

By **Jonathan G. Blattmachr** & **Martin M. Shenkman**

## Planning in a Time of Uncertainty: Part I

Why hitting the pause button may not be the optimal approach

**T**he election of Donald J. Trump as our 45th President was largely unexpected. While it's difficult to forecast the specifics of what that will mean during his term, and, perhaps, his second term, predictions can be useful to evaluate current planning. President-elect Trump has proposed wide-ranging changes to the nation's tax system that will affect virtually all Americans and their advisors. He appears to have made tax legislation a priority for his administration. He's suggested substantial reductions in corporate and individual tax rates and the simplification of the tax system generally through elimination of many deductions and other complexities. Estate planners, in particular, are already facing a dramatic impact on their practices, as many clients have hit the pause button on planning in anticipation of a possible repeal of the estate tax. This may not be the optimal approach for clients, and this two-part article will explore why.

The ramifications of a repeal of the estate tax, as Trump has proposed, would be significant in many ways.<sup>1</sup>

From a practical perspective, practitioners need to assess all these possible options, inform clients of the possibilities, guide them to continue taking planning steps that are appropriate now and endeavor to anticipate, to the extent feasible, how the myriad of possible changes might affect drafting, planning and their very practices. Pausing doesn't address the anticipated retention of the gift tax, planning for elderly or infirm clients,

the risks of a client dying before change occurs, the uncertainty of what change will occur and many other common planning situations. We'll endeavor to provide some insights and suggestions to assist practitioners in these matters and identify specific strategies that may still be useful in light of the current uncertainty. Part II of this article, which will appear in next month's issue, will cover helping clients who are in different stages of planning.

### Change Not Guaranteed

In addition to Trump's personal victory, the Republicans were also victorious. The House of Representatives is controlled 241 to 194 by the Republicans, and the Senate is controlled by a slight majority of the Republicans. This balance in power might make it more likely that many of Trump's tax changes discussed throughout this article could be enacted.

But, certain commentators say that there's no guarantee that Trump's proposed changes will get through. Here are some other perspectives:

- Although the strength of the Republican success was significant, some pundits suggest that it may not assure Trump the support to push all legislation he proposes to enact.<sup>2</sup> Trump, according to this view, may have to spend time building bridges not only with Democrats, but also with those in his own party. But, the pundits couldn't have been more wrong about the election, so the weight to afford any particular prognostication is "iffy" at best.
- Some have suggested that under the rules of Senate parliamentary procedure, any senator can filibuster virtually any bill (unless 60 senators vote to end it). However, a filibuster doesn't apply to a budget bill that uses the so-called "reconciliation" process, so using that process may present an option for Trump

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to use to circumvent a filibuster should one occur. Nonetheless, getting a budget resolution adopted can be politically challenging and typically results in many compromises.

- With the array of substantial legislation a Trump administration might propose, the inevitable horse trading will almost assuredly shape any actual legislation enacted. Trump's approach may also dampen

under the Bush administration (so tax relief could be granted elsewhere—largely, income tax reductions), many estate tax planners (including, attorneys, accountants, life insurance representatives and trust officers) never really experienced the significant reduction in business that they could have if there'd been immediate repeal. And, those practicing in decoupled states (that is, states that have an independent estate tax system) may

jobs as infrastructure changes must occur here in the United States, although materials (for example, steel) may come from overseas.

These plans may produce at least two negative effects. First, there will be a huge increase in the federal debt, at least in the short run. That simply is Keynesian economics: The government should incur debt to spur economic activity but should pay the debt off when the economy recovers—but the “later” (repayment of the debt) never occurs because of the political pressure never to cut a government program. So, the debt might almost certainly continue to grow permanently. Second, funding for infrastructure and how and where it will be used will

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complicate political and fiscal matters and likely delay other action.<sup>5</sup>

The tax cuts for individuals may not spur the economy. Bush essentially “tried” to both incur large spending and have individual tax cuts. We had the Iraq War, which resulted in massive government expenditures, and Bush also enacted massive tax cuts. It may be informative to read the late television journalist Tim Russert’s interview with Bush, which includes the following statements:

**Russert:** That’s a very important point. Every president since the Civil War who has gone to war has raised taxes, not cut them.

