NOT TOO RICH, NOT TOO POOR:

TRANSFERRING WEALTH FOR THE MIDDLE RICH

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Not Too Rich, Not Too Poor:
Transferring Wealth for the Middle Rich

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A. Organized Planning

1. Introduction. Goal of this session is to provide ideas that are organized in a meaningful way that could be a guide for how we approach our estate planning clients and think about helping them, and that can be implemented by a diligent, knowledgeable lawyer, client, CPA, and investment professionals. Almost all of the ideas here have a "next level" that may make them more efficient or effective, but may also make them more risky, more likely to be improperly implemented, and, most importantly from the point of view of the middle-rich client, unnecessary.

2. Things a Planner Must Know Before The Client May Be Helped

a. Who is the client?

b. Are there other clients affected by this representation?

If spouses, then what we need to tell them
If parent and child, what we need to tell them
If whole families, what we need to tell them (with a "yikes")
If individuals and a business, what we need to tell each

c. What is the lawyer being asked to do?

General estate planning? If so, then ALL the assets of the client(s) will be needed, with values that the planners and clients agree to rely on, and ownership that the planners and clients agree to rely on. If the client wants to provide values and ownership information, make sure that is noted.

A specific project? Review or modify a trust, change trustees, consult on the ownership of specific assets, provide ideas to save taxes on a specific transaction, transform a fractious family with a failing business into a harmonious and loving family with a business that will be a case study in business school. Whatever that project is, write it up in an engagement letter, then read the letter and consider "can I do that?" If the answer is no, change the letter or decline the representation.

d. Family information the lawyer needs. All of it. Legal names and nicknames, dates of birth, citizenship, "what are they doing" – which may mean where they are in school or went to school, where does everyone live, do they work, do they have children, would they like to have more children (fewer children? – humor is good), ditto grandchildren/great-grandchildren (people live forever nowadays), how is everyone's health? Do the individuals you are talking to have siblings? What about upstream generations – are the parents/grandparents of the individuals you are talking to living, how are they doing if so, and where are they living.

Some planners like to ask all of this in paperwork that the potential client completes before arrival at the office. That saves time and can show that the client is serious about working on a plan. On the other hand, a great deal of information can be gleaned from watching and listening carefully to the answers to questions, and follow-up questions can be asked that would never appear on any kind of intake sheet. Who answers the questions if a couple is the client, do they clearly agree or is there unspoken tension (maybe there's a charging elephant in the room that you don't see), how do they describe a descendant and the descendant's spouse, lifestyle, work, and judgment (if indeed the descendant has any of these!).

e. Defining Descendants. A good way to consider whether you have the family information you need is to think about drafting definitions in the client's Will and Trusts. Here is a sample provision to help with your thinking. Lots of lawyers use longer definitions; lots use shorter. "Issue" may replace "descendants." Some lawyers, and clients, like to name specifically who the children of the grantor are, and that may be the best practice generally.

Definitions.

A. The words "children" and "descendants" as used herein in reference to the Grantor shall mean the children of the Grantor identified in Section 1.2, and their respective descendants, and in any context shall include descendants of any generation of the designated parent, whether legally adopted or naturally born before or after the date of this Agreement, subject to the following:

1. If a court terminates the legal relationship between a parent and child while the parent is alive, that child and that child's descendants will not be regarded as descendants of that parent.

2. No step-child of any person shall be deemed to be a descendant of such person unless the person has legally adopted such step-child.

3. Legal adoption shall be the equivalent to blood relationship, but only if the adoption is begun before the adoptee reaches the age of eighteen years.

4. A child born after the death of the child's parent shall be deemed living at the time of such death only if such child attains the age of thirty (30) days and was born within one (1) year of such parent's death.

5. Notwithstanding any other provision hereof or of state law, the class of any person's "descendants" shall not include an individual who is any such person's "descendant" by virtue of legal adoption if such individual (i) was so adopted after the Grantor's death and (ii) is older than the oldest other beneficiary of this Trust who was a living member of said class at the Grantor's death.

6. A child conceived by assisted reproduction is the child of an individual and the woman who gave birth to the child, but only in any of the following circumstances: (a) both individuals were married to each other and the child is born during the marriage, whether the marriage is or could be declared invalid; (b) both individuals married each other after the birth of the child, whether the marriage is or could be declared invalid, and the individual at any time asserted parentage of the child or agreed to be and is named as a parent of the child on the birth certificate of the child; or (c) the individual resided in the same household with the child for the first two years of the life of the child, including any period of temporary absence, and openly held out the child as the individual's child.

B. A person who is related to the Grantor or the Grantor's spouse through more than one line of relationship is entitled to only a single share established or defined in Section __ of this Article. If the shares that otherwise would be established for the person are unequal, that person is entitled to the largest share. The person and the person's descendants are deemed to be predeceased with respect to the other line or lines of relationship hereunder.

Note the many substantive choices in even this simple provision; e.g. the children are named in the document; "starting" an adoption causes inclusion, if the adoption is eventually completed, but only if the adoptee is younger than 18; adopting "older" individuals is limited.

3. The Non-Tax Nature of the Overall Plan

a. Assets That Do Not Pass Pursuant To the Lawyer's Documents. Some property interests pass by beneficiary designation automatically – life insurance and retirement plans including IRAs. Those designations must be validated by the lawyer, or stipulated by the client in such a way that the lawyer is allowed to rely on the stipulation. Many other assets may be held in joint name and pass to the survivor, or may transfer by pay on death clauses or transfer on death provisions. Whether the client is agreeable to changing those to coordinate with whatever provisions are recommended for Will and Trust will affect what the Will and Trust ought provide.

b. Trusts as the Backbone of the Estate Plan. One key decision point is whether the purpose of the trust is to enable the beneficiary to manage assets but help with – not guarantee – asset protection, spousal insulation, and tax flexibility. We might call that a *Beneficiary Advised Trust*. Or, is the beneficiary to be protected by one or more third parties, either because the beneficiary has present or potential risk-factors that call for protection in the settlor's mind (substance abuse, business creditors or a risky profession, a terrible spouse, "they don't work hard enough," "I'm not giving a dime to someone with tattoos"), or the settlor believes that long-term protection by, and thus interaction with, third party protectors, is good for beneficiaries. We might call that a *Protector Advised Trust*. Trusts may be designed so that they may begin as BATs and toggle to PATs, or vice versa, but the very nature of such a design tends to sort the trust into one category or the other because some individual or group must do the toggling.

c. Design of BATs. Typically, at an appropriate age, the beneficiary becomes trustee, or has the option of becoming trustee. Accordingly, the trust will provide that distributions are governed by ascertainable standards when the beneficiary is trustee but will have a mechanism to change trustees to allow an independent trustee with broader standards (either because the beneficiary needs a distribution for good purposes, or wants to avoid distributions compelled by creditors or spouses). The trust will be structured so that the beneficiary/trustee may hire expertise as needed, for instance professional investment advice. Most often, a BAT will give each generation a broad power of appointment – this approach tends to presuppose that there is one, or perhaps more than one but a small number (e.g. a parent and the parent's descendants), of beneficiaries per trust: parent creates separate trusts for children, children create separate trusts for their children, etc. The category includes trusts in which a beneficiary is not yet capable of controlling a trust – e.g., the too young beneficiary – even if safe-guards are put in that allow an individual or group to transform the BAT into a PAT if the too young beneficiary turns out to be forever (too) young. However, a trust in which the beneficiary is thought never likely to be capable of control, or if the grantor believes that independent trustees are better in all circumstances, will be structured as a PAT.

d. Design of PATs. A PAT has one or more third parties as decision-makers. This allows multiple beneficiaries in the same generation to be beneficiaries of one trust much more easily than would a BAT. When creating a PAT, the first round of questions would include who should make investment decisions, who should make distribution decisions, who should keep books and records and organize the tax reporting, and who may remove and replace the above. The second round of questions are what are the parameters of the investment and distribution decisions. And, typically, the third round of questions are what authority, if any, does anyone – beneficiary, third party (trust protector, trust director, advisor), combination – have to modify the parameters.

e. Tools for Keeping Influencers At Bay.

(i) Lock in the independence of the independent trustee—not only to require tax independence and prevent estate tax inclusion for a beneficiary-Trustee, but also to eliminate romantic partners or any others without the requisite, quantifiable experience. Note that if the trustee is directed in whole or part, then the required qualifications of the director(s) should be given careful attention. A sample description of a trustee's qualifications:

An attorney, certified public accountant or other professional experienced in the administration of trusts and who is neither (i) the Grantor, nor (ii) the Grantor's spouse, nor (iii) a beneficiary hereunder, nor (iv) related or subordinate to the Grantor, the Grantor's spouse or any beneficiary hereunder according to the standards of Section 672(c) of the Internal Revenue Code, nor (v) a romantic partner or cohabitant of any beneficiary hereunder, nor (vi) legally obligated to support any beneficiary hereunder.

(ii) Preclude adult adoption in the definition of issue, so the beneficiary cannot add his or her friend or partner as a beneficiary by adopting them.

(iii) Include robust decanting and trust merger provisions, especially in a state without a decanting or merger statute.

(iv) Don't use staged or age-based principal distributions. They are invitations to creditors and divorcing spouses.

4. Long-Term Trusts and Flexibility.

a. The impetus for trust planning has evolved over time. The primary purpose of a trust in previous centuries was to protect family fortunes from future irresponsible beneficiaries. In modern times, many clients' primary purpose for creating a trust became protecting the family fortune from taxation. Additional goals such as avoiding probate, maintaining family privacy, and protecting beneficiaries from themselves became secondary for many. However, beneficiaries have not necessarily become more responsible, exemptions have increased, and the potential for mental illness, addiction, a damaging divorce, and all forms of litigation remain strong reasons for clients to consider long-term or "Dynasty" trusts. The longer the trust's term, the greater the need for flexibility to address what future generations (or current ones) might experience. Call them a wild child, a "black sheep," or simply those beneficiaries with poor judgment or who are easily influenced by others, certain provisions are desirable to give the trustee the flexibility to protect the family fortune against the family itself.

As always, some clients need to be reassured that they are not obligated to treat their children equally, either by share, or by manner. Some must be encouraged to leave one child's share in trust (or better yet, to leave them all in trust). Most do not need to be reminded to revisit their plans as their children mature; nothing seems to bring them back quicker than witnessing a child's struggles, the all too prevalent divorce, or business failure.

b. Trustee Tools to Address Distributions to Incapacitated or Problematic Beneficiaries.

If a client insists on outright distributions to a beneficiary (why? why? why?), the client should provide the trustee with tools to protect that beneficiary. There are nonprofits in most states which run pooled trusts or act as trustee of individual trusts for disabled beneficiaries. They are ideal for small funds. See the national directory at https://specialneedsanswers.com/pooled-trust. Alternatively, a provision similar to this may be used (or the two may be combined of course):

Facility of Payment. Trustee may distribute an amount distributable to a beneficiary who is under a legal disability or who the Trustee reasonably believes is incapacitated, by: (A) paying it directly to the beneficiary or applying it for the beneficiary's benefit; (B) paying it to the beneficiary's conservator of the estate or guardian of the estate; (C) if the beneficiary does not have a conservator of the estate or guardian of the estate paying it to an adult relative or other person having legal or physical care or custody of the beneficiary, to be expended on the beneficiary's behalf; or (D) managing it as a separate fund on the beneficiary's behalf, subject to the beneficiary's continuing right to withdraw the distribution.

A more general power may be preferable, such as:

Payments to Incapacitated Beneficiaries. Whenever, pursuant to the provisions of this Agreement, any part, share or subshare of a trust shall be payable outright and free of trust to a beneficiary who is then incapacitated or under twenty-five (25) years of age, title to such part, share or subshare shall vest in such beneficiary, but the Trustee may in its sole, absolute and uncontrolled discretion hold such part, share or subshare in further trust until such beneficiary is no longer incapacitated or attains such age. During such time, the Trustee shall pay or apply to or for the benefit of such beneficiary so much of the net income and principal of such part, share or subshare as the Trustee in the Trustee's sole, absolute and uncontrolled discretion shall determine to be necessary or advisable for the health, education, support and maintenance of such beneficiary. Any net income not so paid or applied shall be accumulated and added to principal at least annually. Notwithstanding the foregoing, the Trustee in the Trustee's sole, absolute and uncontrolled discretion may deliver part or all of such part, share or subshare (i) to such beneficiary, (ii) to the

legally appointed guardian of such beneficiary, (iii) to a custodian for such beneficiary under the applicable Uniform Transfers to Minors Act or other equivalent statute, or (iv) to any other person deemed suitable by the Trustee, in its sole, absolute and uncontrolled discretion, for the exclusive benefit of such beneficiary. A written receipt from such beneficiary or any such other person shall be a complete release of the Trustee with respect to such distribution. The Trustee shall distribute to such beneficiary the balance of such part, share or subshare, outright and free of trust, when such beneficiary is no longer incapacitated or upon such beneficiary attaining such age. If such beneficiary shall die while incapacitated or before attaining such age, the Trustee shall distribute the then existing principal and any undistributed net income of such trust as follows:

The Trustee shall distribute all assets of such trust, other than Retirement Assets, to the legal representatives of such beneficiary's estate, outright and free of trust.

The Trustee shall distribute all Retirement Assets of such trust per stirpes to such beneficiary's living issue, outright and free of trust; subject, nevertheless, to the provisions of this Section; or, if none, per stirpes to the living issue of such beneficiary's parent who is an issue of the Grantor who are younger than such beneficiary, outright and free of trust; subject, nevertheless, to the provisions of this Section; or, if none, per stirpes to the living issue of the Grantor who are younger than such beneficiary, outright and free of trust; subject, nevertheless, to the provisions of this Section.

Consideration may also be given to a trustee holdback provision that is not limited to incapacitated beneficiaries. For example:

Discretion to Retain Distributions. *If a beneficiary is incapacitated (but is not qualified for government benefits) or has not attained age 25 when Trustee is directed to distribute to such beneficiary any portion of the principal of a trust, or if Trustee determines, in the exercise of reasonable discretion taking into consideration the beneficiary's personal and economic circumstances (including, but not limited to, such beneficiary's physical, mental, or emotional capacity, demonstrated lack of fiscal responsibility, and any history of drug or alcohol abuse or dependency), that withholding such distribution is in the best interest of the beneficiary, Trustee may withhold possession of such distribution or any portion thereof during any such period of incapacity, until such beneficiary becomes age 25, or until Trustee determines, in the exercise of reasonable discretion again taking into consideration the beneficiary's personal and economic circumstances, that such distribution would be in the best interest of such beneficiary, whichever is later, at which time the remaining assets will be distributed to the beneficiary or the beneficiary's estate if the beneficiary dies prior thereto. In the meantime, Trustee will distribute to or for the benefit of the beneficiary as much net income and principal as Trustee deems advisable for the beneficiary's health, education (including education beyond the undergraduate level), maintenance, and support. Undistributed income will be added to principal. Provided, however, this paragraph will not apply to any trust described in sections 664, 2056, 2056A of the Code or otherwise to the extent it would cause the loss of a charitable or marital deduction, or prevent the beneficiaries of my estate plan from being a Designated Beneficiary.*

5. Drafting for Disabled Beneficiaries

a. Generally. While many of us focus planning on death and estate tax issues, planning for disability can be as important and technically challenging for attorneys as more traditional estate planning. In 2018, over 12 million Americans between the ages of 18 and 64 were receiving some form of disability payment from social security, about 3.4 million of them SSI benefits. SSI Annual Statistical Report, 2018.

Disability can arise at birth, early childhood or in late old age. The cause may be developmental such as autism, an illness such as multiple sclerosis, Alzheimer's disease - or it may be caused by a third party through an automobile accident, medical malpractice or other outside force.

Disabilities respect no socioeconomic boundaries. While many affluent families can afford to fully support a profoundly disabled child or other beneficiary, they may wish to take advantage of certain public programs which provide social settings and housing suitable for the beneficiary's needs.

b. Types of Trusts for the Disabled.

(i) The term “Special Needs Trust” or (SNT) typically refers to a trust established with the applicant/beneficiary’s own assets (a first party or self-settled trust).

(ii) The term “Supplemental Needs Trust” commonly refers to a trust established by a third party, often a parent or other close relative, with the third party’s own funds. Both types of trusts if properly drafted allow the disabled beneficiary continued access to some, although not necessarily all, governmental programs for individuals with both disabilities and limited resources. This outline only addresses supplemental needs or third party trusts.

(iii) Third party, supplemental needs trusts are most commonly drafted as part of the estate plan of a family member of the disabled person to provide for the disabled person after the family member’s death.

(iv) Many family members and their counsel mistakenly draft these trusts to provide for what worries them most - the support and medical needs of their disabled loved one. Unfortunately, this is often the worst type of trust distribution standard that can be used to provide for a disabled person who receives SSI, Medicaid or a related state or federal program. Sometimes it is important to be careful what you say, and not say exactly what you want.

(v) A health, education, maintenance and support (HEMS) standard can render the trust a “support” trust for Medicaid and SSI purposes, not a discretionary trust, even if the Trustee is given sole discretion over distributions. The support and health standard is such that a court may enforce and a beneficiary can compel distributions for those purposes; the trustee’s discretion is how much and when, not whether to distribute. “Thus, the trustees' "sole discretion" is limited by the ascertainable standard of the plaintiff's ‘health, support in reasonable comfort, best interests and welfare ....’” Corcoran v. Department of Social Services, 271 Conn. 679 (2004).

(vi) While some recent cases are encouraging in terms of skating the fine line between being an asset for the beneficiary but not a resource, others are not. A scrivener is still well advised to keep on the straight and narrow in drafting such a trust. Here are some drafting considerations for third party trusts.

Never ever, ever use the “evil” words “support” “health” or “maintenance” as a mandatory, enforceable standard for distribution in a special needs trust. The ability of the trustee to pay and the beneficiary to enforce distributions for these purposes, may mean that the otherwise valid trust is an available asset and disqualifies the beneficiary from receiving SSI or Medicaid benefits. While some recent court decisions may provide some relief if there is a proper spendthrift clause and other restrictions on access, there is no guarantee and your client does not want to be in the position of defending, arguing and hoping for a favorable decision. A fully discretionary trust with precatory special or supplemental needs language is often the best solution for drafting.

Unlike first party or special needs trusts, where spendthrift status is more uncertain, third party trusts may and should always be spendthrift to the extent allowed by local law to make clear the settlor’s intent that assets in the trust are not directly available to or assignable by the disabled beneficiary. Further, in SSI world, the ability to liquidate or force liquidation by assignment or sale to a third party is a factor in determining that a trust is a resource to a beneficiary. A valid spendthrift or other protective clause should make clear that the beneficiary has no ability to assign, transfer, sell or liquidate trust assets.

(vii) Be careful that well-intentioned tax planning does not create unexpected negative consequences in a third party, inter vivos supplemental needs trust. While Crummey powers are useful to ensure that a lifetime gift qualifies for the annual exclusion for the Settlor, they can create negative unintended consequences for a disabled beneficiary. If the beneficiary is receiving benefits under assistance programs such as SSI or Medicaid, the beneficiary may be required to withdraw the proffered amount as a condition of benefits eligibility. If the gift amount is not withdrawn and lapses, state law may consider the beneficiary as having made a disqualifying transfer of assets or the beneficiary may be considered as part owner of the trust assets. If your client really wants to make a gift to a disabled family member, he or she may wish to purchase in-kind benefits for the disabled person, or more likely,

simply not use the annual exclusion amount if the gift is to a trust. In this time of increased estate and gift tax exemptions, the annual exclusion may not be as important as it has been in the past for the vast majority of clients, and qualifying a disabled family member for benefits may be much more critical to the success of an estate plan.

(viii) Include good administrative provisions that allow reasonable trustee fees, fees to attorneys and accountants for tax preparation and advocacy services, etc. - this will encourage the trustee to seek out qualified assistance and in the long run, competent legal, accounting and investment advice can be worth much more than their costs to keep the trust supplemental and the trustee performing his or her duties properly. Powers to invest, distribute in kind, handle real estate, sell, lease and hire advisors and other appropriate help are the powers to focus on, as well as trustee succession. Review the trust administrative provisions carefully to make certain there are no powers or authorizations, such as small trust termination to the beneficiary or the ability to add assets to a trust by the beneficiary that you may wish to re-think in light of the unique purposes of these trusts. Less is more. Pick the powers that give you joy and delete the rest.

(ix) Consider permitting a reduction or possible reduction in benefits. It is often advisable to permit the Trustee to make distributions that may reduce governmental benefits if the Trustee believes that such a reduction would ultimately be in the beneficiary's best interests. For example, the absolute prohibition of distributions for food and shelter (which can reduce but not eliminate SSI cash payments due to "in-kind support and maintenance" or ISM) is often ill-advised. The quality of life that having a better apartment or living arrangement can provide is often worth more to the beneficiary than the approximately $300 per month that the beneficiary's benefits would be reduced, especially if the beneficiary does not qualify for an ABLE account or the amounts do not fit within the account limits.

(x) Consider authorizing distributions to an ABLE account for the beneficiary if he or she became disabled before age 26. Distributions from the trust to such an account can be beneficial for a number of reasons, including distributing excess trust income (DNI), allowing tax free build-up of funds and paying for shelter costs without running into ISM reductions. Income has different meanings for SSI and income tax purposes.

(xi) The choice of Trustee is often the most difficult aspect of drafting a supplemental needs trust Families often believe that a brother, sister or other relative of the disabled is the best choice for sole Trustee. There can be conflicts of interest, of course, if the proposed Trustee is a potential remainder beneficiary, and perhaps most important, these trusts are technical and difficult to administer, requiring a detailed knowledge of benefit programs, and may create many more burdens on the family member than may initially be considered. Family members are often ill-prepared for administering these types of trusts. An independent co-Trustee is recommended for supplemental needs trusts, but such a person or entity may not be easy to locate.

(xii) Because an independent Trustee can be helpful in administering these types of trusts, it may be appropriate for a family member or advisor (not the beneficiary) to have the power to remove and replace the independent Trustee without an expensive and lengthy court removal proceeding if small local bank or advisor is bought up by Behemoth Bank and Trust Company, headquartered in Very Far Away, Nowhere Close.

(xiii) Consider drafting a sole beneficiary QDisT status trust. For attorneys drafting third party trusts for the disabled in the parents', grandparents' or other's estate plans, consider making the trust a QDisT. Usually the only change in drafting these otherwise fully discretionary, spendthrift trusts is to limit the beneficiary to the disabled person only, not his or her siblings and not his or her descendants (except as remaindermen). It means drafting a separate, well thought-out trust for that disabled individual and not relying on standard trust language, but the result, especially if a portion of an IRA or 401(k) will be payable to the trust on behalf of the disabled individual, can be important and make a difference in each taxable year.

(xiv) No conduit trusts. If a qualified retirement account will be payable to a third party supplemental needs trust, do not make it a conduit trust. Rather draft a sole benefit, accumulation QDisT – type trust as otherwise the trustee must make distributions of the Required Minimum Distribution (RMD) to the beneficiary, who may then be disqualified from benefits. An accumulation QDist is a better choice.

"Drafting for Disabled Beneficiaries" is substantially based on a 2019 outline prepared by Deborah J. Tedford entitled, "Taking Care of Those in Need: All you Wanted to Know about Special Needs Trust Planning". It is used with her permission. See also, Krooks and Fleming, "Elder Law and Special Needs Planning," 56th Annual Heckerling Institute on Estate Planning (2022); and Reaves, Fleming and Krooks, "Special Needs Trusts: Recent Developments and Ethical Considerations," 54th Annual Heckerling Institute on Estate Planning (2020).

6. Provisions for A Surviving Spouse

A benefit of discussing trusts for descendants first is that the planners and the clients have talked about trusts and have a sense of general direction. A detriment, of course, is that the first thing on the mind of one or both spouses may be what is being done for me, and if that appears to be true then that discussion must occur first.

a. Using Effectively the Applicable Exclusion Amount. The first question is how the amount for the surviving spouse is to be established: by a formula (if so, which one), or by a decision (e.g. Clayton QTIP), or in some other way (e.g. spouse receives specific assets).

