepared" Form 706 estate tax return. There is no Form 706EZ because §2010(c)(5)(A) requires the filing of an estate tax return, the government needs certain information to confirm that the marital deduction is properly allowed for property passing to the surviving spouse, and the government needs adequate information to compute the DSUE amount.

Nevertheless, to facilitate filing of a return to elect portability, these regulations establish special valuation rules for property that will qualify for the marital or charitable deduction. Applicable only if no return otherwise is required, and if four stated disqualifications are avoided, then this deductible property need not be formally appraised. Instead, Treas. Reg. §20.2010-2(a)(7)(ii)(A) establishes a due diligence standard by which an estate may estimate the value of property as falling within specified ranges provided on the Form 706.

This relief from normal valuation procedures is unavailable if any of the following four disqualifications apply:

(a) If the value of the property involved "relates to, affects, or is needed to determine the value passing from the decedent" to another recipient. This could apply if the amount of the marital and charitable bequests are determined by a formula that divides the estate, such as between marital and nonmarital trusts.

(b) If "[l]ess than the entire value of an interest in property includible in the decedent's gross estate is marital deduction property or charitable deduction property." This means that an intestate estate cannot qualify unless the surviving spouse and charity receive 100% of the decedent's probate estate. Note, however, that Treas. Reg. §20.2010-2(a)(7)(ii)(C) *Example 2* illustrates a probate estate that qualifies for the appraisal exception, notwithstanding life insurance that passes to children outside of probate. In the *Example* the insurance does not escape normal rules to establish its value, but the probate estate does.

(c) If only a partial QTIP election is made, or there is a partial disclaimer, resulting in less than 100% of the entitlement qualifying for the marital or charitable deductions.

(d) If values are needed to determine the estate's qualification for relief under §§2032 (alternate valuation), 2032A (special use valuation), "or another estate or generation-skipping tax provision of the Code for which the value of such property or the value of the gross estate or the adjusted gross estate must be known (not including section 1014 of the Code)." Curiously, reference in the proposed regulation to §6166 (deferred payment of estate tax) was deleted, and the reference to §1014 was added.

6. An impasse may arise if a surviving spouse wants the decedent's estate to make the portability election but the executor is not the spouse and chooses not to do so. This tension is not relieved, because any "appointed" executor's decision governs. But Treas. Reg. §20.2010-2(a)(6)(ii) does specify that, if there is no §2203 appointed executor acting, then any person in possession of estate property ("a non-appointed executor") may file a return and make an election, with the first to file having supremacy. Only appointment of a §2203 executor that then timely files a Form 706 can subsequently overcome or reverse this filing. This puts a premium on any race to file and it gives a surviving spouse who is in possession of estate assets one avenue to accomplish postmortem portability planning.

7. An "ordering" rule in Treas. Reg. §25.2505-2(b) provides that a surviving spouse uses any portable DSUE amount before using the spouse's own basic exclusion amount. This applies to

inter vivos transfers made by the spouse after remarrying but before that new spouse dies. It means that the surviving spouse can preserve and use a prior deceased spouse's DSUE amount without risk of losing it if the new spouse also predeceases the surviving spouse (which would cause the new spouse to become the last deceased spouse of the surviving spouse). See also Treas. Reg. §25.2505-2(a)(3) for confirmation that use after remarrying but before the new spouse's death is copacetic.

8. In a related vein, Treas. Reg. §20.2010-3(a)(3) specifies that divorcing a new spouse before that new spouse dies will preserve the surviving spouse's ability to use the DSUE amount from the last prior deceased spouse. Either way, these rules mean that a surviving spouse who did remarry and is likely to survive that new spouse can avoid loss of a portable DSUE amount by acting before the new spouse dies, either via divorce or by making a gift that consumes the portable DSUE amount.

9. Treas. Reg. §20.2010-3(b)(1) also confirms that a surviving spouse can make use of multiple DSUE amounts by surviving a series of spouses whose estates all make the portability election, *if* that surviving spouse is willing and able to make gifts of the portable exclusion amount of the last deceased spouse before the next (current) spouse dies.

10. Treas. Reg. §20.2010-2(c)(2) addresses the case of inter vivos taxable gifts that exceeded the exclusion amount that existed in the year of the gift, as to which the decedent paid gift tax. The regulation provides that, because those taxable gifts did not use the exclusion amount during life, they do not reduce the amount that can be transported at death. This is *only* relevant if (a) the exclusion amount increases subsequent to the year of those gifts, and therefore was not totally consumed by the inter vivos gifts, and (b) the estate at death also does not fully consume this increased exclusion amount (meaning that it remains unused). In such a case the calculation of the DSUE amount that can be transported to the surviving spouse calls for a reduction by only the amount of the exclusion actually used to reduce gift tax inter vivos and estate tax at death.

11. The portability election is more complex if a decedent employs a QDOT for marital deduction purposes because the surviving spouse is not a United States citizen. This is because §2056A(b) taxes a QDOT as if it was still the decedent-settlor's property. It is fundamentally unlike a normal marital deduction trust that incurs tax payable by the surviving spouse's estate when the spouse dies. (The surviving spouse *also* may incur tax on a QDOT but that does not eliminate the tax imposed on the donor's estate. It simply gives the spouse a nonlapsing credit similar to that in §2013 for tax paid by the deceased settlor.) The end result is that a QDOT incurs tax in the settlor's estate, with the calculation deferred in most cases until the surviving spouse dies. And that tax ultimately will consume what otherwise might appear to be a DSUE amount. Which means that the DSUE amount cannot be known until the QDOT has terminated and all tax attributable to that trust and imposed on the settlor has been calculated. As a result, Treas. Reg. §§20.2010-2(c)(4)(i), 20.2010-2(c)(5) *Example 3*, 20.2010-3(c)(3), and 25.2505-2(d)(3)(iii) *Example* all address the QDOT situation. In the final analysis these provisions confirm that a QDOT is merely a means by which the decedent's estate tax is deferred, rather than being shifted to the surviving spouse. And they make the DSUE amount uncertain while subject to adjustment prior to final termination of the QDOT or the surviving spouse becomes a citizen of the United States and meets the requirements of §2056A(b)(12), meaning that the tax imposed by §2056A(b) will not subsequently apply.

Note also that Treas. Reg. §§20.2010-2(a)(5) and 20.2010-3(e) confirm that a nonresident noncitizen decedent's estate cannot make a portability election in the first instance, even though it could use the §2056A QDOT. So care is required to distinguish between noncitizens and

nonresidents and to carefully consider whether estate tax will be imposed under §2001 in either spouse's estate.

A curious question – unanswered by these regulations – is whether spouses may establish a presumption of survivorship as between them that, if honored for state law purposes, would allow the deemed survivor to use the DSUE amount of the spouse who is deemed to die first. This might be attractive planning to permit a wealthy spouse to use a portable exclusion amount from a less wealthy spouse, in a simultaneous death context. The alternative is for the wealthy spouse to presume the less wealthy spouse to survive for marital deduction purposes, make a transfer to that spouse (for example, using a QTIP trust) that ultimately will benefit the same objects of the wealthy spouse's bounty. Either approach could be followed to effectively shelter the less wealthy spouse's unused exclusion amount, and either spouse ought to be able to presume the other to be the survivor for purposes of either the marital deduction or to make a portability election. Arguably the "relation back" regulation accomplishes that objective.

5. Sections 2031 and 2032: Estate Tax Valuation

Aggregation Denied in Valuing Real Estate. Two facts were crucial in **Estate of Pulling v. Commissioner**, T.C. Memo 2015-134: (1) the decedent's separately owned parcels had no access to any public right-of-way, and (2) the land with which the government wanted to aggregate those parcels for valuation purposes was owned by a partnership that was formed 34 years before the decedent's death. The decedent owned only a 28% interest in that entity, but other family members appeared to own another 32%. The court rejected the government's effort to aggregate the parcels because "Congress has explicitly directed that family attribution or unity of ownership principles be applied in certain aspects of Federal taxation, and in the absence of legislative directives, judicial forums should not extend such principles beyond those specifically designated by Congress" (quoting Minahan v. Commissioner, 88 T.C. 492, 299 (1987), citing Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981), and referencing only §6166).

The court's holding is especially meritorious because the entity and the decedent had so much time to aggregate their properties, and chose never to do so. In addition, the entity had rejected offers to sell its property for development purposes, and the only reason to aggregate the acreage was to determine a "highest and best use" value as residential rather than agricultural (citrus) property. (Note that §2032A special use valuation was not involved.)

The court addressed the valuation question in terms of a "use to which [property] may be readily converted," and applied a "reasonable likelihood standard" under which "there must be a reasonable probability of the lands in question being combined with other tracts for that purpose in the reasonably near future." This standard entails a question of fact and a presumption that "the use to which the land is currently being put is . . . the highest and best use," imposing the burden on the government to disprove that notion. Because it said that the record contained no evidence that aggregation was reasonably likely, the court specifically rejected the government's argument that family relationships alone were sufficient to support the notion that aggregation was a reasonable likelihood based on clear economic benefits that would flow from aggregation.

An interesting sidelight is that the estate originally used a 2004 appraisal, prepared for gift tax purposes and reported on the estate's Form 706 that was filed in 2006. The court adopted as correct a 2011 appraisal that reported much lower values, with no suggestion or discussion whether the Form 706 was an admission against interest by the taxpayer.

Alternate Valuation Proposed Regulations. **[Note: this item has not changed since its inclusion in 2011; it is here as a "place holder," awaiting final regulations.]** Proposed regulations were released in April 2008. Treasury retracted those original proposals in November 2011 and released a new set of proposed regulations, which are reflected in this summary.

The original impetus for these changes was Kohler v. Commissioner, 92 T.C.M. (CCH) 48 (2006), nonacq., 2008-01 AOD, 2008-1 C.B. 483, which involved three siblings and both gift and estate tax valuations. The primary wealth transfer tax issue was the §2032 requirement that an asset valued on the alternate valuation date must be the same as the asset that was included in the decedent's gross estate at death. Postmortem changes that alter the nature of the includible asset cannot be reflected in the alternate valuation.

The deceased Kohler sibling and two survivors were among family members who held about 96% of the stock in their privately held company (known primarily for its plumbing products). The decedent died in March and the company completed a tax-free reorganization in May, such that on the alternate valuation date in September the asset to be valued was arguably either the stock owned pre-reorganization or the post-reorganization replacement stock.

That made a difference, apparently, because the reorganization forced outsiders to sell their stock and it imposed transfer restrictions and granted purchase options that were designed to keep the reorganization stock within the family's control. Unexplained by the opinion, however, was why the government was exercised about the issue, given a stipulation that the stock-for-stock exchange was a tax-free §368(a) reorganization (apparently a §368(a)(1)(E) recapitalization) and, as a condition to qualify, the stock value before and after the reorganization had to be the same. Indeed, Judge Kroupa expressed surprise in her footnote 7 that the government pursued the §2032 argument. Presumably the rationale was that the value on the date of the reorganization was the same but the value of the new stock declined thereafter (and before the alternate valuation date), due to the restrictions.

At the time, Treas. Reg. §20.2032-1(c)(1) provided that a §368(a) tax-free reorganization is "a mere change of form" and not a disposition that accelerates the alternate valuation date. In large part based on this slightly different issue (acceleration), the court held that valuation of the post-reorganization stock owned on the alternate valuation date was appropriate, because it meant that only the form of the stock had changed (it essentially was the same), and because (of necessity) the values of the old and new stock were unchanged on the date of the reorganization. The court cited no precedent on point and a computer search revealed only TAM 7103129640A (involving the related "disposition/acceleration" issue rather than the question of the proper asset to be valued).

Rather than appeal the decision, the government nonacquiesced to *Kohler* and then issued proposed changes to the §2032 regulations themselves. These sought to preclude what the government apparently anticipated as abuses that evoke planning that is fundamentally different from the *Kohler* reorganization, but arguably validated by that decision. Through changes now found in **Prop. Treas. Reg. §20.2032-1(f)(1)**, the government refined its original approach to articulate a principle that changes will affect the federal estate tax value of includible assets only if they are attributable to (1) "economic or market conditions" or (2) uncompensated theft or casualty losses (that are not deducted under §2054).

The first proposed regulation described postmortem events (including voluntary acts or manipulations) that would be ignored in valuing a decedent's gross estate. The revised proposal now essentially abandons that approach to instead describe events that will accelerate the

valuation date under §2032(a)(1). This then triggers valuation at the moment before the acceleration event, which precludes valuations that reflect the postmortem event. By addressing the acceleration issue directly the new proposal also is more in line with prior authority. The construct therefore differs, but examples of events that generate this result are only expanded, and are essentially unchanged from the prior proposed regulations. Which is to say that the new proposal addresses the issue from a different direction but appears to yield the same results.

In addition to the "obvious" acceleration events (such as a sale, reinvestment, or estate distribution), the proposed regulation describes other transactions that may accelerate the alternate valuation date, including

(1) creation, recapitalization, reorganization, or merger of an entity,

(2) redemptions or other changes in the ownership structure of an entity that alter the value of the decedent's interest in that entity, and

(3) postmortem distribution of a fractional interest in an asset or in an entity that otherwise would justify a fractional or minority interest discount.

Also identified in **Prop. Treas. Reg. §§20.2032-1(c)(1)(i)(I)(3) and (4)** are entity-level transactions (such as disbursements, distributions, or reinvestments of an entity's assets) that alter the value of the decedent's ownership interest in the entity. See, e.g., **Prop. Treas. Reg. §20.2032-1(c)(5)** ***Example 4***, in which the decedent owned an interest in a corporation that contributed all of its assets to a partnership, which was a transaction that accelerated valuation of the decedent's ownership interest in the corporation to the moment immediately prior to the corporation's investment in that partnership. Alternatively, however, **Prop. Treas. Reg. §20.2032-1(f)(1)** provides that "[g]enerally, management decisions made in the ordinary course of operating a business . . . are . . . occurrences related to economic or market conditions" and therefore do not trigger the acceleration rule unless "these decisions change the ownership or control structure of the business . . . ."

Prop. Treas. Reg. §20.2032-1(c)(1)(ii) provides an exception to the acceleration rule for "same-value" transactions — such as an exchange of stock for stock of another class or in another entity — that do not change the value of the decedent's interest by more than 5% of the fair market value of the interest held at the date of the decedent's death. Helpful in evaluating this same-value principle is a rule that aggregates the value of all forms of replacement or distributed property with whatever may remain of an original holding to determine whether values have changed. To illustrate, **Prop. Treas. Reg. §20.2032-1(c)(5)** ***Example 6*** posits a partnership distribution to all partners during the alternate valuation period, which did *not* trigger the acceleration rule because the decedent's share of the distribution plus the value of the decedent's partnership interest after the distribution equaled the value of the partnership interest prior to the distribution. The transaction thus was sheltered in the same-value safe harbor because the aggregate value of the two interests did not differ by more than 5% from the transaction date value of the date-of-death includible interest.

On the other hand, **Prop. Treas. Reg. §20.2032-1(c)(5)** ***Examples 7*** and ***8*** illustrate distributions of fractional interests in real property or minority interests in an LLC that constitute dispositions that accelerate the alternate valuation date. As such they preclude any valuation effect of the transaction on the distributed interest. For example, imagine an estate that owns Blackacre in fee simple or 100% of the stock in a closely held business. During the alternate valuation period the estate transfers fractional or temporal interests in the realty, or minority interests in the entity, with each distributed portion valued on the date of its distribution, leaving a lesser interest in the estate to be valued on the alternate valuation date. As expected, valuation

of the portions distributed is accelerated, and no fractional or minority interest discounts may be taken for those distributed portions. In addition, by virtue of an aggregation principle in **Prop. Treas. Reg. §20.2032-1(c)(1)(iv)**, the interests that remain in the estate *also* are denied minority interest or fractional interest discounts, notwithstanding the postmortem distributions.

Prop. Treas. Reg. §20.2032-1(f)(3) clarifies that alternate valuation may reflect postmortem market conditions and certain postmortem events — meaning that the value of the interest owned at death could be lower for alternate valuation purposes if there was a general market value decline, or a loss due to theft (***Example 3*** illustrates a loss due to embezzlement, discovered during the alternate valuation period and allowed to be reflected in the alternate valuation), fire, or other natural calamity that otherwise would spawn a §2054 theft or casualty loss deduction.

The government's most immediate *Kohler* related concern is illustrated by **Prop. Treas. Reg. §20.2031-1(c)(5)** ***Example 1***, in which the decedent's personal representative and other members of the decedent's family create a new entity postmortem, to which they transfer property — including the estate's interest in marketable assets — taking back ownership interests in the new entity. Without stating whether those new interests are restricted in a manner that would produce a discount for lack of marketability or lack of control, the *Example* merely states that the estate's transfer into the entity will accelerate the valuation date of the marketable assets held at death, and that the interests to be valued are those assets that were owned at death, rather than the interests received back from the entity. Also illustrated is that an estate either could act alone in creating an entity, could act in concert with others, or could transfer assets into a pre-existing entity. Each postmortem transaction is regarded as a disposition that will accelerate the alternate valuation date and result in valuation of the assets distributed, at their distribution date values, rather than any product or reinvestment thereof.

Other modest clarifying changes made in the proposed regulations deal with:

(1) the effect of a postmortem grant of a conservation easement, retitling an account in the name of the new account owner, and dividing a trust or account into subaccounts for multiple beneficiaries (none of these will trigger acceleration),

(2) the proper value under §2036(a)(1) of a GRAT that continues to make annuity payments to the decedent's estate for the balance of the retained annuity term, and

(3) a priority-of-distribution rule that treats "excluded property" — such as postmortem earnings (e.g., interest or rent) on estate assets — as the first assets distributed in certain cases (which is taxpayer favorable because those distributions will not trigger the acceleration rule).

As originally proposed these changes, when made final, would have been retroactively effective to decedents dying after April 24, 2008 (the date the first proposed regulations were issued). The new proposed regulations are more traditional and will apply after they are published as final.

6. Sections 2036 and 2038: Retained Interests or Powers

Family LLC Survives Attack. In a case that the government likely never should have litigated, the taxpayer successfully defeated a $4 million deficiency based on three attacks against a family LLC, the most significant of which being the §2036 notion that assets were transferred into the entity in exchange for interests in the LLC that were not adequate and full

consideration, such that estate tax inclusion of the transferred assets should replace inclusion of the LLC interests themselves. Lifetime gifts of the LLC interests also were challenged as failing the present interest requirement for gift tax annual exclusion purposes, and a $21,000 interest deduction under §2053(a)(3) also was attacked as a nondeductible *Graegin* loan. The court's opinion is so terse that it cannot be determined what level of discount was asserted by the taxpayer. Sufficient indications of the government's consternation suggest that the case failed to settle because one of five children was obstreperous.