**Bush:** Yeah.

**Russert:** Raised to pay for it. Why not say, “I will not cut taxes any more until we have balanced the budget?” If our situation is so precious and delicate because of the war, why do you keep cutting taxes and draining money from the treasury?

**Bush:** Well, because I believe that the best way to stimulate economic growth is to let people keep more of their own money. And I believe that if

you raise taxes as the economy is beginning to recover from really tough times, you’ll slow down economic growth. You’ll make it harder.

See, I’m more worried about the fellow looking for the job. That’s what I’m worried about. I want people working. I want people to find work. And so, when we stimulate the economy, it’s more likely that person is going to find work. And the best way to stimulate the economy is not to raise taxes but to hold the low taxes down.<sup>6</sup>

In any case, “studies have shown that tax cuts done in the U.S. in the past several decades seldom recoup revenue losses and have minimal impact on GDP growth.”<sup>7</sup>

President Obama tried many times to get funding to rebuild U.S. infrastructure, but certain Republicans in the House opposed it because there would have to be an increase in taxes and/or increase in the deficit.<sup>8</sup>

Many Republicans profess to be deficit hawks.<sup>9</sup> So, it seems there will likely be some limitations on expenditure increases and tax cuts. Indeed, although the 2001 Tax Act repealed the estate tax, its implementation was



## SPOT LIGHT

### Rush Hour

“On Time—Grand Central Terminal,” by Bruce Braithwaite, sold for \$20,000 at Heritage Auctions’ American Art Signature Auction in Dallas on Nov. 12, 2016. Braithwaite is a realist painter whose work previously focused on capturing city images of Atlanta. He’s currently working on a large collection of New York City-themed paintings, such as the one above.

postponed due to the cost to the fisc.

What will happen is uncertain. But, there's a real prospect of at least some significant change in the estate tax system even if outright repeal proves elusive (for example, higher exemption, lower tax and exclusion for farms and small businesses). It may also be that the forecasted revenues from a capital gains tax on death might sufficiently offset the revenue loss from a repeal of the estate tax to facilitate repeal.

Nonetheless, the question that needs to be addressed is: What do estate planners tell their estate-planning clients to do in the meantime? "Nothing" is the wrong advice. What might the impact be on existing documents and plans?

## Economic Market

Many pundits predict a period of heightened market volatility that may have an impact on existing planning (for example, budgets, forecasts and market returns). Market volatility could also add to the uncertainty that the Trump tax proposals will create, making planning even more difficult. Although the stock market rose significantly after Trump won the presidency, it's uncertain if an upward trend will continue. Some stocks will rise and some will decline, perhaps based on perceived benefits or detriments following the legislative directions of the Trump administration.

## Feasibility of Estate Tax Repeal

Trump has proposed a repeal of the death tax. It's not fully clear whether he intended that repeal to include the gift tax. The Republicans have long wanted to repeal the estate tax, and the large march upward in the estate tax exemption may prove to have been a prelude to the elimination of the tax. The dubbing of the estate tax as a "death tax" reflects (and perhaps contributed to) the hatred many Americans, surprisingly including many not remotely likely to be affected by the tax, have had for what's become viewed as an unfair double tax.

We participated in a conference call after the election with 30 prominent estate-planning lawyers. The consensus seemed to be that estate tax repeal isn't probable—one reason is that Trump may not want to appear to be benefiting his family. All who spoke appeared to agree it was unlikely that the gift tax would be repealed (as it would cut the income tax receipts), but that consensus might not prove prescient. For those subscribing to this

view, deferring planning for a future that they anticipate will include a gift tax doesn't make sense.