Next is the form in which the surviving spouse is to receive assets. A surviving spouse may receive a BAT or a PAT. The ultimate BAT is an outright bequest; a trust that qualifies for the marital deduction but gives the spouse a withdrawal right over all the assets is the equivalent, from the spouse's point of view, of an outright bequest but may create advantages. If another form of trust is used, there are some particularities if the trust is to qualify for the marital deduction but that does not change the larger picture: who is in charge, the surviving spouse or third parties. All decisions flow from there, just as in the discussion above. Other decisions as arise with BATs and PATs arise here, too; for instance, what sort of power of appointment, if any, should the surviving spouse have.

For years, estate planners have designed bypass trusts with the express goal of excluding those assets from the taxable estate of the surviving spouse for estate tax purposes. While estate taxes were avoided, so too was a cost basis adjustment in those assets upon the death of the surviving spouse. For many clients, bypass trusts are still important to help achieve a number of non-tax goals. For clients with estates subject to the estate tax, these trusts often have the felicitous effect of lowering overall taxes for the family as well but not in every case. With fewer estates subject to estate tax, however, achieving the clients' non-tax objectives may come at the price of higher overall taxes.

> Example: H and W have an estate of $6 million, equally divided. H creates a traditional bypass trust for W who outlives H by 10 years. Over that time, the trustee distributes all of the bypass trust's income to W, but the fair market value of the trust's assets doubles to $6 million. Meanwhile, W has retained her own $3 million in assets, which have held their value at $3 million. At the time of W's death, no estate tax will be due on her $3 million estate. The assets in the bypass trust will not be included in her estate for federal estate tax purposes, so they will not receive a new cost basis at the time of her death. As a result, H and W's children will inherit assets in the bypass trust with a value of $6 million, but with a basis of only $3 million. If instead, H had left the property outright to W (and if H's executor had filed an estate tax return electing portability to save estate tax if W dies after 2025), no estate tax would be owed on W's $9 million estate. Had H left his assets to W outright (or to a differently designed trust), the children would have received a new cost basis of $6 million in the assets passing from H to W, potentially saving them $714,000 in taxes ($3,000,000 x 23.8%). Of course, an outright bequest might have a much worse tax result if the wife had remarried, her second husband had died leaving her no DSUE amount, and W died after 2025 with a reduced basic exclusion amount. Moreover, an outright bequest might a yield a higher overall tax if H's property had declined in value, thereby causing a step-down in basis.

b. Some Assets Cause Greater Tax Burdens. IRAs, qualified plans, and deferred compensation give rise to ordinary income taxes, without regard to their basis (other than distributions that qualify as the owner or other recipient's "investment in the contract" as that term is defined for these assets). Retirement plan assets left outright to a spouse are eligible to be rolled over into the spouse's name, which may make them eligible for a more favorable income tax deferral schedule than if they passed into a bypass or other trust.

A personal residence may be eligible to have all or a portion of any capital gains tax recognized on its sale excluded from income if owned outright. § 121(a). The exclusion is not available to the extent that the residence is owned by a non-grantor trust. See TAM 200104005. For assets that the family has no intention of selling or depreciating (such as a family vacation home), a basis adjustment may be unimportant. Similarly, with regard to an investment account that is actively traded, capital gains and losses may be recognized as a result of frequent trades, and the basis in the investments at the time of the surviving spouse's death may very nearly equal the fair market value of those investments at that time, making a basis adjustment less important.

c. Disclaimer Bypass Trusts. Married couples may allow the surviving spouse to take a "second look" when the first spouse dies. If the total combined estates will be less than the applicable exclusion amount (including any DSUE amount) then the survivor can accept an outright bequest of assets the executor can file an estate tax return making the portability election. If the total value of the estate is expected to exceed the applicable exclusion amount, then the surviving spouse can disclaim all or any part of the inheritance. Language in the will or revocable trust could provide that the disclaimed amount passes into the bypass trust. In order for the disclaimer to be effective, it must comply with the technical requirements of local law and the Code. The disclaimer must be filed within nine months of the date of death and before any benefits of the disclaimed property are accepted in order to be valid under federal law. The disclaimed property must generally pass in a manner so that the disclaiming party will not benefit from the property. An important exception to this rule, however, permits the surviving spouse to disclaim property and still be a beneficiary of a trust, including a bypass trust, to which the disclaimed property passes. § 2518(b)(4)(A). However, the surviving spouse should not retain a power of appointment over the bypass trust to which assets pass by disclaimer. See Treas. Reg. §§ 25.2518-2(e)(1)(i), -2(e)(5), Exs. (4), (5).

7. Financial and Health Care Powers of Attorney

a. The durable financial power of attorney is used by both the wealthy and the non-wealthy for incapacity planning, as well as for convenience. It is an inexpensive means of allowing an agent, or surrogate, to make decisions and engage in financial transactions for another person. Even the modestly wealthy (i.e., the "middle rich") often prefer to have an agent pay bills or handle day to day finances for them. Almost all states have some form of power of attorney statute, which typically regulate their use and usually, provide protections against abuse, facilitate recognition by financial institutions, and shield innocent third parties from liability when dealing with the agent.

At a minimum, all clients should have durable financial powers of attorney allowing their agents to fund existing trusts and handle other non-controversial transactions. Planners will need to consider and specify whether, if the client wishes to name more than one agent, the agents must act together (unanimously, or by majority vote), or if they are permitted to act alone. Simpler is far better as far as recognition of the agents' authority and ease of use are concerned.

Other useful powers to consider granting the named agent include the authority to make gifts, either limited to nontaxable or unlimited, and the authority to access online accounts and digital assets. It may also be helpful to expressly make the agent's authority effective during any period of uncertainty as to whether the principal is dead or alive (the disappearing principal, which happens more often than one would think.)

b. While some clients have no close family or friends whom they feel comfortable naming as their financial or health care agent, some have several children and have trouble naming one over the other. If the client wishes to name more than one person as financial or health care agent, the agent will almost always have a harder time convincing a financial or health care institution to recognize the agent's authority. Some lawyers have clients sign multiple, alternative powers naming only one agent, and offer to act as escrow agent, as a means of ensuring recognition. Others name a series of successors. Some clients name multiple agents to act jointly (unanimously, or by majority), which health care providers despise, because it is unwieldy in most situations. Finally, some clients name multiple agents to act severally, meaning that any one of them can act alone.

c. Given the variation in state laws governing them, health care powers of attorney, or directives, tend to be somewhat state-specific. The Uniform Power of Attorney Act (2006) has been enacted in 34 states, so financial POA's tend to be much more uniform.

The Uniform Law Commission is currently updating its Uniform Health Care Decisions Act (1993). The original act was not widely enacted because it was approved too long after states reacted to the Supreme Court's decision in Cruzan v. Director, Missouri Dept. of Health, 497 U.S. 261 (1990). In addition to updating the 1993 act in a thoughtful and comprehensive manner, the new act will contain a suggested statutory form (which may be ignored, or varied). Information on this, and all, Uniform Law Commission projects is available at www.uniformlaws.org.

The draft act expressly includes mental health advance directives (often called Psychiatric Advance Directives, or PAD's), as useful tool for clients with family members who have mental illness. It accomplishes that goal by defining "mental health care" as care, treatment, service, or procedure to maintain, monitor, diagnose, or otherwise affect an individual's mental illness or other emotional, psychological, or social condition, and by expressly providing that a health care instruction may include a person's statements regarding their mental health treatment, and that those instructions may be contained in a separate health care directive (instructions or a power of attorney) addressing only mental health care. Significantly, the health care directive addressing mental health care may contain a so-called "Ulysses" clause that waives, in advance, the person's right to challenge a health care provider's determination that they are incapable of making their own mental health decisions (i.e., during a psychiatric crises). While PAD's are only feasible when the family member is agreeable to signing one, in appropriate family situations they are helpful for families struggling to support a family member's therapy and recovery. The National Alliance on Mental Illness (NAMI) supports the use of PAD's, and as of 2019, approximately half of the states have statutes that authorize and govern PADs. The NAMI website has a wealth of state-by-state information on this topic. www.nrc-pad.org/states/. Existing laws are not uniform in their breadth, effectiveness, or approach.

Assuming that the new Uniform Health Care Decisions Act is approved by the ULC in July of 2023, as scheduled, and is thereafter widely enacted by the states, health care directives and PAD's may become more uniform. For now, it is best to have capable clients sign directives using the forms that are statutorily recognized in each state in which they reside. This sidesteps potential recognition issues and best facilitates the implementation of the client's health care treatment decisions and wishes. It is also wise to routinely have clients sign updated health care directives when they update their estate plans, even if they do not wish to change their designated agents. (Newer is always better in the power of attorney business.)

8. No Contest Clauses. This topic has been extensively discussed at Heckerling. For reference, below are the sorts of clauses that might be used in a Will and a Revocable Trust. [*Key Provisions and Clauses for Trusts That Will Stand the Test of Time (And War Stories of Many That Didn't)*, David A. Handler, Mary Elizabeth Anderson and Jane G. Ditelberg, Heckerling 2020, Special Session I-E; and *Estate Planning in Anticipation of a Contest or a Difficult Beneficiary*, S. Andrew Pharies, Heckerling 2018.]

(Will) No Contest Clause. The provisions of this paragraph will be enforced broadly to the maximum extent applicable state law permits. Any beneficiary under this Will, or the beneficiary of any power of appointment that has been exercised by this Will, who, without having a substantial likelihood of success, commences or joins in (except as a party defendant) (i) an action to contest the probate or validity of all or any portion of my Will, the validity of all or any portion of my Revocable Trust, or the validity of all or any portion of any other instrument of my estate plan (including, without limitation, any beneficiary designation executed by me or that disposes of assets over which I have control), or (ii) an action to prevent any provision of any instrument described in (i) above from being carried out in accordance with its terms, will be presumed to have predeceased me or otherwise to be dead, and the property administered by my Will be administered and distributed as if such beneficiary is dead. The provisions of this paragraph will not affect the right of any person or beneficiary to question and/or challenge the validity of any act of any fiduciary in the administration of my estate or any trust administered under my Revocable Trust nor will they affect the interests of any person or beneficiary who in good faith participates in any proceeding for a construction (legal interpretation) of the meaning or effect of my Will or of my Revocable Trust. Any person who elects to take a statutory share of my estate will be deemed to have predeceased me for purposes of this Will.

(Revocable Trust) No-Contest Clause. The provisions of this paragraph will be enforced broadly to the maximum extent applicable state law permits. Any beneficiary of a trust hereunder, or the beneficiary of any power of appointment that has been exercised over a trust hereunder, who, without having a substantial likelihood of success, commences or joins in (except as a party defendant) (i) an action to contest the probate or validity of all or any portion of my Will, the validity of all or any portion of this Agreement, or the validity of all or any portion of any other instrument of my estate plan (including, without limitation, any beneficiary designation executed by me or that

disposes of assets over which I have control), or (ii) an action to prevent any provision of any instrument described in (i) above from being carried out in accordance with its terms, will be presumed to have predeceased me or otherwise to be dead, and the property administered by my Will and by any trust administered hereunder will be administered and distributed as if such beneficiary is dead. The provisions of this paragraph will not affect the right of any person or beneficiary to question and/or challenge the validity of any act of any fiduciary in the administration of my estate or any trust administered hereunder nor will they affect the interests of any person or beneficiary who in good faith participates in any proceeding for a construction (legal interpretation) of the meaning or effect of my Will or of any trust created hereunder. In addition, and specifically, if my spouse elects to take a statutory share of my estate, my Spouse will have no rights in or over any trust created or administered hereunder nor rights to or over the assets of any such trust(s).

9. Spendthrift Clauses. This topic has been extensively discussed at Heckerling. For reference, below is the sort of clause that might be used in a Revocable Trust. [*Estate Planning Through An Asset Protection Lens – It's Not Just Self-Settled Trusts*, Gideon Rothschild, Heckerling 2017, Ch. 5; *Protecting the Estate From In-Laws and Other Predators*, Gideon Rothschild, Heckerling 2001, Ch. 17; *Asset Protection and Estate Planning – Why Not Have Both?*, Barry A. Nelson, Heckerling 2012, Ch. 17; *Straightjacket Trusts: Requested, Needed or Imposed by Default?*, John F. Bergner, Heckerling 2012.]

Anti-Spendthrift Provision. No beneficiary of any trust has any right or power to anticipate, pledge, assign, sell, transfer, alienate, or encumber such beneficiary's interest in the trust in any way; nor will any such interest in any manner be liable for or subject to the debts, liabilities, or obligations of such beneficiary or claims of any sort against such beneficiary. This paragraph will not limit the exercise of any power of appointment granted herein. All benefits granted to a beneficiary under this Agreement are the separate and individual property of such beneficiary (as distinguished from marital property, community property, quasi-community property or any other form of property as to which such beneficiary's spouse might have a claim or interest arising out of the marital relationship under the law of any jurisdiction, domestic or foreign), and such benefits will be free of any interference from, or control or marital power of, his or her spouse. For purposes of this paragraph, the term "benefits" includes real or personal property, tangible or intangible, and the provisions of this paragraph apply not only to benefits actually paid to any beneficiary but also to trust property allocated to a trust in which the beneficiary possesses an interest hereunder.

10. Material Participation In the Income Tax Context For Fiduciaries. There is a surtax of 3.8% on the unearned income of individuals, estates, and trusts for taxable years beginning after December 31, 2012. In common parlance this is called the Medicare Tax. For estates and trusts, the tax is 3.8% of the lesser of (a) the estate or trust's adjusted gross income (under §67(e)) in excess of the highest income tax bracket threshold, or (b) the estate or trust's undistributed net investment income. Section 643(f) prevents the use of multiple identical trusts to lower the tax.

Net investment income includes income from interest, dividends, rents, royalties, annuities, gains, income from passive activities, reduced by all "properly allocable" expenses. Net investment income specifically does not include (a) distributions from IRAs in qualified plans, (b) active trade or business income, (c) tax-exempt income and tax-exempt annuities, and (d) guaranteed payments from partnerships. Note that gain upon the funding of pecuniary bequests will be subject to the Medicare Tax.

To be an active trade or business for Medicare Tax purposes requires that (a) there be an activity that involves a trade or business (within the meaning of §162) and (b) is a passive activity within the meaning of §469, which requires material participation by the taxpayer. There is no separate definition of a "trade or business" for the Medicare Tax. Generally, most of the income of estates and trusts will be net investment income unless the trust is carrying on an active trade or business. The IRS has not issued regulations on what "active" means for a trust or estate. In its discussion of the passive activity rules for small businesses the IRS describes the seven tests for material participation as follows:

> A trade or businesses is a passive activity if the taxpayer does not materially participate. The taxpayer materially participates if and only if he or she meets one of the following seven tests provided in Reg. § 1.469-5T(a):
>
> The taxpayer works 500 hours or more during the year in the activity.

The taxpayer does substantially all the work in the activity.

The taxpayer works more than 100 hours in the activity during the year and no one else works more than the taxpayer.

The activity is a significant participation activity (SPA), and the sum of SPAs in which the taxpayer works 100-500 hours exceeds 500 hours for the year.

The taxpayer materially participated in the activity in any 5 of the prior 10 years.

The activity is a personal service activity and the taxpayer materially participated in that activity in any 3 prior years.

Based on all of the facts and circumstances, the taxpayer participates in the activity on a regular, continuous, and substantial basis during such year. However, this test only applies if the taxpayer works at least 100 hours in the activity, no one else works more hours than the taxpayer in the activity, and no one else receives compensation for managing the activity.

Note: The first four tests look to a set number of hours of participation in the tax year. The next two tests look to material participation in prior tax years. The final test looks to the facts and circumstances, but is highly restrictive.

The application of the tax to trusts that own closely-held business interests is uncertain and controversial. In Mattie K. Carter Trust v. U.S., 256 F. Supp.2d 536 (N.D.Tex. 2003) the court held that in determining material participation for trusts the activities of the trust's fiduciaries, employees, and agents should be considered. The government argued that only the participation of the fiduciary ought to be considered but the court rejected that argument. The IRS ruling position was traditionally that only the fiduciary's activities are relevant. The IRS reaffirmed this ruling position in TAM 201317010. The ruling explains the IRS rationale as follows:

> The focus on a trustee's activities for purposes of § 469(h) is consistent with the general policy rationale underlying the passive loss regime. As a general matter, the owner of a business may not look to the activities of the owner's employee's to satisfy the material participation requirement. *See* S. Rep. No. 99-313, at 735 (1986) ("the activities of [employees] . . . are not attributed to the taxpayer."). Indeed, because an owner's trade or business will generally involve employees or agents, a contrary approach would result in an owner invariably being treated as materially participating in the trade or business activity. A trust should be treated no differently. A trustee performs its duties on behalf of the beneficial owners. Consistent with the treatment of business owners, therefore, it is appropriate in the trust context to look only to the activities of the trustee to determine whether the trust materially participated in the activity. An interpretation that renders part of a statute inoperative or superfluous should be avoided. *Mountain States Tel. & Tel. Co. v. Pueblo of Santa Ana*, 472 U.S. 237, 249 (1985).

At issue in the ruling were the activities of "special trustees" who did the day to day operations and management of the companies in question but lacked any authority over the trust itself. The ruling states:

> The work performed by A was as an employee of Company Y and not in A's role as a fiduciary of Trust A or Trust B and, therefore, does not count for purposes of determining whether Trust A and Trust B materially participated in the trade or business activities of Company X and Company Y under § 469(h). A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company would count for purposes of determining the Trusts' material participation. However, in this case, A's time

> spent performing those specific functions does not rise to the level of being "regular, continuous, and substantial" within the meaning of § 469(h)(1). Trust A and Trust B represent that B, acting as Trustee, did not participate in the day-to-day operations of the relevant activities of Company X or Company Y. Accordingly, we conclude that Trust A and Trust B did not materially participate in the relevant activities of Company X or Company Y within the meaning of § 469(h) for purposes of § 56(b)(2)(D) for the tax years at issue

The need for a trustee to be active may affect the organization of business entities held in trust. For instance, a member-managed LLC may be more efficient than a manager-managed LLC unless a fiduciary is the manager.

The Tax Court disagreed with the IRS in Frank Aragona Trust v. Commissioner, 142 T. C. No. 9 (2014). The issue there was §469 and the passive activity loss rules. The court held that the trust could qualify for the real estate professional exception if the trustees are individuals because the work of the trustees, in that instance, could be work performed by an individual which is required for the §469(c)(7) exception. In addition, the court held that the trust materially participated (one of the requirements for the exception) in the real estate business because the activities of the trustees, including as members of LLCs, counted when determining material participation. The opinion describes the trust and trustees as follows:

> Frank Aragona died in 1981. He was succeeded as trustee by six trustees. One of the six trustees was an independent trustee.3 The other five trustees were Frank Aragona's five children, including Paul V. Aragona, the executive trustee.4 Although the trustees formally delegated their powers to the executive trustee (in order to facilitate daily business operations), the trustees acted as a management board for the trust and made all major decisions regarding the trust's property. During 2005 and 2006 the board met every few months to discuss the trust's business. Each of the six trustees was paid a fee directly by the trust (referred to here as a "trustee fee" or collectively as "trustee fees") in part for the trustee's attending board meetings. Three of the children -- Paul V. Aragona, Frank S. Aragona, and Annette Aragona Moran -- worked full time for Holiday Enterprises, LLC, a Michigan limited liability company that is wholly owned by the trust. Holiday Enterprises, LLC, is a disregarded entity for federal income tax purposes. Holiday Enterprises, LLC, managed most of the trust's rental real-estate properties. It employed several people in addition to Paul V. Aragona, Frank S. Aragona, and Annette Aragona Moran, including a controller, leasing agents, maintenance workers, accounts payable clerks, and accounts receivable clerks. In addition to receiving a trustee fee, Paul V. Aragona, Frank S. Aragona, and Annette Aragona Moran each received wages from Holiday Enterprises, LLC.
>
> The trust conducted some of its rental real-estate activities directly, some through wholly owned entities, and the rest through entities in which it owned majority interests and in which Paul V. and Frank S. Aragona owned minority interests. It conducted its real-estate holding and real-estate development operations through entities in which it owned majority or minority interests and in which Paul V. and Frank S. Aragona owned minority interests.

The court skirted the direct issue presented by the IRS' refusal to accede to the Mattie Carter decision and did not decide whether the work of the non-trustee employees counted (see footnote 15 below). But the court counted the activities of the trustee/employees resulting in a clear win for the taxpayer. The opinion states:

> The IRS argues that in determining whether a trust is materially participating in an activity, only the activities of the trustees can be considered and the activities of that trust's employees must be disregarded. In support, the IRS cites S. Rept. No. 99-313, at 735 (1986), 1986-3 C.B. (Vol. 3) 1, 735, which states that a trust "is treated as materially participating in an activity * * * if an executor or fiduciary, in his capacity as such, is so participating." The Senate committee report

also stated that "the activities of * * * [employees] are not attributed to the taxpayer".13

13The Senate committee report stated:

> The fact that a taxpayer utilizes employees or contract services to perform daily functions in running the business does not prevent such taxpayer from qualifying as materially participating. However, the activities of such agents are not attributed to the taxpayer, and the taxpayer must still personally perform sufficient services to establish material participation.

S. Rept. No. 99-313, at 735 (1986), 1986-3 C.B. (Vol. 3) 1, 735.

On the basis of these legal principles, the IRS would have us ignore the activities of the trust's non-trustee employees.14 Additionally, the IRS would have us ignore the activities of the three trustees who are employees of Holiday Enterprises, LLC. It reasons that the activities of these three trustees should be considered the activities of employees and not fiduciaries because (1) the trustees performed their activities as employees of Holiday Enterprises, LLC, and (2) it is impossible to disaggregate the activities they performed as employees of Holiday Enterprises, LLC, and the activities they performed as trustees.

14The IRS disagrees with Carter Trust v. United States, 256 F. Supp. 2d 536, 541 (N.D. Tex. 2003), which held that the activities of the trust's non-trustee employees (and of the trustee) are considered in determining whether the trust materially participated in ranching activity.

If the Court adopts all these arguments made by the IRS, then it should ignore the activities of the 20 or so non-trustee employees and the 3 trustee employees (Paul V. Aragona, Frank S. Aragona, and Annette Aragona Moran). This would leave only the relatively insignificant activities of the trustees who are not employees (Salvatore S. Aragona, a dentist, Anthony F. Aragona, who is disabled and unable to work, and Charles E. Turnbull, an outside attorney who is the independent trustee).

Even if the activities of the trust's non-trustee employees should be disregarded, the activities of the 15 e trustees--including their activities as employees of Holiday Enterprises, LLC--should be considered in determining whether the trust materially participated in its real-estate operations. The trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary. Mich. Comp. Laws sec. 700.7302 (2001) (before amendment by 2009 Mich. Pub. Acts No. 46); see also In re Estate of Butterfield, 341 N.W.2d 453, 459 (Mich. 1983) (construing Mich. Comp. Laws sec. 700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws sec. 700.7302). Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. Cf. In re Estate of Butterfield, 341 N.W.2d at 457 ("Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy."). Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.16

> 15 We need not and do not decide whether the activities of the trust's nontrustee employees should be disregarded.

One of the reasons the IRS was grumpy was because the entities owned by the trusts were minority positions. The court rejected that distinction stating:

> The IRS argues that because Paul V. Aragona and Frank S. Aragona had minority ownership interests in all of the entities through which the trust operated real-estate holding and real-estate development projects and because they had minority interests in some of the entities through which the trust operated its rental real-estate business, some of these two trustees' efforts in managing the jointly held entities are attributable to their personal portions of the businesses, not the trust's portion. Despite two of the trustees' holding ownership interests, we are convinced that the trust materially participated in the trust's real-estate operations. First, Frank S. and Paul V. Aragona's combined ownership interest in each entity was not a majority interest--for no entity did their combined ownership interest exceed 50%. Second, Frank S. and Paul V. Aragona's combined ownership interest in each entity was never greater than the trust's ownership interest. Third, Frank S. and Paul V. Aragona's interests as owners were generally compatible with the trust's goals--they and the trust wanted the jointly held enterprises to succeed. Fourth, Frank S. and Paul V. Aragona were involved in managing the day-to-day operations of the trust's various real-estate businesses.