Estate of Purdue v. Commissioner, T.C. Memo 2015-249, involved spouses who owned marketable assets in five separate investment accounts managed by three separate management firms, and an undivided fractional ownership interest in a commercial building that was leased under a triple-net lease. Their primary objective for creation of the LLC was to combine all of these assets for asserted nontax reasons, such as to consolidate management to satisfy qualified investor requirements. The court addressed the §2036 issue by finding that the transfers into the LLC were made for legitimate and significant nontax reasons, which is the standard now applied to satisfy the bona fide transfer for adequate and full consideration exception to §2036(a). Among the reasons that the court articulated in addition to (1) the consolidation for investment purpose, it found that (2) there was no commingling of the decedent's funds with those in the entity, (3) formalities of the entity were respected (such as the proper documentation, accounting, and holding of meetings, (4) assets actually were transferred into the entity, (5) the taxpayer was not financially dependent on the entity because sufficient assets were held outside the entity to support the taxpayer, and (6) the taxpayers were in good health when the entity was created.

Curious about the decision is the rote nature of the conclusions stated, along with a nearly summary dismissal of the government's argument that the LLC interests were not likely to generate current income and therefore could not qualify as present interests for annual exclusion purposes, and that a loan from the LLC to the decedent's estate was necessary for payment of estate tax. The latter was particularly interesting, given that the taxpayer held sufficient assets outside the LLC to avoid the §2036 argument that she was dependent on entity distributions for her day-to-day support but apparently not enough to pay the estate tax liability without reliance on the loan. The impression given is that the court was somewhat bored with the task involved, and perhaps that the government wasn't particularly ardent about the litigation and thus threw several random issues into their briefs but didn't really advocate them. Nevertheless, the result is favorable precedent for the legitimate use of discount entities and provides support for the next taxpayer faced with a government effort to defeat valuation discounts for marketable assets held inside a family-controlled entity. It also may show why the government really wants to issue the promised §2704 regulations, which may permit it to avoid this kind of litigation and defeat discounts in a more direct manner in the future.

Private Trust Company "Tentative" Guidance. [**Note: this item has not changed since its inclusion in 2008; it is here as a "place holder," awaiting the government's promised Revenue Ruling on this subject.**] In an unusual "first draft," the government has issued guidance to taxpayers who wish to create a private or family controlled trust company. **Notice 2008-63**, 2008-2 C.B. 261, is labeled as a "proposed" revenue ruling, available for comment, much like regulations are issued in proposed form. Although not without a few flaws, the general drift of the draft is quite favorable to taxpayers and makes it relatively easy to avoid untoward income or wealth transfer tax consequences by following a number of easy prescriptions. For example:

- a "discretionary distribution committee" (DDC) that controls all discretionary distributions of income or principal will insulate family members from liability if "no member of the DDC may participate in the activities of the DDC with regard to any trust of which that DDC member or his or her spouse is a grantor, or . . . a beneficiary . . . [or] with respect to any . . . beneficiary to whom the DDC member or his or her spouse owes a legal obligation of support";
- "no Family member may enter into any reciprocal agreement, express or implied, regarding discretionary distributions from any trust for which [the private trust company] is serving as trustee" (although "reciprocal agreement" is not defined, it is fair to assume that this constitutes a broad prescription against any "I'll-scratch-your-back-if-you-scratch-mine" style of arrangement);
- only officers and managers of the trust company may participate in personnel decisions (but family members may be officers and managers of the trust company without hazard);
- an independent "Amendment Committee," "a majority of whose members must always be individuals who are neither Family members nor persons related or subordinate . . . to any shareholder" of the private trust company, has the sole authority to make changes to the documents that govern the trust company.

With these prescriptions, the result is that the private trust company itself will not

- cause estate tax inclusion exposure under §§2036, 2038, or 2041 to family members;
- prevent completed gift treatment for transfers to a trust administered by the private trust company;
- alter generation-skipping transfer tax exemptions and inclusion ratios; and
- affect otherwise applicable grantor trust income tax treatment.

The Subchapter J consequences are the most convoluted:

- §675 exposure turns (as is usual) on how fiduciary powers actually are exercised;
- §677(b) exposure turns on whether distributions are made for the support or maintenance of someone the grantor is obliged to support or maintain (misstated in the draft by reference to actual use to discharge a support obligation — which is not the metric used by the Code but is the short-handed reference made by most casual students of Subchapter J); and
- adverse party treatment will not be provided by the trust company or the DDC.

Interestingly enough, use of "ascertainable" or "reasonably definite external" standards is neither required nor useful (unless it means that a power therefore does not entail discretion, which is neither right nor stated), acting as an employee or director of the private trust company is benign, and "voting control of [the private trust company] has been made irrelevant as it applies to the power to make distributions from the Family trusts. . . . Thus, the ownership of voting stock should not be deemed to be 'significant' under section 672(c)" and, instead, is relevant only to the extent it gives control over discretionary distributions. Thus, related or subordinate party treatment is avoided unless more than half the members of the DDC may be nonadverse parties who are related or subordinate to the grantor. In essence, membership on the DDC is the functional equivalent of service as fiduciary, so in virtually every respect looking at the DDC members is more important than looking at control of the private trust company proper.

Note that, while awaiting further word on private trust companies, the SEC adopted a final rule (the **Family Office Rule**) under the Investment Advisers Act of 1940 that exempts certain

family offices from the definition of an investment adviser. Although private trust companies and family offices differ, advisors who represent families with such operations should consult the SEC rule and, when the government releases the private trust company guidance, pay careful attention to the degree of coordination or deviance between the two pronouncements.

7. Section 2056: Estate Tax Marital Deduction

Marital Deduction Allowed for Same-Sex Surviving Spouse. By a five-to-four vote, **Windsor v. United States**, 133 S. Ct. 2675 (2013), held that §3 of the federal Defense of Marriage Act (DOMA) ("In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation . . . 'marriage' means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or a wife") is an unconstitutional discrimination against same-sex marriages. Exactly two years to the day later the same five justices extended the *Windsor* holding to declare in **Obergefell v. Hodges**, 135 S. Ct. 2584 (2015), that state laws that also discriminate against same-sex marriage are similarly unconstitutional.

Rev. Rul. 2013-17, 2013-38 I.R.B. 11, which announced the federal tax consequences of *Windsor* for same sex married couples, stated that the federal government will follow a "state of celebration" rule – meaning that if a marriage was valid in the state in which it was performed, it will be regarded as valid for all federal tax purposes, no matter where the couple may live and what the law of that state might provide. Following *Obergefell* that refinement should no longer be relevant. On the same date (August 29, 2013) the government also released two lists of frequently asked questions dealing with same sex couples, one addressing couples who lawfully marry, and the other for couples (same sex or otherwise) who chose to be registered domestic partners or participate in a civil union that is not the equivalent of a legal marriage under state law. (There appears to be no official designation or number by which to locate these FAQ documents but they are available on Tax Notes Today as 2013 TNT 169-17 and 169-18.)

The Revenue Ruling also stated expressly, and now has been followed by **Prop. Treas. Reg. §7701-18(c)**, stating that "[t]he terms spouse, husband, and wife do not include individuals who have entered into a registered domestic partnership, civil union, or other similar relationship not denominated as a marriage under the law of a state, possession, or territory of the United States." So, if a taxpayer wants "married" treatment, the taxpayer must in fact become married. Referencing **Prop. §7701-18(b)**, the preamble also states that "whether a marriage conducted in a foreign jurisdiction will be recognized for federal tax purposes depends on whether that marriage would be recognized in at least one state, possession, or territory of the United States." Quaere what that reference anticipates? Might it be polygamy, recognized abroad but nowhere in the U.S.?

Notice 2014-19, 2014-17 I.R.B. 979, released on April 4, 2014, specified that qualified plans must recognize same-sex marriages back to June 26, 2013 when *Windsor* was decided and may, but need not, recognize them even before then. Plans that do not in any way identify which marriages are respected (but, instead, merely refer to "spouses" or similar generic terms) need not be amended but must be administered in a manner that does not distinguish between same-sex and other marriages.

8. Gift Tax

No Statute of Limitation Protection for an Ancient Gift. The shocking element in two cases involving the Redstone family (Sumner is Chairman of Viacom, and his late brother Edward) is that the litigation was brought in 2010 for transfers in 1972 that allegedly were gifts. In **Estate of Redstone v. Commissioner**, 145 T.C. No. 11 (2015), Edward's estate avoided gift tax liability based on a finding that his transfer into a trust for his children was made for adequate and full consideration. In **Redstone v. Commissioner**, T.C. Memo 2015-237, brother Sumner was found to have made a taxable gift as to which the statute of limitation had not run when he made a similar transfer into a similar trust for his children. The fundamental difference between the cases is that Edward made his transfer to settle bona fide litigation between he and his father, and Sumner made his transfer several months later, voluntarily as "a gesture of goodwill toward his father," essentially to mimic the result reached in settlement of the prior litigation. Essential to Sumner's loss was testimony in a separate case that "I voluntarily set up an arrangement . . . to do the same thing that my brother did, only he did it as a result of litigation. I did it voluntarily."

Three other elements are worthy of mention. One is that neither Edward nor Sumner filed a gift tax return in 1972 to report their transfers (and take the position that they were not taxable gifts). As a result, they did not begin the running of the statute of limitation for gift tax purposes. A second is that state-court litigation in 2006 regarding Edward's transfer put this matter on the government's radar and led to the asserted deficiencies. Finally, the court correctly held that the consideration exception to the gift tax can be satisfied if consideration is received by the donor from *anyone*, not just from the donee. In Edward's case that consideration was received from his father, who acceded to Edward's claim to own stock in the family business, in exchange for Edward agreeing to place one-third of that stock in the trust for his children. The gift (which the government might yet be able to assert, notwithstanding that the estate tax statute of limitation expired long ago) was made by Edward's father, indirectly through Edward to Edward's children, via the settlement. No mention is made of that in either of the *Redstone* opinions.

Discount Valuation for a "Net Net" Gift. The Tax Court first held in **Steinberg v. Commissioner**, 141 T.C. 258 (2013) (a reviewed opinion with one dissent), that a government motion for summary judgment should be denied. The case proceeded to trial and now the court has determined that the taxpayer is entitled to a valuation discount. 145 T.C. No. 7 (2015).

The facts in *Steinberg* are not usual, but the concept is simple. At age 89 the taxpayer made a gift of cash and securities, subject to a "net gift" agreement by which the donees (the taxpayer's adult daughters) agreed to pay the gift tax incurred on the transfer. Under established net gift precedent the daughters' assumption of the donor's gift tax liability constituted consideration furnished for the transfer, resulting in income tax part-sale, part-gift treatment. (Gain may be realized for income tax purposes if the net gift tax liability assumed exceeds the donor's basis in the property.) Further, for gift tax purposes the gift tax liability assumed by the donees reduces the value of the gift itself. The appraiser hired by the taxpayer calculated the value of the net gift as over $71 million and the gift tax was calculated to be over $32 million. There was no dispute over those elements of the case.

The net net aspect of this gift reflects a second obligation assumed by the daughters. If the donor had died within three years of the gift, then the §2035(b) gross-up rule would have caused inclusion in the donor's gross estate of the $32 million of gift tax incurred on the gift. Even though the daughters paid that gift tax, the treatment is as if they gave the donor that amount and the donor paid the tax (which normally is imposed on the donor). See Estate of Sachs v.

Commissioner, 88 T.C. 769 (1987). In *Steinberg* the daughters agreed to pay any federal and state estate tax increase attributable to any potential §2035(b) gross-up rule inclusion. The donor did *not* die within that three year period, meaning that the daughters did not actually incur an estate tax liability attributable to this added obligation. Nevertheless, the Tax Court allowed an additional discount to reflect the daughters' assumption of the additional, contingent liability.

In the process of denying the government's motion the first Tax Court opinion stated that the court was wrong to embrace the government's position in McCord v. Commissioner, 120 T.C. 358 (2003), rev'd and rem'd, 461 F.3d 614 (5th Cir. 2006), which held that no discount was allowable for the net net aspect of such an agreement. This turnaround reflects the fact that the court's prior holding was rejected by the court of appeals in *McCord*. To some observers this alone was a major victory.

Predictions of the donor's mortality inform the likelihood of §2035(b) being triggered by death within the three year period and normally support only a very low value for the contingent liability assumed by the donees. Attorney Larry Katzenstein produced the following data, which suggests that the game may not be worth the candle, even if the donor is relatively old. He demonstrated the proper calculation and illustrated results in materials prepared for the ALI CLE broadcast on estate planning updates, aired in February 2014 and an update in September 2015. By his calculation, a donor age 85 who gifted $10 million when the §7520 rate was 2% would reduce the gift to $7,142,857 by imposing the gift tax on the donee, and a net, net gift agreement would reduce it further, but only to $6,922,055 (a reduction of only $220,802, which is just 2.2% of the $10 million gift). If that donor was only 60 years old the reduction would be to $7,116,068 (the probability that a person age 60 will die within 3 years is only about 3.4%; the probability of an 85 year old dying before age 88 is only 28.7%). That is a $26,789 saving, which is only 0.26% of the $10 million. Nevertheless, the Tax Court granted the Steinbergs an added 8.2% discount, based solely on calculations by the taxpayer's appraiser, which the government did not contradict (they argued the case solely on the law and did not hire their own expert appraiser). The appraiser has stated privately that the difference in value is entirely attributable to a higher interest rate assumption and the taxpayer's more advanced age (89) at the time of the transfer.

An interesting issue relates to the state law apportionment of the tax attributable to §2035(b). Apparently the government asserted that applicable state law "would apportion the Federal estate tax attributable to the . . . gross up [rule] to the persons benefited by the gifts, and the statute would require those persons to pay that portion of the estate tax" in all events. Judge Halpern's dissent in the first decision repeated an assertion made by the taxpayer's appraiser in this case, who coauthored an article stating that "in the absence of a direction under the donor's will, most state tax apportionment statutes would allocate the [gross-up tax] liability to the donee." If that is the case, then perhaps the only value of the donee's agreement is "any incremental enforcement benefit" that the net net agreement added to the obligation that otherwise would exist in all events. For example, the Steinbergs created an escrow account to guarantee that the funds would be available to satisfy the donees' obligation. And enforcement of their agreement was better guaranteed by the fact that all the parties were represented by independent counsel.

State law in most jurisdictions is not as certain as represented by the taxpayer's appraiser. This is best illustrated by a disparity between New York law (which was applicable in *Steinberg*) and the law elsewhere in the United States. New York E.P.T.L. §2-1.8 provides that

> (a) Whenever it appears . . . that a fiduciary has paid or may be required to pay an estate or other death tax, under the law of this state or of any other jurisdiction, with respect to any property required to be included in the gross tax estate of a decedent under

> the provisions of any such law . . . , the amount of the tax . . . shall be equitably apportioned among the persons interested in the gross tax estate . . . to whom such property is disposed of or to whom any benefit therein accrues . . . .
>
> (c) Unless otherwise provided in the will or non-testamentary instrument . . . :
>
> (1) The tax shall be apportioned among the persons benefited in the proportion that the value of the property or interest received by each such person benefited bears to the total value of the property and interest received by all persons benefited . . . .

The commentary to this provision specifically states that it "does not require the beneficiaries of lifetime gifts to share the taxes . . . because subparagraph (a) refers to property included in the decedent's 'gross tax estate,' and lifetime gifts are not included in gross estate . . . . It is unlikely that the donor would have intended the donee to pay any taxes, or she would have extracted the gift taxes from the donee at the time of the gift."

The commentary also acknowledges the difficulty of enforcing apportionment against a donee, who may have received the subject matter of a gift many years prior to the decedent's death. And then it notes that §2035(b) requires inclusion of any gift tax paid on gifts made within just the last three years before the decedent's death, and cites In re Kennedy, N.Y.L.J., October 10, 2001, at 21, col. 6 (Surr. Ct.), for the proposition that "the court apportioned against the donee the estate taxes attributable to the inclusion of those gift taxes in the gross estate." Similarly, In re Application of Rhodes, 22 Misc. 3d 766 (Surr. Ct. 2008), held that "gift taxes paid are a component of the gross estate as defined by [§2035(b)] and as such are subject to apportionment. [Therefore], the donees of the gifts made within three years of decedent's death are responsible for paying their ratable share of the estate tax attributable to the inclusion of the gift tax paid." Which is to say that, in New York, the donees are not responsible for estate tax attributable to the gift itself (e.g., because the gift pushed the estate into a higher estate tax bracket) but they may be charged with any estate tax attributable to the gross-up rule.

According to Gerzog, Equitable Apportionment: Recent Cases and Continuing Trends, 41 Real Prop. Prob. & Tr. J. 671 (2007), the drafters of the Uniform Estate Tax Apportionment Act specifically considered whether the donees of gifts made within three years of a decedent's death should be apportioned estate tax liability attributable to §2035(b) inclusion of the gift tax paid. Citing Kahn, The 2003 Revised Uniform Estate Tax Apportionment Act, 38 Real Prop. Prob. & Tr. J. 613, 630 (2004) (Prof. Kahn was the Reporter for the Uniform Act), Gerzog states that the drafting committee "decided not to apportion any tax liability to the donees." Instead, Uniform Act §2(1) provides that the value of the gross estate for purposes of apportionment of the estate tax is reduced by "any amount added to the decedent's gross estate because of a gift tax on transfers made before death." Which is to say that the Uniform Act is directly contrary to New York precedent, which is the case in most other jurisdictions as well. Indeed, this issue has not been addressed in the vast majority of states. See, however, §2035(c)(1)(C), which basically establishes transferee liability on the donee of a gift on which §2035(b) gift tax was paid, which only means that those donees are on the hook to pay the estate tax if the lien rules under §6324 become applicable because the estate otherwise is inadequate to pay the tax, which is a one-off (or more distant) application of this topic.

Obviously this is a subject about which there is a great deal of uncertainty. Indeed, New York may stand alone on the fundamental apportionment concept, which did not harm the taxpayer in *Steinberg* because the court held that (1) the donor could have changed domicile and die in some other jurisdiction, and (2) her will could alter the default state law tax apportionment rule. In the final analysis, it appears that there is no reason to deviate from the *Steinberg* approach,

especially if sufficient amounts are involved that the extra valuation discount is worth any litigation costs that may be involved.

SCIN Case Settles. In what may have been the first salvo in an attack on self-cancelling installment notes (SCINs), **ILM 201330033** took aim at the gift tax consequences of sales to defective grantor trusts in exchange for notes. In that case the note that attracted the government's ire was an interest-only balloon payment SCIN, based on the decedent's §7520 mortality table life expectancy. No principal was paid because the decedent died within six months of the transaction, prior to expiration of the term. According to the ILM the face amount of the SCIN was almost double the value of stock sold in the exchange, which was meant to compensate for the risk that the decedent might die and the notes would self-terminate.