The reality is that the estate tax affects very few taxpayers and raises insignificant federal revenue. A recent *Forbes* article noted:

In tax year 2015, just 4,918 estates paid \$17 billion in estate taxes (less than 1% of federal revenue). More than a third was raised from the richest of the rich—the 266 estates valued at \$50 million or more brought in \$7.4 billion to the Treasury.<sup>10</sup>

Many have viewed the estate tax not as a revenue

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raiser, but rather as a means of accomplishing a social objective of limiting the concentration of wealth. But, statistics as to the concentration of wealth in the United States suggest that the estate tax hasn't been particularly successful at dampening wealth concentration. "The United States exhibits wider disparities of wealth between rich and poor than any other major developed nation."<sup>11</sup>

So, if the estate tax raises an insignificant portion of the federal revenues, apparently hasn't had great success in dampening wealth concentration (although that isn't to say the situation wouldn't be more extreme absent the tax), generally appears despised and is incredibly complex, repeal may not be as implausible as some practitioners might like to believe. Further, the enactment of a capital gains tax on death (and perhaps on gift) noted below may provide revenue offsets for a sufficient portion of the revenue loss from repeal.

Trump has proposed a capital gains tax at death, meaning perhaps a retention of the gift tax or, like

Canada, perhaps even the imposition of a capital gains tax on the gift of an appreciated asset. So, the repeal of the estate tax may prove a political victory for Trump, but might not mean a complete elimination of transfer taxes for the wealthy.

### Timing of Estate Tax Repeal

Practitioners need to be concerned not only with the potential for repeal and what might replace the estate tax if it's repealed, but also with the timing of any of these changes.

- If the estate tax is repealed, might repeal be effective Jan. 1, 2017 or some other date?

Most taxpayers face no tax impediment by shifting assets to a lower bracket family member because the gift tax exemption is so high.

- Might the Republicans delay repeal until 2018 because of income tax changes that will impact the federal fisc? There's already been some discussion that tax cut legislation might be staggered, with corporate tax cuts first and individual tax cuts later.
  - Might repeal not be immediate but instead be phased in over a 10-year or other period as it was under the 2001 Tax Act? A phased repeal might permit Trump and the Republicans to claim victory on the repeal of the death tax but nonetheless preserve some revenue (albeit modest compared to overall revenues) for a period of time to lessen the impact on deficits.
  - If the estate tax is repealed, might the tax come back at some future time under a Democratic administration in some different and, perhaps, even harsher iteration? It also remains uncertain what might replace the estate tax.
- The timing uncertainty has significant implications

to what estate-planning practitioners should advise clients to do. The timing uncertainty is also why hitting the pause button on planning may prove inadvisable, especially for elderly or infirm clients.

### Gift Tax Repeal Unlikely?

Will the gift tax remain or be repealed as part of a broad repeal of the estate and generation-skipping transfer (GST) tax? While the Republican blueprint (tax plan) mentions estate and GST but not gift tax, it isn't clear whether Trump's proposal to repeal the "death tax" was intended as a shorthand reference to all transfer taxes.<sup>12</sup>

As practitioners know, the gift tax isn't just a backstop for the estate tax; it also ensures the integrity of the income tax.

- If the gift tax were repealed, a taxpayer (for example, a parent) could shift income without tax cost to another (for example, a child) who's in a lower tax bracket. The parent could simply gift the asset to be sold to the child to sell. Absent a gift tax cost, there might be no impediment (other than transfer costs) to making such a transfer. The child could then sell the asset, recognize a lower income tax than the parent and then gift some portion or all of the proceeds back to the parent.
- Family members could freely coordinate losses by some against gains by others.

However, what's the real impact of this purported backstop? When the gift tax exemption was \$1 million, it likely had a far more significant impact as a backstop for the income tax because the transfer of assets could have triggered a gift tax at a much lower wealth level. Now, for most taxpayers, the high current gift tax exemption (2017) of \$5.49 million may have no practical backstop impact such that for most taxpayers, a repeal of the gift tax entirely wouldn't open any flood gates of income shifting. Most taxpayers face no tax impediment by shifting assets to a lower bracket family member because the gift tax exemption is so high. Repeal of the gift tax might permit wealthier taxpayers to shift assets, but at some level of wealth shift, even the donee will be in the maximum income tax bracket so that there may be limited income tax benefit to shifting assets.