Ensuring that individuals who "materially participate" in businesses operated by a trust are the fiduciaries for the trust with control over the businesses can create significant savings.

B. Planning for the Surviving Spouse.

1. Advantages of Trusts over Outright Bequests

With the advent of very high estate tax exclusions and portability, estate planners and their clients concerned about the foregoing issues, or simply seeking "simplicity," may conclude that using trusts in estate planning is no longer warranted. But tax issues are only one part of the equation. In many respects, outright bequests are not nearly as advantageous as bequests made to a trust. In an ideal world, the estate plan would be designed to capture all of the benefits of trusts, without the tax downsides. Why might someone choose to make a bequest in trust instead of outright, despite the potential tax costs?

a. Control of Assets. A trust allows the grantor to better ensure that the assets are managed and distributed in accordance with his or her wishes. Many clients express confidence that their spouses will not disinherit their family or other beneficiaries, but they still fear that a second spouse, an unscrupulous caregiver, or other unforeseen person or event may influence the surviving spouse to change the estate plan in ways that they do not intend. Placing property into trust allows the grantor to control to a large degree how much (if at all) the surviving spouse can alter the estate plan. The grantor can name a trustee other than the spouse if desired. In addition, even if the surviving spouse is the trustee, if he or she later becomes incapacitated, a successor trustee can manage the trust assets, thereby avoiding the need for a guardian or other type of court-appointed conservator.

b. Creditor Protection. If an inheritance passes outright and free of trust, the property will be subject to attachment by outside creditors unless the property is otherwise exempt under local law. Assets inherited in trust may be protected from creditors so long as the trust includes a valid "spendthrift" clause, and the beneficiary's interest is described properly.

c. Divorce Protection. Inherited assets generally constitute separate property of the recipient, which provides some measure of divorce protection. However if those assets are commingled, such property may be lost. If the assets pass in trust, however, the trustee's ownership of the trust assets helps ensure that they will not be commingled.

d. Protection of Governmental Benefits. If the surviving spouse is eligible (or may become eligible) for needs-based government benefits (e.g. Medicaid), a bypass or other trust may be structured to accommodate eligibility planning. An outright bequest to the spouse may prevent the surviving spouse from claiming those benefits. However, a testamentary bypass trust with appropriate spendthrift provisions will generally not be considered to be a resource of the surviving spouse for purposes of determining eligibility for Medicaid. See SSA Program Operations Manual System § 01120.200.D.2.

e. Protection from State Inheritance Taxes. Assets left outright may be included in the beneficiary's taxable estate for purposes of state estate or inheritance tax. While the inheritance tax in many states has been repealed or is inoperable so long as there is no federal estate tax credit for state death taxes paid, there can be no assurance that the beneficiary will reside (or remain) in one of those states. Currently, 17 states and the District of Columbia impose a separate stand-alone estate or inheritance tax. The states that impose an estate or inheritance tax at death are Connecticut, District of Columbia, Hawaii, Illinois, Iowa, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Nebraska (imposed by counties), New Jersey (although its estate tax was repealed as of 1/1/2018, its inheritance tax was not), New York, Oregon, Pennsylvania, Rhode Island, Vermont and Washington. See the ACTEC State Survey, Fox, State Death Tax Chart, available at https://www.actec.org/resources/state-death-tax-chart/ (last revised January 1, 2022). The potential exposure depends upon the exemptions and rates applicable at the time of the beneficiary's death, but the applicable taxes can be surprisingly high. See, e.g., Minn. Stat. §§ 291.016(3)(b), 291.03 (imposing a 13% state estate tax beginning 2020 on estates exceeding $3 million in value, with rates reaching 16% for estates exceeding $10.1 million).

f. Income Shifting. If permitted, income earned by a trust can be distributed to trust beneficiaries who may be in lower income tax brackets than the surviving spouse or the trust. §§ 651, 661. Income from assets left outright cannot be "sprinkled" or "sprayed" to beneficiaries in lower tax brackets. For many families, a trust's ability to shift income may lower the overall family income tax bill.

g. Shifting Wealth to Other Family Members. While a surviving spouse might make gifts of his or her assets to children, elderly parents, or other family members, those gifts use up the spouse's gift and estate tax exclusion to the extent that they exceed the gift tax annual exclusion amount. If assets are held in a bypass trust, and if the trust permits distributions to other family members, the amounts distributed to them are not treated as gifts by the surviving spouse, and do not use any of the spouse's gift or estate tax exclusion or annual exclusion, regardless of the amount of the distributions.

h. No Inflation Adjustment in DSUE. The DSUE amount, once set, is not indexed for inflation, whereas the surviving spouse's basic exclusion amount (the almost $13 million base in 2023) is adjusted for inflation after 2010 (being $12.06 million in 2022). In addition, if assets are inherited in a bypass trust, any increase in the value of those assets remains outside the surviving spouse's estate. The importance of this feature increases: (i) as the value of a couple's net worth approaches $26 million; (ii) if asset values are expected to increase rapidly; and (iii) if the surviving spouse may be expected to outlive the decedent by many years.

i. Risk of Loss of DSUE Amount. The surviving spouse is entitled to use the unused estate tax exclusion only of the most recently deceased spouse, i.e. the last deceased spouse. § 2010(c)(4)(B)(i). If the surviving spouse remarries, and the new spouse then dies, the new spouse (who may have a substantial estate, or for whose estate an estate tax return may not be filed to pass along any DSUE amount), becomes the last deceased spouse. Unless the surviving spouse makes taxable gifts before the new spouse's death (thereby using the DSUE amount of the first deceased spouse), any unused exclusion of the first spouse to die is then lost. If no DSUE amount is acquired from the new last deceased spouse, the cost to the family could be significant. This risk does not apply if assets are inherited in a bypass trust.

For gift tax purposes, one's "last deceased spouse" is determined at the time of the gift. The DSUE amount from a spouse is used to determine the applicable exclusion amount with respect to a gift, even if a subsequent spouse of the donor dies before the end of the year. Treas. Reg. § 25.2505-2(a)(1)(i). Without this rule, the DSUE amount from a subsequent spouse who died before the end of the year in which the gift was made would generally apply, because section 2505(a)(1) provides that the gift tax unified credit is based on the applicable exclusion amount that would apply "if the donor died as of the end of the calendar year." If the donor's unified gift tax credit were determined based upon the donor's applicable exclusion amount determined as of the end of the calendar year without this special

rule, no DSUE amount from the first deceased spouse would be available to offset gifts made by the donor-spouse any time during that calendar year. Accordingly, if a surviving spouse wishes to make gifts to utilize the DSUE amount from a deceased spouse, the donor should consider making the gift as quickly as possible to assure that the DSUE amount from that particular last deceased spouse is utilized.

The rule has a potentially detrimental effect from a taxpayer point of view. A donor who is married to an individual who is expected to die in the near future cannot make a gift utilizing an anticipated DSUE amount from that individual, even if the individual dies before the end of the calendar year. In other words, the last deceased spouse has to be deceased before the gift is made. (Yes, you must wait for your spouse <u>to die</u> before you can use his or her DSUE amount).

The regulations include a favorable ordering rule as well, providing that if a surviving spouse makes a gift with a DSUE amount from the last deceased spouse determined at the time of the gift, "such surviving spouse will be considered to apply such DSUE amount to the taxable gift before the surviving spouse's own basic exclusion amount." Treas. Reg. § 25.2505-2(b).

An incredibly taxpayer-favorable position in the regulations permits the use of DSUE amounts from multiple deceased spouses. Because the statute was not amended by ATRA 2012 or TCJA 2017 to revise any of the taxpayer-friendly positions taken in the proposed and temporary regulations, presumably Congress has tacitly approved these regulatory interpretations.

The regulations provide that, for both estate and gift tax purposes, if the surviving spouse has applied DSUE amounts to gifts from prior deceased spouses who are different than the last deceased spouse at the time of a particular gift or estate transfer, then the DSUE amount to be included in determining the applicable exclusion amount of the surviving spouse at the time of the surviving spouse's death (or at the time of a current taxable gift) is the sum of —

> (i) The DSUE amount of the surviving spouse's last deceased spouse . . .; plus
>
> (ii) The DSUE amount of each other deceased spouse of the surviving spouse, to the extent that such amount was applied to one or more [taxable gifts] [previous taxable gifts] of the surviving spouse.

Treas. Reg. §§ 20.2010-3(b), 25.2505-2(c). (The first bracketed provision appears in the estate tax regulations; the second appears in the gift tax regulations.)

This special rule means that an individual can take advantage of DSUE amounts from multiple spouses, as long as the individual makes a taxable gift to utilize the DSUE amount from a particular deceased spouse before the individual has a new last deceased spouse. Without this special rule, the aggregate DSUE amount that could possibly be used would be limited to the highest single basic exclusion amount that applied at the deaths of any of the deceased spouses.

> <u>Example</u>: W1 dies in 2011, leaving her entire estate to H, and a portability election is made with regard to W1's estate on a timely filed estate tax return. H marries W2 in 2014. W2 dies in 2022 leaving her sizable estate to the children of her first marriage. As a result, no DSUE amount is available to H with regard to W2's estate. Since W2 is now H's "last deceased spouse," H has no DSUE amount. The DSUE amount formerly available from W1 is lost.

j. <u>No DSUE Amount for GST Tax Purposes</u>. There is no "portability" of the GST tax exemption. In 2022, a couple using a bypass trust can exempt $24.12 million or more from both estate and GST tax, if not forever then at least a long as state law allows. A couple relying only on portability can only utilize the GST tax exemption of the surviving spouse ($12.06 million in 2022).

k. <u>Must File Estate Tax Return for Portability</u>. In order to take advantage of the DSUE amount, the executor of the deceased spouse's estate must file a timely and complete estate tax return. Once the last timely estate tax return is filed, any election regarding portability is irrevocable. If there is no appointed executor, the

regulations provide that persons in possession of the decedent's assets (whether one or more) are the "executor" for this purpose. If those persons cannot agree upon whether to make the portability election, a probate proceeding may be advisable, simply to appoint an executor.

2. Using QTIPable Trusts

Placing property into a trust eligible for the estate tax marital deduction offers many of the same non-tax benefits as bypass trusts but without many of the tax detriments.

a. Control, Creditor, and Divorce Protections. Like a bypass trust, a QTIP trust offers creditor and divorce protection for the surviving spouse, potential management assistance through the use of a trustee or co-trustee other than the spouse, and control over the ultimate disposition of assets for the transferor.

b. New Cost Basis at Second Spouse's Death. If a valid QTIP election is made under section 2056(b)(7)(B)(v) of the Code, which requires the filing of an estate tax return, then upon the death of the surviving spouse, the assets in the QTIP trust are treated for basis purposes as though they passed from the surviving spouse at the second death. § 1014(b)(10). As a result, they are eligible for a basis adjustment at the death of the surviving spouse. A QTIP election does not have to be made on an all-or-nothing basis, but rather a partial QTIP election may be made. Treas. Reg. § 20.2056(b)-7(b)(2)(i). Accordingly, in providing for the surviving spouse, if the estate plan provides for one trust for the sole benefit of the survivor and the other requirements to qualify the trust as a QTIP trust are met, the executor could make a partial QTIP election (perhaps severing the trust into two parts), resulting in both a bypass trust and a QTIP trust for the surviving spouse's benefit. This technique is often referred to as a "one-lung trust."

c. Preservation of GST Tax Exemption. If no QTIP election is made for the trust by filing an estate tax return, the first spouse to die is treated as the transferor for GST tax purposes, so the deceased spouse's GST tax exemption may be allocated (or may be deemed allocated), thereby preserving the GST tax exemption of that spouse. See § 2632(e)(1)(B). If a QTIP election is made for the trust, the executor may nonetheless make a "reverse" QTIP election for GST tax purposes, using the decedent's GST tax exemption to shelter the QTIP assets from tax in succeeding generations. See § 2652(a)(3). Although a reverse QTIP election generally applies to the entire QTIP trust, it may be possible under state law or the governing instrument to sever the QTIP trust into two trusts, and then make the reverse QTIP election for only one of the severed trusts. See, e.g., PLRs 201825023, 201845007.

d. QTIPs and Using the DSUE Amount. One strategy that a surviving spouse might consider, especially if remarriage is a possibility, is to make a taxable gift prior to remarriage (or at least prior to the death of a new spouse) to be sure to capture the DSUE amount of the prior spouse. If the spouse is a beneficiary of a QTIP trust, one possible form of that gift would be to intentionally trigger a gift of the QTIP trust assets under section 2519. Section 2519 provides that if a surviving spouse releases any interest in a QTIP trust, transfer taxes are assessed as though the entire QTIP trust (other than the income interest) had been transferred. If the surviving spouse were to release a very small interest in the QTIP trust, the result would effectively be to make a gift of the entire QTIP, thereby using his or her DSUE amount, even though the surviving spouse would retain the use of the unreleased income interest. Despite making a gift of some interest in the QTIP trust while retaining substantially all of the income interest, the trust assets will be treated as passing from the surviving spouse at death, thereby receiving a new cost basis. § 1014(b)(4). Moreover, because estate tax inclusion arises under section 2036 and not section 2044, a corresponding adjustment will be made to the surviving spouse's computation of adjusted taxable gifts at death. See Treas. Reg. § 20.2044-1, Ex. 5.

In the context of a QTIP trust, the purchase of the remainder interest may also be treated as a "disposition" of that interest by the spouse pursuant to section 2519, and, as a result, the spouse may be treated as having made a taxable gift to the remainder beneficiaries equal to the value of the purchase price. Rev. Rul. 98-8; see also PLR 201426016. Of course, the gift may be sheltered by the spouse's remaining applicable gift tax exclusion amount, which would include any DSUE amount Because section 2519 generally applies to the entire QTIP trust, if the plan is to give assets of less than all of the QTIP, the QTIP trust should be partitioned into two separate trusts, and then undertake section 2519 planning for one of the partitioned trusts but not the other. See, e.g., PLR 201834011.

3. QTIP Trust Disadvantages

a. No "Sprinkle" Power. Because the surviving spouse must be the sole beneficiary of the QTIP trust, the trustee may not make distributions from the QTIP trust to persons other than the surviving spouse during the surviving spouse's lifetime. § 2056(b)(7)(B)(ii)(II). As a result, unlike the trustee of a bypass trust, the trustee of a QTIP trust cannot "sprinkle" trust income and principal among younger-generation family members. Of course, this places the surviving spouse in no worse position than if an outright bequest to the spouse had been made. The surviving spouse may still use his or her own property to make annual exclusion gifts to those persons (or after a portability election, make even larger taxable gifts by using his or her DSUE amount) without paying any gift tax.

b. Estate Tax Exposure. Presumably, the QTIP trust has been used in order to achieve a step-up in basis in the inherited assets upon the death of the surviving spouse (which, of course, assumes that the trust assets appreciate in value – remember that the basis adjustment may increase or decrease basis). The basis adjustment is achieved by subjecting the assets to estate tax at the surviving spouse's death. The premise of using this technique is that the surviving spouse's basic exclusion amount (or applicable exclusion amount, if portability is elected) will be sufficient to offset any estate tax. There is a risk, however, that the "guess" made about this exposure may be wrong. Exposure may arise either from growth of the spouse's or QTIP trust's assets, or from a legislative reduction of the estate tax exclusion, or both (and, of course, under TCJA 2017, the basic exclusion amount is scheduled to be reduced for individuals dying after 2025). If these events occur, use of the QTIP trust may expose the assets to estate tax. Again, this risk is no greater than if an outright bequest to the spouse had been made. However, if the source of the tax is appreciation in the value of the QTIP trust assets between the first and second death, and if the income tax savings from the basis adjustment is less than the estate taxes payable, then with hindsight, one could argue that using a bypass trust instead would have been more beneficial to the family. In many instances, distributions to the beneficiary spouse will be desirable to allow the spouse to transfer that property. The distribution standards should allow for such.

c. Termination of QTIP Trust. Where a QTIP locks distribution standards that allow sufficient assets to be distributed to the spouse to allow the spouse to undertake desired estate planning, consideration is often given to terminating the QTIP in favor of the surviving spouse. That may be perilous. CCA 202118008 involved simple facts and a most unfortunate result. Surviving spouse was the beneficiary of a QTIP trust, received all the income of course, could receive principal for health, maintenance, and support in the spouse's accustomed standard of living if the income were insufficient, and had a testamentary power of appointment among descendants. Apparently for planning purposes, the spouse and descendants decided to terminate the trust and give all of the trust assets back to the spouse who then disposed of the assets in what appear to be sales and perhaps other estate planning transactions. The National Office determined that spouse made a gift of the value of the QTIP assets when the trust was terminated, and that the descendants made a gift of the value of their remainder interests. There was no offset for the respective gifts, and the transaction was not treated as a sale. The termination was done via a commutation agreement that the CCA describes this way:

> On Date 3, Spouse, as the current beneficiary and as the trustee of Trust 1, and Child 1 and Child 2, as remainder beneficiaries and virtual representatives of the contingent and unborn beneficiaries of Trust 1, entered into Agreement. Under the terms of Agreement, Trust 1 was commuted1 and all of its property was distributed to Spouse. Recital H of Agreement provides that Spouse and Children agree that "Trust assets could be more effectively utilized if [Spouse] held such assets outright and free of trust." In Recital F of Agreement, the parties acknowledge that Spouse's testamentary limited power of appointment is "not operative." Paragraph 3 of Agreement provides:
>
>> By signing this Agreement and by virtue of the QTIP election for the Trust, the commutation of the Trust results in a deemed gift, for federal gift tax purposes, of the remainder interest in the Trust assets from [Spouse] to [Children] under Section 2519 of the Code. By virtue of the distribution of all of the Trust assets to [Spouse], the commutation of the Trust does not result in a deemed gift of [Spouse's] income interest in the Trust under Section 2511 of the Code. Additionally, by signing this

> Agreement and by virtue of the distribution of all of the Trust asset [sic] to [Spouse], the commutation of the Trust results in a gift, for federal gift tax purposes, of the remainder interest in the Trust from [Children] to [Spouse]. The deemed gift of the remainder interest from [Spouse] to [Children] and the gift from [Children] to [Spouse] results in a reciprocal gift transfer.

First up to be considered were the tax consequences to the spouse. The CCA states:

> In this case, Spouse, as personal representative of Decedent's estate, made an election under § 2056(b)(7) to treat Trust 1 as QTIP and claimed a marital deduction on Decedent's Form 706 for the value of Trust 1. Years later, on Date 3, Spouse and Children entered into Agreement. By its terms, Agreement effected the commutation of Trust 1.
>
> In a commutation, the trustee makes terminating distributions to the holders of the beneficial interests in the trust equal to the actuarial value of the interests. Each beneficiary gives up his or her respective beneficial interest in exchange for a lump sum payment, in what is essentially a sale transaction. The commutation terminates any relationship between the beneficiary and the trust, and if all interests are commuted, the trust terminates.
>
> Based on the above, the commutation of Trust 1 effected by Agreement constitutes a disposition by Spouse of Spouse's qualifying income interest within the meaning of § 2519(a). Section 25.2519-1(a) and (f); *Estate of Novotny*. Accordingly, for gift tax purposes, Spouse is treated as transferring by gift all interests in Trust 1 other than the qualifying income interest.3

Footnote 3 states:

> Note that the commutation does not constitute a gift of Spouse's qualifying income interest under § 2511 because Spouse received adequate and full consideration for Spouse's qualifying income interest based on the distribution of all trust property to Spouse. *See* § 25.2519-1(g), *Example 2*.

The CCA summarized the Estate of Novotny, 93 T.C. 12 (1989) like this: the surviving spouse and remainderman divided the sale proceeds of QTIP proportionately on the basis of the respective values of their interests; the court indicated that the commutation constituted a disposition by the spouse of the income interest for purposes of § 2519 and was thus subject to gift tax.

So, the QTIP was terminated, the spouse received all the QTIP assets, and the spouse made a gift of the value of those assets to the descendants. Now let's look at the what the descendants did. Before the termination they would have received the assets when the spouse died. The CCA provides as follows:

> In this case, Child 1, Child 2, and Spouse entered into Agreement, which legally bound all persons interested in Trust 1. The effect of Agreement was to extinguish Spouse's testamentary limited power of appointment, commute Trust 1, and terminate Trust 1. As a result, Agreement vested a valuable property interest (the value of the remainder) in Children, the then remaindermen. Rather than accept a terminating distribution of the value of their beneficial interest, Child 1 and Child 2 agreed that the trust property "could be more effectively utilized" by Spouse holding the property outright. The outright distribution of all trust property to Spouse pursuant to the terms of Agreement constitutes a transfer of the value of Children's remainder interests without receipt of adequate and full consideration.4 Accordingly, Child 1 and Child 2 each made a gift under § 2511

> of the value of their respective remainder interest in Trust 1 to Spouse. Section 2512(b).

Footnote 4 is omitted and deals with spouses' subsequent transfers.

The children argued that there had to be some offset here, otherwise the property was being taxed twice. The National Office rejected that position stating:

> In *Commissioner v. Wemyss*, 324 U.S. 303 (1945) and its companion case *Merrill v. Fahs*, 324 U.S. 308 (1945), the Supreme Court considered the gift tax meaning of the term "adequate and full consideration in money or money's worth" in the context of antenuptial contracts.
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> In *Wemyss*, the donor transferred assets to his fiancé to compensate her for the loss of an income interest that would terminate upon her marriage to him. There was no dispute that both a promise of marriage and detriment to a contracting party constituted valuable consideration for purposes of the law of contracts. The Tax Court had held that if the promise of marriage was the consideration, it was not one reducible to a money value and, if the fiancé's loss of the income interest was the consideration, it did not constitute consideration in the hands of the donor. The Supreme Court stated:
>
> If we are to isolate as an independently reviewable question of law the view of the Tax Court that money consideration must benefit the donor to relieve a transfer by him from being a gift, we think the Tax Court was correct. . . . The section taxing as gifts transfers that are not made for "adequate and full (money) consideration" aims to reach those transfers which are withdrawn from the donor's estate.
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> *Wemyss*, 324 U.S. at 307-08. In other words, valuable contractual consideration in the hands of the donor is not sufficient; adequate and full consideration is that which replenishes, or augments, the donor's taxable estate.
>
> In *Merrill,* the donor transferred property to donor's then spouse in exchange for spouse's relinquishment of marital rights in donor's remaining property. The Court held that spouse's relinquishment of the marital rights did not constitute adequate and full consideration for donor's transfer because the assets subject to the marital rights were already includible in donor's gross estate. *Id*. at 312-13.
>
> Rev. Rul. 69-505, 1969-2 C.B. 179, involves a transfer to a trust of joint-tenancy property that is treated as a reciprocal exchange for consideration in money or money's worth. A and B owned the property as joint tenants and could each unilaterally sever the joint tenancy, and if not severed, the property would pass to the survivor upon the death of the other joint tenant. A and B transferred the property to a trust, reserving the right to receive one-half of the income therefrom for their joint lives and all to the survivor for life with remainder to C. Citing § 25.2511-1(e) and *U.S. v. Estate of Grace*, 395 U.S. 316 (1969), the revenue ruling holds that the transfers between A and B are treated as a reciprocal exchange for consideration in money or money's worth. Thus, neither A nor B made a gift to the other to the extent that the transfers were of equal value. The revenue ruling concludes that since the value of the gift by B is less than the value of the gift by A, A is deemed to have made a gift to B of the difference in value of A's and B's transfer.

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Agreement characterized the transaction as a commutation of Trust 1 followed by a distribution of all trust property to Spouse. Thus, Spouse agrees to the extinguishment of Spouse's lifetime interest in Trust 1 and Children agree to the extinguishment of their remainder interest in Trust 1 in exchange for receipt of their respective proportionate share of trust property. Also pursuant to Agreement, Children transfer their proportionate share of trust property received in the commutation to Spouse and receive no consideration from Spouse in exchange for the transfer. Absent entering into Agreement, Spouse had no right to the remainder under the terms of Trust 1 or otherwise. Therefore, from an economic perspective, the transaction resulted in a one-sided gift transfer from Children to Spouse.