The ILM stated that neither interest nor principal were paid, or includible in the decedent's gross estate, and the government's response was therefore that the sale was a taxable gift: "nothing more than a device to transfer the stock to other family members at a substantially lower value than the fair market value of the stock. . . . [W]e believe that the notes lack the indicia of genuine debt because there must be a reasonable expectation that the debt will be repaid." Which the ILM argued was lacking.

ILMs normally are issued in support of litigation, and this ILM likely was issued in support of the government's gift tax challenge to a "very similar" transaction involving the estate of William Davidson, an exceedingly wealthy (exceeding $3 billion) business owner.

Most controversial is the following position stated in the ILM:

> We do not believe that the section 7520 tables apply to value the notes in this situation. By its terms, section 7520 applies only to value an annuity, any interest for life or term of years, or any remainder. In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in [Treas. Reg. §]25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account.

This statement may be technically correct, that the §7520 tables are authorized specifically to determine "the value of any annuity, any interest for life or a term of years, or any remainder or reversionary interest." But the primary feature of a SCIN is the mortality component – much like an annuity or life insurance, in which life expectancy is factored into the payment amount. One of two primary goals when Congress enacted §7520 was to eliminate reliance on actual life expectancy – with costly and frequently inaccurate individuated determinations of it – and substitute instead reliance on actuarial tables determined for the population at large (indeed, based on the latest census data), which apply unless it can be established that the decedent had a greater than 50% chance of dying within 12 months, as specified in Treas. Reg. §25.7520-3(b)(3). In Davidson's case a panel of four experts (two each appointed by the taxpayer and the government) concluded by a unanimous vote that the decedent did have a greater than 50% chance of living a year. Further, the government unsuccessfully made the same §7520 argument in *Steinberg* (reported at page 16).

In cases like Davidson the government could argue that the mortality assumptions in §7520 should not apply because the predictability of imminent death exceeded the 50% threshold. But the government likely does not want to engage in individual determinations, because it lacks the proof

– and the funds to engage experts – that the decedent's life expectancy on the date of a transfer was substantially less than the tables assume. The alternative, however, is not clear.

All of this was preclude to a 2013 case filed in the Tax Court in which the Davidson estate was assessed a multi-*billion* dollar deficiency (through double counting, and a few other alleged errors, the government sought in the neighborhood of $2.8 billion in estate, gift, and generation-skipping transfer (GST) taxes). Via a settlement executed in late July of 2015 the estate agreed to deficiencies in combined estate and GST tax of $320,523,233, gift tax of $186,626,788, and GST tax for lifetime transfers of $48,604,482, or a total liability of $555,754,503. At the time some commentators regarded this as a taxpayer victory, although it was not known what the total size of the estate might have been if none of the planning had been undertaken, nor what the settlement amounts reflected, in terms of the SCIN issue that we know and other issues that may have been involved, such as valuation of the underlying stock that was sold in exchange for the SCINs. It seemed conceivable, for example, that the taxpayer and government stipulated that the SCINs were inadequate consideration for the lifetime transfers, that the sales therefore should be ignored, but that the taxpayer's valuation of the underlying stock should be accepted by the government. Would that be a taxpayer victory? We simply did not know. Further, it was impossible to know whether any reliable message could be taken from the Davidson experience, in terms of how life expectancy and acceptable SCIN premia should be determined.

About ten weeks after the settlement was reached in the Tax Court, however, the Davidson estate filed suit against Deloitte Tax, which did the pitch and the planning that resulted in the SCIN transaction. The information found therein is one side's representation of the facts, which always is suspect, but from the complaint emerges additional information that may be helpful to other SCIN planners in the future. Here are a few nuggets from the over 90 page (double spaced) complaint filed in the Supreme Court of New York County, New York:

1. The plaintiffs are seeking "approximately/over" $500 million "in additional estate and gift taxes, and related fees, penalties, and interest" for such things as fraud, fraudulent concealment of risk, malpractice, and negligent misrepresentation. The complaint does not mention generation-skipping transfer (GST) taxes.
2. Several alleged "failures" in the Deloitte plan mimic the government's arguments, including Deloitte's:
   - Failure to use the decedent's individuated actuarial life expectancy, instead using the §7520 mortality tables to calculate the risk premium.
   - Failure to make periodic payments of either interest or principal, prior to a balloon payment on termination of the SCIN.
   - Conducting all steps of the SCIN transaction within one month's time, with several steps occurring on a single date, yielding exposure to the step transaction doctrine.
3. Among the decedent's physical and medical maladies at the time of the transaction were:
   - He had a pacemaker, quintuple bypass surgery, and an aortic valve repair.
   - He had uncontrolled diabetes, a bone infection, gastrointestinal "issues," and a condition that impaired his ability to swallow, which resulted in malnutrition.
   - He was taking almost 20 different medications on a daily basis and had 24/7 nursing care.
4. The petition states that the estate was obligated to pay additional taxes, penalties, and interest of $457.5 million, in addition to $168.5 million in estate tax and $82.7 million in gift tax

already paid – yielding a total liability in excess of $708 million. Again, no mention is made of GST taxes.

- These numbers are not consistent with the Tax Court settlement order that showed estate and GST tax assessed on the Form 706 of $168.4 million, an assessed estate and GST tax deficiency of $152 million (a total of $320.4 million at death), a gift tax deficiency of $186.6 million, and a GST deficiency for inter vivos transfers of $48.6 million. The settlement appears to yield a total liability of $554.6 million in tax incurred.
- In the year prior to the decedent's death the complaint states that the decedent's estimated net worth was approximately $3 billion. The complaint further asserts that the decedent's estate plan before Deloitte became involved included bequests of $109 million to specific individuals, $717 million to the decedent's surviving spouse, and the bulk of the estate (about $2.2 billion) going to charity. These total just more than $3 billion.
- On an estate of $3 billion, $708 million of tax constitutes an average tax of 23.6% – which isn't an unexpected amount, considering the charitable and marital deductions available and the generation-skipping transfers involved.
- The complaint estimates that taxes attributable to the decedent's original plan would have been approximately $88 million. Doing the math, a taxable estate (after marital and charitable deductions) of $197 million ($109 million in nondeductible bequests, plus $88 million paid in tax), calculated at a 45% tax rate, would yield a tax of $88.7 million. If this is correct, then Deloitte's failed plan increased that liability by $620 million (yet the damage prayer is for $500 million).
- The complaint alleges that Deloitte estimated that the estate would pay $158 million in total taxes under its plan ($70 million more than the estate estimated), yet the decedent proceeded with the plan. Quaere why that made sense.
- Also claimed as damage is loss of the estate's basis increase that would flow from inclusion, which apparently was lost due to the inter vivos transfers. No dollar figure is attached to this loss of new basis.
- At one point the government's deficiency calculation determined over $1.2 billion in estate and gift tax exposure attributable to failure of the SCIN transactions. No mention is made of GST tax liability. When asserted, the government's deficiency was for $845.7 million in gift tax and $1,886,700,000 in estate tax, totaling over $2.7 billion in tax and interest. By some accounts paying a "mere" $708 million (26%) was a taxpayer victory.
- At one point Deloitte calculated the worst case deficiency would be $954 million in added gift, estate, and GST taxes, over and above the $251.2 million that the estate already had paid. A total of over $1.2 billion. Again making a settlement for a total of $708 million (59%) look like alchemy.

5. Calculations in this case are difficult because the charitable remainder would have received the amounts ultimately paid in taxes, meaning that there is an interrelated calculation of the tax deficiency, and then payment of that tax, which reduces the charitable deduction, which results in more tax, and then payment of that tax, with another reduction in the charitable deduction, and so on.
6. Deloitte billed over $5.2 million in fees. The complaint is not specifically seeking recovery of that amount.

Regarding SCINs in particular, these basically represent a taxpayer selling for a vanilla note, coupled with a premium equal to what an insurer would charge for a decreasing term life insurance policy in the amount of the outstanding debt. An insurer would base that premium on the taxpayer's actual life expectancy (determined by an underwriter using actuarial factors such as the taxpayer's age, health, occupation, medical history, and known and reasonably anticipated maladies), which would not likely resemble the §7520 life expectancy tables. With no decision in the Davidson litigation it is unknown how this form of planning should be structured, albeit the government's challenge can be expected, at least in extreme fact cases. The Davidson estate's complaint essentially embraces the government's challenge, which may simply be its best posture for painting Deloitte into a liability corner. The more interesting litigation on this entire matter may emerge from the New York courts, rather than the Tax Court. Stay tuned.

9. Generation-Skipping Transfer Tax

Exemption Allocation Regulations. [**Note: nothing new regarding this item has occurred since promulgation of proposed regulations in 2008; it is here as a "place holder," awaiting release of the government's final regulations.**] Proposed generation-skipping transfer tax exemption allocation regulations will make Notice 2001-50, 2001-2 C.B. 189, obsolete and override the relief provisions of Treas. Reg. §301.9100-3. **Prop. Treas. Reg. §26.2642-7** applies to taxpayers seeking (1) to make an affirmative allocation, (2) to elect out of the automatic (default) allocation, or (3) to elect to treat a trust as a §2632(c) GST trust — in each case after the deadline for a timely allocation/election. The mechanism to obtain relief remains by private letter ruling, with a filing fee. That cost may be palatable, however, if exemption allocation is permitted at the value that would have applied had the action been timely, rather than the (typically, inflated) value when the late allocation actually occurs.

To qualify for relief the "taxpayer" (shorthand here for either the transferor or the transferor's personal representative — which reflects that failure often is discovered after the transferor's incapacity or death) must establish *reasonable*, *good faith* action that *does not prejudice* the government. Prop. Treas. Reg. §26.2642-7(d)(2)(i) through (v) contain a nonexclusive list of elements speaking to the reasonable and good faith elements; -7(d)(3) speaks to prejudice to the government; -7(e) identifies several circumstances in which relief absolutely will not be granted. A full study of these provisions is advisable but, in summary fashion, here are highlights gleaned from them:

- Taxpayer intent to timely allocate/elect may be found in transfer documents, tax returns, and correspondence. For example, a trust instrument may refer to a "GST Exempt Grandchild Trust" — a pretty good illustration of original intent to allocate exemption. As would be a GST tax return that shows zero tax for a direct skip transfer. Conversely, payment of tax on a nondirect skip taxable transfer would indicate that the taxpayer thought that election out of automatic allocation had been accomplished. Common correspondence is among a taxpayer, an attorney, and an accountant, all referring to an allocation/election that everyone anticipated would be made on a gift tax return that would be filed by one of them but that fell into a crack.
- Events beyond the taxpayer's control that caused the allocation/election to fail. For example, perhaps the taxpayer, or a professional who was involved in the transaction, became ill, incompetent, or died before anticipated action was taken and there was no follow up to protect against a missed timely allocation/election.

- Lack of taxpayer awareness of the need to allocate/elect, despite reasonable diligence, given the complexity of the allocation/election and the taxpayer's experience. For example, a sophisticated taxpayer who has engaged in similar transfers and who regularly deals with wealth transfer tax advisors has less credibility in alleging lack of awareness than a taxpayer with no history of prior transfers.
- Consistency in allocating/electing, which normally bespeaks an intent to do the same thing (unless a change in circumstances or beneficiaries makes a change in intent appear likely). Imagine a series of annual transfers to a GST trust with the requisite allocation/election to all but one, and whether it would matter if that one was the first, the last, or somewhere in the middle of the series, and what this indicates, considered alone or in conjunction with other factors.
- Reasonable reliance on the advice of a qualified tax professional, which requires a showing that the professional was competent and was made aware of all relevant facts. An affidavit must list every advisor (agent, representative, or tax professional) who consulted in the transfer or return preparation, along with a description of the scope of their engagement and responsibilities, and an attestation by those advisors to the taxpayer's representations (or an explanation of an advisor's refusal to attest) — basically making advisors fall on their swords if they were the source of a failure to properly allocate/elect.
- Whether hindsight informs a late allocation/election. For example, the taxpayer is strategically choosing among multiple transfers to which allocation/election might apply, retroactively considering investment performance since the time a proper allocation/election was required. Or if an economic factor changed, arose, or was discovered after the time for a proper allocation/election.
- Indications that delay strategically deprived the government of time to evaluate aspects of the transaction (such as valuation, or the transferor's identity). Exceedingly helpful is Prop. Treas. Reg. §26.2642-7(d)(3)(ii), stating: "the combination of the expiration of any . . . period of limitations with the fact that the asset or interest was valued for transfer tax purposes with the use of a valuation discount will not by itself prohibit a grant of relief." This should quash previous governmental misbehavior in evaluating relief requests.
- Whether a taxable transfer occurred between the time when an allocation/election was due and the requested relief, and whether relief would require difficult adjustments of GST tax consequences in the interim.
- Relief will not permit a taxpayer to subsequently decrease an allocation or revoke an election; an affirmative allocation/election is irrevocable once made. See, e.g., **PLR 200816007** in which the taxpayer sought to reverse an allocation to one trust to reallocate the exemption to another.
- Relief also will not allow alteration of an allocation/election decision that follows accurate advice of an adequately informed and competent advisor.
- Increased exemption cannot be allocated retroactively to transfers occurring before the increase.

Relief does not extend any statute of limitation that bars a refund/credit. But the government may request an extension of a gift or GST (but not estate) tax statute of limitation that relates to the transfers involved in the request for relief.

Two final matters: Treas. Reg. §301.9100-2(b) continues to permit the automatic six-month extension, and Rev. Proc. 2004-46, 2004-2 C.B. 142, continues to provide "a simplified alternate method for obtaining an extension to make an allocation of . . . exemption under §2642(b)(1)" if its somewhat rigid requirements are met: (1) the transfer occurred before 2001 (after 2000 the

automatic allocation rule in §2632(c) likely applies), (2) no taxable transfers have been made yet from the trust involved, (3) the gift involved did not exceed the gift tax annual exclusion amount (in combination with all other gifts to the same donee in that year), (4) no exemption was allocated to the transfer, and (5) the taxpayer has exemption remaining available to allocate.

A detailed process avoids the need to file a ruling request or pay the normal fee. The most important requirement is that the application must be made "on or before the date prescribed for filing the federal estate tax return for the transferor's estate (determined with regard to any extensions actually obtained), regardless of whether an estate tax return is required to be filed." This is a function of §2632(a)(1), requiring affirmative allocations before that time, and Treas. Reg. §26.2632-1(d)(2), which automatically allocates any remaining exemption at that same time. As illustrated by PLR 200710001, after that time these irrevocable exemption allocations will have exhausted any exemption remaining at death.

10. Chapter 15: Gifts and Bequests from Expatriates

§2801 Proposed Regulations. Donative transfers from certain expatriate former United States citizens or residents are subject to United States taxation under §2801. On 11 September 2015 the Treasury Department released **Proposed Treasury Regulation §§28.2801-1** through **-7** (and various coordinating rules), establishing how certain recipients of lifetime and testamentary transfers must report and pay tax on "covered gifts or covered bequests" (covered transfers). Before studying these regulations, readers are encouraged to read the next paragraph to determine whether their clients are subject to this obligation.

According to the preamble to these regulations, only an estimated 1000 respondents are affected by these rules, which apply if a United States citizen or resident (or a domestic trust) receives a covered transfer:

- from a transferor who expatriated after 16 June 2008, **and**
- that transferor (a) had a five-year *average* annual net income tax *liability* (prior to expatriation) in excess of $124,000 (indexed for inflation, this is $161,000 in 2016), **or** (b) had a net worth of at least $2 million (not indexed), **or** (c) failed to certify that he or she had complied with all U.S. tax obligations for the five taxable years preceding expatriation, **and**
- the covered gift exceeds the dollar amount of the gift tax annual exclusion (note: the covered gift need not *qualify* as a present interest for gift tax annual exclusion purposes – it only must exceed the indexed amount of the exclusion in the year of the transfer), **and**
- the transfer is not excepted because it is (a) subject to Chapters 11 or 12 (the estate or gift taxes), (b) a qualified disclaimer, (c) qualified for the gift or estate tax charitable deduction, (d) made to the expatriate's United States citizen spouse and qualifies for the gift tax marital deduction as a QTIP (but not otherwise, such as under the all-income, general-power-of-appointment trust alternative), (e) made inter vivos to a noncitizen spouse and is below the §2523(i) gift tax limit (ten times the indexed gift tax annual exclusion amount), **or** (f) a testamentary transfer that qualifies as a QDOT.

Treasury representatives have indicated that a Revenue Procedure will be issued to "explain the procedure for taxpayers to get information from the IRS about [an] expatriate's tax returns" when needed to comply with a recipient's §2801 obligations.

Covered transfers are subject to wealth transfer tax that is imposed on the *transferee* at the highest gift tax rate in effect in the year of the transfer (including when a distribution of either income or principal is made from a foreign trust). Transfers must be reported by the transferee on Form 708, which will be issued once the proposed regulations are made final. Tax may be due on transfers prior to that date, but interest will not accrue until the due date for payment is specified in the final regulations.

Advisors should (1) first determine whether any client may be subject to these rules, and (2) then establish a system to track the client's obligation to file when Form 708 becomes available. There is much more detail in the proposed regs that must be digested, but only by advisors to the (un)lucky 1000 to whom §2801 purportedly applies.

11. Subchapter J and Other Income Tax Developments

Uniform Basis Allocation. Expressing concern about an impropriety involving §664 split interest trusts, Notice 2008-99 asked for comments about the rules in §1001 that allocate basis when both the lead (taxable) and the remainder (charitable) beneficiaries terminate a charitable remainder trust (CRT) by selling their interests at one time. If only the lead (life estate or term of years) beneficiary sold their interest, then §1001(e)(1) would apply to deny that seller any portion of the trust's "uniform basis." But if all interests are sold at the same time, then §1001(e)(3) overrides §1001(e)(1) and the trust's basis is apportioned among the lead and remainder interests based on percentages determined under the §7520 valuation tables.

To illustrate the perceived problem with this imagine that a taxpayer created a CRT and contributed a highly appreciated asset to it, which the trust sells. The gain on that sale is not taxable to the trust (because it is exempt). But the gain does go into the "tiers" of income that is available for carryout to the lead beneficiary under the income ordering rules, as annuity or unitrust distributions are made. Meanwhile the trust has sufficient other income to be carried out before that gain is deemed to be distributed. And then the trust terminates because both the lead and remainder interests are sold to a third party. Basis inside the trust was increased by realization of the gain on sale of the appreciated asset, but that gain was never carried out for recognition by the lead beneficiary. Nevertheless, when sale of all interests occurs, the lead beneficiary claims a portion of the trust's basis, as increased to reflect the gain realized on the trust's sale of the appreciated asset. The same issue can arise if the trust earns income greater than the lead interest distributions, accumulates that income, uses it to purchase assets, and thereby increases the trust basis – again without taxation of that income to the lead beneficiary.