Thus, for some wealthy families, there may be little income shifting possible, not because of the impediment

created by a gift tax, but because all family members are already in the maximum income tax bracket. So, as the exemption grows, the repeal of the gift tax may become in some respects less relevant as a backstop to the income tax, although there are other ramifications. Also, lowering the income tax rate as Trump has proposed will lessen the incentive to shift income in all events.

But, it isn't the high tax bracket to high tax bracket transfers that would be problematic to the federal fisc. Rather, it might be transfers to a taxpayer with tax loss or other deduction carryforwards or transfers to a non-resident alien (NRA) taxpayer who pays no tax that might especially require retention of the gift tax. If carryover basis is limited to, say, \$10 million, a simple expedient would be to leverage a partnership investment and distribute the cash by a gift to the next generation. Without a gift tax, there would be no impediment to such a transfer. This could then create a large negative basis partnership interest with very little value. Also, without a gift tax, the transfer from person A to person B for income tax efficiency can easily be undone after a reasonable amount of time by a reverse transfer. Furthermore, state tax revenues could easily be lost. For example, taxpayers in high tax states could gift assets to individuals in low tax states so the recipients of the gifts could consummate the sales, in general, and avoid state income tax.

Later, if there were no gift tax, the proceeds could be gifted back to the nominal donor. These are just a few of the many abuses that gift tax may minimize. The imposition of a capital gains tax on gifts (mark-to-market tax with gift tax elimination) might also address many of these issues.

James Brockaway, a partner in the New Haven, Conn. office of Withers Bergman, mentioned to one of the authors that, if the estate tax on U.S. assets owed by NRAs were repealed, there may be a significant influx of capital into the United States as a result of non-U.S. investors looking for a politically safe place to invest assets, which could then be done without estate tax exposure and the complex planning transfer taxes had required.

A repeal of the gift tax would eliminate an impediment to asset protection planning for wealthier taxpayers. Shifting assets into irrevocable trusts

to protect them from creditors is complicated by the need to avoid a gift tax. The repeal of the gift tax would permit asset protection planning unfettered by that limitation. It would also eliminate a primary non-asset protection motive used to justify such planning. This is an important point for practitioners advising clients while the future remains uncertain. If the end result of planning now would be the shift of assets into protective trust structures, the only benefit to hitting the planning pause button may be the reduced professional fees associated with planning while there's a gift tax versus planning if the gift tax is repealed. With a gift tax, transfers might require the complexity and cost of a note sale and appraisal. If the gift tax were repealed, transferring the same assets to an irrevocable trust for asset protection might require no more than a simple stock assignment. The end result of planning under each scenario is the same, shifting assets to a more protective trust structure. The only distinction is the cost of planning before the fate of the gift tax is known. But, is that cost really material relative to the assets that may benefit from protection? If so many practitioners believe that the gift tax is unlikely to be repealed, does pausing planning that would also provide asset protection, divorce protection and management control, seem optimal? Can we forget the non-tax reasons for planning while we're in limbo of knowing what the future of the estate tax might be?

## Repealing Repeal

Even if the transfer taxes are repealed, that's no assurance that, just like "They're back," the classic line in the horror film "Poltergeist," a future administration may not re-enact the estate and gift taxes. The interim period during which the taxes may be repealed might provide clients with a window of planning opportunity to

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restructure their financial holdings in the manner they would prefer if not for gift and estate tax restrictions. As N. Todd Angkatavanich, a partner in the Connecticut office of Withers, Bergman, has mentioned to one of the authors, parents would have the flexibility to create profit interests for their children and devise various divisions of economic interests in investment transactions without gift and estate tax concerns, while maintaining control and access without complications. Thereafter, if it appeared that the transfer tax system would be re-enacted based on the then political landscape, there might be adequate lead time to modify financial/asset structures before new transfer tax rules were implemented.