It is the deemed gift transfer arising by application of § 2519(a) that is the crux of Spouse and Children's position, as stated in Agreement, that the transfers are reciprocal gift transfers. However, unlike in Rev. Rul. 69-505, Spouse's deemed transfer under § 2519(a) and Children's transfers of their remainder interests under § 2511 do not constitute offsetting exchanges of consideration. Spouse received no consideration for the deemed transfer to Children under § 2519(a). That is, because the entire value of Trust 1 was subject to inclusion in Spouse's gross estate under § 2044, the transfer of the remainder by Children to Spouse does not augment Spouse's estate and, thus, cannot constitute the receipt of adequate and full consideration for gift tax purposes. *See Commissioner v. Wemyss; Merrill v. Fahs.*

The fact that Spouse can receive no consideration for the deemed transfer resulting from the application of § 2519(a) does not nullify Children's transfers of their remainder interests in Trust 1. When Trust 1 was commuted, the remainder interest vested outright, equally in Children, the then remaindermen. Children then transferred their valuable property interest to Spouse and received nothing in exchange. Under § 2512(b) and *Wemyss*, these transfers by Children for no consideration constitute a gift. If Children were to transfer their remainder interests to a third party other than Spouse, the transfers would clearly be a gift. The result is the same if the donee is the surviving spouse beneficiary of a QTIP trust.5 Thus, the transaction cannot be considered involving offsetting transfers for consideration within the meaning of Rev. Rul. 69-505.

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In Rev. Rul. 98-8, 1998-1 C.B. 541, the surviving spouse purchased from the trust remainderman the remainder interest in a QTIP trust by issuing a promissory note equal to the actuarial value of the remainder interest to the remainderman. As a result of the purchase, the trust terminated under its terms and the entire corpus was transferred to the surviving spouse. The surviving spouse then used the proceeds to pay the remainderman the value of the remainder interest. The revenue ruling concludes that the purchase of the remainder interest, which is analogous to a commutation of the QTIP trust, is treated as a taxable disposition by the surviving spouse of the qualifying income interest, resulting in a gift of the value of the remainder interest under § 2519. Citing to *Wemyss*, the revenue ruling explains that the receipt of the remainder interest cannot increase the donor's taxable estate because it is already subject to inclusion in the surviving spouse's taxable estate under § 2044. Accordingly, the surviving spouse's receipt of the remainder interest cannot constitute adequate and full consideration under § 2512 for the promissory note transferred. The revenue ruling notes that any other result would subvert the legislative intent and statutory scheme underlying § 2056(b)(7).

In *Estate of Kite v. Commissioner*, T.C. Memo. 2013-43, the surviving spouse was the beneficiary of two QTIP trusts. According to a prearranged plan, the QTIP trusts were terminated and all assets were distributed to the surviving spouse. Two days later, the surviving spouse sold the assets to her three children in exchange for three deferred private annuity agreements under which payments would commence ten years thereafter. In the event that the surviving spouse died within the ten-year period, her annuity interest would terminate and nothing would be payable to her estate. Based on the facts and circumstances, the court found the sale of the assets of the QTIP trusts to the children in exchange for deferred annuities constituted a bona fide sale for adequate and full consideration and treated the annuity transaction as a single integrated transaction for purposes of § 2519. Moreover, the sale of the assets of the QTIP trusts, followed by the payment to the surviving spouse of the proceeds equal to the value of her income interest, was a disposition of her qualifying income interest for purposes of § 2519. In response to petitioner's post-opinion argument that there was no gift tax deficiency for the § 2519 disposition of the surviving spouse's qualifying income interest based on the receipt of full and adequate consideration, the court stated,

> [S]ection 2519(a) treats the disposition of a qualifying income interest as a deemed transfer of the remainder interest. In other words, "the donee spouse is treated as making a gift under section 2519 of the entire trust less the qualifying income interest" (emphasis added). Sec. 25.2519-1(a), Gift Tax Regs. The term "gift" is not an accident. The remainder interest is a future interest held by the remainderman and not the donee spouse. Accordingly, the donee spouse cannot receive full and adequate consideration, or indeed any consideration, in exchange for the remainder interest. This result is supported by the intent of the marital deduction and the QTIP regime.

Estate of Kite v. Commissioner, No. 6772-08 (T.C. Oct. 25, 2013) (order and decision under Tax Court Rule 155). The court ruled that the decedent owed gift tax on the value of the deemed § 2519 gift. *Id*.

Here, the QTIP statutory scheme and legislative history support the view that Rev. Rul. 69-505 has no application and the separate transfers by Spouse and Children cannot be offset by consideration for gift tax purposes. Decedent's estate received the benefit of deferral of the estate tax liability allocable to the property of Trust 1 as a result of electing QTIP for such property under § 2056(b)(7). Because the commutation effected by Agreement constitutes a taxable disposition by Spouse within the meaning of § 2519(a) (see Issue 1), it marks the end of the deferral of the tax.

Rev. Rul. 98-8 and *Estate of Kite* illustrate that a disposition under § 2519(a) has significant tax consequences, which are appropriate in view of the QTIP statutory scheme and legislative history. Here, because the commutation of Trust 1 results in a disposition of Spouse's qualifying income interest within the meaning of § 2519(a), Spouse is treated as effectively transferring the remainder interest even though under state property law precepts the remainder interest is held by Children, not Spouse. The taxable transfer by Spouse resulting from the application of § 2519 marks the end of the deferral of estate tax on the Trust 1 property that passed untaxed from Decedent's estate, and is no longer subject to inclusion in Spouse's gross estate under § 2044(b)(2). Eliminating the taxable transfer by Spouse based on a deemed reciprocal gift transfer by the remaindermen would allow the value of the remainder of Trust 1 to escape transfer

> tax under both §§ 2519 and 2044, which would be contrary to the QTIP statutory scheme and legislative history.

Finally, the National Office got around to valuing the two gifts. The spouse's gift – recall that the spouse received all the property – was valued by subtracting the spouse's income interest from the full value of the trust property. The children's gifts were valued based on standard actuarial methods. The CCA states:

> Section 25.2519-1(c)(4) provides that the amount treated as a transfer under § 25.2519-1(c)(1) is further reduced by the amount the surviving spouse is entitled to recover under § 2207A(b) (relating to the right to recover gift tax attributable to the remainder interest). Under § 25.2519-1(c)(4), if the donee spouse is entitled to recover gift tax under § 2207A(b), the amount of the gift tax recoverable and the value of the interest treated as transferred under § 2519 are determined by using the same interrelated computation applicable for other transfers in which the transferee assumes the gift tax liability. The gift tax consequences of failing to exercise the right of recovery are determined separately under § 25.2207A-1(b).
>
> Under § 2207A(b) and § 25.2207A-1(a), a surviving spouse treated as transferring an interest in property by reason of § 2519 is entitled to recover from the "person receiving the property" the amount of gift tax attributable to that property. The right of recovery arises at the time the gift tax is actually paid by the surviving spouse subject to § 2519.
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> In this case, the amount of Spouse's gift under § 2519 is determined by subtracting the value of Spouse's qualifying income interest from the fair market value of the trust property as of Date 3, the date of Agreement. Section 2519(a); § 25.2519-1(a). Discretionary principal distributions and the testamentary limited power of appointment are not taken into account. A standard § 7520 income factor can be used to value the qualifying income interest, and thus, the value of Spouse's qualifying income interest is determined by multiplying the value of the trust property by the income factor of
>
> 0.09172.6 Section 25.2512-5(d)(2)(iii); § 25.7520-1. Based on a value of the trust property of \$b, the value of Spouse's qualifying income interest is \$e. The amount of Spouse's gift under § 2519, therefore, is \$f (i.e., \$b – \$e = \$f).
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> To the extent Spouse is entitled to recover gift tax attributable to the remainder interest under § 2207A(b), this amount is reduced, using an interrelated calculation. Note that, under § 25.2207A-1(b), if Spouse waives or otherwise fails to exercise Spouse's right of recovery, Spouse will be treated as making an additional gift in the amount of the unrecovered tax.7
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> ***
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> Based on the available facts, it is appropriate to value each of Children's interests as one-half of the actuarial present value of the remainder interest, adjusting as necessary for the restrictions on the beneficial interests. The determination takes into account that the possibility of principal invasion was so remote as to be negligible, given that the combined value of the property held by Trust 1 was \$b at the time of commutation and, thus, annual income of Trust 1 would have been substantial and likely sufficient for Spouse's health, maintenance, and support, even if Spouse's accustomed manner of living were extravagant.8 Further, the determination takes into account, based on all the facts and circumstances, that the testamentary limited power of appointment would be appropriately treated as having no measurable effect on the values of these interests.

> Accordingly, based on the available facts, we conclude that the actuarial value of Children's proportionate shares of the remainder interest is properly determined under § 7520, using a standard remainder factor. Thus, the value of each child's remainder interest under § 7520 is determined by multiplying the value of the trust property by the remainder factor of 0.908289 then dividing the product by 2. Section 25.2512-5(d)(2)(ii); § 25.7520-1. Based on a value of the trust property of $b, the fair market value of each child's gift, therefore, is $g (i.e., ($b x 0.90828) ÷ 2 = $g).

Footnote 8 notes that the spouse must not have needed principal distributions because the spouse sold most of the assets received "immediately after Spouse received it in exchange for promissory notes that did not provide for the payment of principal until a date after Spouse's probable life expectancy."

The Tax Court case involved in the ruling is McDougall v. Commissioner, No. 2458-22.

In PLR 202116001 a QTIP ("Qualified Trust") was divided and the spouse released an income right over part of the trust. The ruling describes what happened as follows:

> On Date 1, Trustee divided Qualified Trust into two trusts, Qualified Trust-A and Continuing Qualified Trust, both with terms and provisions identical to those set forth in Qualified Trust. Trustee placed $x in cash and marketable securities into Qualified Trust-A and retained all other assets in Continuing Qualified Trust. The assets retained in Continuing Trust are income producing such that Spouse retains the enjoyment of the assets. On Date 2, Trustee and the beneficiaries of Qualified Trust-A petitioned Court for entry of an order with respect to Qualified Trust-A. On Date 3, finding that a continuation of Qualified Trust-A unchanged would defeat or substantially impair its purposes, Court entered Order. Order modifies the terms and provisions of Qualified Trust-A.
>
> Article V of Qualified Trust-A, as modified by Order, provides that Qualified Trust-A shall terminate upon the death of the last surviving income beneficiary. However, at any time, including prior to Spouse's death, Qualified Trust-A may be terminated as to a beneficiary's interest and any part of the trust property representing her interest may be distributed to that beneficiary if the trustee considers such distribution to be in the best interests of the beneficiary, considering the demonstrated ability of the beneficiary to handle money and property wisely, her judgment, prudence and discretion, and any other factors the trustee may consider relevant. The trustee may exercise the power of termination even if the beneficiary is restrained from alienating her interest.
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> Article III, section 3.1, as modified by Order, provides that the original and principal beneficiaries of Qualified Trust-A shall become the income beneficiaries in proportion to their interests in the principal. Section 7.2, allowing the trustee to make distributions to Spouse for her health, education, maintenance and support, is deleted in its entirety. Order further provides that, the terms and conditions of Qualified Trust-A shall be interpreted and applied as if Spouse had died on the date Order is entered, and that Trustees shall continue to be the trustee of Qualified Trust-A and Continuing Qualified Trust. Although Order is effective on Date 3, it is expressly conditioned on receipt of favorable rulings from the Internal Revenue Service prior to Date 4.

Because the trust continued even after the income interest was given up, there was no gift form the remainder beneficiaries. However, the gift by the spouse was described like this:

> In the present case, following the division of Qualified Trust on Date 1, the trusts resulting from the division, Qualified Trust-A and Continuing Qualified Trust, had terms and provisions identical to those set forth in Qualified Trust. Thus, the division of Qualified Trust did not change the beneficial interests of Spouse, Daughter 1 or Daughter 2 in the property originally held in Qualified Trust. Accordingly, based on the facts submitted and representations made, we rule that the division of Qualified Trust on Date 1 did not cause the assets remaining in Qualified Trust after the division (referred to as Continuing Qualified Trust) to be subject to the United States Gift Tax pursuant to § 2519 or 2511.
>
> Order, however, modifies the terms of Qualified Trust-A to change the beneficial interests of Spouse, Daughter 1, and Daughter 2 in the property of Qualified Trust-A. Article V of Qualified Trust-A, which continues to provide that Qualified Trust-A shall terminate upon the death of the last surviving income beneficiary, is modified to provide that at any time, including prior to Spouse's death, Qualified Trust-A may be terminated as to a beneficiary's interest. In other words, Order terminates Spouse's income interest as of Date 3. The term "disposition" as used in § 2519, applies broadly to circumstances in which the surviving spouse's right to receive the income is relinquished or otherwise terminated, by whatever means. See H. Rep. No. 97-201, at 161 (1981). The property in Qualified Trust-A is a portion of the property originally held by Qualified Trust with respect to which Decedent's estate was allowed a deduction under § 2056(b)(7). Thus, for purposes of § 2519, the entry of Order on Date 3 resulted in a disposition of a qualifying income interest for life in Qualified Trust-A.
>
> Accordingly, based on the facts submitted and representations made, we rule that Spouse is deemed to have made a transfer of all of the property in Qualified Trust-A under § 2519, other than the value of her qualifying income interest, and Spouse is deemed to have made a transfer of her qualifying income interest in Qualified Trust-A under § 2511, on Date 3 upon entry of Order approving modifications by which the income interest of Spouse in Qualified Trust-A is terminated and distributions from Qualified Trust-A are permitted to be made prior to death of Spouse.

A QTIP election is at root a "deal" between the surviving spouse and the government. The government allows a marital deduction and the surviving spouse agrees that all of the enjoyment and value of the property as to which the election is made will flow through the hands of the surviving spouse. The "deal" is necessary because a QTIP trust often is designed without any other power in the surviving spouse which would cause estate tax inclusion. Accordingly, if the surviving spouse gives up any of the income interest in QTIP property, the surviving spouse is deemed by section 2519 to have made a gift of the entire value of that QTIP property (that would not have had to be the rule; the surviving spouse could have been deemed to have made a gift of that portion of the income, but such a determination is complicated and uncertain, thus a strict "penalty" rule was imposed by statute). However, concluding that a "transfer" of a remainder by the children has occurred and is a gift creates double-taxation of the same QTIP property. Had there been no QTIP election the government's approach would have been more sensible: the spouse had an income interest, the children a remainder interest, the children allowed all the trust property to be distributed to the spouse which could have been a gift of the remainder interest.

d. Income Tax Exposure. A QTIP trust is a "simple" trust for federal income tax purposes, in that it must distribute all of its income at least annually. Remember, however, that simple trusts may nevertheless pay income taxes. As noted above, a trust which distributes all of its "income" must only distribute income as defined under the governing instrument and applicable state law (typically, the Uniform Principal and Income Act), which is not necessarily all of its taxable income. Thus, for example, capital gains, which are taxable income, are typically treated as corpus under local law and thus not distributable as income. Other differences between the notions of taxable income and state law income may further trap taxable income in the trust. Although simple trusts often accumulate less taxable income than complex trusts, they may nevertheless be subject to income tax at compressed tax rates.

e. Is a QTIP Election Available? On September 27, 2016, the IRS issued Revenue Procedure 2016-49, which modifies and supersedes Revenue Procedure 2001-38 and outlines new procedures under which the IRS will disregard a QTIP election, but it provides that these procedures are unavailable if a portability election was made for the DSUE amount under section 2010(c)(5)(A). The IRS will, however, continue to disregard an unnecessary QTIP election and treat the election as null and void solely "for estates in which the executor neither has made nor has considered to have made the portability election." Revenue Procedure 2016-49 treats QTIP elections as void if three requirements are satisfied: (1) the estate's federal estate tax liability was zero, so the QTIP election is unnecessary to reduce federal estate tax liability; (2) the executor did not make and was not considered to have made a portability election under section 2010(c)(5)(A); and (3) specific procedural requirements for relief to treat a QTIP election as void as outlined in Section 4.02 of the Revenue Procedure are satisfied.

Conversely, the Revenue Procedure does not treat as void a QTIP election in any of the following situations: (1) a partial QTIP election was required for a trust to reduce estate tax liability but the executor made the election for more property than was necessary to bring the estate tax liability to zero; (2) a QTIP election was made "in terms of a formula designed to reduce the estate tax to zero"; (3) the QTIP election constituted a protective election under Treas. Reg. § 20.2056(b)-7(c); (4) the executor made a portability election "even if the decedent's DSUE amount was zero based on values as finally determined for federal estate tax purposes"; or (5) the procedural requirements for relief to treat a QTIP election as void as outlined in Section 4.02 of the Revenue Procedure are not satisfied.

The Revenue Procedure also notes that, going forward, the procedures set out in the Revenue Procedure "must be used in lieu of requesting a letter ruling." In addition, QTIP elections for which relief was granted under Revenue Procedure 2001-38 do not fall within the scope of Revenue Procedure 2016-49.

Thus, Revenue Procedure 2016-49 accomplishes three things. First, taxpayers now have certainty that a QTIP election made solely to increase a DSUE amount will not be ignored or treated as void. Second, it expands the grounds for automatic relief for invalidating QTIP elections when the election provides no benefit. Third, as IRS user fees for private letter rulings continue to climb, taxpayers can now rely on Revenue Procedure 2016-49 for certainty in lieu of a costly and lengthy private letter ruling process.

f. Clayton QTIP Trusts. When the statute authorizing QTIP trusts was first enacted, the IRS strictly construed language in section 2056(b)(7) of the Code requiring the property in question to pass from the decedent. In Estate of Clayton v. Commissioner, 97 TC 327 (1991), the IRS asserted that no marital deduction was allowed if language in the will made application of QTIP limitations contingent upon the executor making the QTIP election. Regulations at the time also adopted this position. After the Tax Court found in favor of the IRS's position, the Fifth Circuit reversed and remanded, holding that language in a will that directed property to a bypass trust to the extent no QTIP election was made did not jeopardize the estate tax marital deduction. Est. of Clayton v. Comm'r, 976 F2d 1486 (5th Cir. 1992). After other courts of appeal reached the same result and a majority of the Tax Court abandoned its position, the Commissioner issued new regulations that conform to the decided cases and permit a different disposition of the property if the QTIP election is not made. Treas. Reg. §§ 20.2056(b)-7(d)(3)(i), 20.2056(b)-7(h), Ex. 6. The final regulations explicitly state that not only can the spouse's income interest be contingent on the election, but the property for which the election is not made can pass to a different beneficiary, a point that was somewhat unclear under the initial temporary and proposed regulations issued in response to the appellate court decision. As a result, it is now clear that a will or a revocable trust can provide that if and to the extent that a QTIP election is made, property will pass to a QTIP trust, and to the extent the election is not made, the property will pass elsewhere (for example, to a bypass trust). Including this Clayton QTIP language in a client's will or revocable trust would allow the executor of the estate of the first deceased spouse additional time compared to a disclaimer bypass trust to evaluate whether a QTIP or bypass trust is best. Because the QTIP election can only be made on a federal estate tax return, the Clayton option would require the filing of an estate tax return if property is to pass to the QTIP trust. Presumably, since a QTIP election can be made on an estate tax return filed on extension, a Clayton QTIP would give the executor fifteen months after the date of death to evaluate the merits of the election. In addition, since no disclaimer is involved, there is no limitation on the surviving spouse holding a special testamentary power in the bypass trust that receives the property as a result of the Clayton election. Note that the executor is defined as the court-appointed executor, or if there is no appointed executor, the person in actual or constructive possession of property of the decedent. § 2203.

If a Clayton QTIP election is contemplated, should the surviving spouse not serve as the executor? There is a concern that the spouse's right to alter the form of her bequest from a bypass trust that may "sprinkle and spray" among family members to an "all income for life" QTIP trust might give rise to gift tax exposure to the spouse for making (or failing to make) the election. A more aggressive approach would be for the spouse to serve, but to require the surviving spouse/executor to make (or not make) the QTIP election as directed by a disinterested third party. Consider whether state law allows for a "special executor" that may serve only for this purpose or whether a "special trustee" under a post-death revocable trust may make the election. Note that these concerns should not apply to a “one-lung trust” because a partial QTIP election does not alter the surviving spouse's beneficial interest.

Sample Clayton QTIP Trust Language

1. If my [spouse], survives me, and if my Executor (other than my [spouse]), in the exercise of sole and absolute discretion, so elects for some or all of my net residuary estate to qualify for the federal estate tax marital deduction under Section 2056(b)(7) of the Code (the "QTIP election"), I direct that my net residuary estate shall be divided into two portions, to be known as Portion A and Portion B.

a. Portion A shall consist of that share of my net residuary estate, if any, with respect to which my Executor has made the QTIP election. I give, devise and bequeath Portion A to the Trustee hereinafter named, IN TRUST, to be held as a separate [QTIP] trust and disposed of in accordance with the provisions of paragraph ___ of Article ______.

b. Portion B shall consist of the balance, if any, of my net residuary estate. I give, devise and bequeath my net residuary estate to the Trustee hereinafter named, IN TRUST, to be held as a separate [Bypass] trust and disposed of in accordance with the provisions of paragraph ___ of Article _____.

2. If my [spouse], survives me, and if my Executor (other than my [spouse]), in the exercise of sole and absolute discretion, does not make a QTIP election with respect to some or all of my net residuary estate, I give, devise and bequeath my net residuary estate to the Trustee hereinafter named, IN TRUST, to be held as a separate [Bypass] trust and disposed of in accordance with the provisions of paragraph ___ of Article ______.

3. Each of Portion A and Portion B is intended to be a fractional share which participates in appreciation and depreciation occurring in the property disposed of under this Article. Subject to the provisions of paragraph ___ of Article ______, each portion may be funded with cash or other property, or a combination thereof, and any such other property so used shall be valued as of the date of distribution.

g. The QTIP Tax Apportionment Trap. Remember that if estate tax ultimately proves to be due as a result of having made the QTIP election, the source of payment for these taxes becomes important. Under federal law, except to the extent that the surviving spouse in his or her will (or a revocable trust) specifically indicates an intent to waive any right of recovery, the marginal tax caused by inclusion of the QTIP assets in the surviving spouse's estate is recoverable from the assets of the QTIP trust. § 2207A(1). Many state tax apportionment statutes adopt this rule, either expressly or by reference. When the beneficiaries of the surviving spouse's estate and the remainder beneficiaries of the QTIP trust are the same persons, this rule generally makes little difference. Where they differ, however, the result could be dramatic, and highlights the need to check the "boilerplate" of clients' wills.

> Example: H and W each have a $20 million estate. H dies with a Will leaving all to a QTIP trust for W, with the remainder interest in the trust passing upon W's death to H's children from a prior relationship. H's executor files an estate tax return making both the QTIP and the portability elections. W immediately thereafter, knowing she can live from the QTIP trust income, makes a gift of her entire $20 million estate to her children. No gift tax is due because W can apply her applicable exclusion amount to eliminate the tax (i.e., her basic exclusion amount plus H's DSUE amount). Upon W's later death, the remaining QTIP trust assets are subject to estate tax under section 2044 of the Code. Since W used nearly all of her applicable exclusion amount to shelter her gift to her children, none of her exclusion (or a nominal amount because of the inflation adjustment of her basic exclusion amount) is available to shelter estate tax, and the entire $20 million (assuming no changes in value) is taxed. All of this tax is attributable to the QTIP trust assets, so unless W's Will expressly provides otherwise, the estate tax liability of $8 million is charged to the trust (and

therefore, in effect, to H's children). As a result, H's children are left with $12 million from the remainder of the QTIP assets, while W's children receive $20 million tax free. Note that this same result occurs if W makes no gift! Her applicable exclusion amount (including H's DSUE amount) would shelter her assets from estate tax, with the QTIP paying all of the marginal tax caused by the inclusion of its assets in W's estate.

A potential solution to this problem may be to have H and W enter into a post-nuptial agreement whereby each agrees that if the executor of the first deceased spouse's estate makes both a QTIP and a portability election, the surviving spouse will sign a Will that equitably apportions any estate tax due upon the surviving spouse's death. Alternatively, H's executor could agree to the portability election only if W (i) agrees to waive estate tax recovery under section 2207A except to the extent of pro rata taxes (instead of marginal taxes); and (ii) agrees to retain sufficient assets to pay applicable estate taxes associated with her property transfers, whether during lifetime or at death. As one might imagine, drafting such an agreement would not be a trivial matter.