In each case the government regards it as inappropriate for the lead beneficiary to benefit from any portion of the trust basis that was increased to reflect the gain or accumulated income that went into the tiers but never was taxed out to the lead beneficiary. So by final amendment (promulgated on 12 August 2015, effective retroactively to January 16 of *2014*) to **Treas. Reg. §1.1014-5(c) and (d)** ***Examples*** *7* and ***8*** (and a cross reference to them in **§§1.1001-1(f)(4) and 1.1015-1(b)**) the lead beneficiary's share of the trust's basis is reduced by the lead beneficiary's proportionate (actuarial) share of the basis increase attributable to the trust's undistributed net ordinary income and capital gain. The charitable remainder beneficiary is not allocated the basis that is denied to the lead beneficiary – that basis is lost. This is not inappropriate, however, given that this income and gain was tax exempt at the trust level and never was taxed to the lead beneficiary – meaning that it should not be recognized for any income tax purpose as an addition to basis.

New Basis at Death. **Part A.** The third revenue procedure issued each year contains a list of issues on which the government will not issue rulings. **Rev. Proc. 2015-37**, 2015-26 I.R.B. 1196, updated §5.01 of that list to include a new item, reading: "Whether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under [the estate tax] chapter 11 of subtitle B of the Internal Revenue Code."

This may be a reaction to PLR 201245006, which involved a nonresident, noncitizen of the United States [NRA] and property that the NRA's descendants would acquire at the NRA's death. According to the PLR, those assets would not be includible in the NRA's estate but "are within the description of property acquired from a decedent under §1014(b)(1)." And, therefore, the PLR held that they would receive a new basis equal to fair market value on the date of the NRA's death. Further, the PLR said that this ruling "applies to property located outside the United States as well as to property located inside the United States." All of which fueled speculation that new basis is allowable for other property that is not includible in other situations, provided that it is "acquired from the decedent" as required by §1014(b)(1).

The attorney who obtained the PLR believes that reference to §1014(b)(1) was error, and that the PLR should have referred instead to §1014(b)(3) (because the NRA made an inter vivos transfer into trust and retained the right to income for life). That being the case, the PLR ought not to be regarded as authority for the beguiling notion that nonincludible property might still qualify for a new basis when its transferor dies. More recently, see also PLR 201544002, which applied §2014(b)(2) and indicated that it was issued notwithstanding the moratorium only because it was requested prior to the June 15, 2015, effective date for Rev. Proc. 2015-37.

Part B. Since Congress made the $5 million (plus inflation index adjustment) basic exclusion amount permanent many planners have considered how to improve basis at a decedent's death, in circumstances in which estate tax inclusion can be caused without (1) granting control to an impending decedent and (2) increasing any state or federal wealth transfer tax that may be applicable at that decedent's death. Those two requisites are difficult to accomplish:

- Outright distributions to the impending decedent would be easy and effective, but give the impending decedent control.
- Granting a general power to appoint property with the consent of a nonadverse party could be effective, if giving the consent power control to the nonadverse party is acceptable.
- A general inter vivos power that the powerholder immediately releases is more certain, with the second clause of §2041(a)(2) causing inclusion if enjoyment is granted to the powerholder from the trust until death.
- And the impending decedent may be given, and then exercise, a narrow nongeneral power that allows purposeful triggering of the Delaware Tax Trap of §2041(a)(3), but success requires the creation by exercise of a new, presently exercisable general power in a permissible appointee, which just shifts the control issue to a new level. It also requires that state law "cooperate" – meaning that extension of the permissible period under the applicable Rule Against Perpetuities is possible, which is not true in many states that have modified or repealed their version of the Rule.

Part C. Aside from these planning opportunities, §2004 of the Surface Transportation and Veterans Health Care Choice Improvement Act (H.R. 3236, the Highway Act), signed into law on 31 July 2015, added new §1014(f), effective for "property with respect to which an estate tax return is filed after the date of the enactment of this Act." It mandates that:

(1) IN GENERAL.—The basis of any property to which subsection (a) applies shall not

exceed—

(A) in the case of property the final value of which has been determined for purposes of the tax imposed by chapter 11 on the estate of such decedent, such value, and

(B) in the case of property not described in subparagraph (A) and with respect to which a statement has been furnished under section 6035(a) identifying the value of such property, such value.

(2) EXCEPTION.—Paragraph (1) shall only apply to any property whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11 (reduced by credits allowable against such tax) on such estate..

Quaere whether the exception in (2) possibly could mean that assets includible but qualifying for a deduction (e.g. §§2055 and 2056) do not increase the liability for tax and thus are not subject to this rule? As of the date of this writing there is no legislative history to explain the provision, but notice that this language resembles language in §2032(c), providing that taxpayers cannot elect an alternate valuation unless the "election will decrease the tax imposed by [chapter 11] with respect to property includible in the decedent's gross estate (reduced by credits allowable against such taxes)" and that this language has been taken to mean that alternate valuation is not allowed if the estate tax marital deduction reduces estate tax to the point that it is fully sheltered by the unified credit.

The reference in §1014(f)(1)(B) is to a new reporting requirement, adopted as §6035(a)(1), specifying that:

> The executor of any estate required to file a return under section 6018(a) shall furnish to the Secretary and to each person acquiring any interest in property included in the decedent's gross estate for Federal estate tax purposes a statement identifying the value of each interest in such property as reported on such return . . . .

This appears to mean that assets acquired from estates that are smaller than the basic exclusion amount, as to which §6018 does not require the filing of a return, are not subject to this reporting rule. But then new §6035(b) provides that "[t]he Secretary shall prescribe such regulations as necessary to carry out this section, including regulations relating to — (1) the application of this section to property with regard to which no estate tax return is required to be filed." Which raises the question of which estates are not required to file but as to which reporting should be required. That would not include estates for which there is no estate tax liability due to a marital or charitable deduction, because those zero-tax estates must file a return. Perhaps this is a negative reference, saying that the regulations should clarify that an estate that must file a return to elect portability but that is not taxable because it is smaller than the exclusion amount is not subject to the reporting regime. A draft Form 8971 exists but it does not clarify any of these issues.

With what amounts to a retrospective effective date – to decedent estates for which the estate tax return had not yet been filed, this new provision is certain to cause immediate and widespread heartburn with long-lasting implications for estate beneficiaries.

Part D. Effective on August 21, a mere three weeks after enactment of new §1014(f), **Notice 2015-57** delays until February 29, 2016 the due date for filing or furnishing a §6035 statement for any decedent whose estate is required to file an estate tax return by virtue of §6018(a) or (b). Only estates that exceed the §6018(a) filing threshold (for citizens or residents, the basic exclusion amount ($5,450,000 in 2016; for nonresidents not citizens it means $60,000 with no inflation index), reduced by any lifetime taxable transfers. The fact that the regulations under §2010(c)

make reference to the §6018 filing date for smaller estates that must file to elect portability does not appear to make those smaller estates subject to §6035.

The Notice does not relieve estates that otherwise are required to file – it only "delays" the filing deadline and specifically provides that "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." The Notice also states that the government expects to issue added "guidance to assist taxpayers with complying with sections 1014(f) and 6035." Meaning that §1014(f) heartburn has been relieved for the present time, but it will return.

Deductions Denied for Conservation Easements. A "qualified conservation easement" is tied to the §170(h)(1) income tax definition of a qualified conservation contribution, meaning a perpetual restriction on use with a conservation purpose. See §170(h)(4). In essence, involved is preservation of land areas for outdoor recreation or education, protection of natural habitat, or preservation of open space for scenic enjoyment or pursuit of federal, state, or local conservation policies that will "yield a significant public benefit" (whatever that means). See §170(h)(4)(A) and Treas. Reg. §1.170A-14(d)(4)(iv)(A). See also §170(h)(4)(B) and Treas. Reg. §1.170A-14(g), permitting a charitable contribution deduction for a perpetual façade easement.

A slew of recent developments reveal that the government has been very actively denying conservation easements, for a number of predictable reasons. For example, **Graev v. Commissioner**, 140 T.C. 377 (2013), denied the deduction for a façade easement and cash because a "side letter" from the grantee promised to return the cash and remove the façade easement if the taxpayer's charitable deduction was reduced. The return agreement made the contribution fail the perpetuity requirement because denial of the deduction was not a negligible risk under the facts involved. **Kaufman v. Commissioner**, 136 T.C. 294 (2011), and 134 T.C. 182 (2010), vacated, 687 F.3d 21 (1st Cir. 2012), 107 T.C.M. (CCH) 1262 (2014) (on remand), aff'd, 784 F.3d 56 (1st Cir. 2015) (also noting that the government put conservation easements on its "dirty dozen" list of tax scams in 2005, 2006, and 2009), originally denied the deduction because a mortgage on the property gave the mortgagee priority rights that precluded the requisite perpetual protection and ultimately also concluded that the objectivity of the taxpayer's appraiser was "fatally compromised," that the taxpayer failed to prove that the easement reduced the value of the taxpayer's property, and imposing a negligence penalty. Citing *Kaufman*, **Mitchell v. Commissioner**, 138 T.C. 324 (2012), aff'd, 775 F.3d 1243 (10th Cir. 2015), also denied the deduction due to a lack of subrogation of a prior lender's mortgage at the time of the contribution, even though the lender had agreed to subrogation prior to litigation in the case, the court refusing to apply a "so-remote-as-to-be-negligible" standard to assess the possibility of foreclosure. Citing and following *Mitchell* on similar facts, see **Minnick v. Commissioner**, 104 T.C.M. (CCH) 755 (2012), aff'd, 796 F.3d 1156 (9th Cir. 2015). **Wall v. Commissioner**, 103 T.C.M. (CCH) 1906 (2012), denied the deduction because two lenders had priority claims against any insurance and condemnation proceeds from the property. **Carpenter v. Commissioner**, 103 T.C.M. (CCH) 1001 (2012), reconsideration denied, 106 T.C.M. (CCH) 62 (2013), denied the deduction because the conservation easement could "be terminated or extinguished, whether in whole or in part, by judicial proceedings, or by mutual written agreement of both parties," and was not salvaged by a proviso that would preclude termination if any "laws or regulations are violated by such termination." In *Carpenter* cy pres also was

deemed not to apply as a means of avoiding reversion of the property, which meant that the termination agreement violated the "in perpetuity" requirement. **Seventeen Seventy Sherman St. v. Commissioner**, 107 T.C.M. (CCH) 1599 (2014), denied the claimed deduction because the easement was granted in exchange for consideration received (in the form of negotiated zoning variances) and the taxpayer failed (against the advice of tax counsel) to reduce the value of the contribution by the value of that consideration, which also led to a negligence penalty (which itself is not uncommon in these cases). Similarly, **Costello v. Commissioner**, 109 T.C.M. (CCH) 1441 (2015), also denied the deduction because the taxpayer received a quid pro quo in the form of permission to sell development rights that the taxpayer otherwise was not permitted to sell.

Information Letter 2012-0017 spoke to the perpetuity requirement and stated that a "swap" provision in a grant of easement also would preclude qualification because it meant that a donated easement could be removed in exchange for "some other property or the payment of cash." **Belk v. Commissioner**, 774 F.3d 221 (4th Cir. 2014), **Balsam Mountain Investments LLC v. Commissioner**, 109 T.C.M. (CCH) 1214 (2015), and **Bosque Canyon Ranch v. Commissioner**, T.C. Memo 2015-130, all denied the deduction for conservation easements involved because of such swap provisions (*Bosque Canyon* referred to it as a right to "modify the boundaries"). The *Balsam* agreement was similar in several respects to the agreement in *Belk*, which dealt with a golf course, as to which special attention seems to be devoted by the government. **Atkinson v. Commissioner**, T.C. Memo 2015-236, denied a deduction related to a golf course simply because the court found that there was not a relatively natural habitat and there was no scenic enjoyment available for the general public. Perhaps more was involved than meets the eye in *Balsam*, but it appears harsh because the agreement required that any exchange must not reduce the "calculated area of land" involved, any land added must be contiguous and connected to the original acreage, the swap must preserve or increase the "contribution to the Conservation Purposes" and not "directly or indirectly result in any material adverse effect on any of the Conservation Purposes," not exceed 5% of the total land involved, nor occur more than 5 years after the original contribution. *Bosque Canyon* entailed a variety of other defects in documentation, unreliable appraisals, inconsistencies in the documents and various exhibits, and indications that perhaps some documents were back dated. All of which resulted in 40% gross valuation misstatement penalties under §6662(h).

A second illustration of why charitable conservation easements are being denied deductions is because the property is so remote that there is no current development potential and therefore no value to the easement. **Turner v. Commissioner**, 126 T.C. 299 (2006), illustrates a situation in which location informed no development value, which made the easement worthless, there because half the property lay in a floodplain that by law could not be developed. Because the taxpayer was aware of this, a negligence penalty was upheld for deducting an amount based on a bogus easement value. Another illustration is property located in an historic preservation district that already is restricted by various laws that it could not be altered anyway. See, e.g., **Rothman v. Commissioner**, 103 T.C.M. (CCH) 1864 (2012), supp. op. at 104 T.C.M. (CCH) 126 (2012), in which "irrespective of the easement, New York City law already precluded [the taxpayer] from altering the subject property unless the change was approved by the Landmarks Preservation Commission," which was not considered in the taxpayer's appraisal, **Zarlengo v. Commissioner**, 108 T.C.M. (CCH) 155 (2014) (also involving New York, finding a 3.5% reduction in value), citing **Gorra v. Commissioner**, 106 T.C.M. (CCH) 523 (2013), in which the court granted a 2% reduction in value (and, in the process, imposed a 40% §6662(h) gross valuation misstatement penalty). See also the valuation appraisal imbroglio illustrated by *Kaufman* (cited above), **Chandler v. Commissioner**, 142 T.C. 279 (2014), also citing *Kaufman*

and rejected the taxpayer's expert report and concluded that the taxpayer failed to establish that the easement caused any reduction in value, and **Scheidelman v. Commissioner**, 100 T.C.M. (CCH) 24 (2010), vac'd and rem'd by 682 F.3d 189 (2d Cir. 2012), 105 T.C.M. (CCH) 1117 (2013) on remand, aff'd, 755 F.3d 148 (2d Cir. 2014), ultimately denying any deduction, based in part on mistakes in the appraisal that negatively affected the appraiser's credibility and concluding that, in any event, the easement did not reduce the value of the property. **Gemperle v. Commissioner**, T.C. Memo 2016-1, denied the deduction because the taxpayer totally failed to provide an appraisal, even though one ostensibly had been prepared.

Graev is particularly significant because the court stated that the recipient of the façade easement – the National Architectural Trust (NAT – now renamed the Trust for Architectural Easements) – testified that it was "standard policy" for it to return contributions to the extent the government disallowed a deduction and that it had issued so-called "comfort letters" such as the side letter in *Graev* "in numerous instances." The same appraiser was engaged in several of these cases that involved the NAT and was permanently enjoined from preparing any further property appraisals for federal tax purposes by **United States v. Ehrmann**, 2013 WL 7873795 (N.D. Ohio), which itself may speak to the methods and fallout consequences of some of these claimed deduction cases.

Limited Relief for Those Who Mess Up. Unless they are advised properly, many donors may not know that §170(f)(8)(A) requires a contemporaneous written acknowledgement (CWA) from a charitable donee to claim an income tax deduction for any contribution of $250 or more. Indeed, many qualified charities realize that they must provide that acknowledgement to their donors to avoid embarrassing problems at tax time that might dissuade generous donors from making another gift to the charity in the future. But what happens if donor and donee both overlook this failure to comply with the CWA requirement? Apparently this is sufficiently pervasive that the government issued proposed regulations to deal with implementation of an exception to the CWA requirement. To qualify, **Prop. Treas. Reg. §170A-13(f)(18)** would have required the charity to submit all of the information described in §170(f)(8)(D) plus the donor's name, address, and taxpayer identification number, and submit its report no later than February 28 of the year following the contribution. It was questionable whether major charitable donees would be able and willing to assume this obligation. And extensive pushback was received by the government from hundreds of charities, asserting that the fix was both unnecessary and not helpful. Treasury ultimately retracted the proposed regulation on 8 January 2016.

Is the §642(c) Deduction Limited to Basis? **CCA 201042023** first addressed the question whether the §642(c) charitable contribution deduction available to trusts and estates should be limited to the basis of appreciated property distributed in kind. When written, the government stated that there were no prior cases or citable precedent on the question, which is astounding given that the principal requirements of §642(c) have existed since 1918 and the issue could have arisen in many prior contribution situations. As a case of apparent first impression, **Green v. United States**, *** F. Supp. 3d *** [2015 WL 6739089] (W.D. Okla. 2015), held that the lack of any express limitation in §642(c) means that the deduction is allowable for the full fair market value of distributed property. Thus, the §642(c) charitable deduction was not limited to the trust's basis.

There are enough similarities between the facts in *Green* and the CCA that they might be the same case (this is not 100% certain because of slight variations in the stated facts of each). Both

situations involved trusts that authorized distributions of income to charity. Simplifying the facts, each trustee owned assets purchased with gross income (the CCA specifies that it was income accumulated in a prior year; the *Green* opinion appears to say that it was income distributed to the trust in the same year in which the properties were purchased). The important fact is that those assets were distributed to charities in subsequent years, after they had been held in the trusts and had appreciated in value.

To put *Green* into context, recall that individual taxpayers deduct contributions of cash or property (appreciated or not) to charity under §170. Trusts and estates are denied the §170 deduction and, instead, claim their deduction under §642(c). By §§170(b) and (e), individual taxpayer deductions for charitable contributions are capped by percentage limitations that are tied to the donor's "contribution base" (which essentially is adjusted gross income for the year) and by the donor's basis in certain assets (e.g., short-term capital gain assets or tangible personal property). By comparison, the only limits in §642(c) are that contributions must be sourced to gross income and must be made pursuant to the terms of the governing instrument. There expressly is no percentage limitation or basis cap in §642(c) – and no express provision denies a deduction for unrealized capital gain.

The opinion in *Green* presumes that the omission of any limitations similar to §170 is intentional. Arguing to the contrary, the government relied on Ferguson, Freeland, & Ascher, FEDERAL INCOME TAXATION OF ESTATES, TRUSTS, AND BENEFICIARIES §6.09 (3d ed. 2014), for the proposition that deduction of the full FMV would violate two fundamental tax policy principles. One is that it would permit the donor to avoid income taxation of the appreciation. And the other is that it would permit a deduction for an amount (the appreciation) that is not gross income of the trust. The *Green* opinion stated that (1) Code provisions regarding charitable deductions should be liberally construed in favor of the taxpayer, (2) the fact that the donated properties were purchased in a year prior to the one in which they were contributed did not disqualify the charitable deduction, because it was not difficult to trace those assets to gross income as the source of their purchase, and (3) reading a limitation into §642(c) where none expressly exists would improperly impute an intent to Congress regarding an issue on which the Code is silent. (The court also held that owning the contributed assets as a part of the trust's accounting principal was irrelevant to the question, because doing otherwise would improperly conflate the separate concepts of fiduciary accounting income and taxable income.)