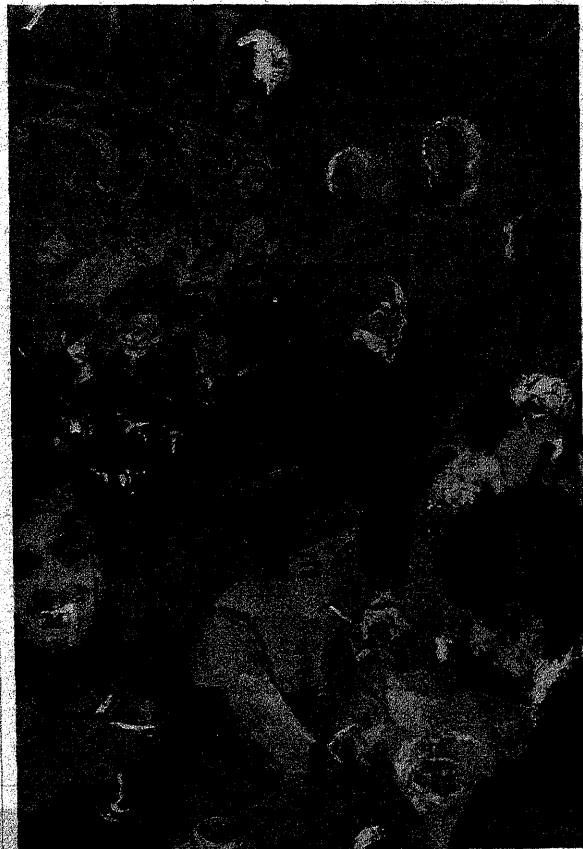
Under a capital gains tax on death regime, clients might benefit by swapping appreciated assets into a grantor trust before death to avoid a capital gains tax on death.

**Caution:** It should be noted that the U.S. Supreme Court has ruled that wealth transfer changes may be made retroactive.<sup>13</sup> Whether the government's ability to retroactively reintroduce the estate tax is covered by that decision isn't clear. The Treasury concluded in 2001 that repeal of the gift tax would substantially erode the income tax. Canada Revenue has advised that's why Canada adopted a capital gains on gifts.<sup>14</sup> This is all why wealthy taxpayers should continue to plan now, and if there's a repeal of the estate tax and/or gift tax, they should act to take advantage of that opportunity. Relying on advance notice of a future restriction or re-enactment may prove quite costly.

**Capital Gains Tax vs. Carryover Basis**  
When the estate tax was repealed for 2010 (by election essentially), carryover basis took effect.<sup>15</sup> There's no assurance, however, that carryover basis will be enacted if the estate tax is repealed, and it may be a question of cost. Some may think that a capital gains tax at

death will be enacted in place of the estate tax, as it was in Canada in the early 1970s. Indeed, that's what Trump has proposed for transfers at death in excess of \$10 million. The Trump proposal may include additional exemptions from the capital gains tax on death for family businesses and farms.

Those evaluating prior estate-planning transfers should carefully consider the possibility of a capital gains tax on death. Might shifting assets out of an estate into an irrevocable trust (even perhaps an irrevocable



## SPOT LIGHT

### Need A Light?

"The Pickwick Club" by LeRoy Neiman, sold for \$35,000 at Heritage Auctions' American Art and Signature Auction in Dallas on Nov. 12, 2016. Neiman is known for his brilliant use of color. Neiman's personal life was just as colorful; he traveled the world to exotic locales, observing and painting leisure and social activities, such as the Olympics.

trust that's structured as a grantor trust to preserve flexibility) avoid that capital gains tax on death? This could be vitally important to evaluating existing plans (should we terminate a trust if feasible?) and current planning (do we finish a so-called "spousal limited asset trust" or "spousal lifetime access trust" in process?). This might also give rise to inverse swap planning. Under a capital gains tax on death regime, clients might benefit by swapping appreciated assets into a grantor trust before death to avoid a capital gains tax on death. This is the opposite of how planning is pursued under the current tax regime. Is it possible that the Trump plan might treat grantor trusts differently from non-grantor trusts with respect to any gains tax at death? Perhaps, incorporating a trust protector with the power to turn off grantor trust status to provide flexibility might be advisable.

**Example:** Your client is in the midst of creating an irrevocable, dynastic, grantor trust, to transfer assets that are subject to valuation discounts. Your client undertook this planning in the wake of the proposed Internal Revenue Code Section 2704 regulations (proposed regs), which most read as reducing or even eliminating discounts in valuation. You and your client both were reconsidering the timing, structure and need for such planning as the Treasury has backpedaled from what the original proposed regs appeared to provide for. Should the plan continue? In many cases, it should, although perhaps without the timing frenzy that initially was anticipated, as discussed below.

