Heckerling Institute on Estate Planning

Hosted by:

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Introduction

Some Themes

- **Litigation** – Closing comment by Dana G. Fitzsimons Jr. and today's malpractice environment.
- **Trust modification** or change by any means is being attacked by the IRS. Is the day of easy decanting ending?
- **Formalities count** – Connelly follows Sorensen, Levine and Smaldino.
- **Complexity** continues to spiral out of control: Secure, Corporate Transparency Act, Basis consistency reporting, etc. And its not only tax issues, consider cybersecurity issues, and more.
- **Uncertainty** what will post-2024 election bring to tax laws? Rev. Rul. 2023-2 doesn't resolve all uncertainty as to basis. What does it take to make a trust non-grantor using an adverse party? And more.

Modest Estates

Planning for those Not Subject to Estate Tax

General Considerations

- 2026 exemption drops from $13,610,000 in 2024 (inflation adjusted in 2025) to half that perhaps about $7.2 million.
- Be cautious as clients may have a mismatch between GST and regular exemption amounts remaining.
- Unlimited marital and charitable deductions remain for these estates.
- Portability is permanent.
- Income tax considerations are important. For trusts the highest tax bracket is reached at only $15,200 of trust income. This contrasts to about $600,000+ of income before individual taxpayers reach maximum bracket.

Annual Gifts Pros/Cons

- Annual gifts should not be done just because they have been done historically. Be deliberate.
- Power of annual gifts invested over time can be significant.
- For some clients even in the moderate wealth range it may be simpler to make a single gift to a trust instead of making annual gifts year after year.
- For many moderate wealth clients, the cost of having a gift tax return prepared may dissuade them from larger gifts in favor of simpler annual gifts.

Spousal Lifetime Access Trusts ("SLATs")

- The idea is to use up the excess or bonus exemption above what ½ the exemption will be in 2026. While client would be uncomfortable gifting away large amount but may get indirect benefit from the trust.
  - Comment: Premature death (and divorce which is discussed below) should all be considered. Life insurance may be used to protect the settlor spouse from premature death. Financial forecasts should be used to illustrate potential outcomes, tax burn, etc. Caution should be exercised in what types and amounts of "indirect" benefit the settlor spouse may obtain. Practitioners should be cautious about what the put in writing in regards to benefits the settlor spouse may obtain. Consider naming a trustee in a DAPT jurisdiction and qualifying the trust as a DAPT to provide a backstop if the indirect benefits are challenged by a creditor or the IRS.
- Consider who you represent. Most practitioners usually represent both spouses.
- Divorce. Settlor may lose access and under grantor trust rules repeal of Sec. 682 in 2017 Tax Act the settlor will remain taxable on SLAT income. Should consider the impact on each spouse if they get divorced the next day. If the clients are worried about divorce why are they doing a plan?
  - Comment: Wealthy clients well educated clients may face a divorce rate that is perhaps about half of that of other clients. On the other hand, the only cohort of people for which divorce rates continue to rise are seniors, the so-called gray divorce issue. Since much of estate planning focuses on clients over 50-60 those may well be the clients most likely to divorce.

Spousal Lifetime Access Trusts ("SLATs")

- Probably no gift splitting if spouse is beneficiary of the trust.
- Reciprocal SLATs. Estate of Grace. They should not be identical. Need substantively different trusts. There are no bright line rules. Economics should be materially different between the trusts. Some try to do a SLAT and a dynasty trust without spouse as beneficiary, but they acknowledge that moderate wealth clients are not comfortable doing that.
- Step transaction doctrine under the Smaldino Case. What if starting with separate property funds, e.g. inherited funds. What if gift assets to the non-moneyed spouse who then funds a trust. Smaldino was not a SLAT case but alerts us to those step-transaction issues.
  - Comment: Smaldino was also a bad facts case but looking at step-transaction doctrine is critical and speakers are right to point this at as so much focus is given to the reciprocal trust doctrine and not the step transaction doctrine. In Smaldino the husband transferred entity interests to the wife who then made a gift to a trust the next day that only benefited the husband's children from a prior marriage. The operating agreement for the LLC given was never updated to reflect the wife as owner. The Form 1065 forms K-1 were never issued to the wife for the day she supposedly owned and interest. The list of foot faults in Smaldino is quite long. Just as with the reciprocal trust doctrine as noted above, there are no bright line rules. This will become more of an issue the closer we get to 2026.

Upstream Planning

- Parent or senior generation has exemption that you want to capture. Give GPOA to the parent in a trust. Contrast if gave asset outright to parent it would be included in the estate and if parent lives for 1 year + 1 day you avoid Sec. 1014(e) and get a basis adjustment. But the child donor has not control. So, child sets up a grantor trust to benefit child's descendants and gives in the trust a general power of appointment. GPO can be narrow. Parent can appoint assets to a creditor with the consent of another person up to her remaining exemption. No need to inform parent of the existence of GPOA. But note that parent could exercise the GPOA.
  - Comment: Consider the following as possible steps to enhance or differentiate a GPOA plan.
  - Consider corroborating that the intended powerholder has legal capacity when the grant of the GPOA is made, GPOA is made, although this appears to be unnecessary based on several of the cases on GPOAs. Nonetheless, several authorities relied on for GPOA planning results have fact patterns where the decedent had capacity when the power was granted. If the powerholder does not have capacity, perhaps the GPOA could expressly state that an agent under a power of attorney or guardian for the powerholder could exercise the GPOA on behalf of the powerholder, if the donor were comfortable with that.
  - Consider the possibility of making the powerholder a beneficiary of the trust and perhaps of even making distributions to the powerholder. That, as in the Freeman case might demonstrate knowledge of the trust's existence.

Upstream Planning

- Consider giving notice of the existence of the GPOA to the powerholder. This might be accomplished by verbal communication, although transmission in a manner that the receipt can be acknowledged might be preferable. This could include sending a copy of the trust agreement via certified mail return receipt to evidence receipt. Perhaps an e-signature on a document acknowledging receipt might suffice. Perhaps emailing the instrument creating the GPOA with a read receipt may be adequate. Perhaps, for existing GPOAs for which no notice has been given, practitioners might discuss with the client the pros and cons of giving notice to the powerholder now, or if the powerholder is incapacitated to the agent under the powerholder's durable power of attorney.
- Consider explaining to the client that there are uncertainties in the law as to the assured inclusion of a GPOA in the powerholder's estate to cause estate inclusion, that most or all authorities on the issue occurred when the tax laws were quite different than the current free-basing environment, and that the IRS or a court might argue the position in the Finlay case.

Other Techniques

- GRAT. The benefit for moderate wealth clients is the annuity or return of funds plus the 7520 rate. So a GRAT for these clients might serve as a type of estate freeze.
- QCD - qualified charitable distribution. Over 70.5 not 72. Money never shows as AGI which can have many tax benefits for a client, even one of modest means. Couple gets $30,700 standard deduction so may never get a charitable contribution deduction. Instead of taking RMD instead use QCD to have the IRA custodian to send the money to charity what would otherwise be RMD and income this amount would be equivalent to a deduction. AGI is lower so medical expense deduction may be greater. Lower of AGI may save them money on Medicare premiums.

Testamentary Trust Plan/Options

- Why still use Bypass trusts?
  - Consider creditor issues. A CST provides protection.
  - You can have beneficiary as trustee and still have creditor protection also protection from divorce from a future spouse.
  - Consider implications of surviving spouse remarrying?
  - Income shifting benefits of bypass trust as can sprinkle income to surviving spouse, children and grandchildren (whoever is named as a beneficiary of the CST) many or even all of whom may be in lower income tax brackets then the trust.
  - For special needs beneficiaries trusts can protect assets to protect government benefits by incorporating a supplemental needs trust.
  - Loans can be made instead of a distribution to retain assets in the trust. This can be done as a teaching tool for heirs. Loan heirs money and see how they react.
  - Trusts get unlimited charitable income tax deductions so a bypass trust may be a valuable tool for charitable planning but must include charity in the original document to meet the governing instrument rule.

Testamentary Trust Plan/Options

- QTIP.
  - All income must pass to surviving spouse. That is FAI not taxable income so there could be a mismatch between the two.
  - Get basis step up on second death.
  - Reverse QTIP election to preserve GST exemption.
  - May be able to use DSUE to avoid estate tax on second death.
  - Cannot sprinkle income as you can in a bypass trust and cannot have charitable beneficiaries.
- Clayton QTIP
  - This gives the executor the ability to decide whether it should be a bypass or QTIP after the first death.
  - To extent executor makes a QTIP election those assets pass to QTIP and to the extent the executor does not make a QTIP election the assets pass to the bypass trust.
  - Surviving spouse should not be the person with the power to exercise this. If state law permits you can have a special executor. If not name a special trustee in a revocable trust and have surviving spouse be a successor trustee for everything other than the Clayton QTIP election.
  - If you make a QTIP elect it postpones tax. The portability election preserves exemption. Who will pay tax on QTIP assets? Those QTIP assets will be stacked on top of the surviving spouse's estate and the QTIP may pass to children from another marriage. The marginal estate tax rate is paid by the QTIP unless the documents provide otherwise. This can be bargained for.h

Recent Developments

Trust Modification

Tax Reimbursement and Trust Modifications CCA 202352018

- Rev. Rul. 2004-64 when grantor pays income tax it is not a gift to the trust. If trustee is required to reimburse the grantor that is a retained interest that will cause inclusion in grantor's estate. If trustee only has discretion to reimburse that will not alone cause inclusion in the settlor's estate but other factors added to that could result in estate inclusion (e.g., implied agreement). Distinguished the CCA from the Rev. Rul. 2004-64 where the trust included the right to discretionary reimbursements.
- In the CCA discretionary trust to distribute income to child and on death distribute to child's issue per stirpes. Grantor retained a power to make it a grantor trust. Neither the trust or state law authorized reimbursement.
- Pursuant to state law the grantor's child and that child's issue consented to the modification. IRS concluded that as a result, there was a gift.
- The CCA said that the result would be the same if the modification were the same if pursuant to a state statute that permitted beneficiaries to non-object.
  - Comment: See the discussion of the Horvitz case below. Is there a pattern of the IRS attacking trust modifications however and whyever accomplished? Is the IRS trying to reverse the trend of modern trust administration to prevent modifications of irrevocable trusts generally? At minimum practitioners should caution clients to this possible issue. See CCA 202353018 above.

Tax Reimbursement and Trust Modifications CCA 202352018

- CCA did not address how to value the gift. How do you estimate income? How do you estimate tax to be paid? How can you determine whether a discretionary power will be exercised? How do you apportion the value among the various current and future beneficiaries.
- What if the grantor could relinquish the power? What if the grantor relinquishes power to make it a non-grantor trust? What if trustee and beneficiaries agreed to permit a tax reimbursement power in exchange for grantor not relinquishing the power? No clarity.
- Can you move the trust to FL and FL law permits the trustee to reimburse the grantor for taxes regardless of what the trust provides. No clarity on result of what this would be because in this situation there is no beneficairy consent.
  - **Comment**: How do you deal with gift tax returns for 2023 that have not been filed? What if you file a gift tax return and guesstimate the value of the purported gift. That puts the onus on the IRS to produce a different value.
  - **Comment**: How can you value a discretionary right of the trustee, with unknown tax rates, unknown income, factor in discounting these unknowns to present value? Practitioners should consider cautioning any client that modifies a trust in any manner about the potential risks of a broad reading of the CCA.

Tax Reimbursement and Trust Modifications CCA 202352018

- **Comment**: Many trust companies insist on beneficiary sign off on any action or push the family to instead effectuate a non-judicial modification agreement if feasible to avoid the trustee having to be involved because of concerns about potential liability. Now CCA 202353018 may make the provision of beneficiary approval potentially problematic in that the IRS may argue for an imputed gift (or some other challenge). But will trustees be willing to just proceed without those sign offs? If not, if there is a trust protector or other mechanism to change trustees, the family will just change trustees to one that will proceed without a sign off. If that change is accomplished by a trust protector action by an independent trustee there would seem to be no issue. But what if the trust protector is a family member or a even a beneficiary? What if the change of trustee mechanism gives the beneficiaries by majority vote the right to change trustees. Will changing trustees in those latter situations be argued by the IRS to be equivalent to the beneficiaries approving the decanting? There is another facet to all of this. Let's say that after CCA 202353018 the trustee is willing to decant the trust without any approval or even advance notice to beneficiaries. What about the professionals advising on the decanting? The sign offs by the beneficiaries in the past would also seemed to have negated a beneficiary later objecting after all they had notice and either agreed or did not object. Without that, might this increase the risks of beneficiaries suing the adviser?