The challenging question is why Congress limited the §642(c) deduction to amounts paid from a trust's gross income in the first place, and whether that informs the question involved? Several potential explanations might flow from analogies to (1) the §661(a) distributions deduction, which is limited to the taxable portion of DNI (and thereby precludes a trust from deducting amounts greater than its taxable income for the year), and (2) the §170(b) contribution base percentage limitations that also preclude individual taxpayers from claiming charitable deductions that otherwise might offset other taxable income in the year of contribution.

Neither analogy is compelling, and *Green* may be correct, based on the current law. However, respected charitable planning gurus Larry Katzenstein and Conrad Teitell join Ferguson, Freeland, and Ascher in concluding that the result is wrong. It therefore seems probable that the government will appeal (presumably to the Court of Appeals for the Tenth Circuit). If it loses in that arena, it also might lobby Congress to amend §642(c). At the moment, however, it may be that following *Green* in current charitable planning is a low-risk endeavor, *provided that* any appreciated assets that are distributed in kind easily can be sourced to gross income in the year of their purchase. It also may be wise for taxpayers to follow the strategy in *Green* by avoiding the Tax Court (and any deficiency judgment that would be payable with

interest) by (1) paying a higher tax (by limiting their deduction to basis), and then (2) amending their return to claim a higher deduction based on fair market value, followed by (3) a suit for a refund in District Court if/when the government denies the claimed refund.

So Remote as to be Negligible. What does this term mean, either for wealth transfer or income tax purposes? For example, under Treas. Reg. §20.2055-2(b)(1) a charitable gift subject to a condition precedent is deductible for wealth transfer tax purposes only if the possibility that the charitable transfer will not become effective is so remote as to be negligible.

Numerous authorities regard 5% as the appropriate threshold for that standard. See, e.g., Rev. Rul. 77-374, 1977-2 C.B. 329; Rev. Rul. 70-452, 1970-2 C.B. 199. Compare Graev v. Commissioner, 140 T.C. 377 (2013) (deduction for conservation easement denied because "side letter" from the grantee promised to return cash and remove a façade easement if the taxpayer's charitable deduction was reduced, which was not a negligible risk under the facts involved); Estate of Lockett v. Commissioner, 75 T.C.M. (CCH) 1731 (1998) (no charitable deduction was allowable for a bequest of the decedent's home under a mandate that it be set aside as a historical site, notwithstanding that the trustees complied with that request); TAMs 9443001 (the charitable deduction was disallowed for a bequest to any entity that would accept, maintain, and limit development of the property according to the decedent's wishes as judged by a personal representative; no charity accepted the bequest as conditioned), 8205002 (a charity guaranteed a bank loan to a person who donated the loan amount to the charity, which bought a certificate of deposit and pledged it as collateral to secure the loan; no deduction was allowed because the charity could not benefit until the loan was repaid and the possibility of nonpayment was not so remote as to be negligible), and 8010011 (a charitable remainder interest contingent on a never-married 60-year-old man dying without a surviving child was nondeductible because of the ability to adopt a child), with Rev. Rul. 78-255, 1978-1 C.B. 294 (the charitable deduction was allowed for a gift that was contingent on a 78-year-old widow surviving the testator by 30 days); TAMs 9443004 (regarding a contingency of a school ceasing to exist as a state accredited institution at any time within a 30 year period as so remote as to be negligible and allowing the deduction, although the contingency had to be reflected in determining the value of the deduction allowed; quaere how to determine the value of a contingency that is so remote as to be negligible), and 9236003 (a contingency was so remote as to be negligible and did not disallow the deduction notwithstanding that it was enforced by the local Attorney General and the charity relinquished the property).

For income tax purposes, §642(c)(2) permits a deduction for amounts of income permanently set aside for a qualified charitable purpose pursuant to the terms of the instrument governing an estate or a §645-electing trust. The requirement under Treas. Reg. §1.642(c)-2(d) is that "under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside . . . will not be devoted to [a qualifying] purpose or use is so remote as to be negligible." Calling its interpretation of the "so remote as to be negligible" provision a question of first impression under §642(c)(2), **Estate of Belmont v. Commissioner**, 144 T.C. 84 (2015), involved litigation that was pending when the estate's income tax return was filed that claimed the §642(c)(2) set-aside deduction. The estate had received IRD from a pension fund that it sought to offset with the charitable set-aside deduction, even though the money had not yet been paid to the charity, nor was it segregated from other estate funds, *and* the pending litigation was generating fees that could, and did, dissipate the fund that was set aside for the charity. As such, the court held that "a real possibility existed that the funds set aside . . . would be invaded in order to continue the estate administration" and, thus, "it was not 'so remote as to be

negligible' that the funds set aside . . . would be depleted because of the ongoing and future litigation." As a result, the deduction was denied for the year in which it was claimed.

The *Belmont* opinion cited the 5% negligibility test that has applied for wealth transfer tax purposes, but relied instead on cases establishing substantive evaluations such as "a chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction" (quoting United States v. Dean, 224 F.2d 26, 29 (1st Cir. 1955)) and "a chance which every dictate of reason would justify an intelligent person in disregarding as so highly improbable and remote as to be lacking in reason and substance" (quoting Briggs v. Commissioner, 72 T.C. 66, 657 (1979)). Because the estate litigation was underway when the income tax return was filed claiming the deduction, the court found that "facts and circumstances known to the estate when it filed its Form 1041 . . . were sufficient to put the estate on notice that the possibility of an extended and expensive legal fight – and consequently the dissipation of funds set aside for the [charity] – was more than 'so remote as to be negligible'." A similar result was reached in **Estate of DiMarco v. Commissioner**, T.C. Memo 2015-184, citing both *Graev* and *Belmont*, in which will contest litigation was unresolved in the year for which the estate claimed a charitable deduction for income allegedly permanently set aside for charitable purposes.

NIMCRUT Calculation Rule Ratified. Charitable remainder trusts – either annuity (CRAT) or unitrust (CRUT) versions – pose §664 calculation and valuation requirements that can preclude qualification for income or wealth transfer tax charitable deductions and prevent the trust from qualifying as tax-exempt. For example, the annual payout must be a minimum of 5% of either the initial (CRAT) or annual (CRUT) fair market value of the trust. The payout cannot exceed 50% of those values, either (but this limitation is far less commonly encountered than the 5% minimum payout rule). In addition, the value of the charity's interest – the remainder following a lead interest in one or more private beneficiaries – must be no less than 10% of the initial fair market value of the trust. A larger lead payout means the remainder will be smaller, so there is a tension between meeting the 5% minimum payout and the 10% minimum remainder requirements.

The §7520 assumed income yield rate can play a role in this also, because any expectation that income generated will be lower than the 5% minimum required payout translates into an expectation that corpus of the trust will be invaded to satisfy the minimum required payout. So, for example, if the §7520 rate is 2% and the payout distribution is the 5% minimum, the assumption is that the 3% differential will be satisfied by distribution of corpus, which reduces the remainder interest passing to charity. If the assumed §7520 rate is low and the trust duration is long, the possibility exists that the charitable remainder will fall below the 10% minimum requirement and the trust will fail to qualify. For reasons that need no development here, this is far more of an issue in a CRAT than in a CRUT, but the general concept is helpful to understand.

To make this more complex yet, the CRUT rules allow for several alternatives that are not available in a CRAT. For example, the trust can call for distribution of the *lesser of* the stated percentage payout (e.g. the 5% minimum amount) or the net income of the trust. These trusts, known as NICRUTs, also can provide that any shortfall in a prior year – if income was less than the payout percentage – can be made up with income that exceeds the minimum percentage payout in a future year. These make-up trusts are known as NIMCRUTs and are more common than plain NICRUTs.

Two separate NIMCRUTs were involved in **Estate of Schaefer v. Commissioner**, 145 T.C. No. 4 (2015) – one calling for an 11% annual distribution and the other for a 10% annual percentage distribution – each with the net income limitation and both with the income make-up option. With such high payout percentages (10 and 11%), the likelihood that the remainders would not satisfy the 10% minimum was high, and the issue was the proper calculation of that 10% minimum requirement. In a nutshell, the government relied on pronouncements in §7.01 of Rev. Rul. 72-395, 1972-2 C.B. 340, and §6.09 of Rev. Proc. 2005-54, 2005-1 C.B. 353, that the net income option should be ignored and that the remainder should be valued as if the stated (10 or 11%) payout percentage would be distributed. The taxpayer argued that the net income limitation meant that, in many years, the trust would distribute less than the stated percentage, meaning that more corpus of the trust would remain for the charitable remainder beneficiary, which would make it more likely that the 10% minimum would be met. The taxpayer argued that the §7520 income yield assumption should apply (if it was greater than the 5% minimum payout requirement). That refinement is not significant for this summary, because the court agreed with the government.

The taxpayer's position may have been informed by the government position if a NIMCRUT is terminated, for example by both lead and remainder beneficiaries selling their interests to a third party, or the lead beneficiary selling its interest to the remainder beneficiary. In such cases, prior to the change worked by amendment at the end of 2015 via §344 of the PATH Act the issue was how to value the lead interest. The notion that the legislation reversed was that the net income limitation should be reflected to minimize the amount distributed to the lead beneficiary and therefore ensure that a larger amount is allocated to the charitable remainder. See, e.g., PLRs 201325018, 200733014, and 200725044, all of which reflected a policy that the charitable remainder must be protected, such that the deduction allowed and the benefit ultimately flowing to the charity are better aligned. Today the lead interest is calculated the same way on creation and on early termination, without reflecting the net income limitation. This means that a smaller deduction is allowable at creation (that is because the larger stated percentage is deemed to be payable every year, rather than a lower net income amount) and the value of the lead interest also is deemed to be larger at the time of any premature termination. That treatment only seems fair – to value the lead interest consistently both at creation and at termination.

12. Procedure

Tax Lien Asserted Against GRIT. The source of the unpaid gift tax liability involved in **United States v. MacIntyre**, 2012-1 U.S. Tax Cas. (CCH) ¶60,642 (S.D. Tex. 2012), aff'd sub. nom., **United States v. Marshall**, 771 F.3d 854 (5th Cir. 2014), is not important. Nor is it of more than prurient interest that the trust was created by and held for the first wife of J. Howard Marshall II – whose last wife was Vickie Lynn Marshall, a/k/a Anna Nicole Smith. The bottom line was that stock was held in one of the last grantor retained income trusts created before Chapter 14 of the Code was adopted, there was an unpaid gift tax liability with respect to that stock, the trust had terminated before the §6901(a)(1)(A)(iii) gift tax transferee liability issue arose, and the question was whether the trust, or its income or remainder beneficiary (both now deceased) should pay that gift tax liability. The court held that the income beneficiary should pay, which probably is the wrong result – at least in part.

The fact that the trust was an income tax grantor trust was not discussed, although the result reached – that the settlor as income beneficiary should pay – was the same result that the grantor

trust rules would dictate. Thus, it would be easy (but wrong) to misconstrue the result as being a function of grantor trust status. Instead, the fact that the trust would be "ignored" for income tax purposes was irrelevant, because the liability was for gift tax, and the court's challenge was to define the "donee" of the gift for purposes of transferee liability, which the lower court stated was a question of first impression. That also is potentially misleading, because existing authority is clear that, in such a case, the transferee liability should befall the trust. But within the trust, as between income and remainder beneficiaries, the surprising reality is that this particular issue does *not* appear to have been addressed previously.

In this context, the court's rationale for imposing the unpaid gift tax liability on the trust grantor as its income beneficiary was:

> [T]he Supreme Court has set forth a test for determining whether beneficiaries of a trust are donees eligible for a gift tax exclusion pursuant to [§2503(b) – the gift tax annual exclusion]. In *Helvering v. Hutchings*, the Supreme Court established that "[a] gift to a trust is, in fact, a gift to the beneficiaries." . . . In two companion cases decided the same day the Court determined that exclusions applied only to present rather than future interests and defined a present interest as a right to the present enjoyment of the gift. . . . The court sees no reason why the definition of a donee for a gift tax exclusion should differ from the definition of a donee for purposes of gift tax liability.

Which is to say, the present interest requirement for gift tax annual exclusion purposes is "good enough" for gift tax transferee liability purposes. In a word, that's goofy and does not appreciate the gift tax present interest requirement for annual exclusion purposes.

The court elaborated, saying that this rule "makes a great deal of sense" because the unpaid gift tax liability "should be paid from a known present source of money" and that, "if something happened and the remainder beneficiary received little or no money from the remnants of the trust at the time of its disbursement, then collecting the taxes from the remainder beneficiary would create a hardship on a person who never enjoyed any benefits of the gift itself." That also is wrong.

If the gift tax had been timely paid from corpus – which is the result the lower court also realized should apply ("the gift taxes should have been paid from the corpus of the trust at the time it became clear that the donor would not pay them") – the result would have been to amortize that cost, because a reduced corpus would have produced less income that the income beneficiary would have received. The corpus remaining at termination of the trust also would have been less, essentially reflecting the more appropriate amortization of the transferee liability against the value of both the remainder and the income interests. So, at bottom, the court's rationale and its conclusion both are improper.

It also is surprising that the court did not mention the state law Principal and Income Act, which also likely would have dictated that this transfer tax be paid from corpus, not income. See, e.g., Uniform Principal and Income Act §502(a)(6) ("A trustee shall make the following disbursements from principal: . . . estate, inheritance, and other transfer taxes, including penalties, apportioned to the trust"). Also ignored by the court was any mention whether allocation of any part of the gift tax liability to the remainder beneficiary would have left some portion of the tax unpaid, the remainder beneficiary being the settlor's son, E. Pierce Marshall, who died in 2006 and whose trail of litigation might have made collection significantly more difficult. See Stern v. Marshall, 131 S. Ct. 2594 (2011), and the history documented therein.

Subsequent to the court's initial decision in *MacIntyre* the court was again presented with a question of significant controversy, in this case on which there is a conflict of opinions. The question is whether a donee's transferee liability was capped by §6324(b) (to the amount of the gift received) for *both* the gift tax and interest incurred but not paid *by the donor*, *plus* any interest *of the donee* for late payment of the transferee liability. Following the decision in Baptiste v. Commissioner, 29 F.3d 1533 (11th Cir. 1994), and rejecting the contrary holdings in Baptiste v. Commissioner, 29 F.3d 433 (8th Cir. 1994), and Poinier v. Commissioner, 858 F.2d 917 (3d Cir. 1988), the appellate court originally held that the donee's liability for the donor's gift tax and the donor's interest is capped, but that there is no limit on the added amount of interest imposed on the donee for late payment. Then, in an extraordinary event, the three judge panel reversed itself, in the same case, upon reconsideration, withdrawal, and reissuance of the opinion, upending the court's two-to-one result on this one issue, 798 F.3d 296 (5th Cir. 2015). The original dissent became the panel decision on this question and the original majority opinion on this issue was preserved as dissent. Just as this question divided the two *Baptiste* courts (involving liability of brothers), it generated two opposing dissents on the appeal in *MacIntyre/Marshall*. The original panel justified its result because, were the rule otherwise, a donee whose liability for the donor's tax is already capped would have no incentive to timely pay the government to reduce the interest assessed on the donee's late payment. The revised opinion concluded that the statute simply does not support that result.

13. Notable State Law Developments

The following materials are provided on the theory that Congress has made the applicable exclusion amount permanent at a level that excludes something over 99% of all decedents from the federal wealth transfer taxes. As such, our attention as estate planners will focus on many issues that affect the "middle rich," for whom competent estate planning services are necessary but wealth transfer tax motivated planning is not. This may be a new orientation for some estate planners, after many years of tax-centric planning. Numerous interesting and new state law nontax issues deserve attention, and developments that have a wider significance than the particular state's law are useful learning tools. Both notions inform these selections.

Beneficial Interests in Revocable Inter Vivos Trust. Uniform Trust Code §603 operates under a general principle that a revocable inter vivos trust is the functional equivalent of a will. As such, while the settlor is alive all rights of beneficiaries other than the settlor are subject to the settlor's control, and the trustee's duties run exclusively to the settlor. This informs the suspended application of the §813 duty to inform and report to beneficiaries, which does not apply while the settlor is alive and competent. As applied by In re Trimble Trust, 826 N.W.2d 474 (Iowa 2013), and Raines v. Synovus Trust Co., 41 So. 3d 70 (Ala. 2009), successor beneficiaries of revocable trusts also were precluded from suing the trustee for alleged mismanagement that occurred while the settlor was still alive, on the ground that only the settlor had a cause of action for anything that occurred during the settlor's life.

Trimble is an important case because it illustrated a difficult conflict of principles that can arise. The decedent was settlor of a self-trusteed declaration of trust. She stepped down as trustee only eight months before dying, at age 104. The successor trustee was one child, who was asked by another child to account for the eight month "gap period" that existed after the trustee succession and prior to death of the settlor. The court concluded that the successor trustee had no

duty to account to anyone other than the settlor while the settlor was still living. This reflects the general rule in §603, which was the model statute adopted in Iowa.

If a settlor becomes incompetent prior to death, the personal representative of the settlor's estate may seek the accounting that the court denied to the successor beneficiary in *Trimble*. And if that personal representative has a conflict (for example, if the personal representative also was the successor trustee whose accounting was sought) the solution, according to the *Trimble* court, is a beneficiary's right to request appointment of a temporary administrator of the settlor's estate, to request and receive the successor trustee's accounting. That right may not exist, however, if the aggrieved trust beneficiary is not also a beneficiary of the estate – meaning that standing in the probate court may not exist. And the *Trimble* court did not explain how a beneficiary who does have standing would know to request appointment of a temporary administrator without first having an accounting that might reveal the kind of financial misuse that would justify a court's appointment of such an administrator.

These issues are difficult, because courts acknowledge that a settlor should have the same right to privacy regarding premortem transactions as would a testator – whose beneficiaries typically do not have the right to examine the testator's premortem financial activities. These conflicts are apparent by comparing Boyd v. Boyd, 57 So. 3d 169 (La. Ct. App. 2011), Fulp v. Gilliland, 998 N.E.2d 204 (Ind. 2013), In re Gunther Revocable Living Trust, 350 S.W.3d 44 (Mo. Ct. App. 2011), and Pennell [no relation to Prof. Pennell] v. Alverson, 2012 WL 4088679 (Ariz. Ct. App. 2012), all of which denied successor beneficiaries the right to challenge a trustee for acts while the settlor was alive, with In re Estate of Giraldin, 290 P.3d 199 (Cal. 2012), which allowed successor beneficiaries to sue the trustee for breach of duty to the settlor while the trust was revocable "to the extent that violation harmed the beneficiaries' interests."