If the above plan is completed and assets shifted to an irrevocable trust, will those assets outside of the client/grantor's estate be subjected to a capital gains tax on death if such a tax is enacted? If the repeal of the estate tax is accompanied with the enactment of a capital gains tax on death (and perhaps on gift or even on assets held in trust every so many years), might assets transferred to irrevocable trusts prior to enactment be grandfathered and thereby avoid that capital gains tax? If we view that as a possibility, then planning should proceed apace on this basis. However, might the opposite prove the case? Might assets transferred in current planning to irrevocable trusts instead lose out on an income tax basis step-up by not being included in the client/grantor's estate if IRC Section 1014 is retained? Perhaps more creative planning now can hedge a client's planning "bet." Perhaps planning to shift assets to robust irrevocable trusts should

continue in light of the non-tax benefits noted above and the possibility of avoiding a future capital gains tax (if the estate tax is in fact repealed). But, those trusts might appoint a person in a non-fiduciary capacity to hold a right to vest in the grantor powers that would taint the trust corpus as includible in the grantor's estate under IRC Section 2038. This might give the client potentially the better results in each of the above scenarios.

### The Devil May Be in the Details

Because only very broad strokes of a Trump tax plan have been presented so far, the details of any such proposal can't be known. For example, if a capital gains tax on death is instituted as part of the repeal of the estate tax, will transfers to trusts during lifetime be permitted as a means to avoid that capital gains tax? Some foreign countries tax assets inside trusts every 21 years if they haven't been exposed to the capital gains tax on death. Might such a program be proposed in the negotiations that accompany so many tax bills? Will assets transferred to trusts prior to the new legislation be grandfathered for purposes of avoiding a 20 percent capital gains tax? Might this mean that any trust can be terminated before the 21st anniversary is reached? Could this diminish the use of trusts?

If a capital gains tax on death is provided for, how will taxpayers find tax basis data to determine the tax? Many practitioners voiced just such concerns in 2010 when a carryover basis regime temporarily existed. Perhaps, the difficulties aren't as significant as some think. Canada had an estate tax that was similar to the U.S. estate tax system, which it repealed in favor of a capital gains tax on death. When asked about issues of historic income tax basis determination, Canadian practitioners indicated that they really had no great difficulty in this regard. When the Canadian system was created, there was a step-up in tax basis accompanying the new law so that taxpayers didn't have to look back further than that year for basis data. Might such an approach be considered as part of a Trump repeal and capital gains on death plan? If so, then practitioners will have to guide all clients as to the recordkeeping involved to identify income tax or fair value basis for the year of transition. There was a different approach under the carryover basis regime (later repealed) under the Tax Reform Act of 1976.<sup>16</sup>

The biggest losers of all under a capital gains tax at death system might be "leveraged" families—that is,

those whose assets have large debts against them especially if the indebtedness is greater than remaining basis at death, a common situation for families owning significant improved real estate. The law is well settled after *Commissioner v. Tufts* that virtually any transfer during lifetime (even a gratuitous one) results in income recognition to the extent the debt exceeds basis.<sup>17</sup> Currently, under Section 1014 and Treasury Regulations Section Sec. 1.742-1, the debt at death is added to basis in the hands of the inheritor, and the *Tufts* gain is never recognized. Presumably, that would change under a capital gains at death system.