4. Is a Life Estate Power of Appointment (LEPA) Trust a Better Choice?

A QTIP trust isn't the only method of obtaining a marital deduction for property passing into trust for a surviving spouse. Long before the advent of QTIP marital trusts, another form of marital trust was available. Unlike the more familiar QTIP trust format, this trust is available without the need to file an estate tax return.

a. Structure of LEPA Trusts. Section 2056(b)(5) permits a marital deduction for property passing into trust for a spouse so long as the surviving spouse is entitled for life to the income from all or a specific portion of the trust, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the trust property (exercisable in favor of the surviving spouse or the estate of the surviving spouse, or in favor of either, whether or not the power is exercisable in favor of others), so long as no power is given to anyone to appoint any part of the trust to anyone other than the surviving spouse. This so-called Life Estate Power of Appointment ("LEPA") trust thereby allows a marital deduction without many of the other restrictions applicable to QTIP trusts. Note that the spouse must be given the right to income from all of the trust (or a specific portion of the trust determined on a fractional or percentage basis) that is intended to qualify. The power of appointment must be exercisable by the spouse alone, and may be inter vivos or testamentary, as long as it is exercisable over all of the trust property from which the spouse has a right to the income. § 2056(b)(5).

b. Benefits of LEPA Trusts. Estate planners have generally preferred QTIP trusts because they allow the creator of the trust to restrict the disposition of any trust property remaining at the death of the surviving spouse by restricting or even eliminating the surviving spouse's power to appoint the trust property. However, LEPA trusts do cause inclusion in the surviving spouse's estate, thereby providing a basis adjustment in the trust's assets at the death of the surviving spouse. § 1014(b)(4). In addition, they provide many of the other trust benefits such as creditor protection and divorce protection, as well as management assistance through the use of a trustee or co-trustee other than the spouse. While neither the income nor the associated tax liability of a LEPA trust may be shifted to others, a LEPA trust may avoid application of compressed tax rates if the surviving spouse has a general power to appoint property to him- or herself during lifetime. § 678. In smaller estates, especially where a couple share beneficiaries, such as the children of the marriage, and in states with no state estate tax, the LEPA trust may see a rise in popularity because couples with smaller estates don't need to file an estate tax return to obtain the second basis adjustment.

c. No Reverse QTIP Election and Other Disadvantages of LEPA Trusts. LEPA trusts do have some drawbacks. Most notably, while a QTIP trust permits preservation of the decedent's GST tax exemption by making a "reverse" QTIP election for GST tax purposes, there is no "reverse" LEPA election. Assets in the trust are simply included as part of the surviving spouse's estate at the time of his or her death, and the surviving spouse is thereby treated as the transferor of the trust property for GST tax purposes. In addition, granting the surviving spouse a general testamentary power of appointment over trust assets may not be compatible with every client's estate plan. Also, the grant of a general power of appointment, whether inter vivos or testamentary, may subject the property to the spouse's creditors in certain states.

5. A Word About Portability

a. Generally. TRA 2010 added, and ATRA made permanent, the notion of "portability" of a deceased spouse's unused exclusion amount. In essence, portability provides that upon the death of one spouse, the executor of that spouse's estate may file an estate tax return and elect on that return to allow the surviving spouse to effectively inherit any unused federal estate tax exclusion of the deceased spouse. In other words, the deceased spouse's unused exclusion amount can be "ported" to the surviving spouse. § 2010(c)(2)(B). Final regulations were issued effective June 12, 2015 which provide guidance regarding portability. Treas. Reg. §§ 20.2010-2, -3.

The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount," otherwise known as the "DSUE amount." Once a spouse receives a DSUE amount, the surviving spouse can use the DSUE amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her "last deceased spouse." Every individual has a basic exclusion amount equal to the federal gift or estate tax exclusion in the year of the transfer. In 2011, this amount was $5 million. In 2017, the basic exclusion amount was $5.49 million. For transfers occurring in years 2018 through 2025, however, TCJA 2017 set the basic exclusion amount to $10 million, adjusted for inflation after 2010. As a result, for 2023, it is $12.92 million. § 2010(c)(3). The applicable exclusion amount is the sum of one's basic exclusion amount, plus his or her DSUE amount, if any. § 2010(c)(2).

b. The Election. Section 2010(c)(5)(a) states that the DSUE amount is available to the surviving spouse only if the decedent's "executor" timely files an estate tax return on which the DSUE amount is computed and makes an election on the return for portability to apply. The portability election is made by the "executor" of the deceased spouse's estate. § 2010(c)(5)(A). If there is a court-appointed executor, that person is the executor (referred to in Treasury regulations as an "appointed executor"). If there is no court-appointed executor, any person in actual or constructive possession of property (a "non-appointed executor") may make the portability election.

Portability is relatively new and only recently permanent. Consequently, most existing wills and revocable trusts do not contemplate the possibility of preparing an estate tax return if the decedent's estate is not taxable. In most of these existing testamentary documents, no provision permits the executor to prepare the return and no provision directs whether the estate may or may not pay for the preparation of the return. It is easy to imagine situations where a conflict exists as to whether the return should be prepared, such as multiple beneficiaries of the decedent's estate or where the surviving spouse is not a beneficiary of the decedent's estate and the estate passes to the decedent's children (think blended families). After all, portability has the potential to benefit the beneficiaries of the surviving spouse's estate, who may not be the same as the beneficiaries of the decedent's estate.

If language is included in testamentary documents providing that the return may be prepared, then the mechanics of doing so and how the associated costs will be paid should also be addressed. For example, as a starting point, one might consider adding language to a Will that provides, in effect:

> My Executor may make the election described in section 2010(c)(5) of the Code to compute my unused exclusion amount and thereby permit my spouse to take that amount into account. My Executor may incur and pay reasonable expenses to prepare and file any estate tax return or other documentation necessary to make such election, and to defend against any audit thereof.

-or-

> If my surviving spouse so elects, and agrees to pay to or reimburse my estate for the reasonable costs incurred by my Executor in preparing and of filing an estate tax return required only to make the required election, my Executor shall make the election described in section 2010(c)(5) of the Code to compute my unused exclusion amount and thereby permit my spouse to take that amount into account. My spouse shall advance or reimburse to my Executor all reasonable expenses necessary to prepare and file any estate tax return or other documentation necessary to make such election, and to defend against any audit thereof.

Generally, a portability election must be made on a timely filed estate tax return (including extensions). § 2010(c)(5)(a). The regulations make it clear that the last return filed by the due date (including extensions) controls. Subject to restrictions when more than one person may make the election (discussed below), before the due date, the executor can supersede the election made on a prior return. After the due date, the portability election (or non-election) is irrevocable. Treas. Reg. § 20.2010-2(a)(4).

Rev. Proc. 2022-32 updates Rev. Proc. 2017-34 to allow a longer period for "late" portability elections. The reason is not policy but practicality: the IRS continues to be inundated by requests for relief. The Rev. Proc. states:

> .04 On June 26, 2017, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) published Rev. Proc. 2017-34, which provides a method for obtaining an extension of time under § 301.9100-3 to make a portability election under § 2010(c)(5)(A) that is available to the estates of decedents dying after December 31, 2010, if that estate was not required by § 6018(a) to file an estate tax return and if such a decedent was survived by a spouse. Under Rev. Proc. 2017-34, this method is a simplified method that is to be used in lieu of the letter ruling process and is available for a period extending to the second anniversary of the decedent's date of death.
>
> .05 Since the publication of Rev. Proc. 2017-34, the IRS has continued to issue numerous letter rulings under § 301.9100-3 granting an extension of time to elect portability under § 2010(c)(5)(A) in situations in which the decedent's estate was not required by § 6018(a) to file an estate tax return and the time for obtaining relief under the simplified method had expired. The IRS has observed that a significant percentage of these ruling requests have been from estates of decedents who died within five years preceding the date of the request. The number of these requests continues to place a significant burden on the available resources of the IRS. The Treasury Department and the IRS have determined that the considerable number of ruling requests for an extension of time to elect portability received since the publication of Rev. Proc. 2017-34 indicates a need for continuing relief for the estates of decedents having no filing requirement under § 6018(a). Accordingly, this revenue procedure supersedes Rev. Proc. 2017-34 and updates the procedures set forth therein by extending the period within which the estate of a decedent may make the portability election under that simplified method to on or before the fifth anniversary of the decedent's date of death.

This procedure is exclusive as noted in the Effective Date Provisions:

> SECTION 7. EFFECTIVE DATE
>
> .01 In General. This revenue procedure is effective July 8, 2022.
>
> .02 Letter Rulings Will Not Be Issued. On or before the fifth anniversary of a decedent's date of death, the exclusive procedure for obtaining an extension of time under § 301.9100-3 to make a portability election under § 2010(c)(5)(A) for the estate of a decedent, if the decedent and executor meet the requirements of section 3.01(1) through (3) of this revenue procedure, is the procedure described in section 4.01 of this revenue procedure. If an executor of such an estate has filed a request for a letter ruling seeking an extension of time under § 301.9100-3 to make a portability election under § 2010(c)(5)(A) and that letter ruling is pending in the National Office on July 8, 2022, the Office of the Associate Chief Counsel (Passthroughs & Special Industries) will close its file on the ruling request and refund the user fee, and the estate may obtain the relief granted by this revenue procedure only by complying with section 4.01 of this revenue procedure.

Does the effective date provision mean that the decedent had to die before the effective date, or that no filing was made (or due) before the effective date? The Ruling is oblique.

The election is made by filing a "complete and properly-prepared" estate tax return. Treas. Reg. § 20.2010-2(a)(2). There is no box to check or statement to attach to the return to make the election. Part 6 on page 4 of IRS Form 706 provides, "A decedent with a surviving spouse elects portability of the deceased spousal unused exclusion (DSUE) amount, if any, by completing and timely-filing this return. No further action is required to elect portability of the DSUE amount to allow the surviving spouse to use the decedent's DSUE amount." Part 6, Section A of Form 706 also includes a box to check to opt out of portability. Of course, another way of not making the election for estates below the filing threshold is to simply not file a return. Treas. Reg. § 20.2010-2(a)(2)-(3). When Treasury was drafting final regulations commentators asked for inclusion of a "protective: portability election. For example, if there is a will contest, the DSUE amount may depend on who wins the contest. Until the contest is resolved, there may be no way of knowing who the executor is, or even who is in actual or constructive possession of property unless the court appoints a temporary executor. The suggestion wasn't adopted.

A "complete and properly-prepared" return is generally one that is prepared in accordance with the estate tax return instructions. However, Treasury regulations provide relaxed requirements for reporting values of certain assets. For assets that qualify for a marital or charitable deduction, the return does not have to report the *values* of such assets, but only the description, ownership, and/or beneficiary of the property together with information to establish the right to the deduction. However, the values of assets passing to a spouse or charity must be reported in certain circumstances (where the value relates to determining the amounts passing to other beneficiaries; if only a portion of the property passes to a spouse or charity; if there is a partial disclaimer or partial QTIP election (i.e. an election to qualify the trust as Qualified Terminable Interest Property or "QTIP" for marital deduction purposes); or if the value is needed to determine the estate's eligibility for alternate valuation (2032), special use valuation (2032A), or Section 6166 estate tax deferral). Treas. Reg. § 20.2010-2(a)(7)(ii)(A). Therefore, assets passing to a bypass trust are not eligible for the relaxed valuation rules.

In any event, the executor must exercise "due diligence to estimate the fair market value of the gross estate" including property passing to a spouse or charity. The executor must identify the range of values within which the "executor's best estimate" of the gross estate falls. The current instructions to IRS Form 706 provide that estimated values be rounded up to the nearest $250,000, up to $11 million then it is up to the next $180,000. *See* Instructions to Form 706 (revised September 2022), for decedents dying after December 31, 2021, p. 19.

c. Last Deceased Spouse

A surviving spouse may only use the exclusion of the spouse's "last deceased spouse." § 2010(c)(4)(B)(i). Under the Treasury regulations discussed below, "last deceased spouse" means "the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse." But as noted below, at various times based on the timing of transfers made by a surviving spouse, a person may have more than one "last deceased spouse." Treas. Reg. § 20.2010-1(d)(5). As a result, under some circumstances, a surviving spouse may use the DSUE amount of multiple last deceased spouses.

d. Nonresidents Who are Not Citizens

(i) Decedent Nonresident. If a decedent is a nonresident and not a citizen of the United States, the executor of that decedent's estate cannot make a portability election. No DSUE amount is available to the surviving spouse of the nonresident decedent. Treas. Reg. § 20.2010-2(a)(5). The Preamble does not offer an explanation for this conclusion, but it does make sense. The portability rules of Section 2010 are in Subchapter A of Chapter 11 of the Code, which Subchapter is titled "Estates of Citizens or Residents." Subchapter B, titled "Estates of Nonresidents Not Citizens" contains no discussion of the portability concept.

(ii) Nonresident Surviving Spouse. A surviving spouse of a decedent may not make any use of the DSUE amount for that person's last deceased spouse any time the surviving spouse is a nonresident/noncitizen for either estate or gift tax purposes, unless allowed under an applicable treaty. Treas. Reg. §§ 20.2010-3(e), 25.2505-2(f). The final regulations clarify that if the surviving spouse subsequently becomes a resident or citizen, that individual then could utilize the DSUE amount for subsequent gifts or at the individual's death

because the individual would then be a resident or citizen. Treas. Reg. §§ 20.2010-3(c)(3)(ii); 25.2505-2(d)(3)(ii). Therefore, even when the surviving spouse is a nonresident, he or she (or the executor) should consider filing an estate tax return in order to make the portability election and capture the resident deceased spouse's DSUE amount.

(iii) Qualified Domestic Trusts. If a decedent who is survived by a non-resident spouse transfers property to a qualified domestic trust ("QDOT"), the estate is allowed a marital deduction. § 2056A. When distributions are made from the QDOT or when trust assets are distributed at the termination of the QDOT, an estate tax is imposed on the transfers as the decedent's estate tax liability. § 2056A(b). Accordingly, subsequent transfers from a QDOT would reduce the amount of the decedent's unused exclusion amount.

The regulations provide that when a QDOT is created for the surviving spouse, the executor of the decedent's estate who makes the portability election will compute a preliminary DSUE amount that may decrease as distributions constituting taxable events under section 2056A are made. The surviving spouse will not be able to make any use of the DSUE amount from the decedent who created a QDOT until the date of the event that triggers the final estate tax liability of the decedent under section 2056A with respect to the QDOT. That typically would not occur until the surviving spouse's subsequent death, or until there is a terminating distribution of all of the assets of the QDOT to the surviving spouse during his or her lifetime. Treas. Reg. §§ 20.2010-3(c)(3), 25.2505-2(d)(3).

> Example: H, a U.S. citizen, made a taxable gift in 2002, valued at $1 million, and reported the gift on a timely-filed gift tax return. No gift tax was due because the applicable gift tax exclusion amount for that year ($1 million) equaled the fair market value of the gift. H died in 2011 with a gross estate of $2 million. H's Will made a pecuniary bequest of $1.5 million to a QDOT for the benefit of W, who was not a U.S. citizen. H's executor timely filed an estate tax return and made the QDOT election for the property passing to the QDOT. As a result, H's estate was allowed a marital deduction of $1.5 million for the value of that property. H's taxable estate is $500,000. On H's estate tax return, H's executor computes H's preliminary DSUE amount to be $3.5 million (the excess of H's $5 million applicable exclusion amount over the sum of the $500,000 taxable estate and the $1 million adjusted taxable gifts). No taxable events within the meaning of section 2056A occurred during W's lifetime with respect to the QDOT, and W made no taxable gifts. In 2012, W dies and the value of the assets of the QDOT is $1,800,000. H's DSUE amount is redetermined to be $1.7 million (the lesser of (i) the $5 million basic exclusion amount in 2011, or (ii) the excess of H's $5 million applicable exclusion amount over $3.3 million (the sum of the $500,000 taxable estate augmented by the $1.8 million of QDOT assets and the $1 million adjusted taxable gifts)).

> Example: H, a U.S. citizen, dies in Jan. 2011 having made no taxable gifts during his lifetime. H's gross estate is $3 million. H's wife W is a U.S. resident but not a U.S. citizen. Under H's Will, a pecuniary bequest of $2 million passes to a QDOT for the benefit of W. H's executor timely files an estate tax return and makes the QDOT election for the property passing to the QDOT. As a result, H's estate is allowed a marital deduction of $2 million for the value of that property. H's taxable estate is $1 million. On H's estate tax return, H's executor computes H's preliminary DSUE amount to be $4 million. No taxable events occur during W's lifetime with respect to the QDOT. W makes a taxable gift of $1 million to her child in Dec. 2011 and another taxable gift of $1 million to her child in Jan. 2012. W dies in Sept. 2012, not having married again, when the value of the assets of the QDOT is $2.2 million. H's DSUE amount is redetermined to be $1.8 million (the lesser of (i) the $5 million basic exclusion amount in 2011, or (ii) the excess of H's $5 million applicable exclusion amount over $3.2 million (the sum of the $1 million taxable estate augmented by the $2.2 million of QDOT assets)). On W's gift tax return filed for 2011, W cannot apply any DSUE amount to her gift. However, because W's 2012 taxable gift was made in the year that W died, W's executor will be allowed to apply $1 million of H's redetermined DSUE amount to the gift on W's gift tax return filed for 2012. The remaining $800,000 of H's redetermined DSUE amount is included in W's applicable exclusion amount to be used in computing W's estate tax liability.

(iv) Statute of Limitations For Considering Determination of DSUE Amount. Section 2010(c)(5)(b) provides that the IRS "may examine a return of the deceased spouse" to make determinations in carrying out the portability provisions without regard to any period of limitations under Section 6501. The regulations confirm that the IRS may examine the returns of each previously deceased spouse whose DSUE amount is claimed to be

included in the surviving spouse's applicable exclusion amount at the time of any transfer by the surviving spouse, regardless of whether the period of limitations on assessment has expired on such returns. The IRS may adjust or eliminate the DSUE amount based on such examination, but it may not assess additional estate tax against a prior deceased spouse's return unless the applicable period of limitations on assessment of estate tax is still open. Treas. Reg. §§ 20.2001-2(a), 20.2010-2(d), 20.2010-3(d), and 25.2505-2(e); see also, Est. of Sower v. Comm'r, 149 TC 249 (2017).

C. Estate Tax Reduction Strategies

1. Outright Gifting.

Outright gifts lack the sizzle and sophistication of the alphabet soup of more exotic techniques. Simple annual exclusion gifts, however, can have a dramatic effect on wealth shifting over time. For clients willing to pay a current gift tax or use a portion of their lifetime gift tax exclusions, the results can be impressive. Making gifts can be even more effective when the value of the assets given are depressed, and when the number of donees is large.

a. The Technique. Outright gifts can be as simple as handing cash or writing a check to the donee. Gifts can take the form of stock, real estate (or undivided interests in real estate), life insurance policies, or family limited partnership interests. Gifts to minors can be placed into custodial accounts (although to ensure that the assets are not included in the donor's estate if he or she dies before the donee reaches age 21, the donor should not serve as custodian). Section 529 plans offer another opportunity for gifting to minors, although gifts to Section 529 plans must take the form of cash. For clients that expect to pay estate tax at death, even taxable gifts may make sense, since the gift tax is tax exclusive (i.e., it is based upon the net amount received by the donee), whereas the estate tax is tax inclusive (i.e., all dollars are subject to the estate tax, including the dollars used to pay the tax). It is important to remember that for estate tax reporting, adjusted taxable gifts are added back in as part of calculating the gross estate tax. § 2001(b).

b. What to Give. Despite the basis issues discussed below (and above), estate planners often recommend making outright gifts when market conditions are depressed–sometimes called "natural discounting" (i.e., making gifts of stock when the stock market takes a significant downturn, or gifts of real estate or oil and gas interests when those markets are depressed). As mentioned above, post-gift appreciation lands in the junior generation's hands with no gift or estate tax.

Another ideal candidate for gifting to younger-generation family members (or to a trust for their benefit) is life insurance, which in virtually all cases will have a value for gift tax purposes lower (and in many cases significantly lower) than the value of the death benefit paid upon the death of the insured. Once ownership of the life insurance policy is changed, the insured can make ongoing gifts of cash to the new owner to enable the owner to pay life insurance premiums as they come due. The almost automatic benefit of shifting life insurance death benefits out of one's estate at a low gift tax cost has caused Congress to impose a three-year "wait" on the effectiveness of this strategy. That is, if there is a transfer of an existing life insurance policy owned by the insured, and the insured dies within three years of the transfer, the insurance proceeds are nevertheless included in the taxable estate of the insured. § 2036(a)(2). The use of this strategy in conjunction with an irrevocable life insurance trust is discussed below.

c. Clawback. Prior to ATRA 2012, a concern existed as to whether clawback might arise in the traditional transfer tax area. For estate and gift tax purposes, the concern regarding clawback centered around the potential difference between the amount of the gift tax exclusion in the year that a gift was made and the amount of the estate tax exclusion in the year of the donor's death. In other words, if a taxable gift was made in a year when the exclusion was greater than in the year of the donor's death and then adjusted taxable gifts were added back into the donor's estate for estate tax purposes, the estate would have to use the lower estate tax exclusion amount which might not cover the donor's adjusted lifetime taxable gifts! With the enactment of ATRA 2012, because the exclusion amount did not decrease but instead continued to increase each year as a result of the inflation adjustment, the issue of clawback in relation to gifting went away. And then came December 2017. With the enactment of TCJA 2017 and the potential return in year 2026 to the exclusion amounts of ATRA 2012, the concern regarding clawback in the transfer tax area has returned. As part of TCJA 2017, rather than addressing this issue directly, Section 2001(g) was amended to provide that regulations are to be issued as needed to deal with the difference between the basic exclusion

amount that applies when a decedent dies and the amount applicable at the time the decedent made any gifts. § 2001(g)(2).

On November 23, 2018, Treasury and the IRS issued proposed regulations pursuant to the mandate of section 2001(g). The preamble to the proposed regulations noted four circumstances in which clawback might arise for gift and estate tax purposes: (i) the donor makes taxable gifts resulting in the payment of gift tax when the exclusion amount is high, and then makes additional taxable gifts when the exclusion amount is reduced; (ii) the donor makes taxable gifts resulting in the payment of gift tax when the exclusion amount is high, and then dies at a time when the exclusion amount is reduced; (iii) a donor makes gifts sheltered by a higher exclusion amount and then makes taxable gifts after the exclusion amount is reduced, and (iv) a donor makes gifts sheltered by a higher exclusion amount and then dies after the exclusion amount is reduced. The preamble goes through a detailed examination of the steps required to compute gift and estate taxes, and concludes that in the first three of these scenarios, the existing computations ensure that the donor gets the benefit of the higher exclusion amount. In the fourth scenario, however, the way in which estate tax is computed (adding together net estate and adjusted taxable gifts, computing tax on the total, and then subtracting the applicable exclusion amount available in the year of death), would cost the decedent the benefit of a higher exclusion amount, resulting in "clawback." As a result, Treasury and the IRS issued proposed § 20.2010-1(c) providing that if the total of the amounts allowable as a credit in computing the gift tax payable on a decedent's post-1976 gifts exceeds the credit allowable in computing the estate tax when applying the tax rates in effect at the decedent's death, then the portion of the credit allowable in computing the estate tax attributable to the basic exclusion amount is the sum of the amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts. The amount allowable as a credit in computing gift tax payable for any year may not exceed the tentative tax on the gifts made during that year, and the amount allowable as a credit in computing the estate tax may not exceed the net tentative tax on the taxable estate.