Most recently, **Tseng v. Tseng**, 352 P.3d 74 (Or. Ct. App. 2015), addressed these same issues and held that UTC §603 only precludes reporting to beneficiaries other than the settlor *while the settlor is alive*, and that §603 only "defers" the beneficiaries' ability to protect and enforce their interests until after the settlor's death. The facts were somewhat unusual, in that the settlor had come to America from his native China, leaving behind three sons and their mother, who the settlor believed to be deceased. So he remarried and had several children in America, who were the trustees of a trust created when the settlor learned that his sons from that first marriage still were alive. Naming all of the children as cobeneficiaries, the accounting issue arose addressing large transfers out of the trust, made in the year before the settlor's death. The three plaintiffs sought information in an effort to determine whether the cotrustees had breached the trust in any way. Their response was that the plaintiffs were not entitled to any information.

Tseng balanced the equities involved by holding that "qualified trust beneficiaries are entitled to obtain the material information needed to protect their beneficial interests under the trust (although, in the case of a revocable trust, the qualified beneficiaries cannot obtain such information while the settlor is alive)." The court did not address the situation in which a living settlor no longer is competent, but held that the plaintiffs were entitled to "whatever information [state law] generally requires the trustee to provide to beneficiaries" that would permit them "to challeng[e] actions by the trustee during the settlor's lifetime that harmed the beneficiaries' beneficial interests once the settlor has died." Note, however, that *Tseng* also stated (in a footnote) that there could be no actionable breach while the settlor was the trustee because "there can be no doubt that the trustee's actions were approved by the settlor." So, in *Trimble*, the *Tseng* holding would mean that the successor beneficiary would be entitled to information about successor trustee actions between the settlor's resignation as trustee and her death. Which seems to be a reasonable compromise.

Failed Tax Apportionment. Proper apportionment of the estate tax burden is a critical aspect of many estate plans, especially if the recipients of nonprobate property may be at odds with beneficiaries of the decedent's probate estate. This especially is true if state law or the decedent's will does not impose the burden of paying the tax equitably on those beneficiaries.

In **Smoot v. Smoot**, 2015 WL 2340822 (S.D. Ga. 2015), the decedent's child sought to require the decedent's surviving former spouse to pay estate tax attributable to life insurance, retirement benefits (a qualified plan, IRA, and a Keogh account), and an annuity that were payable to the former spouse. The decedent's will apportioned taxes against each beneficiary on a pro rata basis, but that dictate was contrary to Georgia law, which is one of just four remaining burden-on-the-residue states (Arizona, Iowa, and Wisconsin being the others). This generated two issues, with a split-the-baby result.

The estate tax attributable to the insurance proceeds was subject to the IRC §2206 pro rata right of reimbursement, which is similar to the provision in the decedent's will. So the first issue was not whether the former spouse, beneficiary of the insurance proceeds, was required to bear the pro rata share of the decedent's taxes attributable to those proceeds. That was clear. Instead, the issue was whether the former spouse had to pay interest incurred on the outstanding taxes that were attributable to those proceeds. That issue arose because §2206 does not mention interest, and uncertainty exists because the more recently enacted tax reimbursement provisions in §§2207A(d) (dealing with QTIP property includible under §2044) and 2207B(c) (dealing with property includible under §2036) specifically refer to interest along with the underlying tax (§2207 deals with §2041 power of appointment property, but does not mention reimbursement for interest).

On this first issue the *Smoot* court concluded that the tax and interest thereon "are one and the same," quoting §6601(e)(1), which provides that "[i]nterest prescribed under this section on any tax shall be paid . . . in the same manner as taxes. Any reference in this title . . . to any tax imposed by this title shall be deemed also to refer to interest imposed by this section on such tax." Consistent with Uniform Estate Tax Apportionment Act §2(2), that result was fortunate for the son because the will was silent regarding interest, and Georgia state law does not apportion the tax, much less the interest.

The second, more significant, question was whether the decedent's will could override the state law burden-on-the-residue dictate by apportioning tax to property that passed outside of probate. The traditional answer is that a provision in a will cannot govern property that is not subject to probate. However, a decedent's will may negate local law calling for apportionment of tax against nonprobate property, instead directing payment of all taxes out of the probate estate. This is because, if the decedent's intent is clear, relieving a nonprobate beneficiary of a tax burden imposed by state law is essentially a bequest to that beneficiary, which the decedent's will may make. The converse situation, however, was presented in *Smoot*, whether a will may impose a burden on a nonprobate beneficiary.

An interesting application of these notions was addressed by *In re* Estate of Williams, 2003 WL 1961805 (Tenn. App. Ct. 2003), in which nonprobate assets (annuities) were payable to the decedent's ex-wife. The decedent's will contained a tax payment provision that overrode the state law that apportioned tax to those annuities. Instead, the decedent's will placed the tax burden on the residuary estate. The court held that this provision, which favored the ex-spouse, was *not* revoked by a state law specifying that dispositions in favor of a former spouse are deemed to be revoked following a divorce. Notwithstanding the dispositive benefit to the spouse, the court held that the tax payment provision was only an indirect benefit that accrued to the former

spouse (and others) and was not meant to be addressed by the state law divorce-as-revocation-by-operation-of-law provision.

The opposite situation was presented by *Smoot*, because the will provision was not favorable to the former spouse. So a repeal-by-operation-of-law rule normally would not be required. Nevertheless, the court held that the decedent's tax payment provision did *not* apply to the decedent's former spouse because Georgia law specifies that "[a]ll provisions of a will made prior to a testator's final divorce . . . shall take effect as if the former spouse had predeceased the testator." That result turned off the decedent's attempt to apportion tax to the former spouse, who was deemed to be deceased. Although that result might technically be correct, based on the wording of the statute, it is contrary to the logic behind such statutes, which are meant to preclude a will from benefitting a former spouse. This will would have disadvantaged the former spouse, and the court's reliance on the Georgia statute served to favor the spouse. That's backwards.

In the process, the court sidestepped the difficult question whether a will may apportion taxes against nonprobate property, if that direction is contrary to state law. Although there is no clear (or even majority) rule on that issue, in all but the four remaining burden-on-the-residue states the easy planning answer is to avoid overriding the state law apportionment rule, which would cause the former spouse to incur any tax attributable to nonprobate assets received by the spouse. Care is required in such a case, however, to follow the dictates of any property settlement agreement that, incident to the divorce, may have directed that the spouse be designated as beneficiary of nonprobate assets. The important question is whether such an agreement addresses the question whether taxes are to be borne by the surviving former spouse. Quaere how many drafters of such property settlement agreements remember to address the tax apportionment issue.

When In Terrorem Clauses Are Enforceable. By simple observation (rather than by empirics) it seems that there are more cases recently deciding the validity of in terrorem ("ad damnum" or no-contest) clauses than historically has been the case. These cases arise with respect to both wills and trusts. Drafters whose clients are worried about the increasingly litigious nature of beneficiaries, or about individuals who are totally excluded from an estate plan, worry about challenges to everything from the basic validity of the document to actions seeking trust accountings or asserting fiduciary breach that can hamper administration of estates and trusts, perhaps to evoke settlement payoffs or otherwise simply to assuage anger or spite. So various drafting approaches are being evaluated in cases that involve actions brought by beneficiaries or disinherited heirs, testing the validity or reach of various forms of provisions that seek to minimize this form of disruption. And the results of the cases are more uniform and less satisfying than some observers might imagine.

When are these forms of provisions valid? The concern on one side is that undue influence may inform inclusion of a no-contest provision, the same as it did document provisions that improperly favored one beneficiary over other natural objects of the transferor's bounty. After all, if you know what you are doing when overbearing a transferor, you will generate a document that makes it more difficult for anyone to challenge your handiwork. The concern on the other side is that litigation by ungrateful or deservedly disinherited heirs should not tie up an estate or trust and generate unnecessary delay and costs. Any case likely lies somewhere between these poles.

One very well respected commentator suggests that these are important provisions in cases in which the dispositive provisions predict a contest, and that wise drafters include in terrorem clauses as insurance. To the concern about overreaching in both the document provisions and in the no-contest provision, this planner's response is that an ethical attorney would not agree to draft a document for a client who was not competent and who was acting under any form of duress or undue influence. This observer suggests that use by an ethical drafter should not raise concerns. Another very well respected commentator says the following:

> In my experience (not a scientific study), there is a substantial correlation between the use of no-contest clauses and the presence of bizarre, vindictive, or otherwise improper dispositions or, worse, undue influence. The estate planner should be alert for such behavior and affirmatively discourage it, not facilitate it or, in the case of undue influence, absolutely prevent it. The use of no-contest clauses in documents intended to create fiduciary duty and transparency may not be a red flag, but it is at least a yellow flag.

See Aucutt, Identifying and Respecting the Core Elements of a Modern Trust, 48th Ann. Heckerling Inst. Est. Plan. ¶1105.3 (2014).

One important element regarding the difference between these two views is that courts don't know whether a particular client's advisor was ethical or alert, and legislation such as Uniform Probate Code §§2-517 and 3-905 is targeted at garden-variety or vanilla estate planning situations that may fall at one or the other end of the spectrum. It is hard to fashion a one-size-fits-all rule regarding the validity of such provisions. These nearly identical UPC rules specify that "[a] provision in a will purporting to penalize an interested person for contesting the will or instituting other proceedings relating to the estate is unenforceable if probable cause exists for instituting proceedings."

Notice the presumption of invalidity. Other statutes reverse the rule to presume validity but provide an exception if probable cause exists, which may only shift the burden of proof or persuasion regarding enforceability. In **Hamel v. Hamel**, 299 P.3d 278 (Kan. 2013), the court applied Kansas law that presumed no contest clauses to be valid unless probable cause exists, applied the same rule to an in terrorem clause in a trust, and then found probable cause, based in part on the fact that the beneficiary's challenge was accepted as correct and in part on the fact that "the beneficiary relied upon the advice of disinterested counsel sought in good faith after a full disclosure of the facts," quoting from Restatement (Second) of Property: Donative Transfers §9.1 comment *j*. **Rafalko v. Georgiadis**, 777 S.E.2d 870 (Va. 2015), similarly addressed a no-contest provision in a trust, acknowledged that Virginia law allows enforcement of these provisions, but held that they are "disfavored in the law" and must be strictly construed. In this case that meant against the proponents of the trust. **In re Shaheen Trust**, 341 P.3d 1169 (Ariz. Ct. App. 2015), added that every challenge in a multiple-count contest must meet the probable cause standard (in that case one out of nine did not and the court validated the no-contest provision in a trust). Similarly, **Parker v. Benoist**, 160 So. 3d 198 (Miss. 2015), recognized a good faith and probable cause exception to an in terrorem clause, citing both the UPC and Restatement (Third) §8.5 comment *c*, discussed next below. The court's statements are particularly helpful:

> . . . such a provision is . . . void as against public policy, and fundamentally inequitable . . . .
>
> . . . The logic for a good-faith exception is simple: courts exist to determine the truth. . . .
>
> . . .

> . . . Allowing a good faith and probable cause exception would impose no higher burden on chancery courts to ascertain truth and intentions of the parties. Additionally, "[t]o protect and enforce property rights is the object of equity . . . ." For a court of equity to protect and enforce property rights, it must be able to hear disputes regarding those rights. Without a good faith exception to forfeiture clauses, the testator's will would frustrate a very object of equity. This cannot be allowed.
>
> . . . A testator cannot be allowed to hamper so fundamentally such a vital right to . . . seek redress for . . . grievances through due process of law.

More forceful yet is **Stewart v. Ciccaglione**, 2015 WL 1283481 (Super. Ct. Conn. 2015), which determined that an in-terrorem clause was "boilerplate" that the drafter "glossed over" and about which the settlor was not fully appraised, making it void ad initio:

> Those only who have an interest in the will (trust) will have the disposition to lay the facts before the court. If they are forced to remain silent, upon penalty of forfeiture of a legacy or devise given them by the will (trust), the court will be prevented . . . from ascertaining the truth . . . . Courts exist to ascertain the trust and apply it to a given situation, and a right of devolution which enables a testator (grantor) to shut the doors of truth and prevent the observance of the law is a mistaken public policy.

The challenging aspect of all of these rules – regardless of the direction of the presumption – is any "probable cause" standard. Various cases address the validity question in different ways, but boiled down the rule that usually applies is that no-contest provisions are *not* enforceable if a challenge was brought "in good faith, based on reasonable grounds" and was not "frivolous or vexatious" – again depending on what those terms mean. The comment to §3–905 refers to Restatement (Third) of Property (Wills and Other Donative Transfers) §8.5 comment *c* for a definition of probable cause as "evidence that would lead a reasonable person . . . to conclude that there was a substantial likelihood that the challenge would be successful."

When Binding Arbitration Clauses Are Enforceable. **ILM 201208026** (reported in some services as a CCA — either way it is a National Office opinion in support of litigation that articulated two theories on which unexpected gift taxation might attend to a taxpayer's creation of a trust. The theory that is important to this summary relates to trust provisions that are advanced by a growing number of trust drafters – an anti-contest clause (in that case it was a forfeiture-style in terrorem clause) and a mandatory arbitration clause. These sorts of provisions are designed either to preclude litigation entirely, or to divert legal actions by beneficiaries into an alternative dispute resolution forum. In the ILM the government asserted that Crummey clause powers of withdrawal would not satisfy the gift tax annual exclusion present interest requirement because of them.

Subsequent events reveal that the ILM almost certainly was issued early in the case of **Mikel v. Commissioner**, 109 T.C.M. (CCH) 1355 (2015), in which Judge Lauber ultimately dismissed the government's argument that *Crummey* clause powers of withdrawal were illusory. In the process, however, the opinion leaves some doubt about the underlying principles involved. Which may in part explain why the taxpayer was denied attorney fees notwithstanding their victory, in Mikel v. Commissioner, T.C. Memo 2015-173.

The crux of *Mikel* was a trust to which spouses split gifts of four real estate holdings and claimed 60 annual exclusions for each spouse, based on *Crummey* withdrawal rights granted to

descendants and their spouses. The trust contained the binding arbitration and in terrorem provisions that the government regarded as making those withdrawal powers invalid.

According to the ILM, any attempt to enforce the beneficiaries' *Crummey* rights would run afoul of a condition found in AOD 1996-10, which was the government's second acquiescence to Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991). In that AOD the government declared that it would continue to challenge annual exclusions claimed through the use of withdrawal rights if "there was a prearranged understanding that the withdrawal right would not be exercised" or that "doing so would result in adverse consequences to its holder (e.g., losing other rights or gifts under the instant trust instrument or other beneficial arrangement)." The government's contention in the ILM and in *Mikel* was that the binding arbitration and in terrorem clauses combined to negate the withdrawal rights "because any attempt to seek legal enforcement" of those rights would generate such adverse consequences.

The arbitration provision in *Mikel* declared that any dispute concerning interpretation of the trust "shall be submitted to arbitration before a panel consisting of three persons of the Orthodox Jewish faith" (a Beth Din). That panel was directed to "enforce the provisions of [the trust] . . . and give any party the rights he is entitled to under New York law." The in terrorem provision (which the court critiqued as "not a paragon" of drafting) specified that:

> In the event a beneficiary of the Trust shall directly or indirectly institute, conduct or in any manner whatever take part in or aid in any proceeding to oppose the distribution of the Trust Estate, *or files any action in any court of law*, or challenges any distribution set forth in this Trust in any court, arbitration panel or any other manner, then in such event the provision herein made for such beneficiary shall thereupon be revoked and such beneficiary shall be excluded from any participation in the Trust Estate . . . . [Emphasis added.]

The highlighted second clause, set apart with commas, was crucial because the two clauses surrounding it make it reasonably clear that only challenges to trustee distribution decisions were meant to be precluded. This was important because the court concluded that the highlighted clause did not stand apart. For example, the court said that it was not meant to prohibit a beneficiary's unrelated legal action to redress damage caused by a neighbor's mischievous dog. This meant that it did not in any way throttle a beneficiary's enforcement of the *Crummey* withdrawal right. And therefore it did not imperil the 60 claimed annual exclusions.

Regarding the Beth Din provision, the court rejected the government's argument that "legal enforcement" of a withdrawal right *must* occur in a state court.

> [I]t is not obvious why the beneficiary must be able to "go before a state court to enforce [the Crummey] right." Here . . . a Beth Din . . . is directed to "enforce the provisions of [the trust] . . . and give any party the rights he is entitled to under New York law." A beneficiary would suffer no adverse consequences from submitting his claim to a Beth Din, and [the government] has not explained why this is not enforcement enough.

And then, interestingly, in its footnote 4, the court reveals the government's admission that "beneficiaries of a trust will not be deemed by a New York court to have consented to an arbitration provision, and a New York court will not enforce an arbitral award against a nonconsenting party." Meaning that the arbitration provision was not binding in the first instance, which presumably negates the government's argument (and arguably makes the court's entire holding regarding it dicta).

It is not completely clear from the ILM whether the government believes that both the in terrorem and binding arbitration provisions are needed to generate the negative result that the ILM advocates. Just the binding arbitration provision may be problematic for another reason, hinted at by the court's footnote 4. Until very recently the consistent judicial assessment was that mandatory arbitration provisions in trust and estate matters are not valid. See 67 Major Tax Planning ¶1011.8 (2015), for further reference. The consistent ruling in dispositive trust cases (with just two exceptions) is that a trust provision is unenforceable if it denies a beneficiary the right to litigate a grievance in court and instead mandates arbitration. Quaere whether *Mikel* – a Tax Court case – in any way moderates that conclusion.

The crucial aspect of this is whether enforcement via arbitration is "good enough" to satisfy the fundamental need for enforceability. The same notion was involved in *Mikel*, and raises an important issue about binding arbitration provisions in general. Is arbitration adequate – the equal of judicial enforcement – to validate a trust? *Mikel* suggests that the government did not make the case that enforcement in a state court is critical (the ILM appears to assume that the lack of judicial enforcement is an impediment to full validation of a beneficiary's interest, but quaere whether the government briefed and argued that point). Other courts that reject binding arbitration provisions have held that arbitration is not adequate. Frequently the rub is the lack of an opportunity for an appeal, which is a serious consideration in many cases in which the law is sufficiently complex that trial judges (or arbitrators) simply get it wrong – we see an significant number of reversals on appeal for this reason. Which underscores the unanswered question, whether inadequate enforcement of a trust nevertheless is sufficient to validate the trust.

This is an especially important unanswered question for trust drafters in Arizona, Florida, and New Hampshire, where legislation authorizes mandatory arbitration provisions in dispositive documents. That legislation may be invalid as applied to trusts if it defeats the fundamental enforceability required to sustain the existence of a trust. In this respect, see the related question in Wilson v. Wilson, 690 S.E.2d 710 (N.C. Ct. App. 2010), which held that a North Carolina modification of the Uniform Trust Code that omitted certain notice and accounting rules was invalid, saying that a "beneficiary is always entitled to such information as is reasonably necessary to . . . enforce . . . rights under the trust or to prevent or redress a breach of trust" and that state law cannot obstruct the power of a court to enforce a trust. It noted that a trust without accountability is not enforceable, which is contrary to the fundamental nature of a trust — a trust cannot exist, it is not valid, if the fiduciary's duties are unenforceable.