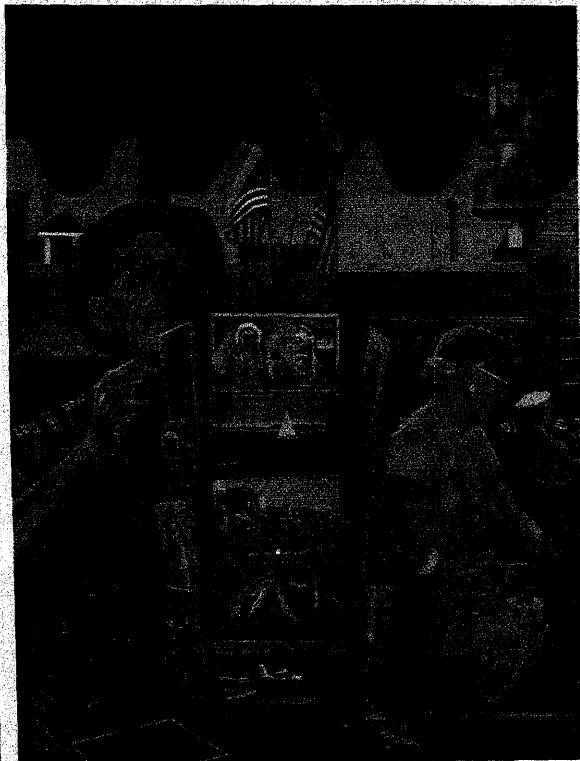
### Beware the Pause Button

At the time of this writing, estate planners are facing uncertainties that exceed those in late 2012 as to the future of the estate tax system. While hitting the planning pause button might feel seductive, it may not prove the optimal approach for the long-term benefit of many clients.

### Endnotes

1. See Jonathan G. Blattmachr and Mitchell M. Gans, "Wealth Transfer Tax Repeal: Some Thoughts on Policy and Planning," *Tax Notes* (Jan. 15, 2001).
2. "While the Republicans will have control of the Senate and the House of Representatives, Trump may still struggle to repeal the estate tax," *www.nytimes.com/2016/11/12/your-money/trump-changes-tax-codes-may-encourage-dynastic-wealth.html?\_r=0*.
3. *www.nytimes.com/2016/11/12/your-money/trump-changes-tax-codes-may-encourage-dynastic-wealth.html?\_r=0*.
4. The "Byrd Rule," first adopted in 1985 and named for the late Robert C. Byrd, allows senators during the reconciliation process to block a piece of legislation if it significantly increases the federal deficit more than 10 years in the future. Any senator can raise a procedural objection to legislation that does affect the deficit more than a decade out. If the objection is sustained, whatever provision is at fault for raising the deficit 10 years out is eliminated from the legislation, unless a 60-vote majority says otherwise." *http://economix.blogs.nytimes.com/2010/08/12/reader-response-why-are-the-bush-tax-cuts-expiring-in-the-first-place/?\_r=0*.
5. See, e.g., *www.cnn.com/2016/11/14/donald-trumps-plan-to-rebuild-american-infrastructure-will-be-harder-than-it-sounds.html*.
6. *www.nbcnews.com/id/4179618/nc/steet\_the\_press/t/transcript-feb-th/#.WChdtCOrLU*.
7. *https://en.wikipedia.org/wiki/Supply-side\_economics*.
8. *www.thefiscaltimes.com/2015/03/25/478B-Infrastructure-Bill-Blocked-Senate-GOP*.
9. *www.investopedia.com/terms/d/deficit-hawk.asp*.

10. *www.forbes.com/sites/ashleaebeling/2016/11/09/will-trump-victory-yield-estate-tax-repeal/#605e766d2bf2*.
11. *http://inequality.org/wealth-inequality/*.
12. The "Tax Reform Tax-Force Blueprint" (June 24, 2016), *https://abetterway.speaker.gov/\_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf*.
13. See *United States v. Carlton*, 512 U.S. 26 (1994).
14. "What's CRA's position on Family Gifts?" (Dec. 27, 2012), *http://fbc.ca/knowledge-centre/whats-cras-position-family-gifts*.
15. See Internal Revenue Code Section 1022 (repealed).
16. See IRC Section 1023 (repealed).
17. See *Commissioner v. Tufts*, 461 U.S. 300 (1983).



### SPOT LIGHT

#### Tourist

"The Vacationers (*Saturday Evening Post* cover)," by Stevan Dohanos, sold for \$87,500 at Heritage Auctions' American Art Signature Auction in Dallas on Nov. 12, 2016. An artist and illustrator, Dohanos was renowned for his social realist depiction of American life. Along with magazine covers, Dohanos designed many stamps for the U.S. Postal Service.