Decanting to Add POA - Estate of Horvitz

- Estate of Horvitz v. Commissioner, T.C. Dkt. No. 20409-19 (Order dated Feb. 7, 2023; Stipulated Decision entered April 6, 2023).
- A QTIP trust was decanted to add a power of appointment for the surviving spouse. He exercised the power and added $20M bequest to charity. The Ohio statute said decanting is allowed if the trustee has discretion as to distributing principal. That discretion was expressed as "comfort, best interests, etc." IRS argued that standard was a HEMS standard, not full discretion. The estate filed a motion for partial summary judgement to allow the estate tax charitable deduction. The IRS claimed the decanting was not valid because of the restrictive language on distributions.
- The Court seemed focused on fact that the charity did in fact receive the $20M dollars.
  - **Comment**: Decanting existing/old trusts to add powers of appointment is potentially a great way to add flexibility to a plan. Review old trusts to discern this. The case points out that caution should be exercised to carefully evaluate the powers and provisions of the trust in context of the governing state statute under which the decanting will be completed to assure that the decanting can be done.
  - Comment: A BIG issue of all of this is that consider the IRS position in Horvitz and the CCA.

Modification of an Irrevocable Trust - Ebersole (PA)

- Ebersole v. Commonwealth, 2023 WL 6560103 (Penn. Commw. Ct.).
- Facts. Transferor created a revocable, inter-vivos trust. The trust listed beneficiaries other than just the settlor and that triggered a local property transfer tax under PA law. The PA Department of Revenue assessed property tax triggered by trust provisions authorizing distributions to individuals other than the trust settlors. According to the DOR, having originally transferred the property, the settlors were unable to rectify the issue by a mere amendment of the trust. What was needed was a modification that had retroactive effect to the trust inception.
- Law. The court applied the PA version of UTC Sec. 416 to permit a modification retroactive to the date of formation of a self-settled trust. The trust modification statute allowed “modification[, which is,] to be distinguished from . . . ‘reformation’ authorized by [UTC §] 415. The modification authorized here allows the terms of the trust to be changed to meet the settlor’s tax-saving objective as long as the resulting terms . . . are not inconsistent with the settlor’s probable intent.” UTC §416 Comment: a “court may provide that the modification has retroactive effect.” This distinguishes §416 from other UTC provisions, allowing prospective reformation or amendment of trusts, as compared to changes that relate back to original creation of the trust.
  - Comment: Did estate planning council not have real estate counsel review the realty transfer before acting?

Recent Developments - Generally

New Laws, Cases and More

Corporate Transparency Act (CTA)

- Practitioners may want to get FinCEN Identification Number.
- CTA creates a national registry for entities. Any domestic entity created by filing a document with a Secretary of State and any foreign entity to do business in the US.
- Will identify owners and those who have substantial control over entities.
- FinCEN estimates that in 2025 when rules are fully effective 32.6 million entities and an additional 5 million each year after that to report. Costs to do so are astronomical.
  - Comment: Wild guess 90%+ of filings should be a quick simple DIY/
- Reporting Companies.
  - Only domestic entities formed by filing with Secretary of State. Common law trusts and general partnership are formed by private agreements and without filings they do not have to report. But if the partnership owns entities it will have to report and its Beneficial Owners will have to report. Exceptions for entities subject to government supervision, large companies with 20+ employees $5M of revenue and physical presence in the US, banks, private trust companies that are regulated should also be exempt.

Corporate Transparency Act (CTA)

- Who reports.
  - Reporting Companies must report for Beneficial Owners and applicants.
  - Beneficial Owners is any individual who directly or indirectly through any arrangement owns 25% of the company or has substantial control over the company. This includes a senior officer, the power to direct the firing of officers, etc.
  - An entity that is owned by 5 partners may not have to report but the Regulations take the position that every entity must have one substantial owner.
  - Trusts will include a grantor that can revoke trust, trustee, anyone who can replace trustee, anyone who can withdraw trust assets, and beneficiary.
  - Beneficiaries of a discretionary trust may not have to report. Applicants must file. That may include paralegal who filed, the associate and the partner. But the Regs say only have to identify two people.
- What Beneficial Owners Report.
  - 1. Focus of statute is identifying information.
  - 2. Legal name.
  - 3. Date of birth.
  - 4. Home address.
  - 5. Unique identifying number and a scanned document containing the number.
  - 6. Or individuals can get a FinCEN ID number and give that to the reporting company. That keeps their personal information private from the Reporting Entity.

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Adequate Disclosure - Schlapfer v. Commissioner, T.C. Memo. 2023-65

- Was there disclosure in a manner adequate to apprise the IRS of the nature of the item? This is critical to toll the statute of limitations.
- Taxpayer filed a 2006 gift tax return. IRS requested information on the Panamanian company which he provided. The brokerage statement showed the portfolio valuation. 2 years later IRS assessed deficiency and the taxpayer said statute had run. Court said Reg is a safe harbor and the requirements are just the requirements to satisfy the safe harbor. These can be satisfied by substantial compliance.
- In this case there were three items that had to be disclosed to satisfy the statute of limitations.
- A description of the transferred property and any consideration received by the transferor – property given was life insurance and all that was described was a gift of the portfolio and Panamanian company shares. What made it a gift was substantially disclosed.
- The identity of, and relationship between, the transferor and each transferee was gift to mother and aunt and uncle. Return indicated mother but not aunt and uncle. Court said it was clear enough that it was family.

Adequate Disclosure - Schlapfer v. Commissioner, T.C. Memo. 2023-65

- Except as provided in §301.6501(c)-1(f)(3), a detailed description of the method used to determine the fair market value of property transferred, including any financial data (for example, balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value of the property, and a description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property. IRS said taxpayer didn’t disclose. Court said taxpayer gave the brokerage statement that listed all assets. The court said an appraiser would start with the portfolio.
- Do not rely on the case and figure out what the requirements are and meet them. But if you “miss” this case might give you an argument.

Buy-Sell/Valuation - Connelly v. United States

- Connelly v. United States, 131 AFTR 2d 2023-1902 (8th Cir. June 2, 2023), aff'g 128 AFTR 2d 2021-5955 (E.D. Mo. 2021), petition for cert. filed (U.S. No. 23-146, Aug. 16, 2023).
- Blount case life insurance proceeds were not taken into consideration in valuing interest in corporation as corporation had an obligation to redeem stock for value of insurance.
- Hypothetical. 50% owned by mother and 50% by daughter. Corporation FMV is $10M and has to buy Mom's share at ½ the value and company has $5M of life insurance to satisfy its redemption obligations. Consider if this was $5M of liquid assets instead of insurance. Full value including the asset would be subject to estate tax. But if instead of saving liquid assets they purchased a $5M life insurance policy, they could argue the company is worth only $10M not $15M with the insurance.
- It is as if the insurance changes the tax result as contrasted to owning an asset.
- Going forward consider having the shareholders themselves purchase the policies as a cross purchase rather than as a redemption.
  - Comment: Practically speaking most redemptions are small and those involved are not worried about an estate tax so it may not matter. This case is also another reminder of the vital importance of taxpayers adhering to the formalities of their own transactions.

Buy-Sell/Valuation - Connelly v. United States

- Facts.
- Company and brothers entered an agreement giving surviving shareholder the right to buy the shares and if not, then the corporation would have the right to buy the shares. Purchase price was to be determined by an annual certificate of value, which they didn't do. The agreement said if not then the purchase price would be determined by two appraisals. The taxpayers failed to do that as well. Estate took the position that the redemption transaction should determine the value. The Court rejected that position. The transaction did not satisfy the Regulations to determine a price as it did not fix a price. An agreement that the purchase price will be set by appraisal doesn't fix the price, a formula would do that. The parties stipulated the value of the company without the life insurance was $3.1 million and with the $3M of insurance, $6.1 million. The taxpayer perspective did not address that the corporation got something of value for the payment, namely the redeemed stock. The proceeds were simply an asset that increased shareholders' equity.
- Cert granted by Supreme Court.

Valuation - Estate of Cecil v. Commissioner

- Estate of Cecil v. Commissioner, T.C. Memo. 2023-24 (Feb. 28, 2023).
- Facts. 2010 taxpayer gave shares of Biltmore to heirs. Each child and trust for grandchildren received stock. Biltmore owns the largest house in the US and operates it as a tourist attraction. It has a hotel, restaurants and other activities. The taxpayers wanted to keep the house in the family. Taxpayers used two valuation approaches. IRS ignored the income approach.
- Court holdings. Net asset value can be relevant to determine shares. For Biltmore this would have been a high valuation number. But this is true only if the recipients of the shares can liquidate the company to get the asset value. Biltmore is an operating company, and no donee could liquidate it. Further, it was clear that the donor wanted the property to stay in the family for the long term. So net asset value was irrelevant in determining the value.
- Court found substantial discounts for lack of control and lack of marketability using discounted cash flow method. Court valued the corporate shares given to heirs at values lower than what was reported on gift tax return and dramatically less than the proportionate values of the company.

Valuation - Estate of Cecil v. Commissioner

- If you value S corporation shares by reference to a C corporation, you must adjust the earnings of the S corporation since the Shareholders will have to pay the tax rather than the corporation. So, the values need to be tax adjusted. So, donors of pass-through entities should take the position that tax liability to be paid by owners should be reflected in the valuation decisions.
- Court said it will evaluate on a case-by-case basis.
  - Comment: If you have an appraiser who is valuing a tax effecting a flow through entity should determine if doing so and address in report.

Assignment of Income Rule - Hoensheid v. Commissioner, T.C. Memo. 2023-34 (March 15, 2023)

- How far can you go on the continuum from nothing going on to a signed and binding deal without triggering the assignment of income doctrine on a gift to a charity of an asset that is thereafter sold?
- A gift asset to charity and charity has no legally binding obligation to sell it, you don't have any anticipatory income issue.
- Facts. Donor gives stock to a DAF. Donor clearly did not want stock to be given to charity until the donor was 99% sure that the company would be sold. Donor kept telling this to other people when he gave the stock to the DAF. DAF refused to sign documents pertaining to the sale until they actually got the gift. Sale occurred immediately thereafter.
- Court said you must really give the asset away and then it must be the charity disposing of it. The Court said: "To avoid an anticipatory assignment of income on the contribution of appreciated shares of stock followed by a sale by the donee, a donor must bear at least some risk at the time of contribution that the sale will not close. On the record before us, viewed in the light of the realities and substance of the transaction, we are convinced that petitioners' delay in transferring the …. shares until two days before closing eliminated any such risk…"
  - Comment: This is a common situation and issue not only with gifts to charities but often with gifts of assets to irrevocable trusts. Clients want to be assured of the economics of what they will have before parting control. One of the best ways to address this is to really have a collaborative team where the advisers, including investment bankers, all communicate with the estate planner.

Basis of Assets in Grantor Trust – Rev. Rul. 2023-2

- On March 20, 2023, Senators Elizabeth Warren, Bernard Sanders, Chris Van Hollen and Sheldon Whitehouse wrote a letter to Janet Yellen Secretary of the Department of the Treasury encouraging her to "…use your existing authority to limit the ultra-wealthy's abuse of trusts to avoid paying taxes. Billionaires and multi-millionaires use trusts to shift wealth to their heirs tax-free, dodging federal estate and gift taxes." The letter goes on to detail various loopholes and abuses that they believed should be acted upon. Shortly after the sending of the above letter, Revenue Ruling 2023-02 below was issued.

Revenue Ruling 2023-2

- One of the issues raised in many estate tax proposals by the Democrats has been the concern about the perceived abuse of practitioners taking the position that assets in an irrevocable grantor trust can obtain a step-up in income tax basis at the grantor's death even though those assets are not included in the taxpayer's taxable estate.
- Revenue Ruling 2023-2 makes the IRS position now clear that there's no step-up in basis, according to the IRS, for such assets being stepped up.
- Section 1014 is inapplicable because no estate-tax inclusion and it is not a bequest under state law
- If there is debt between the trust and grantor this Ruling does not apply.
- Some advisers believe the IRS is wrong. If you do take a contrary position disclose it clearly on the returns affected. One suggestion is file an income tax return paying income tax based on a calculation without a basis step up. Then file a refund claim and fully disclose the rationale.