If the majority of courts are correct in holding that binding arbitration provisions are not valid in wills and trusts, then the government's ILM conclusion that they prevent qualification for the annual exclusion also is incorrect, and the result in *Mikel* is correct. The problem that this raises is that a taxpayer seeking the annual exclusion may need to argue against the very provision that the taxpayer included in the trust. In addition, quaere the result in Arizona, Florida, or New Hampshire due to their legislatures having enacted empowering legislation.

Finally, *Mikel* found that the binding arbitration provision was not actually binding in New York, and therefore that it did not preclude enforcement of the *Crummey* right, and then held that the in terrorem clause did not apply with regard to those withdrawal rights at all. So the court totally rejected the government's rationale in the ILM (and the Chief Judge of the Tax Court did not regard the case as sufficiently significant to make it a regularly reported decision). But could another case reach the conclusion that the government asserted, for example if the arbitration provision is binding? Especially if the in terrorem clause applies to actions to enforce the withdrawal rights? This is not to say that the ILM is correct. It only suggests that *Mikel* does not conclusively lay the government's theory to rest.

Privilege Is Not the Same as the Duty of Confidentiality. A common and easy mistake is to equate an evidentiary privilege with an agent or a fiduciary's duty of confidentiality. A good reminder of the difference is provided by **Brunton v. Kruger**, 32 N.E.3d 567 (Ill. 2015), in which the subject was a statutory evidentiary privilege for information given to a CPA (not to a lawyer). That it was a statutory privilege and not the common law doctrine that applies to attorneys was relevant. But it was not the critical element in the court's determination that (1) the accountant's privilege belongs to the accountant, not to the client, and (2) the privilege may not be waived by the client (or, postmortem, by the client's personal representative). Instead, the privilege protects and belongs to the accountant, much the same way that the work product doctrine protects attorneys.

The issue in *Brunton* involved privileged information and documents given by a now deceased client to an accountant. The question arose in a will contest action between two children. The lower court held that (1) the privilege belongs to the client and (2) it was subject to the same "testamentary exception" that applies to the attorney-client privilege (information that is needed to give effect to a client's testamentary dispositive wishes is not protected from discovery). On appeal the Illinois Supreme Court held that neither concept applies to the statutory privilege granted to accountants. One reason given was that there was no common law accountant/client privilege, so the statutory privilege was the only authority and the statute contained only one express exception, which the court was unwilling expand by judicially adding others. The court expressly declared that the accountant privilege adopted by legislation in Illinois was championed by the Illinois CPA Society, to protect accountants from discovery, and not to protect their clients. The court also noted that, because state and federal courts consistently regard the accountant's privilege as protecting the accountant, it is not informed by the same client-faced concerns that inform the duty of confidentiality owed to a client.

The court did remark that a duty of confidentiality also may apply, that it is owed to the client, and that the client may waive that duty while alive, or the client's personal representative may do so postmortem. Similarly, a client who possesses privileged information may choose to disclose that information (indeed, documents in the client's possession are no-longer privileged), but neither the client nor a deceased client's personal representative has discretion to waive the accountant's privilege. And then, although the attorney/client privilege survives a client's death, and the testamentary exception to that privilege applies because of a presumption that a client would want to forgo the privilege to facilitate implementation of the client's will, the same is not true of the accountant's privilege. The two privileges are not cut from the same cloth.

Thus, the attorney/client privilege and testamentary exception are products of the common law, but the accountant/client privilege is statutory and therefore requires a different analysis. In fact, the court stated that it must "reject the . . . public policy argument that the two professions, accounting and law, should be treated similarly." Instead, the legislature "has determined that public policy [the protection of accountants] trumps the truth-seeking function of litigation in certain circumstances." Thus, the creation of a testamentary exception to the accountant/client privilege "is a matter for the legislature" to craft, not for the courts to determine.

Notwithstanding all of these holdings (which the court regarded as matters of first impression in Illinois), the final result in *Brunton* was an order to turn over the information being sought. "As in the case of attorney-client privilege, when the holder of a privilege voluntarily discloses privileged information, he waives the privilege." In this case the accounting firm has provided the subject information to proponents of the will in the contest action and could not thereafter withhold that information from the contestants. As the holder of the privilege, waiver as to one was a waiver as to all parties in the litigation.

Trust Decanting Failure. Florida Stat. §736.04117 permits "a trustee who has absolute power under the terms of a trust to invade the principal of the trust" to "exercise the power by appointing all or part of the principal of the trust subject to the power in favor of a trustee of another trust." Under modern lexicon, the trustee may *decant* the original trust to a new trust, in Florida provided that "[t]he beneficiaries of the [new] trust may include only beneficiaries of the first trust." **Harrell v. Badger**, 171 So. 3d 764 (Fla. Dist. Ct. App. 2015), held that a trustee's effort to decant into a new trust that qualified as a "pooled fund" version of first-party special needs trust (which allows the entity that manages the fund to retain any remainder after the beneficiary dies) was invalid. It violated Florida law because the entity's remainder cut out the original trust's remainder beneficiaries and added the entity as a new beneficiary.

Interesting but ultimately irrelevant facts disclosed by the opinion were that the special needs trust beneficiary was the settlor's grandchild, born to the settlor's daughter and then adopted as the settlor's child. And the lawyer involved was disbarred, apparently because the lawyer and her husband "were arrested, convicted, and sentenced to prison for the misappropriation of funds" from yet another successor trust to the SNT that was created by the decant.

Most important to students of decanting is footnote 4 of the opinion, which said "we need not address whether [the] statute requires the inclusion of all beneficiaries of the first trust as beneficiaries of a successor trust." All the court held was that the statute precludes addition of new beneficiaries. The decanting statute essentially equates the trustee's authority to distribute principal to a power of appointment, making the decant the functional equivalent of exercising that power to appoint. As a default rule, powers to appoint are "exclusive," meaning that not every permissible appointee must receive something (some may be excluded). Thus, state law reasonably could provide that a new trust need not include all beneficiaries of the original trust.

However, any original beneficiary whose interest is diminished might be deemed to make a taxable gift if state law subjects the trustee's decanting to consent or legal challenge by those beneficiaries of the original trust whose interests are affected. As noted at page 4, in 2013 the government's priority guidance plan deleted a project to provide guidance regarding the tax consequences of decanting. It is widely believed that this was because the project promised to be too extensive for the government to accomplish within one year, as anticipated for projects on any year's priority guidance plan. Meanwhile, §5.01(14), (20), and (21) of Rev. Proc. 2015-3 provide that the government will not rule on the tax effects of any decanting action.

Trust Protector Provisions Are Valid in Louisiana. **In re Stevens Living Trust**, 159 So.3d 1101 (La. Ct. App. 2015), is the latest in a string of cases involving transfers that began when the decedent, Eleanor Pierce Marshall Stevens, divorced her first husband, J. Howard Marshall (he of note for having married Vickie Lynn Marshall, a/k/a Playboy Playmate of the Year Anna Nicole Smith, when he was 89 and she was 26). For a discussion of the transferee liability issue in this case see page 34. This latest action is notable for the Louisiana court's determination that a trust protector provision is not contrary to public policy:

> Although the office of Trust Protector is not expressly provided for by the [Louisiana] Trust Code, . . . we find no law that expressly forbids such a provision. We also find no provision in the Trust Code incompatible with recognition of such an office such that would prohibit its coexistence. Therefore, the provision will be given effect unless it is "opposed to public policy."

The challenge to the trust protector came in the context of a trustee succession controversy, and the party seeking to invalidate the protector's designation quoted from Sterk, *Trust Protectors, Agency Costs, and Fiduciary Duty*, 27 CARDOZO L. REV. 2761, 2777 (2006) that "once a protector is appointed, the trustees become, to varying degrees, accountable to the protector." As a result, the trustee "might be especially inclined to follow the protector's directions in cases where the protector has power to replace the trustee."

Notwithstanding that the court recognized that "a trustee may, to an extent, become accountable to the trust protector," the opinion relied on the fundamental policy of effecting settlor intent and concluded that "[b]y designating a trust protector, the settlor's interest in managing the assets for the benefit of the beneficiaries is better protected, as the trust protector is someone whom the settlor has selected 'to represent the settlor's interests . . .'." Further, although beneficiaries traditionally are responsible "for ensuring the trustee manages the assets in accordance with the wishes of the settlor, that is, for the benefit of the beneficiaries," in some cases the beneficiaries may lack the expertise to judge whether fiduciary actions are proper, and "beneficiaries may be reluctant to take action for any breach detected, as they are, often, dependent on the trustee." And then, noting that there might be circumstances in which "a specific provision of a trust allowing for appointment of a trust protector may infringe on [a] trustee's fiduciary duty to the beneficiaries," the court concluded that recognition of the trust protector office does not violate the public policy of Louisiana.

Wooden Application of an Antiquated Doctrine. Does any musty old common law doctrine fill students and practitioners alike with more dread and loathing than the Rule Against Perpetuities? Most states have either repealed the Rule or made significant changes to it, but not all state laws are as progressive as they could be. **In re Will of Dorie**, 2 N.Y.S.3d 757 (Surr. Ct. 2014), reveals that New York state may be one of the less flexible states.

The document in question was a mess, and the trustee needed a court order to fill in gaps in its coverage and construe the settlor's intent. For example, it created trusts for each of two children for life, then for their children until distributions at certain milestone ages, and provided that the share of a grandchild who died before receiving complete distribution of the grandchild's share would pass to that grandchild's descendants. Among the gaps in the document was a failure to provide for distribution of the share of a grandchild who died without living descendants. And a telltale of drafting incompetence was a provision calling for distribution to descendants "in equal shares per stirpes" – which almost certainly should have said "in equal shares by right of representation" (which is what "per stirpes" means).

The real issue of significance was the fact that the ages for distribution were 50, 55, 60, and 65, and several of the great-grandchildren distributees were not lives in being when the trust was created. Meaning that there was a Rule Against Perpetuities violation with respect to the remainder interests in the great-grandchildren. For those who are not familiar or facile with the Rule, the scenario that would entail a violation is: all the life-in-being beneficiaries die when an after-born great-grandchild is below the age of 44, meaning that it would be more than 21 years before that great-grandchild would receive final distribution of their share of the trust. Also critical (albeit not discussed) is the notion that the beneficiaries were not vested in their shares prior to distribution – the ages used did not just postpone distribution of shares that vested, for example, when a great-grandchild was born or when their parent died.

The court's solution to this violation relied on a New York cy pres statute that reduces an offending age to the maximum age that will not violate the Rule. Here the court held that this

meant that the after-born great-grandchildren must receive their shares no later than their age 21. The concept being that all lives-in-being (children and grandchildren) could die and distribution within 21 years would avoid violation of the Rule.

Among the problems with this result are two aspects that more progressive statutes address. One is the concept of "infectious invalidity" by which a court recognizes the disparity created by the result in *Dorie* – that the after-born great-grandchildren will receive their shares at age 21 but their earlier-born life-in-being siblings or cousins may not receive the totality of their shares until age 65. Infectious invalidity could have been used to cause all similarly-situated beneficiaries to receive the same treatment – final distribution of their respective shares no later than their age 21.

The other doctrine that would apply in many states is the "wait-and-see" doctrine by which a court will not engage in the what-if analysis used in *Dorie* (what if all of the life-in-being grandchildren die before the after-born great-grandchildren reach the age of 44). Instead, wait-and-see would say that nothing should be done about the potential for a violation until the facts actually develop that entail an actual violation – which in this case (and probably the vast majority of others) may not ever occur.

Dorie is a good study in a variety of lessons to be learned from deficient drafting, not the least of which being the gap in the dispositive provisions and how to effectuate a settlor's dispositive intent with the least disruption caused by the Rule. It also is a good reminder that the Rule continues to exist in many states, and that not all states in which it exists have been as proactive as others in adopting legislation that minimizes or avoids the consequences of violations.

North Carolina Taxation of Accumulated Trust Income Is Unconstitutional. North Carolina Gen. Stat. §105-160.2 purports to tax "income of [a] trust that is for the benefit of" a resident beneficiary, even if that trust has no other contacts with the state. (Not implicated was a portion of the statute that imposes income tax on trust income that benefits nonresidents if derived from North Carolina sources, such as realty or a trade or business conducted in state.) **Kaestner Family Trust v. North Carolina**, 2015 WL 1880607 (N.C. Super. Ct.), held that taxation of trust accumulated income based *solely* on the North Carolina residence of trust beneficiaries violates both the Due Process and the Commerce Clauses of both the State and Federal Constitutions.

Although North Carolina constitutionally may tax beneficiaries on income distributed to them from the trust, the court distinguished State taxation of income that is *not* distributed by holding that the residence of the beneficiaries alone is an insufficient connection with the State to justify taxation of the entity. The trust was created and administered in New York and "did not have contacts of a sufficient quality or quantity," nor had it "done anything to seek out the protection, opportunities, and benefits conferred" by North Carolina. As a result, the State had provided nothing to the entity for which it could impose state income taxation on accumulated trust income. Citing Quill v. North Dakota, 504 U.S. 298 (1992), the court held that Due Process requires "sufficient contacts" with the State that make it "fair and reasonable" for the State to impose the taxes involved.

The mere residence of the beneficiaries could not support taxation of trust income that is not distributed, based on a Due Process analysis. But the facts in *Kaestner* might be distinguished in other situations by noting that the beneficiaries could not control the trust or its assets, could not compel distributions, and had no other influence over the income of the trust. Quaere, for example, whether a different result might apply if the trust beneficiaries also were trustees? The

possibility of exposing a trust to otherwise avoidable state income taxation is just one of many factors to consider when naming trustees or cotrustees, particularly individual trustees.

The *Kaestner* court also held that the Commerce Clause was violated because the trust had no "activity with a substantial nexus" to North Carolina, nor was the State tax "fairly related to services provided" by the State. The tax was not a fair compensation for protections that the trust received from North Carolina. "[T]he mere presence of the beneficiaries . . . while some contact with the State, is not a 'substantial nexus' between the Trust and the State" to support taxation of accumulated trust income. Again, the case may be distinguished by the fact that the trust engaged in no activity, made no investments, and did not maintain any records in North Carolina. The facts in other cases might not be so pristine or the result so clear.

Do You Want Interest or Appreciation with that Elective Share? After nearly 20 years of litigation, the issue finally (?) resolved by **Beren v. Beren**, 349 P.3d 233 (Colo. 2015), involved long delayed satisfaction of a surviving spouse's elective share. During the delay the estate had increased in value from $73 million to over $250 million, and the probate court awarded an additure to the surviving spouse's elective share ($26 million, calculated using date of death values) of $24.5 million to reflect an equitable share of that appreciation. On appeal the intermediate court held that Colorado law did *not* entitle the surviving spouse to such an "equitable adjustment," which the Colorado Supreme Court now has affirmed, remanding to allow the probate court to instead "award interest . . . to take into account undue delay in distributing the elective share."

Awarding interest for delayed distribution is the intuitive result in most jurisdictions, especially including those that have adopted the Uniform Probate Code, §2-202(a) of which regards the share of a surviving spouse as a pecuniary amount, determined by a formula, and §2-209(e) (by virtue of a cross reference to §3-904), which regards that general pecuniary amount as entitled to interest for any delay in distribution, beginning one year after the date of death.

Colorado law differed at the time of the decedent's death because it had not yet adopted the 2008 amendment to the UPC that entitles the spouse to interest on a delayed distribution (a flaw that was corrected in 2014). Nor was the Colorado elective share regarded as a fraction of the estate that would participate in either appreciation or depreciation during estate administration (which is consistent with the result in the majority of states that provide an elective share). As a result, in this significantly delayed estate distribution (due to six years of litigation over computation of the elective share itself), the spouse was denied any portion of the estate's very significant appreciation in value. The probate court's "equitable adjustment" to account for this was reversed, but the Supreme Court found that "the probate court has tools at its disposal to exercise equity consistent with the statutory elective-share framework," citing in particular the award of interest.

Other matters left to the probate court's discretion also could arise in other states' elective share calculations, including how to allocate expenses of administration – in *Beren* the estate's cost of the protracted litigation was almost $17 million – and whether the spouse must pay interest on the additure awarded by the probate court that the court on appeal required the spouse to return. Earlier decided, the probate court also determined under Colorado law that the elective share was calculated before payment of estate tax (incurred because the elective share was not sufficient to reduce taxes to zero). The regime in most states is consistent in providing that the elective share is calculated before taxes, but after "reasonable" expenses of administration. It is anyone's guess

whether the return of funds improperly awarded by a lower court will carry interest – the Colorado Supreme Court left that to the probate court to determine "in its discretion."

Dinan v. Patten, 116 A.3d 275 (Conn. 2015), is nearly the functional opposite of *Beren*, in the sense that the elective share under Connecticut law is based on a fraction of the estate rather than a pecuniary amount. It therefore participates in appreciation or depreciation between the decedent's death and final distribution, and the surviving spouse is entitled to a pro rata share of estate income generated during that period, rather than interest if distribution is delayed. In comparison, the two cases reveal variations in state laws that, on their face at least, appear to be directed toward similar results but really are quite different. For example, the court in *Dinan* expressly concluded that the Connecticut elective share statute is meant to protect the surviving spouse – a support theory – rather than reflecting an economic partnership of marriage, which is the regime reflected in the Uniform Probate Code as applied in *Beren*. Further, the Connecticut share is "a life estate of one-third in value of all the property passing under the will," which is basically a dower substitute that is a pale substitute for the share of a surviving spouse in an augmented probate estate jurisdiction. Connecticut's share is based on the probate estate only and it is a mere life estate rather than a fee simple entitlement.

Despite these differences, the fundamental issues in *Dinan* and in *Beren* are strikingly similar. Indeed, even the facts were similar, beginning with the fact that the litigation in each case dragged on for an extraordinary time – over 15 years in *Dinan* and over 20 years in *Beren*. Further, one question in each was whether to calculate the share before or after various charges against the estate – in *Dinan* the charge being estate tax that was attributable to the non-marital portion of the estate and in *Beren* it was postmortem expenses of administration (such as attorney fees). Finally, each raised the question of any right to income during the delay itself – in *Dinan* the court revealing that the estate failed to generate a positive return during the years in issue while in *Beren* the estate had extreme capital appreciation.

One significant difference was that the surviving spouse in *Dinan* was arguing *against* the fractional entitlement that the spouse sought in *Beren*, presumably because the decedent's estate had lost value during the period of administration (indeed, the final footnote in the opinion noted that the surviving spouse *deliberately* sought to "undermine the economic viability of the estate" – whatever that might mean) while the *Beren* estate showed unprecedented growth.