The proposed regulations were made final on November 26, 2019, although with a few wrinkles. In effect, the final regulations confirm that no clawback will occur in the fourth scenario above, which is good news. Again, the concern surrounds how to address situations when the dollar amount of the basic exclusion amount changes from when someone makes a gift and then when that person dies. In addressing how any credit is to be applied when computing gift tax payable, Treasury Regulation § 20.2010-1(c)(1)(ii) provides that if the decedent has any DSUE amount available, the DSUE amount is deemed to be applied to gifts before the decedent's basic exclusion amount is applied. Treasury Regulation §§ 20.2010-1(e)(4) and 20.2010-2(c)(1) make it clear that when calculating the DSUE amount, the basic exclusion amount to be considered for the deceased spouse is the basic exclusion amount in the year of death of that deceased spouse and the deceased spouse's application exclusion amount cannot exceed the basic exclusion amount in effect for that year.

As with the proposed regulations, the Preamble to the final regulations is important, especially in these interim years of 2018-2025 when the basic exclusion amount is higher and clients may be considering making larger gifts than would be within the increased basic exclusion amount available to them now. The comment had been made as to whether the increase in the basic exclusion amount could be used against gifts first – "taking it off the top" – so that when the basic exclusion amount decreases, the base portion of the basic exclusion amount would still be available. The regulations adopt a bottom-up approach, which means that in order for a taxpayer to use the taxpayer's full exemption the taxpayer must make adjusted taxable gifts of that amount. Accordingly, spouses may be better off having one use all of one spouse's exemption before the other spouse uses any, all other things being equal (which is rarely the case).

Treasury has issued Proposed Regulations dealing with "Abuses" under section 2010. Reg-118913-21. The general theory of the proposed regulations is that if a taxpayer wants to use the "bonus exclusion" – the amount "added" by the 2017 Tax Act – the taxpayer must totally part with the gifted amount. A taxpayer who retains an interest, as in a QPRT or a GRAT, and has the gifted assets added back (as, for instance, happens if the taxpayer dies during the term) will have the original gift washed out under 2001(b) but will only benefit from whatever the exclusion amount is in the taxpayer's year of death. The proposed regulations do not affect trusts in which a spouse has an interest (unless section 2036 applies) but may affect gifts triggered by section 2519. The proposed regulation is short and provides:

§ 20.2010-1 Unified credit against estate tax; in general.

* * * * *

(c) * * *

(3) Exception to the special rule —(i) Transfers to which the special rule does not apply. Except as provided in paragraph (c)(3)(ii) of this section, the special rule of paragraph (c) of this section does not apply to transfers includible in the gross estate, or treated as includible in the gross estate for purposes of section 2001(b), including without limitation the following transfers:

(A) Transfers includible in the gross estate pursuant to section 2035, 2036, 2037, 2038, or 2042, regardless of whether all or any part of the transfer was deductible pursuant to section 2522 or 2523;

(B) Transfers made by enforceable promise to the extent they remain unsatisfied as of the date of death;

(C) Transfers described in § 25.2701-5(a)(4) or § 25.2702-6(a)(1) of this chapter; and

(D) Transfers that would have been described in paragraph (c)(3)(i)(A), (B), or (C) of this section but for the transfer, relinquishment, or elimination of an interest, power, or property, effectuated within 18 months of the date of the decedent's death by the decedent alone, by the decedent in conjunction with any other person, or by any other person.

(ii) Transfers to which the special rule continues to apply. Notwithstanding paragraph (c)(3)(i) of this section, the special rule of paragraph (c) of this section applies to the following transfers:

(A) Transfers includible in the gross estate in which the value of the taxable portion of the transfer, determined as of the date of the transfer, was 5 percent or less of the total value of the transfer; and

(B) Transfers, relinquishments, or eliminations described in paragraph (c)(3)(i)(D) of this section effectuated by the termination of the durational period described in the original instrument of transfer by either the mere passage of time or the death of any person.

The Supplementary Information explains the proposal as follows:

> Section 2001(b) (flush language) excludes from the term "adjusted taxable gifts" gifts that are includible in the gross estate. Section 2701(e)(6) and § 25.2701-5 similarly remove from adjusted taxable gifts transfers includible in the gross estate that previously were subject to the special valuation rules of section 2701. See also § 25.2702-6 (excluding from adjusted taxable gifts certain transfers includible in the gross estate that previously were subject to the special valuation rules of section 2702) and Rev. Rul. 84-25, 1984-1 C.B. 191 (excluding from adjusted taxable gifts completed transfers that will be satisfied with assets includible in the gross estate). In keeping with the statutory distinction between completed gifts that are treated as adjusted taxable gifts and completed gifts that are treated as testamentary transfers, these proposed regulations generally would deny the benefit of the special rule to includible gifts.

Regardless of whether a gift is treated as an adjusted taxable gift or as an includible gift for estate tax purposes, the Code ensures that the gift is treated consistently with respect to the credits allowable in the year in which the gift was made. See discussion of the five statutory steps of the estate tax computation in part III, Federal Estate Tax Computation Generally, in the Background section of the preamble to the notice of proposed rulemaking under section 2010 (REG-106706-18) published in the Federal Register (83 FR 59343) on November 23, 2018. The exclusion from adjusted taxable gifts of transfers includible in the gross estate does not affect the second step of the estate tax computation, the determination of a hypothetical gift tax referred to as the gift tax payable. Gift tax payable is based upon all post-1976 taxable gifts, whether or not included in the gross estate. See sections 2001(b)(2) and (g)(1), requiring the determination of a hypothetical gift tax on all post-1976 taxable gifts, which is a gift tax reduced, but not to below zero, by the credit amounts allowable in the years of the gifts. Both the hypothetical gift tax and the credit amounts are computed using the gift tax rates in effect at the date of death. Thus, for purposes of computing the estate tax, an includible gift receives credit for all credit amounts, including those attributable to the increased BEA, allowable in the years in which the gift was made.

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The purpose of the special rule is to ensure that bona fide inter vivos transfers of property are consistently treated as a transfer of property by gift for both gift and estate tax purposes. Bona fide inter vivos gifts are subject to the gift tax based on the values, gift tax rates, and exclusions applicable as of the date of the gift. While such a gift is treated as an adjusted taxable gift for purposes of determining the estate tax rate to be applied to the value of the taxable estate, the gift is not includible in the donor's gross estate at death and is not subject to the estate tax. The special rule avoids the imposition of the estate tax on the gift by ensuring that the gifted property is treated solely as an adjusted taxable gift and not also as property includible in the gross estate.

Unlike an adjusted taxable gift, however, a gift of property that is includible in the donor's gross estate is subject to estate tax based on the values, estate tax rates, and exclusions applicable as of the date of death. The Code itself ensures that an includible gift is not treated as both an adjusted taxable gift and an inclusion in the gross estate. See section 2001(b) (flush language), excluding from "adjusted taxable gifts" gifts that are includible in the gross estate. The Code also ensures that an includible gift receives credit for any credit amounts allowable in the years in which the gift was made. See sections 2001(b)(2) and (g)(1). The treatment of an includible gift for estate tax purposes results in the correct outcome without any application of the special rule: The property is included in the gross estate and subject to the BEA in effect at the donor's death.

There is a subset of includible gifts that the Code treats in a different fashion, but still in a way that results in the correct outcome without the application of the special rule. That subset consists of gifts made during an increased BEA period that are essentially testamentary, but the entire value of which is deductible for gift tax purposes by reason of the charitable or marital deduction (or both). Such transfers are excluded from adjusted taxable gifts because they never were taxable gifts in the first place. See section 2503(a), defining taxable gifts as the total amount of gifts made during the calendar year less the deductions provided in sections 2522 and 2523 for charitable and marital gifts, respectively. As a result of the exclusion of charitable and marital gifts from taxable gifts, and thus from adjusted taxable gifts, there would be no credits allocable to these gifts attributable

to the BEA in computing gift tax payable within the meaning of section 2001(b)(2). Because no BEA is applicable to the deductible gifts, there will be no difference between the BEA applicable to these gifts attributable to the increased BEA and the BEA applicable to the decedent's estate. As a result, there is no possibility of inconsistent gift and estate taxation of such an includible gift, and thus no need for the application of the special rule.

Without additional rules, however, the application of the special rule to includible gifts results in securing the benefit of the increased BEA in circumstances where the donor continues to have the title, possession, use, benefit, control, or enjoyment of the transferred property during life. In those circumstances, there is no possibility of the inclusion of the gift in adjusted taxable gifts at the death of the donor, and therefore no need for the application of the special rule to transfers of such property. In those circumstances, it is appropriate that the amount includible or treated as includible as part of the gross estate (rather than as an adjusted taxable gift) is subject to estate tax with the benefit of only the BEA available at the date of death. Section 2001(g)(2) directs the Secretary to prescribe such regulations as may be necessary or appropriate to carry out section 2001 with respect to any difference between the BEA applicable at the time of the decedent's death and the BEA applicable with respect to any gifts made by the decedent. Given the plain language of the Code describing the computation of the estate tax and directing that certain transfers, including transfers made within three years of death that otherwise would have been includible in the gross estate, are treated as testamentary transfers and not as adjusted taxable gifts, it would be inappropriate to apply the special rule to includible gifts. This is particularly true where the inter vivos transfers are not true bona fide transfers in which the decedent "absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property." *Commissioner* v. *Church's Estate,* 335 U.S. 632, 645 (1949). To prevent this inappropriate result, these proposed regulations would create an exception to the special rule applicable to includible gifts.

A number of examples, some confusing, are included. The effect of the proposed regulation is to penalize the middle-rich: those who can afford to make large gifts but not necessarily to sever all connection to the gifted assets. Applying the anti-abuse rule to achieve "boomerang clawback" to gifts by promise (allowed in Pennsylvania) is generally uncontroversial. However, applying boomerang clawback to gifts "discounted" via sections 2701 and 2702 are subject to more criticism. For example, suppose a grantor created a QPRT in 2022 with a taxable gift equal to $12,060,000. If the donor dies before the term expires such the QPRT assets are included in the grantor's estate and in that year the estate tax exemption is less than $12,060,000, then is it fair that the grantor's "use" of the 2022 exemption is ignored?

d. Gift Tax and the Three-Year Rule. If gift tax is actually paid by a donor, the tax savings that results from the tax-exclusive nature of the gift tax is available only if the senior family member lives for at least three years after making the gift. Congress, recognizing that the gift tax is cheaper than the estate tax, imposes a special rule to prevent death-bed gifts to minimize tax. As a result, if a donor dies during the 3-year period after making the gift, any gift taxes attributable to the gift are added to the donor's gross estate for federal estate tax purposes. § 2035(b).

e. Carryover Basis. In making gifts, the issue of basis is always important. Section 1014 generally provides that an inherited asset gets a new cost basis equal to its value for federal estate tax purposes. However, property received by gift generally receives a carryover of the donor's basis, increased (but not above fair market value) by the amount of any gift tax paid with respect to the gift. § 1015. In fact, if the beneficiary sells the property for less than the donor's basis, the beneficiary may have his or her basis limited to the fair market value of the property at the date of the gift, if that value is less than the donor's basis. § 1015(a). However, with top capital gains rates at 23.8% and the top estate tax rate at 40%, in most situations, a gift is still more beneficial from an overall

tax perspective. This is especially true if the gifted asset is held for a long period of time (thereby deferring the recognition of any income tax payable on the gain), and continues to appreciate in value after the gift is made.

One can determine how much an asset must appreciate for any estate tax savings to exceed the income tax costs of a loss of basis step-up by applying an algebraic formula to compute a "tax efficient appreciation factor." The formula of 1 + [Unrealized appreciation x ((Income tax rate/(Estate tax rate-Income tax rate)) / Total gift] provides a growth multiple by which the gifted asset needs to appreciate to create estate tax savings sufficient to offset the income tax liability inherent in the appreciation at the time of the gift. For example, at current tax rates, a $5 million gift with $1 million of unrealized appreciation would need to appreciate by a factor of 1.29 (to $6.7 million) for the estate tax savings to offset the income tax cost associated with a loss of step-up in basis: 1 + [$1 million x ((.238/(.40-.238))/$5 million] = 1.29.

f. Income Tax Issues. As with intra-family loans and as discussed below, the impact of income taxes on the junior family members needs to be considered. If the senior family members want to assume responsibility for tax on the income earned on the gifted property, the gift can be made to a grantor trust instead of outright to the junior family members. That way, the income tax burden on the assets gifted to the junior family members can remain the responsibility of the senior family member without any additional gift tax. See Rev. Rul. 2004-64.

Making gifts to grantor trusts is a remarkably effective strategy. Cash accumulations in the trust may be “swapped” for assets owned by the client so every year the client’s estate decreases and the trust increases. The cash may be used to pay taxes and for other spending. A “sale” to the trust for a note is, essentially, a swap using fixed values at that time.

g. Disclosure To The Client. When making gifts, sales, or other transfers, informing the client(s) about basis and income tax is important. In Wellin v. Farace, 2023 WL 2918919 (D. Ct. S.C. 2023), the Federal district court refused to dismiss a malpractice claim. The case involves interesting evidentiary matters, but of primary interest to estate planners is the central substantive claim by the plaintiff. The decedent formed a limited partnership in 2003 that owned $90 million of Berkshire-Hathaway stock. The decedent owned 98.9% of the partnership and the decedent’s children through an LLC owned 1.1%. In 2008, the decedent was diagnosed with cancer, and in 2009 he sold his units to an irrevocable grantor trust for a note (taking a 45% discount). In 2013, the decedent fired his lawyer, hired new counsel, and sued the children saying he didn’t know he had lost control over the partnership and he didn’t know if the children sold the stock while he was living then he would pay the income tax. Late in 2013, the stock was sold and the decedent died in September 2014. Whether the decedent would have done the sale had he known what would happen if the stock were sold during his lifetime is the front and center issue. However, another element of potential damages is “lost profit,” on account of the sale. In short, explaining carryover basis and potential income tax on phantom income is important.

h. Giving Discounted Assets. Gifting for wealth transfer usually focuses on giving low valued assets. These values may be the result of market forces, or may result from introduced factors such as gifts of interests in businesses that have lack-of-marketability and minority-interest discounts. If, for example, a fractional interest in real estate or a limited partnership interest in a family limited partnership is being gifted, the leveraging can be magnified.

i. Gifts By Both Spouses. If a gift by one spouse is made with separate property and the gift does not create a general power of appointment in the other spouse, the gift can be treated as being made one-half by each spouse by gift splitting, which requires the filing of a gift tax return by each spouse and making the election to gift split. § 2513; Treas. Reg. § 25.2513-2. Note that if gift splitting would cause each gift to be less than the amount of the annual gift tax exclusion amount, filing gift tax returns to make the election are not necessary. Treas. Reg. § 25.2513-1(c). Technically, the regulation states if the gift by one spouse does not exceed $20,000, but the gift tax return instructions use the current annual gift tax exclusion amount. Gift splitting is an "all or nothing" election in that when the spouses make the election, all gifts are treated as being split. Treas. Reg. § 25.2513-1(b)(5). If a gift is of community property, gift splitting is not necessary because gifts of community property are treated as being made one-half by each spouse.

2. Irrevocable Life Insurance Trusts.

a. Structure. A grantor who desires to acquire life insurance establishes an irrevocable trust with someone else serving as trustee. Instead of purchasing the policy himself, he makes a gift of cash to the trustee. The trustee applies for life insurance on the life of the grantor and uses the cash gift to pay the premium. The trustee of the ILIT is named as the beneficiary of the policy. The grantor may make a large cash gift to the trustee to cover future premiums, but more commonly, each subsequent year, as premiums become due, the grantor makes a cash gift to the trust, and the trustee in turn pays the premiums. Formalities are followed, of course, so that the gifts qualify as present interest gifts, typically that each beneficiary of the trust has a 30 day right of withdrawal that lapses to the extent of 5% of the fair market of the trust assets each year (a Crummey hanging power). If the ILIT provides for second-generation planning, for each year that gifts are made, the grantor files a gift tax return allocating GST-tax exemption, even if the gifts are less than the annual gift tax exclusion amount. If a primary purpose of the life insurance is to provide liquidity for estate tax purposes, for a married couple, the trust can be established by both spouses and own second-to-die insurance. If the grantor has an existing policy that he wishes to remove from his estate, he could assign ownership of the policy to the trustee, but see the discussion of the three-year rule below.

b. Incidents of Ownership. In order to accomplish the objective of excluding the proceeds from the grantor's estate, the insured must not possess any direct or indirect interest in the insurance policy owned by the trust. If the insured possesses any "incident of ownership" over the policy, whether economic or by retaining control, the policy proceeds are subject to federal estate tax in the insured's estate. § 2042. If the policy is community property, only one-half is includable in the deceased spouse's estate. Treas. Reg. § 20.2042-1(a)(3). If the insured is married and the insured's spouse is a trust beneficiary, the non-insured spouse must not make contributions to the trust or the spouse will be treated as a grantor, causing inclusion of proceeds in the spouse's estate. For clients who would otherwise use community property funds to make gifts, those funds should be partitioned so that only separate property funds are used.

c. The Three-Year Rule. One of the problems in attempting to remove existing life insurance from the insured's estate is the avoidance of the "three-year rule" set forth in section 2035. Any transfer of a life insurance policy by the insured results in inclusion of the proceeds in the insured's estate, if the transfer was made within three years of the insured's death and the transfer was not a bona fide sale for adequate and full consideration. § 2035(d).

Because only a transfer by the insured is subject to application of the rule, if an existing policy that was initially purchased by the insured-grantor is being used, one solution is to have the intended donee, i.e. the trust, purchase the policy from the insured-grantor rather than transferring an existing policy to the trust, so that there will be no transfer of the policy for less than adequate and full consideration. For guidance on valuing a life insurance policy, see Jansen, *That Life Insurance Policy may be Worth More than You Think! (Types of Policies and Their Value)*, State Bar of Texas 40th Ann. Adv. Est. Pl. & Prob. Course (2016). However, if an existing policy is purchased, one must be mindful of the "transfer for value" rules which in some circumstances cause the death benefit to be income taxable to the purchaser of the policy. § 101(a)(2). The transfer for value rules do not apply if the transfer is to the insured, to a partner of the insured, or to a partnership in which the insured is a partner. § 101(a)(2)(B). If the ILIT that purchases the policy is a grantor trust, the policy should be treated as being acquired by the insured for income tax purposes, thus avoiding this issue. See, e.g., PLR 201332001. In addition, the transfer for value rules may be avoided if the insured and the ILIT are partners, even if the ILIT is not a grantor trust (for example, where the ILIT holds an interest in a limited partnership in which the insured is also a partner).

An important line of cases dealt with the purchase of insurance by an irrevocable life insurance trust, using funds furnished by the decedent – the typical structure of an ILIT. Although no formal transfer of the insurance policy by the insured occurs, years ago, the IRS took the position that the arrangement was in substance the same as a transaction whereby the insured bought the policy and then transferred it to the trust. In several cases, the courts held that under this set of facts, the taxpayer never possessed incidents of ownership so section 2035 was inapplicable. As a result, the IRS has abandoned its position in this area. A.O.D. 1991-012. Therefore, if a new policy is initially purchased by the trustee, the three-year rule will not apply.

d. The Life Insurance Trust As A Grantor Trust. In order to provide greater flexibility regarding the policy, the ILIT may be structured as a grantor trust. A common method of causing the ILIT to be a

grantor trust is to include a so-called "swap power." A swap power would allow the grantor, in a nonfiduciary capacity and without the consent of a fiduciary, to reacquire the trust assets by substituting assets of equivalent value. § 675(4). The IRS has ruled that this power is not considered an incident of ownership by the grantor as long as the trustee has a fiduciary obligation to ensure that the substituted assets are of equivalent value and that the power cannot be exercised in a way that can shift beneficial interests. See Est. of Jordahl v. Comm'r, 65 TC 92 (1975); Rev. Rul. 2011-28. A swap power will not be deemed to shift benefits if: (a) the trustee has the power to reinvest trust assets and has a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of its income does not affect the interests of the beneficiaries (such as when the trust is administered as a unitrust or when distributions are limited to discretionary amounts of principal and income). Id.

If the trust is a grantor trust, the grantor may be able to sell an existing policy to the trust while avoiding the three-year rule discussed above. In addition, because the trust is irrevocable, it may be difficult to change provisions in later years as circumstances change. By having the trust be a grantor trust, it would be possible to establish a new grantor trust with the desired terms and funded with cash, and then have the new trust purchase the policy without causing negative estate or income tax consequences to the grantor.

e. Split-Dollar Arrangements. When contemplating how to pay the premiums for a policy given to an ILIT, the parties may consider using a "split-dollar" arrangement. "Split-dollar" is not a type of insurance, rather, it is an arrangement in which two parties jointly pay the policy premiums and split one or more of the policy benefits. The requirements to structure split-dollar arrangements properly involving an ILIT, including the differences between the economic benefit and loan regimes, are quite technical. In general, Treasury Regulations define a "split-dollar arrangement" as an arrangement between an owner and non-owner in which (1) either party pays all or part of the premiums, (2) the premium-paying party may recover all or any part of the premiums, and (3) that recovery will be made from the policy values or proceeds, or will be secured by the insurance contract. Treas. Reg. § 1.61-22(b)(1).

Generally, split-dollar arrangements require one party to pay the cost of the pure insurance protection provided by the policy, i.e. the term portion, while the other party pays all premiums in excess of the cost of pure insurance protection. The latter party owns the investment portion of the policy (typically measured by the amount of the premiums the investment owner paid, the cash surrender value of the policy, or some similar measure), while the party paying for pure insurance protection receives the death benefit in excess of that required to repay the owner of the investment portion. The term portion owner in a split dollar arrangement is often an ILIT, while the investment portion owner may be the insured's employer, a spouse, or, if suitable restrictions are imposed upon the right to be repaid, the insured him- or herself.

Using a split-dollar arrangement in estate planning allows the amount of the gift made to the term portion owner (typically, the ILIT) to be measured not by the total premium, but rather by the cost of pure term insurance, which may be significantly less than the premium cost, especially if the insured is young. As a result, split-dollar arrangements may be advantageous if the insured wants to leverage his or her unified credit or GST tax exemption by minimizing the taxable gift to, and maximizing proceeds received by, an exempt trust. In fact, split-dollar funding of life insurance can be one of the best ways to get the maximum amount of property into an exempt trust, since the gift tax cost per dollar of death benefit is minimized.

If properly structured, as noted above, the investment portion of the split dollar arrangement may initially be substantially less than the amount invested in insurance premiums. This structure may be more pronounced where the insured is quite young and healthy, giving rise to the use of a technique known as "intergenerational split dollar." This technique typically involves a senior-generation family member (say, a grandparent of the insured), investing in a life insurance policy on the life of a junior family member. Depending on when the senior family member dies, the investment portion held at his or her death may then be significantly less than the premiums paid by him or her. Accordingly, this reduced value, or reduced economic benefit, may lower the value of the investment which will be included in the senior family member's estate (and thus lower the amount of estate tax due) upon the death of the senior-generation family member.

Several developments have occurred in the intergenerational split dollar arena in recent years. In a case of first impression, the full Tax Court held that the technical requirements set out in the Treasury Regulations for satisfying the economic benefit regime were met, suggesting that the estate could use the discounted value of the retained investment portion for federal estate tax purposes. Est. of Morrissette v. Comm'r, 146 TC 171 (2016).

However, the court did not opine on the value itself in this summary judgment proceeding. The taxpayers filed a motion seeking a partial summary judgment finding that section 2703(a) did not apply to the arrangement, but the Tax Court denied the motion for summary judgment, preserving the issue for trial. In a later case, the Tax Court then cited the holding in Morrissette to dispose of the IRS's criticism of a similar arrangement in Estate of Levine v. Commissioner, Tax Ct. Docket No. 9345-15 (order issued July 13, 2016) and that case went on to trial. Next, in Estate of Cahill v. Commissioner, TC Memo 2018-84, the Tax Court held that on the facts presented, the taxpayer could not obtain a summary judgment ruling that the bona fide sale exception applies to a split-dollar arrangement where the decedent's son, acting as his agent under a power of attorney, entered into the arrangement. The Tax Court, in response to the taxpayer's summary judgment motion, agreed with the IRS that sections 2036 and 2038 applied to the arrangement because the estate had a right to terminate the arrangement in conjunction with the trustee of the life insurance trust, and also agreed that sections 2703(a)(1) and (a)(2) should be applied to ignore the restrictions that the split-dollar agreement imposed with respect to the transaction. The parties settled before trial with the taxpayer conceding the issues raised by the IRS.