What is The Basis?

- **<u>Comment</u>**: What can be done? Swap assets out for a step-up. That should be part of an annual review. Then the asset would get a basis under 1014 without any issue of interpreting the implications of Rev. Rule. 2023-2.
- What is the trust's basis in case of sale to grantor trust if 1014 is inapplicable?
  - Ruling does not address this.
  - If Section 1014 does not apply, the possibilities are
    - Section 1015(a), 1015(b) or 1012
    - Is there gain at death?
    - Ruling does not answer this question
    - But see Backemeyer 147 T.C. 526, 544 (2016)
      - "nonrecognition on death is among the strongest principles inherent in the income tax"

Liability of Successor Trustees and Beneficiaries -

- United States v. Paulson, 68 F.4th 528, 131 AFTR 2d 2023-1743 (9th Cir. May 17, 2023).
- The IRS position was that 6324(a)(2) imposes liability on some or all of the trustees and beneficiaries of a revocable trust.
- Facts. Decedent died in 2000. IRC Sec. 6166 election made to defer estate tax. Periodically made payments of tax. Over the years trustees changed, distributions were made, various people are beneficiaries. Long before estate tax was fully paid, they stopped paying the estate tax. In 2015 IRS sues the family for tax due. The people included widow, grandchild, daughter in law and two sons. People were all co-trustees or beneficiaries of decedent's revocable trust.
- Law. "If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, trustee…surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax."

Liability of Successor Trustees and Beneficiaries -

- Interpretation. What does 6324(a)(2) actually mean? “Property included in the gross estate…beneficiaries who received or on date of death received…” Does placement of commas in statute impact meaning? Estate argued you have liability if you have something on date of death. Court said no, if you have it on date of death or get it later…. What types of trustees or beneficiaries may get the property “later”? It could be a successor trustee and the case had successor trustees. What about beneficiaries who receive benefit years after decedent’s death but before the tax was paid? The court said they are included too. Issue – what happens if property they receive is less than the tax due? Court said you cannot have liability greater than the assets you receive. But the statute was not clear on that point and the court read that into the law.
- This may not be final word. They have petitioned Supreme Court.
  - **Comment**: When handling any estate administration, no successor trustee should assume that role without first ascertaining the status of tax due or other liabilities. Likely no professional or institutional trustee would be so cavalier. Beneficiaries similarly should consider some due diligence to assure that they are not receiving a liability. This is no different then refusing to accept title to real property without due diligence like a title search and perhaps some measure of environmental investigation.

DAF Proposed Regulations.

- Proposed Reg. §§53.4966-1 through -6, REG-142338-07, 88.
- Regulations say they will be effective for the entire year in which they become final.
- 2006 Congress enacted rules direct at Donor Advised Funds (DAFs). It is an account maintained by a sponsoring organization to which taxpayers can make charitable gifts and obtain a contribution and after the gift the donor can make non-enforceable recommendations as to charities to get funds.
- Sec. 4958 – 25% tax on excess benefit transaction engaged in by public charity. Special rule applicable to DAFs excess benefits includes a payment of compensation for services if made to a donor of the fund, or someone with advisory privileges. These persons are called “donor or donor advisor.” This is subject to a 25% tax.
  - **Comment**: Say for example a client structured a note sale to a grantor dynasty trust using a spillover to a DAF with a transaction structure based on the Petter, Christiansen, McCord cases. See John Porter’s outline and recommendations. The DAF receives a slice of equity in the business entity used in the deal. Years later the taxpayer, or a taxpayer entity wishes to repurchase the slice of equity held by the DAF to simplify recordkeeping and plan administration. That purchase by the donor/transferor or a related entity or trust (perhaps to avoid a Powell argument) may be subject to an excise tax if there is an excess benefit to that donor/transferor.

DAF Proposed Regulations.

- An investment advisor also provides investment advice to donor as to their own funds is a problem. Any compensation paid to the investment advisor may be an excess benefit under Sec. 4958.
  - Comment: Client sets up a DAF and their general investment advisor at their brokerage firm manages their general assets and so is requested to manage their newly formed DAF. Is that an issue since that advisor will earn compensation?
- Sec. 4946 20% excess tax on taxable distribution which is a distribution to any individual or for a non-charitable purpose. Exception for grants to other charitable organizations.
- Sec. 4967 excise tax of 125% of value of more than an incidental benefit accrues to donor as a result of advice given by them.
- Regulations identify what a DAF is and what a distribution is. Many questions remain unanswered including the use of DAF funds to satisfy a binding pledge agreement.

Define Standard of Living - Reece Trust

- Reece Trust v. Reece, 2023 WL 6300306 (Colo. Ct. App.).
- What is a beneficiaries “standard of living” to interpret provisions of a trust?
- Facts. The trust required the trustee to consider the beneficiary’s standard of living. When should that be measured? The settlor and the beneficiary were married, but then legally separated for over a year. Then settlor died. During the separation the beneficiary’s standard of living declined. The beneficiary argued consider her standard of living over the duration of the marriage, which would have made it higher.
- Holding. The court applied the Restatement approach and measured her standard of living at the husband’s date of death. The court noted that there was little law on point.
- Discussion. Some state laws provide that divorce may terminate beneficiary status but the divorce process had not begun before husband died.
- In some jurisdictions divorce would revoke or otherwise alter a trust provision in favor of a former spouse, but such a statute likely would not apply in the context of this case, because the spouses had not yet even begun the process of divorce.
  - Comment: Perhaps this is yet another illustration of potential perils of joint representation that practitioners might caution clients about. Should drafting language be modified to specify at what point a standard of living should be measured? That too is problematic at best without a crystal ball.

Principal and Income Act - Sunderland

- In re Sunderland Irrevocable Trust, 2022 WL 17827275 (Nev.).
- How income and distributions from entities owned by trusts are to be treated is important to determine tax and other consequences. The determinations are not simple and are affected by applicable state law, specifically the principal and income act in the state, governing documentation, and perhaps the actions/statements of those involved. For example, the 1997 Uniform Principal and Income Act addresses receipts from entities. The Uniform Fiduciary Income and Principal Act has different rules. Does state law follow either of these or a state specific variation? These determinations are easy to overlook and misapply and a good reason to get someone experienced in trust accounting issues and the determination of Fiduciary Accounting Income (FAI) involved, and not just an income tax specialist.
- Facts. Company being bought and had $4M in cash. The company was going to distribute that to the trust. Was it income or principal? The company said that it was not a liquidation, so it should be income. Generally, taxpayers want the amount to be characterized as principal so that it might be trapped in the trust but that was not objective in this case.
- Holding. NV court applied MO statute. The distribution was not deemed to be in liquidation. So, it was income as the entity indicated.

Which State Law Applies - Dille

- In re Dille Family Trust, 2023 WL 6121850 (Pa. Super. Ct.).
- The trust states that CA state law governs interpretation of the trust. But the trust was moved from CA to PA and thereafter the trust was administered in PA. The law that should govern the determination of the administration of the trust should be the law of the state is where trustee is located, where trustee has situs and where the trust was administered. Since the trust was administered in PA when the issue arose, PA law applies.
- The trust document stated in a choice of law provision that CA law applies. But when the trust is moved or decanted into a new jurisdiction that may change meaning of terms affecting governing law.
  - Comment: Draftspersons could specify that the law of the initial situs could govern certain decisions, e.g. the rule against perpetuities. And the state where the trust is administered law could govern administration. These decisions get more complicated as fiduciaries and beneficiaries change situs and are based in different jurisdictions.

In Terrorem Clauses – Buder Estate

- In re Estate of Buder, 658 S.W.3d 168 (Mo. Ct. App. Nov. 22, 2022).
  - **Comment**: In terrorem clauses are used to hopefully deflect a challenge to a dispositive scheme. If a beneficairy challenges the will they will sacrifice their inheritance. But courts are loathe to let such clauses permit reasonable actions so the efficacy of such clauses is uncertain. Some practitioners do not like to use them for that reason. Other practitioners believe that at minimum such clauses at minimum reinforce what the testator's intent is even if not effective.
- Issue. This leaves beneficiaries subject to such clauses uncertain as to whether they can pursue even a legitimate issue that may not even directly challenge the dispositive provision without losing their inheritance rights.
- Holding. Seeking an accounting will not trigger a no-contest provision. Seeking a replacement of trustee, even based on improprieties in the accounting, causes a loss of beneficial interest. The court viewed seeking enforcement of the trustee's duties was equivalent to an action to invalidate that trust and hence supported a forfeiture of beneficial interest.
- Discussion. The no-contest provision was in a trust which in many states could have a different result. State law in the case permitted a petition by a beneficiary contemplating a contest to seek a determination whether the claim would trigger the in terrorem clause.

Partnership Planning Considerations

Applying Partnership Planning to Common Planning Situations

Investment Company Rules Sec. 721.

- Watch funding of partnerships with marketable securities. The partners may need to have identical securities positions to avoid investment company rules. If they fail the mechanical tests so that the partnership portfolio is deemed to be a diversification, deferred gain could be triggered.

Eliminating Partnership Valuation Discounts

- Most taxpayers never face an estate tax. Valuation discounts may thus prove detrimental. Example: Negative basis property worth $20M in a limited partnership owned by 4 children. Discounts will limit the basis step up each of them will realize on death. IRS may even argue for valuation discounts to limit basis adjustment at death.
- State default rules often provide that any restriction in LP agreement is permissible under state law. States did not change GP statute. GP law provides that a GP can leave the partnership at anytime and receive the greater of their liquidation value or the FMV of their interest. So, if you can convert the LP to a GP each individuals would own a GP interest. But a GP has no limited liability, all GPs are liable for entity debts and claims. But the partners will want limited liability. That might be achieved by each GP contributing his interests into a wholly owned disregarded LLC and converting the LP into GP and thereby eliminating valuation discounts. Each former member owns a single member disregarded LLC. and the 4 LLCs in turn own the GP. That structure, it is suggested may eliminate discounts.

Eliminating Partnership Valuation Discounts

- **Comment**: There are different views as to whether the language in the governing instrument might be used to support the elimination of discounts. Some suggest that approach might trigger some type of gift based on theory of CCA 202353018. Others disagree. See Steve Akers outline from this year at page 50: "have a shareholder agreement that will eliminate the discount (by giving the marital legatee the right to liquidate the company or otherwise have control)."
- **Comment**: Research state law to be certain that under applicable state law each single member disregarded LLC will have charging order and asset protection benefits similar to that provided by a multi-member partnership. If not, have the client weigh the possible benefit of reducing or eliminating discounts versus the potential reduction in, or loss of, liability protection.
- **Comment**: Evaluate depending on the nature of the assets of the entity whether there will, even with the structural change, remain valuation discounts. For example, for real estate there may still be a material partition discount. For example, in the Estate of LeFrak (1993) the court held that the determination of a fractional interest discount must consider the cost, uncertainty and delays attendant upon partition proceedings as the basis to allow a fractional interest discount. The Court in LeFrak found a 30% valuation discount.

Divorce after Creation of Non-Reciprocal SLATs – Partnership Solution

- Common for married couples to create non-reciprocal spousal lifetime access trusts (SLATs). Assume that each SLAT is funded with different assets and that one SLAT is worth $10M and the second SLAT $14M, so that the larger SLAT has $4M more than the other at the time of divorce. Might a partnership plan overlay help negotiate a divorce settlement?
- After SLAT funding husband and wife divorce. There is a different value in each as well as different assets. Perhaps different tax profile. How can this be addressed? During the negotiations the trustee of the larger SLAT modifies and divides that SLAT into two SLATs (by decanting, trustee action, etc.) so that there is the resulting SLATs one has $4M and the other two SLATs have an equal $10M each, identical asset values, although the assets still remain different.
- Effectively the larger SLAT was divided to slice off the excess value into a separate new SLAT. Then the spouse could renounce his or her interests in that SLAT so that it will only benefit say children or other heirs.
  - **Comment**: This presumes that spouse will be willing on the verge of divorce to give up rights to the potential benefits of those assets. Also, will the IRS argue a gift by the renouncing spouse under CCA 202353018?