In the end the *Dinan* court concluded that the one-third fraction was computed before estate tax, applying the concept of equitable apportionment, which treats the marital deduction generated by the elective share as "belonging" to the surviving spouse, in terms of who should reap the benefit of the deduction. That result is consistent with the Uniform Estate Tax Apportionment Act and the interpretation of elective share statutes elsewhere.

The *Dinan* court also concluded that the one-third share should be determined at the time of distribution of the spouse's entitlement, which is consistent with a fractional entitlement (the court compared it to a surviving spouse's entitlement in an intestate estate) but contrary to the result found in states in which the elective share is "an amount" (a pecuniary entitlement) that is computed by applying a fraction to the date of death value of the estate.

These important distinctions often also arise in cases involving the funding of marital deduction bequests as to which the drafter did not consider the differences between a fractional and a pecuniary funding regime. Connecticut's statute dates back to 1877, well before Congress created the marital deduction (in 1948) and long before funding a formula marital bequest became standard fare for sophisticated estate planning. It is probable that no one back then had any idea of the significance of these issues today.

Finally, consistent with finding the share to be a fractional entitlement, the *Dinan* court also held that the spouse was not entitled to interest during the period of delay but, instead, shared pro rata in the success or failure of the estate, in terms of both income generation and capital gain or loss. That, also, is consistent with a fractional entitlement and is a common concern even today in drafting formula marital bequests.

Not revealed in the *Dinan* opinion was how a naked life estate in one-third of the estate was made to qualify for the estate tax marital deduction. Perhaps a QTIP election was made? Nor does it say why values should matter. Was one third of the estate being sequestered and held apart during the overlife of the surviving spouse, or were the parties commuting the value of that life estate and making distribution in kind of a portion of the estate based on the discounted present value of that life estate? The opinion makes several references to "distribution" but gives no further indication of how this was being done in *Dinan*. Still, the drafting issues are clear for any planner who is crafting a marital entitlement, either consistent with or in lieu of a statutory entitlement under state law.

Whose Law Governs Adult Adoption? Two cases recently shone a spotlight on an issue that frequently arises because a will or trust drafter failed to establish their own rules in the document but, instead, relied on state law to determine various results. In each case the question was the rights of an adopted individual to inherit under the estate plan of someone other than the adopting parent. The law everywhere in America today recognizes adopteds as natural born, with certain limitations, such as that found in UPC §2-705 and a number of other state statutes designed to preclude an "adult adoption" that is designed to alter the disposition of a third-party's property. Thus, for example, the life beneficiary of a trust may wish to add someone to the class of remainder beneficiaries that passes to the life tenant's descendants. The easy way to accomplish this is by adoption of that someone as a child of the life tenant. The challenging question is whether this can be done purely for inheritance purposes, to alter the distribution under that third party trust. States that limit adult adoptions are motivated by the concern that such adoptions are manipulative or less legitimate than those in which the adopting parent actually fulfilled a parent-child relationship with the adopted individual while that individual was a minor.

In both **Sanders v. Yanez**, 190 Cal. Rptr. 3d 495 (Cal. Ct. App. 2015), and **Dennis v. Kline**, 120 So. 3d 11 (Fla. Dist. Ct. App. 2015), the added complication was that the adoption was performed under the law of a state other than the law governing the trusts in question, and the adoptions would not have been valid in those jurisdictions whose law governed the trusts. But in both cases the courts concluded that full-faith-and-credit mandated that the relationship established in the state of adoption must be respected by the states whose laws governed the trusts. Which is an important concept for a variety of other estate planning purposes, not the least of which being the significant conflict of laws questions involving domestic asset protection trust planning or (prior to Summer 2015 and the Supreme Court's decision in *Obergefell*) the definition of marriage in the case of same sex spouses. Frequently a conflict of laws issue determines the result in litigation. Not infrequently a conflict of laws analysis should inform the planning involved – here by the adopting parent (whose selection of the state of adoption might be critical) and, depending on the trust settlors' intent, it might have been wise to consider in the drafting of those trusts, too.

Reformation of Wills. Two recent cases illustrate the two ends of a spectrum involving postmortem reformation of wills. UPC §2-805 expressly authorizes a court to

> reform the terms of any governing instrument, even if unambiguous, to conform the terms to the transferor's intention if it is proved by clear and convincing evidence what the transferor's intention was and that the terms of the governing instrument were affect by a mistake of fact or law, whether in expression or inducement.

Further, UTC § 415 expressly authorizes a court to

> reform the terms of a trust, even if unambiguous, to conform the terms to the settlor's intention if it is proved by clear and convincing evidence that both the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement.

Notice how nearly identical each provision is. This authority to reform a document is a major deviation from the common law, in which the standard rule was that there was no remedy for mistake and that extrinsic evidence of intent was not admissible absent ambiguity. As a result, §§2-805 and 415 have been controversial and some states that have embraced the UPC or the UTC have omitted this authority from their enactments.

Without dissent, **Estate of Duke v. Jewish National Fund**, 352 P.3d 863 (Cal. 2015), adopts will-reformation without legislative authority, applying the same "clear and convincing evidence" standard as the UPC, without needing to show that the will was ambiguous. The mistake was a common one, in a holographic will that addressed simultaneous death of the testator and his wife (which did *not* occur) but that failed to dispose of the residue in the case of nonsimultaneous deaths (which *did* occur). Probably unexpected was that the testator would survive his wife, who was 14 years younger than he. Not unexpected was the court's holding that the decedent didn't intend to die intestate and that the same residuary beneficiary (a charity) named in the case of simultaneous death should take in all events. "We conclude that the categorical bar on reformation of wills is not justified" and "concerns about the reliability of evidence do not justify a categorical bar on reformation of wills." Thus, an unambiguous will may be reformed if the evidence shows the mistake in expressing the testator's intent when the will was executed.

The court's holding is not limited to self-drawn wills, and likely will be most relevant in future cases, such as this, in which the testator obtained a form (perhaps on-line) that the testator followed but didn't really understand, and makes a mistake that any experienced drafter would catch and correct before execution.

By comparison, **In re Trust Under Will of Flint**, 118 A.3d 182 (Del. Ch. Ct. 2015), denied relief in a very different context. The decedent's will, executed in 1934, created a traditionally-managed trust, held for the benefit of a daughter and her children, who sought to modify it 80 years later to convert it into a directed trust for investment purposes. Their goal was to preclude the trustee from diversifying the trust's inception assets (approximately 81% of the corpus was stock in IBM, which the decedent's brother founded in 1911). The court refused, finding that (1) that the document "did not contemplate the position of Investment Advisor or the concept of a directed trust," and (2) the decedent intended that the trustees should "exercise judgment and discretion, not act as marionettes for the Investment Advisor." Thus, the court concluded that modification would rewrite and conflict with the decedent's intent, saying:

> Whether the wishes of living beneficiaries should prevail over the wishes of a dead settlor is a contestable issue where reasonable minds can disagree. Different jurisdictions have

> reached different results. English law has long made the wishes of the beneficiaries paramount. By contrast, under the *Claflin* doctrine, the majority rule in the United States has long prioritized the settlor's intent. . . . In Delaware, the settlor's intent controls. . . . Our Trust Code makes it the policy of the State of Delaware "to give maximum effect to the principle of freedom of disposition and to the enforceability of governing instruments." It would undercut this policy . . . to enable . . . beneficiaries to rewrite the instrument after [the settlor's] death.

As a result, unanimous consent of all the beneficiaries was not adequate to modify this trust.

> Notwithstanding that all parties to a case seek relief via consent petition, the petitioners still must introduce "clear and convincing evidence of the decedent's intent" in order to obtain reformation. . . . [T]his court should modify the Trust only if it is no longer possible to achieve [the settlor's] intent. . . . Delaware law does not countenance wholesale consensual modification and only departs from the settlor's intent in narrow circumstances. . . . A court could deviate from [the settlor's] plan only if his scheme became impossible or illegal. Neither has occurred.

Notably, states (like Delaware) that are proactive in seeking to attract trust business from out-of-state settlors, do not accomplish their goal by defeating or circumventing settlor intent. Which makes predictable the result in *Flint*.

Also notable is that one typical modification of an older trust is to move in the opposite direction from that sought in *Flint*, to authorize a trustee to invest in a wider range of investments than the historic legal-list or individuated restrictions common among documents crafted in the wake of the Great Depression. But the applied principle of following the settlor's intent as the lodestar is consistent with traditional American jurisprudence, and with modern statutes, only allowing reformation to better accomplish a settlor's intent, as shown by clear and consistent evidence. The controversial element in many of these cases is admission of extrinsic evidence of intent, and not application of the standard by which courts determine whether to allow change.

As in *Duke*, do-it-yourself planning, particularly using on-line forms, will become more common. It will lead to more postmortem "scramble planning" to cure errors in expression, to fill in gaps in dispositive provisions, and otherwise fix defective plans. The demise of the privity defense to malpractice also will lead to more litigation as disappointed intended beneficiaries seek redress from advisors who failed to accomplish a decedent's intent. Oddly, each trend may be salvation for estate planning lawyers, who operate in an environment in which the basic exclusion amount induces "middle rich" clients to seek less sophisticated planning, and basis improvement planning often is performed by income tax advisors rather than more traditional estate planners. Unchanged is the "pay now or pay later" reality that clients typically benefit more from proactive planning rather than reactive correction.

"Secondary" Disclaimer Disallowed. The issue in some disclaimer situations is whether one person can disclaim property in an effort to direct it back to someone else in search of a tax benefit. Frequently a child is disclaiming so that a surviving spouse will take instead, and qualify for the estate tax marital deduction. But sometimes the child's disclaimer merely causes the property to descend to the child's descendants and their disclaimers also are needed to achieve the intended result. The question that often arises in such cases is whether a next friend, legal guardian, or conservator may disclaim on behalf of descendants who are of tender age (or are not yet born – in any case in which they have a vested remainder). Known as "secondary"

disclaimers, these are performed if but only if the child's disclaimer is valid, and the child's disclaimer is conditioned on the secondary disclaimer – the notion being that the descendant will receive nothing unless the descendant's disclaimer is regarded as valid and therefore the child's disclaimer is effective. And the argument for validity is that the descendant would not receive any property absent the disclaimer, because the child would not step aside otherwise.

The challenging element in these situations is the state law standard for action on behalf of the minor or unascertained descendant – usually that the action (here the disclaimer) be in their "best interests." How can rejection of property be in the minor's best interests? The proffered answer is that it is not contrary to their best interests, because they wouldn't receive the property anyway, and the tax benefit sought by the overall planning will redound to their ultimate benefit. Examples of this planning and court approval based on this notion exist, but there also are a few cases in which courts deny the secondary disclaimer. Such a case is **In re Friedman**, 7 N.Y.S.3d 845 (Surr. 2015), in which the court rejected a mother's petition to disclaim her infant daughter's interest in the decedent's estate to permit the decedent's surviving spouse to take and qualify for the marital deduction, saying "this Court does not find persuasive the rationale that as the infant only possesses a contingent interest in the Decedent's estate the infant is not giving up anything . . . . Any taxes saved by the estate cannot serve to overcome the effect of making it more remote and improbable that this infant will ever receive a benefit . . . ."

Medicaid Qualification with Short-Term Annuities. An annuity is an exempt asset for purposes of Medicaid eligibility if "the annuity (I) is irrevocable and nonassignable; (II) is actuarially sound . . . ; and (III) provides for payments in equal amounts during the term of the annuity . . . ." 42 U.S.C. §1396p(c)(1)(G)(ii). In addition, annuities may be used to spend down or dispose of assets if "the State is named as the remainder beneficiary . . . for at least the total amount of medical assistance paid on behalf of the institutionalized individual . . . ." Id. §1396p(c)(1)(F). **Zahner v. Dep't Human Services**, 802 F.3d 497 (3d Cir. 2015), considered whether the annuity "safe harbor" requires that the annuity have a minimum term or a positive rate of investment return.

Two of the annuities involved were for 12 and 14 months, respectively. The investors paid $84,874 and $53,700 for annuities that would return $85,400 and $53,988 (as calculated by the dissent, a "miniscule return" of .05%). They were negative investments after considering a $1000 "start-up" fee paid to brokers in each case. Regardless, they provided a financial bridge between the date of application for Medicaid and when benefits would begin, after a period of ineligibility based on spend down gifts made prior to making application. And, according to the majority opinion's footnote 14, "shorter annuities make it possible for people with fewer assets to purchase annuities." Most importantly, however, the short term annuities made it possible for these investors to qualify and begin to receive benefits, sooner than if they had retained their own funds and spent their resources at private-pay rates while waiting to qualify for Medicaid.

The Pennsylvania Department of Human Services (DHS) asserted that these short term annuities fell outside the safe harbor for two reasons: one was a Pennsylvania law that purported to make all annuities assignable. The net effect of that statute would make all annuities ineligible for the safe harbor, because they would flunk requirement (I) that the annuity be nonassignable. This statute was deemed inapplicable: Federal law trumped Pennsylvania law under "conflict preemption" because the "state law erects an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."

The second DHS attack was that these annuities failed requirement (II) that they be actuarially sound. DHS' argument was that they cannot be sound if they do not generate a positive return and, in such a case, a positive return is difficult or impossible because the term was so short. Regulations mandate a maximum annuity term that may not exceed the annuitant's life expectancy (which precludes postmortem payments that benefit the annuitant's beneficiaries while sheltering wealth in the annuity safe harbor). But those regulations do not mandate a minimum term, and the court was unwilling to craft a judicial amendment. Nevertheless, the lower court held that these short-term annuities did not pass a "sniff" test, because they did not achieve "a legitimate, non-shelter, purpose or at least have the appearance of such an investment." The appellate court reversed, holding that motive is an illegitimate factor to determine qualification for the annuity safe-harbor.

Medicaid qualification is subject to annual review. Thus, a short-term annuity may return sufficient resources to the annuitant that, on review, the individual's net worth is too great to qualify. The short-term annuity tactic may be viable anyway if the annuity payments finance the individual's care while waiting out a period of ineligibility to qualify, or if costs of living consume the periodic annuity payments and, in the interim, the individual is able to qualify for Medicaid earlier than otherwise would be possible.

What Would You Do? Most practitioners of any experience have represented a client who was blind, deaf, or simply could or would not read — including some very wealthy and successful dyslexics. Maybe the client never admitted this, but the advisor realized that the client did not read important documents, for whatever reason. Less likely but also not uncommon is an advisor who represents a client who does not speak or read English (and the advisor does not speak or read the client's language). So a translator or go-between of some sort is needed. Similarly, some advisors are asked to produce documents for a client who wants a parent or child to execute it. Maybe a durable power, a shotgun rollover trust, health care directive, or perhaps even a deed. The questions presented in cases like this are highlighted by **Barounis v. Barounis**, 34 N.E.3d 756 (Mass. Ct. App. 2015).

The decedent was survived by three children. He had signed three wildly conflicting estate plans that left the children vying for admission of their favored documents and challenging the validity of the rest. One plan left one daughter in control of the family business (that part clearly was the decedent's intent) plus the residue of the estate (the decedent's wife having predeceased him). That element was less clearly the right result. This daughter selected an attorney who spoke the decedent's native language (Greek) because the decedent was not facile in English. The favored daughter was present for part of the initial meeting with the attorney, and the documents were prepared and delivered through that daughter, who acted as "communicant" with the attorney. But the attorney "never discussed the terms of the estate plan" with the daughter – instead only talked with the decedent about the desired plan – and the attorney was conversant in Greek.

A year later the decedent's financial and business accountant suggested that the decedent estate plan required revision because of changes in the law. Over 30% of the accountant's book of business was from the decedent, and he recommended a new attorney to whom the accountant had referred many clients. This attorney did not speak Greek, and never met with or talked with the decedent until the day documents were executed. Instead, the accounted (mis)communicated though the accountant. Essentially disinheriting the one daughter, neither the accountant nor the new lawyer reviewed the new plan (which was over 70 pages in length) with the decedent, and

he never read nor reviewed the documents (which were in English and contained obvious errors, including misspelling the names of the decedent's children).

The trial judge ultimately concluded that the decedent "was unaware of the contents" of the final estate plan, based on the fact that he did not read English or speak it in a "sophisticated way." The accountant's assertion that he effectively conveyed the decedent's wishes was discredited, and the lawyer's language limitation meant that he did not know whether the accountant accurately described the plan to the decedent in Greek.

The decedent's first lawyer sought to deal with the decedent's specific situation. The second lawyer apparently did not. The question for any ethical estate planner is how should you deal with the sort of situation presented by a client such as the decedent?

Guidance Regarding Circular 230. On August 1 the government released a document entitled "**Guidance to Practitioners Regarding Professional Obligations under Treasury Circular No. 230**" – which are the Treasury Department's ethics rules that govern any practitioner (e.g., enrolled agent, appraiser, attorney, or accountant) who is authorized to appear before the IRS or in the Tax Court. This release simply restates certain rules that are familiar and mostly not controversial. But even those who are generally familiar with Circular 230 may be surprised by a number of items that are included in the release, including:

1. A conflict of interest exists in representing multiple clients if there is a significant risk that the representation of one client will be materially limited by responsibilities to another former or concurrent client, or to a third party, or to the advisor's personal interests. Even if such a conflict exists, the representation may be permitted, but only if all affected clients give informed consent, in writing, and the advisor reasonably believes that provision of competent and diligent representation of all affected parties is possible. And then the advisor must retain these consents for 36 months following termination of the representation.
2. Advisors may not sign or assist in the preparation of a tax return – including giving advice regarding any position that the client may take on that return – if the advisor should know that it contains a position for which there is no reasonable basis, or it is an unreasonable position. To be an unreasonable position the advisor must lack substantial authority (as defined in §6662) but have a reasonable basis, and the position is disclosed. Furthermore, an advisor who advised a client or who prepared or signed a return regarding such a position must inform the client of all penalties that may apply and how to avoid those penalties via disclosure.
3. An advisor who knows that a client has made any revenue-law-related error or omission in any return or other document submitted or executed must inform the client of the error or omission and advise the client regarding the consequences of the error or omission. Unstated by this release is that the advisor need not disclose the client's error or omission to the government but, as noted in item 2 above, may not aid or assist the client in filing a return or document that is flawed in this way.
4. On request from a client an advisor must promptly return all client records that are needed for the client to comply with any federal tax obligation, even if there is a dispute over the advisor's fees. The advisor is not required to turn over work product, however, which may include returns or other documents prepared but not yet delivered, but only if the withholding is pending the client's payment of fees that relate to that document and the advisor's contract with the client requires payment of those fees prior to delivery of the document.

5. Failure of an advisor to file four of the last five years of personal income tax returns is per se disreputable and incompetent conduct for which the advisor may be summarily suspended for an indefinite period of time.
6. If an advisor believes that a business partner is engaged in a pattern of practice that violates Circular 230 the advisor may be held accountable for failing to correct that partner's noncompliance, even if the partner is an individual over whom the advisor has no supervisory authority.