Morrissette went on to trial in the Tax Court. In Estate of Morrissette v. Commissioner, TC Memo 2021-60 (or Morrissette II), the Tax Court considered the issues remaining after its ruling on the summary judgment motion, including the value of the receivable, application of understatement penalties, and whether the arrangement was a bona fide sale for adequate and full consideration. The Tax Court held that (i) sections 2036 and 2038 did not apply because there were legitimate and significant non tax reasons to enter into the agreements, so the bona fide sale for adequate and full consideration exception applied (note it helped that the family didn't get along), and (ii) the arrangement fell within the safe harbor of section 2703(a) because the built-in restrictions in the agreements had business purpose and were comparable to arm's length transactions. Regarding valuation, the court did have issues with the taxpayer's approach and imposed valuation understatement penalties, finding that the present value discount rate and approach regarding possible early termination were incorrect, resulting in a much higher value and reliance on the appraisal was not reasonable.

Most recently, the Tax Court ruled in Estate of Levine v. Commissioner, 158 TC No. 2 (2022), that (i) sections 2036 and 2038 did not apply because when the decedent made the transfer, she retained no rights per the terms of the agreement to terminate the arrangement – that power was held solely by the trustee of the life insurance trust who was an unrelated business associate and such power was not illusory, and (ii) section 2703 did not apply because there were no restrictions on the property (i.e., the life insurance policy) that were ever held by decedent since the policy had been purchased by the life insurance trust. Regarding valuation of the reimbursement right that is vastly different from the other cases is that the value was stipulated between the parties, so once the Tax Court ruled, the much lower stipulated value is what applied to the taxpayer.

3. The Spousal Lifetime Access Trust (SLAT).

Even couples with substantial estates are often reluctant to part with significant assets, fearing (whether rationally or not), that they will someday need access to the assets. One approach that may allay their concerns is the use of a "spousal lifetime access trust," or "SLAT." Experienced estate planners recognize that a SLAT is a marketing term for traditional gift planning, akin to a “lifetime bypass trust” that has been used for many years.

a. The Technique. Typically, a SLAT involves one spouse creating an irrevocable trust of which the other spouse is a permitted beneficiary. Children and other descendants are also often permitted current beneficiaries and they (or lifetime trusts for their benefit) are often the remainder beneficiaries. The beneficiary spouse is typically entitled to distributions for his or her health, support, maintenance, and education. The benefit to the donor spouse is that, so long as the couple remains married and the beneficiary spouse is living and willing to use trust funds for the couple's lifestyle, the donor spouse may derive an indirect (but not a legally enforceable) benefit from trust distributions, even if he or she has fully used his or her exclusion amount. Thus, for example, one spouse might make a gift to a SLAT of virtually his or her entire applicable exclusion amount, preserving (under the favorable clawback regulations discussed above) the benefit of that amount, even if estate and gift tax exclusions are later reduced. Properly structured, amounts transferred to the SLAT will ultimately pass to the next generation (or other remainder beneficiaries of the SLAT) with no gift or estate tax. Gift tax is avoided by the use of the donor spouse's applicable exclusion amount, and no estate tax on the assets is due on the death of the surviving spouse because (like a bypass trust), the spouse's access to the trust is limited in a way that ensures the trust's assets are not included in the beneficiary spouse's estate for estate tax purposes.

Example: Sly and Sylvia have been married to each other for many years. Their combined estate is approximately $20 million, owned relatively equally by the two of them. Sly wants to use the bulk of his applicable exclusion amount, but fears parting with substantial assets. After consulting with his advisors, Sly decides to create a SLAT for the benefit of Sylvia, funding it with $10 million of assets. Sylvia will be the trustee of the trust, and the trust agreement will permit distributions to be made to Sylvia and to their children and grandchildren for their health, support, maintenance, and education. Sly decides to grant Sylvia a special testamentary power of appointment to leave any assets in trust at Sylvia's death to Sly and/or his descendants (in trust or otherwise). If Sylvia does not exercise the power of appointment, any remaining assets pass into trust for Sly and Sylvia's children and other descendants.

b. Structure of the SLAT. The key to the success of a SLAT is the creation by one spouse of an irrevocable trust that (i) constitutes a completed gift for federal gift tax purposes, thereby utilizing that spouse's applicable exclusion amount; (ii) successfully avoids estate tax inclusion upon the death of the donor spouse under sections 2036 through 2038 by retaining no "strings" that would cause estate tax inclusion; and (ii) grants the surviving spouse access to the trust in a manner that does not cause the trust assets to be included in the surviving spouse's estate at his or her death. The trust is thus commonly structured as an irrevocable inter vivos trust that contains features similar to a bypass trust that might be created for the surviving spouse at the first spouse's death.

While the specific elements included in a SLAT will vary from client to client, typical provisions might include, for example (i) permitting distributions to the beneficiary spouse for his or her health, education, support, and maintenance (the "ascertainable standard" that prevents the trust assets from being part of the surviving spouse's estate, even if he or she is the trustee of the trust) Treas. Reg. § 20.2041-1(c)(2); (ii) perhaps granting an independent trustee the power to make distributions to the beneficiary spouse without regard to any standard; (iii) permitting discretionary (not mandatory) distributions of income and principal in order to maintain income tax flexibility, and since the trust assets will avoid estate taxation when the surviving spouse dies, to permit the SLAT to retain its income and growth to the extent that other funds are available to the family; (iv) permitting distributions to descendants, who may be in lower tax brackets than the surviving spouse (but see the discussion of the grantor trust rules, below); and (v) granting the beneficiary spouse a "special" power of appointment to direct disposition of trust assets, either during the beneficiary spouse's lifetime or at death, thereby giving the beneficiary spouse a "second look" at family needs in deciding how assets should be distributed and incorporating additional flexibility in the estate plan (but see cautions below about inclusion of the donor spouse in the class of permitted appointees).

c. Giving Property to the Trust. SLATs are often designed to use one spouse's applicable exclusion amount. The goal of such gifts to a SLAT is to remove both the gifted assets and any post-gift income from and appreciation of those assets out of the estate of the donor spouse and also to keep the assets and any income and appreciation out of the estate of the beneficiary spouse. As with other gifting techniques, these goals are typically best achieved when the client can identify and transfer rapidly appreciating assets or assets that throw off substantial income. Note that to avoid estate tax inclusion in the estate of the beneficiary spouse, the beneficiary spouse should not contribute any assets to the SLAT. If the spouses live in a community property state, achieving this goal may require the spouses first partition community property into separate property, with the donor spouse then contributing his or her separate property to the SLAT (and the beneficiary spouse retaining his or her share of the post-partition separate property).

d. Grantor Trust Implications. A SLAT will generally be treated as a grantor trust for income tax purposes. Section 677 applies grantor trust treatment to trusts the income of which, without the consent of an adverse party, either must be paid to the grantor or the grantor's spouse, or may in the discretion of the grantor or a non-adverse party, be paid currently to the grantor or the grantor's spouse. Section 677 will also be invoked if trust income may be accumulated for future distribution to the grantor or the grantor's spouse. For grantor trust treatment to apply to a SLAT, income must be available for the direct or indirect benefit of the grantor's spouse, but even a relatively insubstantial "benefit" may give rise to grantor trust treatment. Section 677 is raised, for example, merely by the use of trust income to pay premiums of life insurance on the life of the grantor or the grantor's spouse, regardless of the ownership or beneficiary of the policy. § 677(a)(3). In addition, payments that discharge a legal or contractual obligation of the grantor (or the grantor's spouse) are treated as indirect payments to the grantor. Note that the income tax liability is that of the grantor, and not the grantor's spouse or the trust, which means trust assets cannot be relied on for this liability of the donor spouse. The donor spouse must thoroughly understand the notion of a grantor trust.

He or she should understand the obligation to pay tax on the SLATs income, even if the SLAT does not have cash flow to make distributions (or if the beneficiary spouse declines to use distributions to assist with paying that tax).

Importantly, however, the grantor's payment of tax on the trust's income is not considered a gift by the donor spouse to the SLAT or to its beneficiaries. Rev. Rul. 2004-64. This feature enables the SLAT to retain and invest more of its income, which may substantially increase the amount that ultimately passes to the remainder beneficiaries of the SLAT. Often the "investment" is to purchase assets from the grantor.

e. What Benefits May the Grantor Retain? A successful SLAT is designed so its assets are not included in the donor spouse's estate at the time of his or her death. Clearly this means that powers or interests directly described in sections 2036 to 2038 should be avoided. In general, the donor spouse should not retain any right to the use or enjoyment of the SLAT assets, should not hold any reversion in the SLAT, and should not retain the right to control the beneficial enjoyment of the SLAT, either during lifetime or at death.

More concerning than these rather straight-forward rules is a concern about the IRS arguing that the grantor has retained some sort of indirect interest. For example, if the beneficiary spouse can compel distributions for support and maintenance, the donor spouse may be able to force the trustee to use the trust property for the grantor's support obligation, resulting in estate tax inclusion for the donor spouse. If distributions are discretionary, there should be no estate tax inclusion. See, e.g., Est. of Chrysler v. Comm'r, 44 TC 55 (1965).

May the beneficiary spouse be given a testamentary power to appoint SLAT assets back to the donor spouse? If so, the beneficiary spouse could exercise the power via his or her will to make the donor spouse a beneficiary of the same trust or a different trust. Is such a power in effect a "retained" power of the donor spouse? At common law, the appointed property "relates back" to the time of the creation of the power that appointed the property, so the donor spouse might be treated as the grantor of a trust for his or her own benefit, which would normally cause inclusion in the donor spouse's estate. The IRS has, by analogy, blessed the right of a grantor to obtain such a benefit, so long as there is no understanding, express or implied, between the donor spouse and the beneficiary spouse regarding the latter's exercise of discretion. *See* Rev. Rul. 2004-64 (trustee's right to reimburse grantor for income taxes on grantor trust not retained interest so long as no express or implied understanding to do so). State law is important in this regard. See, e.g., Tex. Prop. Code. § 112.035(g)(3); comment to Tenn. Trust Code § 35-15-10 ("A person who becomes a beneficiary of a trust due to the exercise of a power of appointment by someone other than such person is not considered under the Tennessee Uniform Trust Code to be a settlor of a trust. This is true even if the person who so became the beneficiary created and funded the trust and granted the power of appointment to another.").

Suppose the spouse's testamentary power was subject to the approval of someone after the spouse died. If that individual were a potential property recipient then arguably the approval would be a gift, although of what amount? If the approver were not a beneficiary, then such a risk is eliminated but the IRS might not give any effect to the requirement. A remote beneficiary might be the best approver.

Note that the individual with the power of appointment need not be the spouse, nor must the power be testamentary. However, a current non-fiduciary power may be considered dangerous because the IRS may argue that the powerholder is simply a stand-in for the grantor. Accordingly, requiring one person to "activate" a power in another, where one or both have some independent awareness of the beneficiaries, their needs, and the trust assets, may be helpful.

f. What if the Spouses Divorce? While SLATs can be effective tools to transfer wealth from one spouse to another, they may generate unintended and adverse consequences if the spouses divorce. Divorce or legal separation will typically mean the end of the donor spouse's ability to indirectly benefit from the SLAT assets. Some SLATs include provisions that accelerate transfers to the next generation by terminating the beneficiary spouse's interest in the SLAT in the event that the couple divorces. While some might express concern that such a provision permits the grantor to change the beneficial enjoyment of the SLAT by getting a divorce and thereby triggering estate tax inclusion concerns under section 2038(a)(1), most practitioners agree that obtaining a divorce is an act of independent significance that would not be treated as a prohibited retained right. See, e.g., Tully v. United States, 528 F.2d 1401 (Ct. Cl. 1976); TAM 9141027 (the act of divorcing one's spouse is an act of independent significance, and the termination of the spouse's interest in trust would be an incidental consequence of that act).

The 2017 Tax Act repealed section 682, which provided that if one spouse created a grantor trust for the benefit of the other spouse and the spouses divorced, thereafter the trust income would not be taxed to the grantor spouse to the extent of any income that the donee-spouse is entitled to receive. These changes are effective for divorce decrees and separation agreements entered into after 2018. Modifications entered into after 2018 are subject to the 2017 Tax Act if the modification expressly states that this provision of 2017 Tax Act applies. 2017 Tax Act § 11051(c)(2). No sunset applies to the repeal of the above provisions regarding alimony and separate maintenance payments and section 682. The IRS intends to issue regulations regarding the application of section 682 before its repeal is effective. Notice 2018-37. In the Notice, the IRS requested comments on whether guidance is needed regarding the application of sections 672(e)(1)(A), 674(d), and 677 following a divorce or separation in light of the repeal of section 682.

In light of the repeal of section 682, sections 672(e)(1)(A), 674(a) and 677(a) may have the effect of triggering grantor trust status due to the non-grantor spouse's powers over a trust even after the spouses divorce. Section 672(e)(1)(A) provides that the grantor of a trust shall be treated as holding any power or interest in such trust held by any individual who was the spouse of the grantor at the time of the creation of such power or interest. Section 674(a) provides, in general, that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the trust assets is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. However, section 674(d) provides that section 674(a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a Trustee or Trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, if such power is limited by a reasonably definite external standard that is set forth in the trust instrument. Section 677(a) provides that the grantor of a trust shall be treated as the owner of any portion of a trust, whether or not the grantor is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse, or held or accumulated for future distribution to the grantor or the grantor's spouse.

g. Benefit to Heirs. The property in the SLAT will ultimately pass to the SLAT's remainder beneficiaries (typically junior family members, either outright or in further trust) with no gift tax liability. While retaining (perhaps indirect) access to the SLAT's assets is often a preliminary objective, that objective could be met without making a gift. The long term goal of the SLAT is to shift wealth to the next generation. If the contributed assets outgrow the need for distributions to the beneficiary spouse, the excess growth passes to the SLAT's remainder beneficiaries with no gift or estate tax.

h. GST Tax Issues. Unlike a GRAT (discussed below), the donor spouse can allocate GST tax exemption to the assets contributed to the SLAT. As a result of that allocation, the SLAT could have a GST tax inclusion ratio of zero from the beginning, which means that all of the assets in the SLAT (both the initial gift and the growth) can pass on to grandchildren or more remote generations with no additional estate or gift tax, and without any GST tax. This multi-generational feature can make a SLAT a powerful wealth-shifting tool.

i. Two, Non-Reciprocal, SLATs? If using one spouse's applicable exclusion amount via a SLAT makes sense, why not have both spouses create SLATs? If this is possible, each donor spouse might feel some assurance that he or she will have access to assets (those of the SLAT created by the other spouse), even the parties divorce. Unfortunately, if two parties create identical trusts for each other, the courts have long held that it is the same as if each party created a trust for himself or herself. As a result, at the death of one of the grantors, the trust created by the surviving spouse will be re-characterized as a self-settled trust and included in the deceased grantor's estate under section 2036. This is commonly referred to as the "reciprocal trust" doctrine. In United States v. Estate of Grace, 395 US 316 (1969), the Supreme Court established a two-part test for a finding of reciprocal trusts. Trusts will be held to be reciprocal to the extent that (i) the trusts are "interrelated," and (2) the arrangement, to the extent of mutual value, leaves the grantors in the same economic position as they would have been in had they created the trusts for themselves. The Court then went on to find the trusts reciprocal where the trusts had substantially identical terms and were created at the same time. Although later cases have filled out the doctrine, case law does not provide a bright-line test for the application of the doctrine, although it appears that an important factor is how different the terms of the trusts are.

For example, in Estate of Levy v. Commissioner, 46 TC Memo 910 (1983), spouses created trusts on the same day and funded each trust with an identical number of shares of stock of the same company. Each spouse was a lifetime beneficiary and trustee of the other's trust. Both trusts named the couple's son as the remainder beneficiary. The Tax Court concluded that the trusts were *not* interrelated because husband's trust granted wife an inter vivos limited power of appointment, and wife's trust did not contain a comparable provision in favor of the husband.

On the other hand, in Estate of Bischoff v. Commissioner, 62 TC 32 (1977), spouses created identical irrevocable trusts not for each other, but for their grandchildren. Each named the other as trustee. The court treated the trusts as if each spouse had named himself or herself as trustee and therefore had retained a right to designate the persons who would enjoy or possess the trust property, causing estate tax inclusion under section 2036.

In PLR 200426008, the IRS ruled that where spouses created irrevocable insurance trusts naming each other as trustee, they would not be reciprocal because although the trusts contained significantly similar language they differed in key respects. The husband's trust gave the wife lifetime and testamentary powers of appointment, and in the wife's trust, the husband did not become a beneficiary unless he were living three years after the wife's death, and he had a right to distributions only if his net worth or income fell below certain levels.

j. SLAT Strategies. Suppose one spouse creates a trust for the benefit of the other spouse and descendants, and the other spouse creates a trust for the benefit of descendants only. An independent party has the power to add the first spouse as a beneficiary to this second trust, but unless such power is exercised the first spouse is not a beneficiary. If acceptable to the clients, this potential SLAT approach would seem to have fewer risks, especially if the second trust were not likely to be "needed" by the potential beneficiary spouse.

If both spouses want to utilize their respective exclusions, consider having one spouse create a SLAT, and the other spouse making a taxable gift not to a SLAT, but to specific beneficiaries or to a trust over which the donor spouse has no interest or control. While some practitioners view Estate of Levy as sanctioning SLATs that differ only as to powers of appointment, the safer course if two SLATs are to be created would be to make them as different as possible. For example, consider one, several, or all of the following: (i) having the second SLAT created long after the first, and perhaps in a different calendar year; (ii) having the second SLAT grant the donor of the first SLAT beneficial interests that are meaningfully different than the rights of the beneficiary of the first SLAT, including for example, making one spouse the discretionary beneficiary of income only, or permitting distributions to the spouse only at the discretion of an independent trustee or only if the spouse's income falls below a stated level, or granting one spouse only a lapsing right to withdraw not more than five percent of the trust assets per year; (iii) contributing assets of a substantially different nature to each trust (e.g., real estate to one trust and marketable securities to the other); (iv) granting differing powers of appointment to each spouse or granting a power of appointment to one spouse and not the other; (v) naming different trustees or a co-trustee; (vi) naming different remainder beneficiaries (e.g., one passing to children and the other passing to grandchildren); (vii) having each spouse represented by different counsel. There is no clear rule about which, or how many, differences are sufficient; the risk of reciprocal trust treatment should be explained to clients.

4. Step-Transaction Gift Concerns. Smaldino v. Commissioner, T.C. Memo. 2021-127, is a cautionary tale, albeit one based on bad facts. From a 30,000 foot view, Mrs. Smaldino needed assets to give to a trust, to use her own applicable exclusion because gift splitting was unavailable as a strategy. This would occur whenever one spouse, like Mr. Smaldino, had used more of his exemption than the other. Mr. Smaldino gave her the assets which she promptly gave to the trust, and the IRS said she was just his agent so he really made the gift. The Tax Court agreed. The opinion states:

> Petitioner owned and operated numerous rental properties in southern California. He placed 10 of these properties in Smaldino Investments, LLC (LLC), which he owned through a revocable trust. In 2013 he transferred about 8% of the LLC class B member interests to the Smaldino 2012 Dynasty Trust (Dynasty Trust), an irrevocable trust that he had created a few months earlier for the benefit of his children and grandchildren. Around the same time, petitioner purportedly transferred about 41% of the LLC class B member interests to his wife, Agustina Smaldino, who purportedly retransferred them to the Dynasty Trust the next day.

> On petitioner's 2013 gift tax return, he reported as a taxable gift only the approximately 8% of the LLC class B membership interests he had transferred directly to the Dynasty Trust. Respondent determined that petitioner had made a taxable gift to the Dynasty Trust of 49% of the class B membership interests, including the approximately 41% interest that assertedly had passed from petitioner to the Dynasty Trust indirectly through Mrs. Smaldino. After revaluing the LLC interests, respondent determined that petitioner had a $1,154,000 gift tax deficiency for 2013.
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> Petitioner has been married to Mrs. Smaldino since 2006. She has a master's degree in economics and since about 1995 has worked almost continuously in petitioner's businesses--first in his liquor-store business and, after a three-year interval, in his property-management business.
>
> Petitioner has 6 children from a prior marriage and 10 grandchildren. Two of the children work in petitioner's property-management business.
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> In 2012, when he was 69, a health scare motivated petitioner to get his estate planning in order. He and Mrs. Smaldino agreed that she should have security in her own assets; they did not want her assets and his children's assets commingled as part of the estate plan. Petitioner wanted to pass his business to his children and grandchildren and to give many of his remaining assets to Mrs. Smaldino. Similarly, she wanted petitioner's progeny to have the property-management business.
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> Petitioner and Mrs. Smaldino developed a plan to provide his progeny a bundle of assets comprising certain properties in the property-management company and to provide her a separate group of assets that would far exceed any share that the children received. As explained below, this plan involved placing certain of petitioner's business properties in the LLC and then transferring interests in the LLC to a trust for the benefit of his children and grandchildren. Petitioner resolved to transfer up to 50% of the LLC interests, the maximum he could transfer without triggering reassessment of property taxes on the LLC's assets.

The government argument was simply that the transfers to Mrs. Smaldino were indirectly made by Mr. Smaldino, analogizing to various annual exclusion and similar cases.

> Respondent contends that the doctrine of substance over form demands that we disregard petitioner's purported transfer of the LLC member interests to Mrs. Smaldino and her purported retransfer of these same interests to the Dynasty Trust a day later because these actions were "part of a prearranged plan between all parties involved to effectuate the transfer of the ownership of the LLC" from petitioner to the Dynasty Trust. Respondent urges us to treat the two purported transfers, in accordance with their asserted substance, as an indirect gift from petitioner to the Dynasty Trust.
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> In support of his position, respondent relies on a line of cases in which the courts have employed substance over form principles to recharacterize multistep property transfers among related parties as indirect gifts between the persons who were determined to be, in substance, the actual donors and donees. See, e.g., Heyen v. United States, 945 F.2d 359 (10th Cir. 1991) (treating the decedent's inter vivos transfers of stock shares to multiple nonfamily members, who immediately reconveyed the shares to members of the decedent's family, as indirect transfers from the decedent to the ultimate donees); Estate of Bies v.

> Commissioner, T.C. Memo. 2000-338 (treating the decedent's inter vivos transfers of closely held corporation stock to her daughters-in-law and granddaughter-in-law, each of whom immediately transferred the stock to her husband, as indirect transfers from the decedent to those husbands); Estate of Cidulka v. Commissioner, T.C. Memo. 1996-149 (treating the decedent's inter vivos transfers of stock to his daughter-in-law, who immediately transferred the stock to her husband, as gifts of minority stock interests to the decedent's son for purposes of valuing blocks of shares).