Divorce after Creation of Non-Reciprocal SLATs – Partnership Solution

- So far, we have equalized the value of the two SLATs. But the assets and tax profiles are still different. That will be addressed next.
- In conjunction with the divorce do an exchange. Exchange $10M value of all the SLAT property so that each SLAT will own ½ of each asset. Both SLATs must be grantor trust as to all income and principal, e.g., by a swap power. Then you end up with each SLAT having a 50% interest in each asset. Then you have each SLAT put the assets it then has into a partnership.
- For 704(c) purposes each spouse is deemed to have put in exactly ½ of each asset. So, since 50/50 partnership, the income tax results will be identical to each SLAT and spouse. Provide for tax distributions each year to each spouse.
  - **Comment**: Combining both SLAT assets into a partnership can address the equalization of income and rates of return. However, will this require more coordination and involvement of the soon to be ex-spouses? Is that a problem?
  - **Comment**: This plan does not address the likely fundamental and economically significant differences of each SLAT from the other. In order to make the trusts distinguishable for purposes of the reciprocal trust doctrine practitioners often build in an array of differences. One SLAT may provide the spouse/beneficiary a 5/5 power and a HEMS standard for distribution during lifetime. The other spouse's SLAT may have neither. The result might be that even if the assets are identical the ability of each spouse to reach and benefit from the SLAT's assets and income may be very different.

Divorce after Creation of Non-Reciprocal SLATs – Partnership Solution – Non Grantor

- Grantor trust status. Each SLAT (created for the other spouse) is by definition a grantor trust as to the settlor spouse. That means post divorce the settlor spouse will remain liable on the income earned by the SLAT that they may not be a beneficiary of and which income may be paid to their ex-spouse.
- One solution is to structure or modify the trusts so that the income distributions of the SLAT to the spouse/beneficiary is subject to approval by an adverse party. That will make the SLAT a spousal lifetime access non-grantor trust or (SLANT) so that this income tax issue will be avoided. Some believe that there is some risk in this approach, in part because of the difficulties in defining who constitutes an "adverse party."
  - Comment: Many practitioners frequently use the adverse party technique and believe that there is reasonable support for that position despite the uncertainties that must be acknowledged.

Sale to Grantor Trust for Note – Improving Tax Results

- Settlor sells appreciated asset to a grantor trust (IDIT) for a note. The IDIT collateralizes the note. You may trigger gain on death. How can you address this problem? Using partnership planning.
- The IDIT and the grantor contribute to an LLC all that they own. Grantor contributes assets including the note due to him from the grantor trust. The IDIT contributes property it owns, subject to the note.
- So, in the new LLC which is disregarded since the grantor and a grantor trust are viewed as a single taxpayer, the result is that the debt and note are held by the same entity/person. Even though the LLC is disregarded for income tax purposes it is respected for state law purposes. So, under state law the note and the debt merge and disappear.
- If the debt disappears under state law there can be no gain triggered.

Sale to Grantor Trust for Note – Improving Tax Results

- On the grantor's death the LLC becomes taxable as a partnership as death ends grantor trust status as to the IDIT, so it is now treated as a partnership under tax law.
- See Rev. Rul. 99-5 gives guidance on the proper accounting for when a single-member LLC converts to a multi-member LLC. The Rev. Rul. considers the approach of the sole owner selling half interest to someone else, or the new owner contributing property in exchange for a half interest in the LLC.

Estate Administration

Tax and Non-Tax Considerations

General Estate Admin Tips

- Communicate timeline beneficiaries will want to know when they get money. Beneficiaries want to know two things: how much will they get and when.
  - **Comment**: This obvious and simple step is often not addressed, especially when family try for a DIY handling of estate administration without professional involvement. Consider suggesting to the fiduciaries to do whatever is reasonably necessary to keep beneficiaries apprised of the status and progress rather than the minimum that might be required by law. That can often deflect or even prevent the type of angst that leeds to suits.
- Plan to have some liquid assets to deal with cash flow needs, e.g. expenses. Example: Bank account outside trust.
- Address disproportionate distributions.

Does Asset Use or Loans Carry Out DNI?

- DNI - Distribution carry out income.
- But what about use of assets? Case law says use of assets is not a DNI distribution.
- Will loans carry out DNI? No but if an interest free loan is made there will be imputed interest income back to the estate. Might that imputed interest income carry out DNI to the borrower akin to a distributions? Recent articles suggest that perhaps that approach is not necessary so that the imputed interest doesn’t carry out DNI. The rationale for this position is that estates and trusts cannot make gifts so that a Sec. 7872 interest free loans may not have a tax consequence.
- What if loan is made for tax avoidance?
- May there be non-tax reasons for making loan?

Trust Tax Distributions

- With compressed tax rates a trust reaches the maximum income tax bracket at $15,200 (2024) of income. Married individuals don't reach that maximum bracket until about $700,000 of income. It is important for trusts and estates to plan for this disparate tax rate treatment. This is especially true for estates as income will be distributed out in a short time anyhow when the estate closes.
- Consider that income tax bracket management is only one factor and not a mandate for a distribution as you must look to the standards in the governing instrument. What does the governing document provide for? What are the tax and other circumstances of the potential beneficiaries?
- What about non-pro-rata distributions? Does the fiduciary have authority to make non-pro rata distributions? If not, the IRS will argue that it was a pro-rata distribution followed by a gift.

Basis Consistency

- Before change 1014 said basis adjustment is to FMV and estate value is presumptively the value but the beneficiaries could argue a different position. But that rule was changed in the pothole bill in 2015.
- Code. Sec. 1014(f) says basis will not exceed estate tax final value. The change also added companion Code. Sec. 6035 reporting requirements.
- If the estate does not owe estate tax, e.g., due to either the marital and/or charitable deduction then Code Sec. 1014(f) does not apply. So, beneficiaries of those estates may take a different position then the estate did as to basis.
- Exceptions from 6035 Reporting requirements.
  - If don't have to file Form 706 there is no Sec. 6035 reporting.
  - If estate files solely to allocate GST or portability it will not have to go through information reporting for basis consistency.
- Non-Recourse debt.
  - Assets in estate subject to non-recourse debt. Sec. 2053 provides that the net value of asset, i.e., the gross value less non-recourse debt, is reported. The basis consistency Regs provide that basis is gross value of the asset even though it is only the net reported on the return.

Basis Consistency

- Omitted Assets.
  - If an asset discovered later and was not reported on the original return, and if the return is not amended before statute runs, the basis is zero. Presumably, this would even apply to cash.
  - Once you are past the statute of limitations period there is no way to cure this.
  - ACTEC pointed out that there is no legislative authority for the above proposed Reg above.
- Schedule A.
  - Executor must give schedule A to each beneficiary indicating the property they might receive. This is very confusing. And executor may not want to disclose all this information to each beneficiary.
  - The disclosure may create problems with the beneficiaries if eventually a particular beneficiary gets different property, or that one beneficiary sees what others might receive.
  - ACTEC suggested just give dollars not assets and then file an amended report.

Basis Consistency

- Subsequent transfers.
  - Initial recipient who receives assets and thereafter makes a gift or other transfer, must give a report to the new transferor.
  - This seems to go on forever and there is no statutory authority for this.

Alternate Valuation Date (AVD)

- Decedent dies and assets decline in value by six month AVD.
- 2 requirements.
  - Full gross estate value must decline in value; and
  - the combined estate and GST tax must decline if AVD is used.
- Must file within 1 year of the due date or you cannot make AVD election.
- Effect of making election is that if in 6-month period there is appreciation estate gets 100% of that but depreciated value reported and estate tax declines.
- What is impact on marital deduction formula. May not decrease estate tax with AVD you cannot reduce estate tax so must make a partial QTIP or disclaim to trigger a reduction in tax as of the AVD or cannot make the election.
- Distributions.
  - Anti-Kohler regs came out 12 years ago and still not finalized.
  - Look at value at sale or distribution date.
  - You can no longer contribute assets post-death into an LP and claim a discount post-death.

Debts of Estate - 2053 Proposed Regs

- Proposed regs came out 1.5 years.
- Any administrative expenses paid more than 3 years after death must be discounted to Present value (PV).
- Interest on loan obligations? The PV rule provides that interest paid more than 3 years after death must be discounted to PV. Apply mid- or long-term rate depending on term (no short term because no discounting required for less than 3 years).
- It may be worse as may not be able to deduct interest at all.
- For Code Sec. 6166 no deduction. For other extensions of tax due the interest the interest will be deductible.

Debts of Estate - 2053 Proposed Regs

- What about other loan obligations?
  - To deduct interest there are new requirements.
  - It must be a valid debt.
  - It must be actually and necessarily incurred.
  - Regs list many factors to consider in determining if the requirements will be met. These are based on case law.
  - Interest rate and loan terms must be reasonable.
  - The lender must include interest in gross income, i.e., consistency. Payment schedule must be necessary.
  - The only practical alternatives to the loan would be a sale at below market price or similarly undesirable financial results. Estate must not have liquidity to pay liabilities and must not have control over an entity to access funds. Cases often hold that they won't second guess business judgement. Estates non-liquid position must not be created from planning decedent did but that is in fact what estate planning steps do.
  - The lender cannot be a substantial beneficiary. In all of cases the lender was a family related entity.
  - The Regs suggest that this family entity relationship is a bad factor.
- So, these Regs are a problem once finalized.

QTIP Planning - General

- Qualified Terminable Interest Property (QTIP) Trust. Spouse as only beneficiary.
- QTIP election must be made on last 706 filed before due date or if no 706 filed before the due date than on the first 706 filed. Example, no 706 filed and 10 years later you can decide to make a QTIP election and file a 706.
- Any asset listed on Schedule M will automatically have QTIP election unless elect box to opt out of the QTIP treatment.
- Reverse QTIP treatment. Cannot make a partial reverse QTIP allocation. You would have to sever the QTIP and just make the QTIP for one trust up to amount of remaining of GST exemption.
- You can make a formula QTIP election these are like the savings clauses the IRS does not like.
- Dividing a QTIP so can make partial QTIP election, and part a bypass.
- 2519 Fully exempt and non-exempt trusts easier to plan for under 2519.

QTIP Planning – Aggregation Issue

- Mellinger case assets in QTIP trust don't have to be aggregated with other assets of surviving spouse.
  - Estate of Mellinger v. Commissioner, 112 T.C 26 (1999), acq. in result only, 1999-2 C.B. 763
  - Example own 75% of an assets if first spouse dies ½ 75% goes into QTIP death with discount and on 2nd spouse's death ½ of the 75% would pass also with a discount. No aggregation to eliminate discount as a control position.
  - **Comment**: For most estates the presence of a discount is detrimental as that would reduce the basis step up with no commensurate estate tax savings (although if in 2026 the exemption declines more estates will be subject to estate tax). So, for most taxpayers the opposite type of planning should be evaluated, namely endeavoring to find an approach to support the lack of discounts.

Funding Marital Bequests

- Watch out to avoid unintentional triggering of gain issues. Rev Proc. 64-19. Use date of distribution values. To use estate values, must have fairly representative clause. Fund pecuniary bequest based on estate tax value, gain will be realized for income tax purposes if the distribution value of an asset exceeds its estate tax value.
- Consider fractionalization discount.
  - Case with gift split to two charities and IRS successfully argued valuation discounts must be applied to value each of the two separate charitable bequests thereby reducing the charitable contribution deduction (but note that the full undiscounted value was included in the gross estate as a control position).
- If you don't consider discounts in what you fund to spouse/marital deduction then you are underfunding the marital bequest. That might lead to an overfunding of the bypass trust and that might trigger gain. Might that make the surviving spouse a partial transferor to the bypass trust for GST purposes? Does that raise 2036 issues if surviving spouse is deemed a contributor to the bypass trust and is also a beneficiary?

Funding Marital Bequests – Discounted Assets

- Planning consideration when funding marital bequests with discounted assets.
  - If you fund the marital bequest with lack of control assets must consider discounts. Could underfund marital bequest because of discount.
  - Alternative, consider funding the marital bequest with note that encumbers the remaining assets. Those remaining assets, subject to and reduced in value by, the note, would pass to the remainder beneficiaries. That could assure the full funding of the marital bequest without any reduction by discounts.
  - Distribute full assets to marital bequest to avoid fractionalization and have the marital bequest give a note back to the estate for the difference and the estate funds the bypass trust with the note. As this is paid off in future years. Might pay off in kind with discounted interests.
  - Use defined value clauses in funding.

2519 and QTIP

- All appreciation and value may be subject to estate tax in surviving spouse's estate.
  - **Comment**: Consider creating grantor trust as to QTIP that is outside surviving spouse's estate, and selling QTIP assets for a note to freeze value in QTIP.
- If spouse disposes of any portion of her qualifying income interest in a QTIP trust, the spouse is treated as having transferred the entire value/remainder interest in the QTIP.
- CCA202118008 - IRS attacked attempt by the surviving spouse to plan with QTIP assets.
  - **Comment**: 2519 planning should be explored for surviving spouse's that have not used all their exemption before 2026. In some cases it is emotionally easier for a surviving spouse to relinquish interests in a QTIP then to gift her own assets.
- 2519 planning. If that planning is a disposition of the spouse's income interest, any of it, it will automatically treat spouse as if she made a gift of all of the remainder interest in the trust.

2519 and QTIP

- Kite case held distribution to spouse followed immediately by sale for a private annuity was treated as a 2519 transfer. Did not decrease gift value by the value of the asset received on the sale.
- McDougall v. Commissioner, and CCA20211800. Reciprocal gifts should be netted out. Distinguished Kite case. IRS seeks to tax the same property multiple times which is ridiculous.
- Planning with distributions, e.g. distribute assets from QTIP to surviving spouse for gift planning. But are the distributions authorized by the governing instrument? Unauthorized distributions from a trust were not given effect for tax purposes.

Bypass Trust Not Funded

- What if bypass trust not funded? E.g., 15 years after first spouse dies discover bypass was not funded. **Comment**: This is a common situation especially with high exemptions and clients that DIY probate.
- IRS didn't negate marital trust qualification for marital deduction because of failure to fund. Deemed funding to have happened at a reasonable time and allocated later appreciation between marital and non-marital bequests. May impute interest on late funding. TAM 8746003.
- How much is in CST at the surviving spouse's death when wasn't funded? Estate of Olsen v. Commr, T.C. Memo. 2014-58.
- Approaches to unfunded CST treat property that should have been transferred to CST as being held in a "constructive trust" by surviving spouse for CST and then funding. Stansbury v. United States, 543 F. Supp. 154 (N.D. Ill. 1982), aff'd, 735 F.2d 1367 (7th Cir. 1984). Or treat property as having been misappropriated by surviving spouse creating a debt to CST. Bailey v. Commissioner, 741 F.2d 801 (5th Cir. 1984). Davis, Funding Unfunded Testamentary Trusts, 48TH ANN. HECKERLING INST. ON EST. PL, ch. 8 (2014).

Portability

- Anytime a spouse dies to consider portability.
- Leave enough cushion for living expenses for surviving spouse.
- Consider the potentially long over life (years surviving spouse lives after first spouse dies). This is statistically significant.
- State income and estate taxes should be considered.
- Consider economics. Say there is a $10M estate. 4% distributions are paid for surviving spouse's life expectancy to cover her living expenses. The estate will likely decline in value and may not have estate tax concerns on the death of the second spouse. So portability may be the best approach to get 2nd basis step up for any remaining assets.
- Contrast the above to a couple with $30M in assets. If surviving spouse receives 4% distributions from the assets, there may be an estate tax issue on the second death, so it is not clear that portability fully used makes sense. It may be better to have some assets paid to a CST to grow outside the surviving spouse's estate.
- How important is second basis step up with portfolio rebalancing. With regular rebalancing there may not be a large gain in the portfolio.

Transferee Liability for Estate Tax

- Code Sec. 6901 governs transferee liability. Courts limit to value of assets received.
- But personal liability under Code. Sec. 6324(a)(2) is not clearly limited to the value of assets received.
- Cases not consistent as to whether limiting liability to value of property at decedent’s death applies to interest and unpaid tax.
- Personal liability under Code Sec. 6324(a)(2) extends to successor trustees and trust beneficiaries who are appointed or receive property even years after decedent’s death. Beneficiaries facing liability include trust beneficiaries and beneficiaries of insurance and annuities.

GRATs

Tips and Planning Ideas

GRAT Requirements

- Transfer in trust.
- Trust can be informal trust or life estate.
- For family members.
- Value of interest retained by transferor and applicable family member.
- Value is -0- if not a qualified interest.
- If you cannot subtract it then entire transfer to the trust is a gift.
- If you have a qualified retained interest value it under 7520.
- Right to received fixed payments not less than annually is a qualified payment.
- Can increase annuity payments 20% each year.
- Need to have valuation certainty so no contingencies.
- You cannot make payments to anyone other than annuitant during GRAT term. Substitutions, reimbursements, etc. may raise issues.
- No commutation. You cannot accelerate the annuity interest by paying to grantor actuarial value of annuity interest.
- You cannot issue debt to make annuity payment.

GRAT Requirements

- Prohibition on additional contributions.
  - Most forms say if there is an additional contribution you cannot add to initial GRAT but rather you have to create a new GRAT on same terms.
  - If all assets funded on same day should not be an issue.
  - But if you are concerned contribute all assets to single member LLC then when LLC is fully funded assign LLC to GRAT.
  - Or make GRAT revocable so it is an incomplete gift not subject to 2702. When trust is fully funded revoke the power of revocation.

GRAT Planning Considerations

- GRUT never delivers value to remainder beneficiary.
- Could make annuity not a dollar amount but a fixed percentage of the initial value. That eliminates valuation risks.
- QTIP.
  - You can pay greater of annuity or income. But why have leakage of payment more? Perhaps to address nervous grantor.
  - If you want to qualify GRAT for marital deduction you can have a QTIP trust so need to satisfy QTIP rules.
  - Even though you know annuity will be more than income that does not technically meet the QTIP requirements so you must say pay greater of annuity or income to comply with marital deduction.
- Want to keep assets in GRAT as long as possible. You must pay no more than 105 days after due date.

GRAT Planning Considerations

- If fund GRAT with hard to value assets, what is the issue? Must apply the same valuation principles to make annuity payments. You have adjustment provisions on the value gifted to GRAT but there is no protection as to the value of the annuity payment which may disqualify the GRAT.
- Consider Atkinson argument that you must comply with the terms of the GRAT Regs to have a qualified annuity interest. What is a solution? Use a longer term GRAT, say 5-year term to put in some easy to value assets into the GRAT so you can use that easy to value asset to make early GRAT annuity payments.
- Can debt control GRAT performance? You can swap note for assets to immunize GRAT but then how will you pay annuity payments as you are not allowed to use a note. The preamble to the GRAT Regs have cautionary language on this so that even if grantor borrows and guarantees debt from third party. So better to pay some of note off and use cash.
- Code Sec. 1014(b)(9) re basis adjustment for property in GRAT if you don’t survive GRAT term. What if you argue only annuity is included in estate not the asset, then you may not get a basis adjustment.

Valuation of Assets Gifted to GRAT

- Value of a gift of publicly traded stock transferred to a GRAT when involved in merger discussions could not use the valuation approach required by Treas. Reg. Sec. 25.2512-1. In CCA 201939002.
  - Using median high low value if knew that there was a transaction in process that a different value should be used. But this was not public information that a willing buyer/seller would know.
  - So be careful. “Clients do not always tell you everything.”
  - There is case law saying you have to depart from default rules as it is so far off from real economic value of the assets.

Valuation of Assets Gifted to GRAT

- CCA 202152018 IRS applied Atkinson analysis to disqualify GRAT. Taxpayer transferred shares to a GRAT. Taxpayer previously transferred shares to a charitable remainder trust. Taxpayer was negotiating a merger and had offers. Used purchase price to value shares gifted to CRT and used a stale appraisal from a deferred comp plan to value shares given to GRAT. The IRS disqualified the GRAT because the taxpayer intentionally used an undervalued appraisal, so he never intended to retain a qualified annuity.
  - Should the IRS be able to treat GRAT as non-compliant because taxpayer is a “bad guy?”
  - **Comment**: Might this call into questions the use of a GRAT as a spillover receptacle in a defined value clause?

Technical Concerns with GRATs

- Is GRAT a wholly grantor trust? Use a related or subordinate party as trustee or use a swap power.
- Grantor's payment of income tax on GRAT income. If grantor pays income tax it is not an additional contribution which would be a problem. Rev. Rul. 2004-64.
- Annuity payment. Is Atkinson problem on making the annuity payment? Put a vesting clause in GRAT so that if do not pay annuity on time, trustee is holding as a nominee.
- What about tax reimbursement clause in a GRAT?
  - Does that violate GRAT rules as it would entail a distribution of corpus?
- Could a GRAT be treated as self-settled trust? That could result in an incomplete gift because of retained annuity interest? No.
- Powers of substitution exercisable in non-fiduciary capacity.
  - Rev. Rul. 2008-22 won't cause estate inclusion if trustee has obligation to confirm properties are in fact of equivalent value and cannot shift beneficial interests among beneficiaries.
  - Don't have grantor as sole trustee as that could be problematic. You should have another trustee and give the swap power to the settlor.

Technical Concerns with GRATs

- At end of the GRAT term you might want to name someone else hold the swap power. In the CLAT area it would be self-dealing for grantor to hold swap power but the IRS forms permit someone else to hold that power. Using a spouse might be safest. Can trustee block a swap that the grantor wants to do?

- GST and GRATs don't work well as allocation cannot close until end of the ETIP period (when GRAT term ends).
  - You should be able to elect out even if subject to ETIP.
  - So, when file GRAT gift tax return make an affirmative election out of automatic allocation of GST exemption.
  - Electing out at inception is smart to do. Some commentators believe you can allocate in the beginning as ETIP rule has an exception that if there is less than a 5% chance of estate inclusion you are out of ETIP rule.
  - Do you have to take into account the likelihood of the settlor dying during the GRAT term which, with a very short term GRAT, is likely small.
- Gift splitting and GRATs.
  - Depends on what remainder trust says. If remainder trust is for descendants only (i.e., not spouse) you can gift split. Note that will lead to a 50/50 GST allocation so both spouses would have to elect out of GST automatic allocation.

Use GRAT defensively in installment sale to IDIT

- Do an installment sale and use formula clause.
- What if do a Wandry clause for gift. Even if successful ,you don't get finality as to units transferred, you only get finality as to dollar value of the interests transferred. IRS can then try to assess estate tax on the retained interest.
- Instead, use a formula allocation/mechanism like in Petter. Transfer everything, i.e., donor gifts up all rights to the interest transferred, so spillover goes to another "bucket" like a self-settled trust, marital deduction trust (but not a QTIP as you have a problem with making a protective QTIP election so instead use a general power of appointment trust which doesn't require an election, etc.).
- The question remains in a Petter spillover as to whether you get finality?
- Planning idea - gift a unit in a gift transfer and the IRS will have to determine its value. The IRS would be in an awkward position to argue a different value on unit gifted versus the units sold.
- Maybe use a GRAT as the spillover. But you don't want to use an unfunded GRAT as the spillover receptacle. Some units, not part of sale, could be gifted to GRAT on same day as the sale. Then IRS must determine value for those units.

Trust on Backend of GRAT

- When GRAT ends you have a typical dynasty trust and you can allocate GST. So, make sure you have all the administrative provisions to be able to administer it. If not, modify the post-GRAT trust. The trustees should not seek approval if not required as that may cause a tax problem e.g. based on recent CCA on tax reimbursement. Beneficiaries are not making gifts if they have no reasonable basis to oppose what is otherwise good planning. If beneficial interests in new trust don’t change, there is no reason for a beneficiary to object. It is the fear of lawsuits and thinking you need consent on everything a trustee does that gets people in trouble.

ESG = Environmental, Social and Governance

ESG

- ESG investing is here to stay so engage settlor to discuss. Also, to what extent does the settlor wish to have the beneficiaries involved in trust administration? Want a flexible means to allow for these matters.
- Some people view ESG as giving up return to accomplish social goals.
- The ESG discussion presumes active management.
- ESG strategies stretch back to religious investors. They sought via negative screening out companies connected to objectionable products etc. in 70s people sought to create a portfolio without for e.g., South African equities.
- Modern ESG is not just employing negative screening. It goes well beyond that.
- UN 17 characteristics are often used, e.g., climate change, principles for responsible investing.
- Corporate social responsibility reports. Voluntary for corporations. They are expanding their responsibility beyond profits to take responsibility for community etc. In 2012 20% of S&P entities did this. By 2020 it was 90%. This has also moved into the estate planning where clients want purpose trusts, e.g., Patagonia transaction, etc.

ESG

- Beneficiaries are asking why ESG is not being used. Northern Trust did survey with WSJ and 81% said interested in ESG investing. Beneficiaries wanted it 86%, yet only 23% were doing this. So, there is a big gap between interest and implementation. There may be significant “pent up demand” for ESG investing. Polling is usually around 80% interested in ESG.
- ESG investing under ERISA. Several attorney generals saying rule allowed fiduciaries to subordinate returns to personal values which is wrong. Now about 20 estates have enacted ESG legislation, most of that legislation restricts ESG investing.
- ESG Categories.
  - ESG Integration. Duty of care is still the prudent investor rule. Duty of loyalty, focus on financial return, etc.
  - Impact investing. Move from only risk or only concessionary to “ESG related.” Change investment strategy and motive. Motive comes from beneficiaries. Can we get comfortable with a narrower middle path as a trustee.
  - Concessionary ESG. Investment strategy can be on par or even focus on ESG even over rate of return. This approach may create challenge of fiduciary duty. Non-concessionary means to compete with non-ESG peers, i.e., not leave money on the table and perform as well as or better than non-ESG funds.

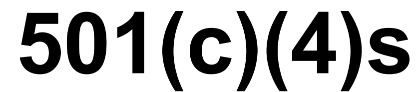
ESG and Trustee Duties

- Duty of loyalty.
  - Is the trustee following duty of loyalty if deploying an ESG strategy that may not maximize return?
  - Trustee must act in sole interest of beneficiaries without regard to trustee's personal views, etc.
  - This duty has been applied very stringently. Trustee cannot consider third party impact. Based on existing common law the no further inquiry rule has been applied re: self-dealing or conflict of interest.
  - There is no clean linear argument. If we agree we are at a best interest standard, is it OK to align the trust portfolio with the trustee's own objectives? It "feels" that the trustee may be benefiting. But the trustee has no conflict, doesn't know parties benefiting, and is getting no benefit. But it "feels" like an impermissible use of trust assets. Psychological research says pursuing these types of goals has health benefits and gives happiness. So, the trustee is getting an intrinsic benefit and sense of personal satisfaction. So, wouldn't the same qualitative "benefit" inure to the beneficiaries if it is their personal goals that trust assets are invested in a manner consistent with?

ESG and Trustee Duties

- Self-dealing.
  - Trustee benefits from transaction, or is on both side of transactions. It is the financial element of the interactions not personal relationships that is important.
- Conflict of interests.
  - Traditionally courts have recognized transactions with an individual who might have a conflicting interest, etc. spouse, siblings, business partner.
  - Transactions with someone more remote, e.g. as in ESG investing, may be OK.
- Best interest standard.
  - Is trustee acting in good faith in the best interests of the beneficiaries, and fairly.
  - How can you determine who benefited from cleaner air (as an example of one common ESG goal)?

Social Welfare Philanthropy



501(c)(4) As Alternative to Private Foundation

- Alternatives to private foundations and restrictions PFs have.
  - DAF – ease of administration but lose control over the assets. But increasingly DAFs are being subject to PF rules.
  - 501(C)(3) Public charities but have to deal with public support test.
  - Supporting organizations.
  - 501(c)(4) but no income tax deductions on contributions in but has some benefits. No public support test. Private foundation rules don't apply. You can contribute appreciated property and avoid gain.

501(c)(4) Benefits

- Get dividends which are free of tax.
- In PF may have 5% distribution rules, excess building holdings, etc. Excess tax on dividends, etc. These restrictions apply to a PF, but not to a 501(c)(4).
- Lobby and political activity are permitted in 501(c)(4).
- Split interest rules don’t apply to 501(c)(4).
- But donor may still have Code Sec. 2036 concerns with a 501(c)(4).
- No gain on contribution of appreciated stock or other assets to a501(c)(4). Can then sell appreciated assets without realizing capital gain.

501(c)(4) History

- Rev Rul 82-216.
- Citizen United Case 2010.
- Prior to 2015 wasn’t clear that could avoid gift tax on gifts to 501(c)(4)s. Sec. 2501(a)(6) says gift tax shall not apply to gifts to 501(c)(4)s. It is not a deduction but rather a non-applicability of the gift tax. But the organization must be a “good” (c)(4).

What is a 501(c)(4)

- To the IRS a 501(c)(4) remains a catch all for exempt organizations that resist categorization under other sections of the Code.
- Purpose is to promote in some way common good of people in the community. Erie Endowment case.
  - Community movement to accomplish community “ends.”
  - Outward community focus rather than inward focus on private benefits.
  - Quantum of social welfare activity can be an issue.
  - Key is to benefit community as a whole and not private interests.
- Should not have private inurement if found will lose exemption. Private benefit rules apply but perhaps a bit more “give” for a (c)(4).
- Membership based organizations and homeowners’ associations. There are many cases on these applications of (c)(4).

What activities can a (c)(4) do?

- More flexibility with (c)(4) to pursue charitable ends, but it must have charitable ends.
- Low and moderate income housing. Low income housing may or may not fit into 501(c)(3) but it will fit 501(c)(4). Moderate or mixed income housing projects involving government organizations and nonprofit organizations a 501(c)(4) permits this but in a 501(C)(3) moderate or mixed housing would likely not qualify.
- Addressing racial wealth gap, e.g., helping minorities start business. That is not a charitable class under existing case law so can do this in (c)(4) but not in a (c)(3).
- Lobbying activities can be social welfare under (c)(4). Not all lobbying counts. It must be in service of a public goal, not for private benefit.
- Political activities. Regs say promotion of social welfare does not include intervention in political activities. So why can this be done in 501(c)(4)?

What activities can a (c)(4) do?

- Business activities in a (c)(4).
  - Carrying on a business for the public is not a social welfare activity.
  - If a significant purpose of (c)(4) is to advance business that won't work. Direct business activities will be looked at differently then in a C corporation. You cannot run a resort and do a bit of social welfare activity.
  - Rev. Rul. 98-15 activities of partnership are activities of partners.
- Unrelated Business Tax (UBTI) – ok in 501(c)(3) but pay tax but could taint charity. Can put inside a C corporation. But does it solve question as to whether (c)(4) is pursuing too much business activity?
  - If a (c)(4) owns C corporation business interests the (c)(4) may assume the coloration of the business activity and be no more than a "wrapper" around the business.
  - That could undermine the (c)(4) status.
  - You need to substantiate that the (c)(4) is intended for the good it is doing and have material social welfare activity.

Tax Considerations Affecting (c)(4)s

- UBIT.
- Excess benefit intermediate sanctions. If you have a transaction with an insider must be fair. Sec. 4958.
- Excess business tax. Should not have highly compensated person in business active in (c)(4).
- Sec. 527 tax on expenditures for political activities. Can pay this tax, as Patagonia has done, on political donations. Not applicable if no net investment income.
- No charitable deduction on gifts going in on gifts but avoids triggering gain. Gift of encumbered property may trigger gain.
- Gift tax doesn't apply but if IRS challenges the (c)(4) as not being valid, then gift tax will apply. Get a determination letter Form 1024A to be treated as (c)(4). It is not clear what a good 501(c)(4) is. Smaller (c)(4)s sometimes self-declare and do not get a ruling.
- When formed file Form 8976.

Estate Tax Considerations of Using a 501(c)(4)

- Bequests to 501(c)(4) do not qualify for a charitable contribution deduction.
- If make lifetime gift to a (c)(4) but have strings it could be included in your estate. So do all the planning you do when you set up a family trust you don't want included in the client's estate. Don't have the client as a director of the (c)(4). Some clients, however, won't accept this exclusion.
- Should not have power to remove directors and insert yourself as a director. Consider a private trust company running the (c)(4)s to avoid this.
- Rev. Rul. 72-552 if you are a member, director or president alone or with others that might require inclusion in your estate. Unlike a 501(c)(3) you don't get a deduction so you could trigger estate tax.
- Planning strategies.
  - Using money as you go. Put money in and use it. This is the most common use of a (c)(4). You don't build up assets, so you are not concerned about estate tax.
  - Create a temporary 501(c)(4) which is converted to 501(c)(3) on death for charitable deduction but gives them more flexibility during lifetime.

Estate and Gift tax Audits

Plan Up Front

Anticipate Dispute at the Planning Stage

- Documents are created at the planning stage so preparation for dispute begins here.
- IRS is staffing up and much of additional funding is being put into estate and gift tax. Number of appeals officers has increased.
- If client is audited, your files will be subpoenaed
- Many times will intentionally waive attorney client privilege.
- Was there a substantial non-tax reason for creating entity. Waived privilege so estate planning attorney can testify. Client has to waive privilege. Best evidence of non-tax reasons for entity or transaction is the contemporaneous correspondence with attorney.
- Yes, taxes were involved, but non-tax attributes should be discussed as well. See, Stone, Schutt and other cases. Court spent considerable time reviewing conversations estate planning attorneys have with clients. Email correspondence is a key area of discovery. Consider how your emails will read.

Valuations and Discounts

- Valuation and discounts are "all over the board."
- Much depends on how good the appraisal is. The appraisal must make sense and must accurately value decisions.
- Cecil case.
  - Interest valued had no control and court adopted income approach not on a net asset basis because they could not control realization of net asset value.
  - Tax effecting was another issue in Cecil. Issue was tax effect on flow through entity valued based on net cash flow. In Cecil both experts tax effected. IRS argued entity pays no corporate level tax.
  - Court said it will evaluate on a case-by-case basis. So, if you have an appraiser who is tax effecting a flow through entity should determine if doing so and address in report.

Formula Transfers

- Trying to provide certainty in uncertain area. Allows transferor to define a value transferred as opposed to transferring a specified interest in an entity.
- Based on values as finally determined for federal gift tax purposes.
- Price adjustment clause – King. Sell asset and get back a note and the note face is adjusted. 10th Circuit.
- Reversion clauses don't work – Proctor. Cannot undo a transfer. This is still good law.
- How is Proctor different from Christensen and Petter? Transferring a specific dollar value of units, as opposed to Proctor which transferred a specified interest.
- Wandry – transferring a specific dollar value of shares. IRS non-acquiesced. Government wants to litigate Wandy clauses. Wandry is based on Petter. But using a Wandry clause will be subject to scrutiny. IRS is "hostile" to it.
- Nelson – Assigned to trust her interest in the partnership having a specified value as determined by a qualified appraiser. Taxpayer meant it to be a Petter type clause, but Tax Court said language was based on appraiser. Appealed to 5th Circuit who cited many of the cases upholding formula clauses.

Formula Transfers

- Preferred techniques.
  - A Petter style clause, based on Christensen. Christensen was a full tax court decision. Petter doesn't have the blessing of the entire court because the issue had already been decided. Petter was affirmed by 9th Circuit. Likes public charity/DAF as a spillover receptacle. They have an independent fiduciary obligation to examine the transaction and appraisal and in these cases the charities hired their own appraisers. But there are practical issues, self-dealing, excess business holdings.
  - Also likes Wandry.
- Have used a lifetime QTIP or a GRAT on the backend. Have different trustees of the grantor trust getting the taxable component.
  - Comment: A Petter spillover to a charity is difficult as many clients are uncomfortable with significant wealth transfer to charity. This is especially so if it is interest in a family business. And that would also raise issues of UBT, excess business holdings, etc.

QTIP Termination and 2519

- Several cases are pending in Tax Court involving termination of QTIPs during the surviving spouse's lifetime. IRS argues 2519 applies to trigger a gift.
- PLR 202118008 IRS argued spouse and remainder beneficiaries made gift back to suriviving spouse, two gifts of same asset at the same time. Per speaker this makes no sense to tax same assets twice.

Adequate Disclosure to Toll Statute of Limitations on Audit

- Schlapfer v. Commr. TC Memo 2023-65.
- Does the return adequately apprise the IRS of the nature of the transaction.
- If you satisfy the adequate disclosure requirements you don't have to get to the above question. These rules are a safe harbor, so not every item in the Regs must be disclosed but then you end up having to prove that you adequately apprised the IRS of the transaction.
- Substantial compliance with disclosure Regs was held to suffice. But don't count on this. This is an argument to make if the IRS challenges that taxpayer did not fully comply with Reg requirements.
- Schlapfer held that substantial compliance, rather than strict compliance, with the adequate disclosure rules sufficed.
- Which year reported should not matter. Gift reported in 2006. IRS said gift should have been reported in 2007, the year it was completed. Tax Court rejected argument, as adequate disclosure regs say disclosure of is adequate disclosure even if the gift is later determined to be incomplete in that year. Treas. Reg § 301.6501(c)-1((f)(5).

Adequate Disclosure to Toll Statute of Limitations on Audit

- The court held that substantial compliance, rather than strict compliance with the adequate disclosure rules, sufficed.
- when deciding whether an item has been adequately disclosed consider the 709 return, and documents attached, and in the formation documents referred to in the return.
- Taxpayer must substantially comply with each requirement of the regulations, not substantially comply with the regulations overall.

Note Sale Audits

- Pierre case.
  - Seed gift and sale were the same day.
  - Suggest putting 30, 60, or even 90 days between the seed gift and sale.
- Distributions made from entity to trust and note payments made to seller.
  - IRS claims that is evidence of retained interest in the property sold.
  - Avoid circularity. Entity distributions should be a different time and amount.

GRAT Audits

- Common audit issue is GRAT operated in conformance with Regs and terms of trust.
- IRS asks for proof of annuity payments.
- In some cases, IRS has done an Atkinson analysis. 11th Circuit decision for a charitable trust. Result if IRS succeeds would be full value of transfer would be taxable as a gift at inception.
- IRS looks at use of hard to value assets to pay annuity. IRS wants to see same methodology used to value assets at the initial gift, as is used to value payment of annuity in kind.
- Use a Wandry clause on the annuity if paid in kind.
- Care and feeding of GRAT after creation is very important.

2036 Challenges

- 2036 is the most litigated issue. If IRS succeeds, entire interest in the entity may be brought back into the estate. Marital and charitable deduction only apply to assets that pass to the spouse or charity, so they won't save the consequence of estate inclusion.
- Receiving full and adequate consideration is the best way to avoid 2036 inclusion. Value of contributed property should be credited to capital.
- There must be a legitimate and non-tax reason for creation of any entity. Stone case – donor diagnosed with inoperable cancer. Putting family members in charge of operating assets was a valid non-tax reason.
- 2036(a)(2) want to avoid distribution powers. Can use business judgement constraints on distribution decisions in the governing documents. Business judgement should address the question of: Why do you need to retain these funds for expenses or future investments? Preferable not to have senior family member as GP but some clients won't accept not being in that role. So, if you have the above business judgement rule provisions it should suffice. Involving next generation may help.

2036 Challenges

- Investment powers are not subject to 2036(a)(2).
  - Comment: This may not be a assured. What if the donor as investment advisor is also involved in the entity? What if the entity pays donor's personal expenses after the transfer to the trust? Might that taint the exercise of investment functions in a manner that causes estate inclusion?
- Powell case.
  - 2036(a)(2) applied because decedent in conjunction with others could dissolve partnership or control amount and timing of distributions.
  - The issue may change over time but should be dealt with at the planning stage.
  - Satisfy the bona fide sales test.
  - Create two classes of interest with one to vote on dissolution, distribution and amendment and a 2nd class that the donor gets that doesn't have these powers.
  - Have senior family member dispose of all interest more than 3-years before death.
  - Terminate the entity more than 3-years before death, but income tax may apply to the latter.
  - Powell could result in double taxation.

Questions and Answers

Grantor trust post-death - What happens when grantor dies and what is basis of assets?

- Can assets receive basis step up under 1014 on owner's death if not included in the estate. See Rev. Rul. 2023-2. Depends on how property was acquired from decedent or passed from decedent under 1014(b) basis adjustment is available regardless of whether included in the estate. Only exception is surviving spouse's share of community property which gets a step up even though not included in the estate.
- Turn off grantor trust status during grantor's lifetime while note is outstanding. Some advisers think gain is recognized on death or when turning off grantor trust status if note face exceeds basis. Most disagree that gain is triggered on death.
- Although property is disposed of when grantor trust status ends, no one was relieved of any non-recourse liability. The liability owed never existed when due to a grantor trust. Only at death, or turning off grantor trust status, did the obligation spring into existence. If the sale took place on death, it leaves open the question as whether the asset receives a basis adjustment before sale. But the grantor trust received the asset by purchase not by methods under Sec. 1014(b). It is possible to argue that the trust purchased asset immediately before death so that it has an asset with carryover basis.

Grantor trust post-death - What happens when grantor dies and what is basis of assets?

- If the client wishes to be sure to avoid gain, form an LLC and have trust contribute asset subject to note to the LLC. The donor/seller contributes the note to the LLC. The note disappears by operation of law as the interests are merged. The LLC and estate are treated as having formed a partnership on death. The trust has a -0- basis. **Comment:** See partnership planning discussion for this point in an earlier slide.
- Is a viable workaround to 2023-2 to have the assets repurchased or swapped back for cash? Yes, the grantor owns the assets, and they would get a step up. This will have no impact on estate tax.
- What about having grantor buy the trust assets for a note because she doesn't have cash. The problem with using a note instead of cash is the lack of clarity as to what the basis is. The note doesn't exist until death. It is possible the basis is zero. The estate could distribute a note to a trust say for descendants. Some time later, after audit, the trust that holds the note could decant into the trust for the same descendants and that should make the note disappear.
- A safer approach may be for grantor to borrow funds pay off note, turn off grantor trust status, then borrow money from the now non-grantor trust to replay the third-party lender.

Can you start the statute of limitations tolling on a sale which is not a gift?

- Make a gift of a fraction of the entity that is seed money and report that. The gift must be reported and that will toll the statute as to the valuation of the gifted interest.
  - **Comment**: Consider using different assets for some or most of the seed gift then sale asset but then perhaps make small gift to toll statute as above.
- Adequate disclosure must inform IRS of the nature of the gift. Reg. 301.6501(c)(1)(f)(4): Description of property, why it is not a gift, identification of the taxpayer, EIN of trust, description of consideration received, etc.
- Regs which suggest you have to do all the required disclosures. "Just do them."
- Reg. 301.6501(c)(1)(f)(5). If you report a gift as a completed gift and it is determined to be an incomplete gift you have still started the statute.
- If you in good faith treated sale as a sale and did not report it having a gift of .1% actual gift to disclose the value, that may not toll the statute as to the sale. So, you should report the sale too.

Spousal Gifts versus Sale

- Step transaction issue when W gifts H $10M in assets and then thereafter H funds a SLAT for W.
- Use a sale from W to H instead of a gift.
- 1014 arguably only applies to gifts. What if Wife sold the property to the Husband so 1014 would not apply even if H died within a year of the gift. Therefore, there could be a basis step up.
- This concept may avoid the Smaldino step transaction issues. Sell the assets to the donee spouse instead of gifting them to arguably avoid Smaldino.
- Buying spouse should have ability to pay note so it is respected.

Spousal Transfers and 1014(e) loss of basis step up

- If W gifts $10M and H dies within a year and his estate gives assets back to or for the benefit of Wife under 1014(e) that will not get a basis step up.
- What if assets go back to a QTIP trust? What if pass to a Bypass trust? There is little law on this. Most people say you have to look at the interests of the surviving spouse. If H bequeaths to a QTIP the law suggests 1014(e) would prevent a basis step up. You can argue that spouse and QTIP are not the same "but the arguments are thin."
- You have a better argument if the bypass trust is a sprinkle trust with other beneficiaries etc. it is a better argument. A better argument might be don't include the Wife as a beneficairy of the bypass trust but give someone the right to add Wife back as a beneficiary.

Cybersecurity, Privacy, Ethics

Tech Considerations

Statistics on Cybersecurity Issues

- Cost of data breach. Average global cost for a data breach. 553 breaches across the globe excluding the mega-breaches, about $9.5M in the US.
- A breach is legal term for the unauthorized access to personally identifiable information ("PII") or sensitive information that was not encrypted.
- For organizations under 500 employees average data breach cost $3.3M.
- Causes of data breaches: The worst is phishing, and the second was stolen credentials. Average number of days for entity to realize they had been breached was about 240 days.
- About 1/3rd of breaches were identified by the organizations own security team. About 40% were identified by clients or other third parties.
- Ransomware average cost to deal with the issue is over $5 million not counting the ransom itself.

ABA Model Rules and Tech

- Model Rule 1.1.
  - You have to have competence and that includes technology.
  - 1.1 Competence. Lawyer has to provide competent representation to a client. 2012 comments to model rules added technological language.
  - Rule 1.1. comment 8 must keep abreast of changes in the law and practice. This requires to better understand advances in technology. This doesn't mean we have to be tech experts. Rather it means we must generally understand technology and safeguards on that technology. We have an obligation to remain up to date. You should understand gathering, storage and use of electronic information. You have an obligation to address means of transmission of confidential information from clients.
  - NY is the first state to mandate that lawyers take 1 hour every two years on cyber ethics or the technological aspects cybersecurity.
- Duty of confidentiality.
  - Security measures impact this.

ABA Model Rules and Tech

- Model Rule 1.6 confidentiality of information.
  - Confidentiality is bigger than just attorney client privilege.
  - Rule 1.6(c). Must take reasonable measures to prevent unauthorized disclosure or unauthorized access to confidential information. There are two comments relevant to tech, 18 and 19.
  - Comment 18 division (c) requires lawyer to act competently against unauthorized access by a third party. The inadvertent disclosure does not constitute a violation if the lawyer has made "reasonable efforts" to prevent access or disclosure.
  - Comment 18 identifies factors to consider in "reasonable efforts" include: sensitivity of the information, likelihood of disclosure if safeguards not employed, cost of safeguards, the impact of measures on being able to represent the client.
  - Must take "reasonable" precautions to prevent information coming into the hands of unintended recipients. Don't have to take special measures if the methods have reasonable protection of privacy.
  - Comment 19 sets forth factors. Key is sensitivity of the information, the extent to which the privacy of information is protected by law, extent to which protected by confidentiality agreement.

ABA Formal Opinion 477R and Tech

- Secure communications of protected client information. Lawyer must understand nature of the threat. How sensitive the information is. Will people want to get at the data? Estate planners are in a high-risk area. How is client data transmitted and stored. How do our firm's systems work. How is email protected or secure as contrasted to a link through Sharefile where they can upload sensitive documents? Is it OK for some documents to be emailed or should it be transmitted by secure link or password protected?
- Secure certain information and documents in a large firm just in the estate planning group to limit who has access it.
- Must determine how communications should be protected.
- Should you label information as confidential?
- How do you train professionals.
- If you are aware that client is under a specific threat, take further precautions. Evaluate what the threat is.
- Resources of large firm versus solo practitioner are very different. How does this impact standards? "It depends." It is a reasonableness standard. Can you reasonably anticipate that a solo practitioner will have the resources to implement a high standard? No, but it is not reasonable for a solo practitioner to dismiss these issues.

Steps to Take

- Physical security. Locking cabinets, etc.
- Technical safeguards. Appropriate technology in place and implemented.
- Patching.
- Password requirements, changed regularly. Use a password manager.
- MFA multi-factor authentication should be used.
- Administration safeguards to implement internal policies and practices. What training is done.
- Endeavor to identify threats and information you need to safeguard.

Corporate Transparency Act (CTA)

Trust as Beneficial Owner

- 25% threshold must first be met for trust to be a Beneficial Owner (BO) but if trust controls the entity, e.g., 1% GP interests is in trust, then trust is a BO based on substantial control.
- Trustee who owns legal tile is a reporting entity.
- Disposition is broad enough to cover distributions.
- Directed trust. Investment advisor has powers and would be a BO. What about person who can replace an investment adviser?
- Trust protector. Powers may make a Bo, but it depends on which powers granted.
- Beneficiary of income or principal is BO. Beneficiary who can withdraw substantially all the assets.
- Lifetime LPOA, not testamentary POA since that takes place in the future.
- Swap power. This is a power to withdraw trust property so grantor holding it would have to report as BO. What if third party holds swap power? Is that person a BO if not the grantor? Would seem so even though not on the FinCEN bright line list.

Trust as Beneficial Owner

- Crummey power. At beginning of funding of trust this might suffice to trigger BO status.
- 5/5 power. That should not seem to get to power to withdraw substantially all of trust property.
- Multiple Beneficiaries. Is the trust drafted so that there are separate shares? If not each beneficiary may not be a BO.
- Directed Trustee holding bare legal title is more akin to an agent but the FinCEN guidance doesn't address so err on the side of caution and report.
- Aggregation rule. No attribution. If you own 10% and trust of which you are sole income and principal beneficairy owns 15% these are aggregated and you must report as BO.
- Silent trust. Incompatible with disclosure rule. If trustee cannot disclose to beneficairy that they are a beneficiary. That information still must be reported and the fact that the trust is "silent" is irrelevant.

Responsibility for Reporting

- Reporting Company is responsible to report. It is the manager of the LLC for example, who is responsible.
- Trustee has to give its BOI or FinCEN ID number to the Reporting Company, but it is not their responsibility.

Ethical Issues on CTA Compliance

- If you are going to advise clients on CTA who is the client? The entity responsible is the reporting company. Are you representing the reporting company or a beneficial owner. If there are multiple beneficial owners, who are you representing? What if the Beneficial Owner does not want to provide information? If there are conflicts of interest, can they be waived? Can you represent both the BO and Reporting Company?
- See Model Rule 1.7.
- An approach -- Get engagement letter from Reporting Entity and get waivers from Beneficial Owners.
- Be careful to limit time duration of representation.

Take-a-Ways

- Think about CTA compliance before forming entity. Who are Beneficial Owners and how will you get information?
- FinCEN Identification Numbers is key. Require everyone to get them. This way you avoid Reporting Company having to update information. Note that there is no way to terminate or surrender a FinCEN identification number.
- Update governing documents for Reporting Companies regarding transfer of ownership interests. Before you can transfer you must file Beneficial Ownership information or its not a permitted transfer.
- Have processes in place for CTA compliance. Penalties require willful failure so being able to show you had a procedure and that you did your best may help deflect penalties.
- Watch out for Minor becoming adult.
- When in doubt file. There is no penalty for over reporting.
- Applicant who must file. Attorney who directs filing of creation document is a company applicant along with whoever physically files it. You can only have two company applicants. The person who sent it to secretary of state must be one of them.

Directed Trusts

What is a Directed Trust

- Gives one or more traditional trust powers to someone else called a trust director or trust advisor or whether that person is a trustee just vested with a particular role or function.
- In a traditional trust structure, the trustee is vested with three trust functions:
  - investment decisions,
  - distribution decisions, and
  - administration (recordkeeping, tax reporting, etc.).
  - A directed trust takes one of these traditional powers and gives it to another trustee.
- DE has had directed trust since 1986, but the use of directed trusts has grown dramatically in recent years, as more clients want the flexibility.

How to Construct Directed Trust

- 4 roles: (1) Trustee, (2) Investment advisers, (3) Distribution adviser, (4) Trust protector.
- Uniform Directed Trust Act (UDTA).
  - Trust protector is a fiduciary and has same responsibilities a trustee would have to the beneficiaries.
  - Standard of care applicable to a trust protector depends on state law. Under UDTA and allows you can provide that the trust protector is held to the same standard as a trustee under state law.
  - Trust director must serve in a fiduciary capacity under UDTA.
- DE.
  - Direction advisor default is to be a fiduciary. What is standard of care to direction advisor? The terms of the governing instrument can indemnify for anything other than willful misconduct.
  - Held to ordinary prudent person standard for ordinary negligence. You must do something in the governing instrument to lessen that, e.g. you can expressly limit in the trust to willful misconduct.
  - If you draft so direction adviser is only liable to willful misconduct is that fair to beneficiaries?

Fiduciary vs. Non-Fiduciary Capacity of Direction Advisor

- Default in DE and other states is fiduciary status but you can draft out of that.
- Trustee must serve in fiduciary capacity, but the others can serve in a non-fiduciary capacity.
- Some suggest not to draft out the fiduciary capacity as that leaves beneficiaries at risk. There are concerns with a trustee in a fiduciary capacity following the direction of a person serving in a non-fiduciary capacity under the theory someone must hold the key trust functions/powers held in a fiduciary capacity.
- Trust protector is the only one where some would have serve in a non-fiduciary capacity because trust protector holds non-traditional fiduciary powers. Some powers given to trust protector may not be exercisable in a fiduciary capacity. For example, if you give the trust protector the power to add beneficiaries that cannot be exercised in a fiduciary capacity.
- Give trust protector power to convert trust from grantor to non-grantor of the trust. This cannot be held in a fiduciary capacity.
- **Comment**: Consider liability of attorney if name trust protector as non-fiduciary.

Fiduciary Cases

Recent Cases

Trust Accountings

- Salce v. Cardello, 348 Conn. 90 (2023).
- Trust Accounting required.
- In terrorem clause. Will said any action removes claimant as a beneficiary.
- Lawyer made errors on death tax return and refused to fix them.
- Kids also sued each other.
- Would violate public policy if beneficiary raises fiduciary errors. The In Terrorem is not enforceable where it would interfere with administration of trust. If brought in bad faith it would be disallowed.

Trust Accountings

- Estate of Sarah Graham Kenan, 2023 NYLJ LEXIS 962 (Surrogate's Court of New York, New York County 2023).
- No trust accounting required.
- Court refused to compel a trust accounting for the time period that was subject to a release agreement signed by beneficiary that included disclosure of the same information that would have been included in the trust accounting.
- The accounting didn't include a Shareholders' agreement, but beneficiary had negotiated it for five years. This was the same information that would have been included in the trust accounting.
- Court held it was not in best interests of trust.

Trustee Making Gifts

- Stewart v. Martin, 2023 U.S. Dist. LEXIS 39395 (S.D. Ohio 2023).
- The trustee was found to have breached his fiduciary duties n making distributions from a revocable trust during the life of the settlor because the trustee because the terms of the trust required a written direction before distributions were made and that was not done.
- **Comment**: This is yet another revocable trust/power of attorney abuse case. The likely number of such abuses that are never bought to light is huge. It is vital for aging and inform clients to build in safeguards. Yet another reminder of the benefits of institutional trustees.

Shortened Period of Liability

- Rogers v. Kemp, 2023 Ark. App. 302 (2023).
- Notice must inform beneficiaries of time period to bring a suit.
- The court held that the failure to inform beneficiary of the time allowed for commencing a proceeding against trustee rendered the notice ineffective to run shortened statute of limitations on claims.
- The fiduciary needed to inform the beneficiaries of 1 year statute to bring suit for the UTC time period to run.
- **Comment**: Any action taken based on the terms of a trust or statute must carefully conform to the requirements of each to be effective.

Distributions

- Bosch v. Kirkby, 2023 IL App (3d) 220483-U (2023).
- The trust included a requirement for the trustee to consider other assets of the beneficairy in determining distributions.
- Since the trustee knew the beneficiary had considerable personal funds, the trustee’s decision not to make distributions to pay beneficiary’s nursing home expenses was not arbitrary or unreasonable.
- **Comment**: These types of phrases are commonly included in trust documents in a wide variety of formats. This case is a reminder that these phrases have consequences.

Miscellaneous

Estate Tax QTIP versus Gift Tax QTIP Election - Manner and Timing

- QTIP clarification issue is timing of making the election and different for gift and estate tax purposes.
- Estate tax – QTIP election must be made on the last estate tax return Form 706 timely filed including extensions. If no estate tax return filed you can make it on first 706 filed after due date.
- Gift to inter-vivos QTIP trust a QTIP election must be on timely filed gift tax return including extensions, e.g. October 15, of year following the gift. Filing a Form 709 late if no tax due no penalties. But if QTIP election it would be a loss of the marital deduction.

Problems with Basis Consistency Requirements

- After file 706 and find after discovered or omitted assets if you don't report on amended Form 706 within 3 years of filing you get a zero basis. It is not that uncommon to find something else out later.
- Who should get reports? If you have a funded trust, does the report get sent to trustee or the beneficiaries? Report is filed 30 days after you file Form 706. Few people know who will get what and usually you don't distribute until an estate closing letter is received. If you don't know who gets what you have to report on Schedule A. Too much information could create fights.
- Executor cannot control all issues. If you get a beneficiary name incorrect there is no grace.
- If a recipient of assets from the estate gets the report and the transfers assets to a related transferee (using Chapter 14 definition) the recipient of the property has to get the schedule A as well.

Gift Tax Adequate Disclosure

- More on Schlapfer v. Commissioner, T.C. Memo. 2023-65.
- This is the first reported case with a detailed discussion of the gift tax adequate disclosure requirements, the Tax Court grants summary judgment to a donor, finding that the disclosure had been adequate and therefore the statute of limitations had run
- Taxpayer did a lot of wrong things in reporting and the Court “bent over backwards” to get them out of it.
- Requires “substantial” not “strict” compliance with the adequate disclosure rules.
- Taxpayers gave the IRS what information the IRS needed: what was given, how it was valued and who it was given to.
- Court was careful to say that if the taxpayer is going to rely on substantial compliance you must substantially comply with each requirement.
- Court looked at Form 709 and documents attached to the return and documents referenced in the return.

Gift Tax Adequate Disclosure

- What happens with transfer of close business where donor does not wish to pay for a full appraisal. An appraisal can be very costly. Adequate disclosure requirements say you do not need a formal qualified appraisal if you give the IRS everything on the list of information. But the list of information that has to be provided is difficult to collect and quite extensive. So, it is important that if no appraisal is given client must give all required information or the statute won't run.
- Lesson of this case is that if IRS argues adequate disclosure rules not met you might argue under Schlapfer that requirements are not mandatory and substantial compliance existed.
- Practitioners should advise clients in writing that the statute won't toll if they don't provide all information. Practitioner may also consider resigning as a return preparer if the client is not adequately disclosing.

CCA 202353018 on Tax Reimbursement

- Trustee if an irrevocable grantor trust was independent. State law did not permit trustee to reimburse grantor even if trust agreement is silent (e.g. NH and FL). Trust did not have reimbursement clause.
- Trustee petitions court to modify trust to add grantor reimbursement clause. The beneficiaries was grantor's child, consented. It was a fully discretionary trust.
- IRS said it is a gift by the beneficiaries as a relinquishment of their interests of their trust. The IRS said result would be the same if modification was done per state statute and beneficiaries and gave beneficiaries notice and they could non-consent.
- State law determines property rights and Federal law how to tax those rights. What the taxpayer did was acceptable under state law. How can it be a gift if the beneficiary has no control over it? Note that donative intent is not required for a gift under federal tax law. State law in some cases may not have any legal impact if the beneficiary objects.

CCA 202353018 on Tax Reimbursement

- There is precedent that the failure to object can be a gift. Rev. Rul. 81-264. Lender refrained from suing on loan and IRS argued it was a taxable gift. This may a relevant consideration to evaluating the CCA.
- Decanting should not require notice to beneficiaries.
- What if trustee moved trust to a state like NH that has a tax reimbursement clause?
- What is value of gift if you cannot know if trustee will exercise the power? Is it an incomplete gift? IRS says in the CCA that the entire value of the trust is a gift. That is an extreme position. Speaker believe value of gift is zero or it is incomplete.
- Treas. Reg. 26.2601-1(b)(4)(i)(E) this is a GST Reg. It sets out example (7) beneficiaries and trustees got together and went to court and agreed that the dispositive provisions of an irrevocable trust should be changed to shift income interest. IRS said GST tax doesn’t apply but beneficiaries whose income interests have been reduced is a gift.

Conclusion and Additional Information

Some Themes and Thoughts

Conclusion

- The IRS is ramping up audits and prep must be part of the planning and administration process but few clients permit advisers to properly administer plans.
- The IRS seems to be focusing effort on modifications by any means of irrevocable trusts.
- The litigious environment in the fiduciary arena is matched by the litigious environment against practitioners. Defensive practice is advisable.
- Some areas of law, such as the Secure Act, are so highly nuanced that properly advising clients will be a challenge.
- The Corporate Transparency Act will affect everyone, Gear up if you haven't and make decisions on how and whether and to what extent your firm will handle it.

Additional information

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