One of the problems the taxpayers had was that the various transfer documents had only "effective as of" dates as the court states:

> The following documents were executed as part of petitioner's family estate plan.
>
> 1. Petitioner, as trustee of the Smaldino Family Trust, executed a document captioned "ASSIGNMENT SEPARATE FROM CERTIFICATE", which states that he "assigns and transfers" to Mrs. Smaldino a "sufficient number" of nonvoting units in the LLC "so that the fair market value of such nonvoting units as determined for federal gift tax purposes shall be Five Million Two Hundred Forty Nine Thousand One Hundred Eighteen and 42/100ths Dollars ($5,249,118.42)". Petitioner and Mrs. Smaldino decided upon this amount on the basis of her then-available Federal estate and gift tax exemption. This document, which is signed by both petitioner and Mrs. Smaldino, states that it is "Effective: April 14, 2013" but does not indicate the date it was executed.
>
> 2. Mrs. Smaldino executed an "ASSIGNMENT SEPARATE FROM CERTIFICATE", which states that she "assigns and transfers" to Allen Douglass Smaldino, as trustee of the Dynasty Trust, nonvoting shares of the LLC that are described identically as in the certificate whereby petitioner had purportedly assigned these same LLC interests to her. This document, which is signed by both Mrs. Smaldino and Allen Douglass Smaldino, states that it is "Effective: April 15, 2013" but does not indicate the date it was executed.
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> 3. Petitioner, as trustee of the Smaldino Family Trust, executed a document captioned "ASSIGNMENT SEPARATE FROM CERTIFICATE", which states that he "assigns and transfers" to Allen Douglass Smaldino, as trustee of the [*9] Dynasty Trust, a "sufficient number" of nonvoting units in the LLC "so that the fair market value of such nonvoting units as determined for federal gift tax purposes shall be One Million Thirty One Thousand Eight Hundred Eighty One and 58/100ths Dollars ($1,031,881.58)." This document, which is signed by both petitioner and Allen Douglass Smaldino, states that it is "Effective: April 15, 2013" but does not indicate the date it was executed.
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> When the dust settled, the Dynasty Trust wound up with 49% of the LLC class B member interests that previously had belonged to petitioner.3 Petitioner hired James A. Biedenbender to value a 49% ownership interest in the LLC class B units. In a report dated August 22, 2013, Mr. Biedenbender opined that "a 49% Class B units nonvoting member's interest in the Company [the LLC] as [of] April 15, 2013 for certain tax reporting requirements on Form 709, US Gift Tax Return" was $6,281,000.
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> In exchange for the use of Mrs. Smaldino's available Federal estate and gift tax exemption, on June 10, 2013, petitioner amended the Smaldino Family Trust to provide her additional moneys and properties. The LLC's operating agreement was never amended to account for any transfer of units to Mrs. Smaldino. However, exhibit A of the operating agreement was amended "as of April 15,

> 2013" to show the Dynasty Trust as holding a 49% ownership interest in the LLC (consisting of two blocks of class B nonvoting units--one of 409.5 units and the other of 80.5 units, representing 40.95% and 8.05%, respectively, of the 1,000 aggregated voting and nonvoting units) and to show petitioner, as trustee of the Smaldino Family Trust, as holding the remaining 51% ownership interest (consisting of 500 class B nonvoting units as well as the 10 class A voting units). This amendment is signed by petitioner as the LLC's manager but does not indicate the date on which it was executed.

Among the other problems for the taxpayers were that Mrs. Smaldino was never admitted as a member of the LLC, the operating agreement never reflected the transfers (no updating of the ownership records), no income tax return ever reflected her ownership, and Mr. Smaldino did not report the gift to Mrs. Smaldino on his gift tax return.

The Smaldinos did not help themselves in their trial testimony:

> He does not expressly dispute, however, that the transactions in question were part of a prearranged plan to transfer ownership of 49% of the LLC class B member interests to the Dynasty Trust while using Mrs. Smaldino's estate and gift tax exemption. Indeed, petitioner testified that he intended for the properties in the LLC to be divided among five of his children, as beneficiaries of the Dynasty Trust, while Mrs. Smaldino would receive a larger share of assets that were "outside the LLC". Mrs. Smaldino testified that before the purported transfer in question she had already made "a commitment, promise" to her husband and family that she would transfer the LLC units to the Dynasty Trust. When asked on direct examination whether she could have changed her mind if she had wanted to, she responded: "No, because I believe in fairness."

The valuation was favorable to the Smaldinos with a 36% discount.

There is no magic "safe" amount of time between two gifts that enables avoidance of a step-transaction argument. Suppose Mr. Smaldino had sold the LLC interest to Mrs. Smaldino for a note, or had swapped assets with her. Anecdotally, some practitioners have heard on audit that 60 days is close to a safe-harbor.

5. The Qualified Personal Residence Trust (QPRT)

In most cases, a gift to a trust in which the grantor retains the benefit of the trust property requires that for gift tax purposes, the value of the grantor's retained interest be ignored. In other words, the full fair market value of the property transferred is treated as a gift, even though an interest in that property is retained by the grantor. § 2702. An exception applies if the property contributed to the trust is a personal residence. § 2702(a)(3)(A)(ii). Personal residences, either in the form of primary residences or vacation homes, often comprise a substantial amount of clients' wealth. Parting with these assets can provide estate tax savings, particularly when substantial appreciation is expected, and the family intends to retain the home for many years. The value of the gift to the trust is the fair market value of the residence less the value of the retained right to occupy the residence (and to direct disposition if the grantor dies during the term). Both of these rights have value, depending on the age of the grantor and the section 7520 rate at the time of the transfer.

a. The Technique. As the name of this type of trust implies, a qualified personal residence trust ("QPRT") is a trust into which the grantor transfers a personal residence. The trust is used to transfer the residence to other beneficiaries, such as trusts for junior family members, at a reduced gift tax cost, while allowing the grantor to continue to live in or use the residence for a fixed period of time, and to receive the residence back (or direct its disposition) if the grantor dies during the fixed term. Both retained rights reduce the amount of the taxable gift. The grantor retains the full use of the residence during the term of the trust. At the end of the trust term, the residence passes to the trust's remainder beneficiaries (often the grantor's children or trusts for their benefit).

Example: Homer, age 60, transfers a vacation home worth $3,000,000 to a QPRT, retaining the right to occupy the house for fifteen years. The remainder interest in the trust is held for the benefit of Homer's children. Language is added to the trust document to cause the house to revert to Homer's estate if he dies during the fifteen-year term. The actuarial factor for the gift by Homer, using the interest rate in effect under section 7520 for January, 2023 of 4.6%, is 0.39739. If the house appreciates at six percent per year, and if Homer survives the term of the trust, the house, then valued at nearly $7.2 million, will have been transferred to Homer's children at a gift tax cost of approximately $1,192,000. If Homer dies during the fifteen-year term, the house will be included in Homer's estate at its then fair market value, but no tax detriment will have been suffered. The estate tax effect in that event would be as if Homer had undertaken no planning (except for the transaction costs). § 2036.

Observe that if the section 7520 rate were 3.0%, the gift would be 0.50076% for a gift of $1,502,000.

Observe that if the section 7520 rate were 4.6%, but Homer were 65, and the term was 15 years, the gift would be 0.34522% . Interestingly, if the term were 10 years, so that Homer needed to live to age 75 as in the original age-60 example, the gift would be 0.52385%. That is because the risk of dying during a 10 year term is less than of dying during a 15 year term, and the retained right for 10 years is less than the retained right for 15 years too.

b. Structure. The terms required to establish a QPRT are set forth by Treasury regulations and the IRS has issued a sample trust agreement for establishing the trust. Treas. Reg. § 25.2702-5(c); Rev. Proc. 2003-42. The grantor creates an irrevocable trust. During the initial term of the trust, the grantor continues to use the residence rent-free and continues to pay mortgage expenses, real estate taxes, insurance, and expenses for upkeep. PLRs 199916030, 199249014. At the same time, the grantor continues to deduct mortgage expenses and real estate taxes for income tax purposes (the latter capped at $10,000 per year between 2018 and 2025). At the end of the term, the residence passes either outright or in further trust for junior family members. As with a GRAT, the interest in a QPRT may not be commuted (meaning that the trust cannot terminate early by having the remainder beneficiaries buy out the grantor's interest). Treas. Reg. § 25.2702-5(c)(6). The residence can include appurtenant structures used for residential purposes and additional property not in excess of that reasonably appropriate for residential use. Treas. Reg. § 25.2702-5(c)(2)(ii). To qualify as a personal residence, its primary use must be that of a residence of the grantor when occupied by him or her. Treas. Reg. § 25.2702-5(c)(2)(iii). In general, a "personal residence" includes the grantor's principal residence or a vacation property. At the end of the trust term, if the grantor desires to continue to use the residence, the grantor may rent it from the junior family members (or the trusts for their benefit), thereby transferring additional assets out of senior's taxable estate in the form of rental payments.

c. Residence, Cash, and Proceeds. The trust must provide for retained use of a personal residence by the grantor and may provide for occupancy by the grantor's spouse, if married, or a dependent of the grantor. Treas. Reg. § 25.2702-5(c)(7)(i). If the residence ceases to be used as a residence for any reason, including sale of the property, it will no longer be a QPRT. However, a QPRT may permit the trustee to sell the residence (other than to the grantor, the grantor's spouse, or an entity controlled by one of them) and invest the sales proceeds into a new residence in order to continue to qualify. Sales proceeds that are not either distributed to the grantor or reinvested in a new residence within two years, must be held in a GRAT for the grantor's benefit for the remainder of the QPRT term. Treas. Reg. §§ 25.2702-5(c)(5)(ii)(C), -5(c)(7)(ii), -5(c)(8), -5(c)(9). A QPRT is permitted to hold cash, provided that the total cash held in the trust does not exceed the amount required to pay trust expenses (including mortgage payments and improvements to the residence) that are anticipated to arise within six months from the date the cash is contributed. Treas. Reg. §§ 25.2702-5(c)(5)(ii)(A)(1)(i), (ii). In addition, the QPRT may hold cash for the purchase of an initial residence within three months of the date that the trust is created as long as the trustee has already entered into a contract to purchase the residence, or it may hold cash to purchase a replacement residence within three months of the date that the addition is made, provided that the trustee has entered into a contract to purchase that residence. Treas. Reg. §§ 25.2702-5(c)(5)(ii)(A)(1)(iii), (iv).

d. Gift Tax Considerations. The gift portion of a QPRT is the actuarial value of the remainder interest determined under section 7520, using the applicable federal rate for the month in which the residence is transferred to the trust. Treas. Reg. § 1.7520-1. If the home reverts to the grantor upon the grantor's death during the term of the trust, the value of the interest retained by the grantor must be increased by the value of the reversionary

interest. § 2702(a)(3); Treas. Reg. § 25.2512-5(d)(2); PLRs 200211036, 199916030. Each addition to the trust for the payment of improvements and/or mortgage payments will be gifts to the trust on which a gift tax will be owed (or the grantor's remaining gift tax exclusion applied), based on the actuarial value of the remainder interests in each payment. Because the gift of the remainder interest is a gift of a future interest, it does not qualify for the federal gift tax annual exclusion. § 2503(b)(1).

e. Estate Tax Considerations. The term of the QPRT and the life expectancy of the grantor are important. If the grantor dies during the term of the QPRT, the entire value of the assets held in the trust are included in the grantor's estate for estate tax purposes. § 2036. In that event, the value of the gift is not included in the grantor's adjusted taxable gifts, and the grantor is entitled to a credit for any gift taxes paid. § 2001. Like a GRAT, no value is included in the grantor's estate if the grantor survives the term of the trust. *Id*. Unlike a GRAT, however, no annuity or income payments are actually made to the grantor. Instead, the interest "retained" by the grantor is the personal use of the residence itself. While this use has substantial economic value to the grantor (in the form of funds that might otherwise be spent for rental of a residence), the retained value is consumed during the term of the trust through the grantor's occupancy of the residence. Therefore, if the grantor survives the term of the trust, no economic asset is includable in the grantor's estate as a result of retaining the right to occupy the residence.

Furthermore, because the residence will then be owned by the remainder beneficiaries at the end of the term, if the grantor continues to use the residence, he will need to pay rent to the new owners, thereby further reducing his estate by the rental payments. The grantor must be aware of and respect the fact that at the end of the term, the right to occupy also ends. Failure to respect this fact and the failure to pay rent if occupancy continues could result in an argument by the IRS that an implied agreement to allow the free use arrangement existed when the trust was established, thereby causing inclusion of the full value of the residence in the grantor's estate under section 2036. Strictly speaking, a lease is not required, just an intent to pay rent. In Est. of Riese v. Comm'r, TC Memo 2011-60, the QPRT expired on April 19, 2003 and the grantor died having had a stroke on October 26, 2003. An appraisal to determine fair rental value was underway and there was testimony that the grantor intended to pay rent. See also Est. of Stewart v. Comm'r, 617 F3d 148 (2d Cir. 2010) where the Tax Court upheld a gift by a mother to her son of a 49% interest in residential property even though the mother continued to live in the property with her son until her death, finding no inclusion in the mother's estate under section 2036.

f. Income Tax Considerations. A QPRT is treated as a grantor trust for income tax purposes both as to the income and principal portions of the trust which allows the grantor to deduct expenses such as mortgage interest and real estate taxes. *See* §§ 671-677; PLRs 199916030, 199249014. As a result, the capital gains exclusion available upon a sale of a residence by an individual is available for the sale of a personal residence held by a QPRT. § 121. When the QPRT regulations were first adopted, the availability of grantor trust treatment offered an interesting planning opportunity whereby immediately prior to the termination of the QPRT, the grantor would purchase the residence from the trust. The effect would be to restore the personal residence to the grantor, while shifting substantial value to the remainder beneficiaries of the trust immediately prior to the expiration of its term. Since the trust was a grantor trust, no gain or loss was recognized at the time of the sale. However, as noted above, the Service has determined that the governing instrument for a QPRT must prohibit the sale or transfer of the residence to the grantor, the grantor's spouse, or to an entity controlled by the grantor, at any time during the retained term interest of the trust, or at any time after the original term interest during which the trust continues to be a grantor trust. A sale or transfer to another grantor trust is considered a sale to the grantor or the grantor's spouse. Treas. Reg. §§ 25.2702-5(b)(1), (c)(9).

If the remainder beneficiary dies during the QPRT term, the remainder interest would be includable in the beneficiary's estate. That inclusion would could cause a basis adjustment to the property when it is ultimately distributed from the QPRT.

g. Joint Purchase of Residence. An alternative to a QPRT is the joint purchase of a residence. Such arrangement does not require the grantor to make a taxable gift nor does it create a mortality risk in the grantor, but it deprives the grantor of the "opportunity" to pay rent as a tax-free gift to the trust after the QPRT term ends. An early example was PLR 9841017 which dealt with the creation of a QPRT without gift tax cost to the parents. A QPRT was created and parents and child contributed to the trust. The child had an independent source of funds. The terms of the trust were that of a standard QPRT. The ruling concludes that the contribution to the trust of the value of the child's remainder interest was sufficient for there to be no gift by the parents. In all other respects, the QPRT

operated normally. PLR 200112023 dealt with a trust into which parents contributed enough cash to purchase the life interest in a residence and son contributed the amount of the remainder interest. Parents could live in the residence until the death of the second of them and the residence would not be included in either of their estates. PLR 200728018 outlines an IRS approved technique for spouses to acquire the life interest in a residence with a trust for their descendants to acquire the remainder interest. If a residence is owned by one spouse, may it be sold to the other spouse and/or the children? The answer should be "yes" but the result is uncertain and a more conservative approach is to use it only for the purchase of new residences to the family.

6. The Grantor Retained Annuity Trust (GRAT)

With a grantor retained annuity trust, or "GRAT," heirs typically won't receive quite as much as they would with a comparably structured sale. But GRATs are also less risky, in part because they can be set up to completely avoid any gift tax consequences. Moreover, because the Code sanctions them, as long as the guidelines are followed, there is very little risk of running afoul of the IRS.

a. The Technique. The grantor sets up a trust and transfers property to the trust. The trust itself requires the trustee to make payments to the grantor in the form of an annuity. As with a loan, a GRAT matures within a specified number of years. As a result, the value of any money (or assets) that the client transfers to the GRAT will be returned through the annuity payments by the time the trust terminates. So, what's in it for the client's beneficiaries? Assuming all goes well, a big chunk of the earnings will go to them, free of gift and estate taxes.

b. Structure. In the typical GRAT, a senior family member transfers assets to a trust, that provides he or she will receive an annual annuity payment for a fixed number of years. The annuity amount can be a fixed dollar amount, but most estate planners draft the GRAT to provide for the payment of a stated percentage of the initial fair market value of the trust. That way, if the IRS challenges the initial valuation, the payment automatically adjusts. Apparently, however, the IRS does not agree that having all the right features and safety valves in the trust agreement is itself determinative. In a recent case where outdated valuations were used to determine the GRAT payments, the IRS issued formal advice as to its position that even the savings clause will be ignored and the grantor will be treated as having made a gift equal to 100% of the value of the contributed property. CCA 202152018. As discussed below, most GRATs are effectively "zeroed out"–that is, payments are usually set so that the actuarial value of the interest passing to the heirs is very close to zero. Once property is contributed to the GRAT (i) no additional assets can be contributed; and (ii) the GRAT cannot be "commuted" or shortened by accelerating payments.

c. Setting the Annuity. The annuity can be a level amount, or an amount that increases each year, although the Treasury regulations limit the amount of each annual increase to not more than 20% per year. Treas. Reg. § 25.2702-3(b)(1)(ii). By providing for an increasing annuity payment each year, payments can be minimized in early years leaving more principal to grow in the GRAT for a longer period of time. If the asset consistently grows in value at a rate that exceeds the GRAT interest rate, retaining these extra funds will allow the principal to grow even more.

d. "Zero" Gift on Formation. Upon the creation of the GRAT, the grantor is treated as making a gift to the ultimate beneficiaries equal to the initial value of the trust assets, reduced by the present value of the annuity payments retained by the senior family member. § 2702; Treas. Reg. §§ 25.2702-1, -2. Since a GRAT results in a gift of a future interest, no annual exclusion can be used to shelter the gift tax. § 2503(b)(1). As a result, taxpayers who set up GRATs with a gift must file gift tax returns to report the transfer. Typically, the gift will be very small, if not actually zero. The present value computation of the retained annuity is based upon the term of the GRAT and the section 7520 rate in the month that the GRAT is created. §§ 2702(a)(2)(B); 7520. Fortunately, the IRS is bound by the actuarial computation performed in the month the GRAT is created. The IRS can't come back at the end of the GRAT term and re-assess how the GRAT actually did to measure the gift tax. The trustee of the GRAT must be sure to make the annuity payments to the grantor on time, pursuant to the terms of the GRAT. Otherwise, the IRS could recharacterize the gift as a gift of the full value of the gifted asset on formation, with no reduction for the value of the promised annuity payments.

e. Effect of Interest Rates. The common wisdom is that GRATs work best in times of low interest rates and depressed markets. This notion is based upon the fact that the lower the section 7520 rate, the lower the annuity payments need to be to zero out the GRAT, meaning the value of the gift is zero or close thereto. As a

result, at the end of the annuity term, more assets will be available to pass to the ultimate beneficiaries, gift-tax free. Surprisingly, studies have shown that for short-term GRATs, current interest rates have very little impact on the success rate of the GRAT. Instead, GRATs work best when the value of the assets contributed to the GRAT are depressed and rebound in the short term to far exceed their value at the time of contribution. In fact, one study showed that the success of short-term GRATs are impacted only about 1% by the section 7520 rate, 66% by first-year growth, and 33% by second-year growth. See Zeydel, *Planning in a Low Interest Rate Environment: How Do Interest Rates Affect the Calculations in Commonly Used Estate Planning Strategies?*, 33 EST., GIFTS & TR. J. 223, 226 (2008).

f. Multiple GRATs. Clients with diversified investment portfolios might want to use a separate trust for each class of investments they own. For example, a client might set up three $1 million GRATs– one composed of U.S. small-cap stocks, another of commodities, and a third of emerging-markets stocks. If any of these three asset classes outperform the 7520 rate, the client will have effectively shifted wealth. Those assets that underperform will simply be returned to the client, perhaps to be "re-GRATed". Had the client instead combined these three volatile investments into a single GRAT, he or she would run a risk that losses on one investment might offset gains on another. Many advisers favor limiting GRAT terms to as few as two years. That way, if a particular investment soars, the client will be able to lock the gains in for the remainder beneficiaries before the market cycles back down again.

g. Grantor Trust Implications. GRATS are structured as grantor trusts. As such, they allow the grantor to pay capital gains and income taxes on the investments in the GRAT on behalf of his or her heirs. Because the IRS doesn't consider such tax payments a gift, they are another way to transfer wealth to the next generation free of gift and estate taxes. Rev. Rul. 2004-64.

h. Death During GRAT Term. If the grantor dies during the annuity period, the grantor/annuitant's estate will include the *lesser of* (i) the GRAT assets at the date of death; or (ii) the amount necessary to yield the remaining annuity. *See* Treas. Reg. §§ 20.2036-1(c), 20.2039-1(e); T.D. Unless interest rates rise substantially, or the trust's assets appreciate in value very rapidly, the amount necessary to yield the remaining annuity will be the entire value of the GRAT. Because the amount includable is the lesser of the date-of-death value of the trust or the amount need to continue the annuity, it is important to make the latter calculation.

In Badgley v. United States, 125 AFTR 2d 2020-1909 (9th Cir. 2020), the taxpayer argued in district court that the regulation requiring inclusion at death was invalid because retention of an annuity interest was not the equivalent to a transfer with the retained right to use or enjoy the transferred interest. The court disagreed, finding the regulation valid. On appeal, the taxpayer argued that section 2036 did not apply because (i) that section does not expressly apply to annuities; and (ii) the taxpayer did not retain possession, enjoyment, or the right to income from the GRAT. She also again argued that the regulation was invalid. The 9th Circuit stated that in applying the string statutes (sections 2036 through 2038), courts must look to the result rather than the form of the transaction, and that courts had found other interests (like reversions and rent, also not specifically listed in the statute) will cause estate tax inclusion. The court concluded that a GRAT annuity constitutes a substantial economic benefit retained by the grantor that constitutes retained "enjoyment" within section 2036(a)(1). As to the challenge to the regulation, the 9th Circuit, after first holding that the argument was waived because of the cursory manner in which it was raised on appeal, went on to reject the challenge as applied in this case. The taxpayer had asserted that the formula used in the regulation was flawed because it assumes that the annuity payment will come entirely from the GRAT's income. However, she did not argue that the annuity at issue contemplated the amortization of principal, or that the formula was flawed with regard to this GRAT. Merely contending that the formula might be arbitrary if applied to a short-term GRAT that contemplates the amortization of principal as the primary source for the annuity payment was insufficient, since those were not the facts at issue in this case.

If the *remainder* beneficiary dies during the GRAT term, the beneficiary's death does not affect the uniform basis of the property held in the GRAT. Treas. Reg. § 1.1014-8(a)(1). However, the remainder interest would be included in the remainder beneficiary's estate, regardless of whether that remainder interest is vested. *See* Rev. Rul. 67-370; Rev. Rul. 76-472. If the remainder interest is held outright by an individual, the basis increase allowed under section 1014 will be taken into account in calculating the basis of the remainder interest in the hands of the beneficiary's estate or heirs. Treas. Reg. § 1.1014-8(a)(1). When the trust property is distributed to the remainder beneficiaries, their basis in the trust property is determined by adding to (or subtracting from) the part of the adjusted uniform basis assigned to the remainder interest the difference between the value of the remainder interest included

in the estate and the basis in the remainder interest immediately before the remainder beneficiary's death. Treas. Reg. § 1.1014-9(a)(2).

i. Payments in Kind. The annuity may be paid "in kind" (i.e., with a portion of the assets initially contributed to the GRAT). However, if the GRAT assets are rapidly appreciating, a return of these assets creates a "leak" in the freeze potential of the GRAT. One partial solution to this "leak" is to have the grantor contribute the distributed assets into a new GRAT. A GRAT must expressly prohibit the use of a promissory note to make the GRAT payments. Treas. Reg. § 25.2702-3(b)(1)(i). Regardless of whether the annuity payment is made in cash or in kind, the payment must be made within 105 days of the anniversary date of the GRAT if payment is based on the date of the trust, or by the due date of the trust's income tax return (without regard to extensions) if the payment is based on the trust's tax year. Treas. Reg. § 25.2702-3(b)(4).

j. Benefit to Heirs. At the end of the annuity period, the property remaining in the GRAT (after paying the senior family member the annuity pursuant to the GRAT terms) passes to the ultimate beneficiaries (typically junior family members, either outright or in further trust) with no further gift tax liability. This is the goal of a GRAT, and why highly appreciating assets work best. If the contributed assets grow faster than the section 7520 interest rate in effect when the GRAT is funded, the excess growth passes to the GRAT beneficiaries.

k. GST Tax Issues. The grantor cannot allocate GST tax exemption to the GRAT until the end of the GRAT term (i.e., the end of the estate tax inclusion period or "ETIP"). *See* § 2642(f). The ETIP rules mean that GRATs do not allow for efficient allocation of GST tax exemption. Therefore, GRATs are typically drafted to avoid the imposition of GST tax. For example, children can be given a general power of appointment (although doing so may hamper creditor protections of a dynasty trust). Naturally, if the GRAT assets remain in trust and are expected to continue to appreciate after the GRAT term ends, it may be worthwhile to allocate GST tax exemption to the trust at the end of the GRAT term based upon the fair market value of the assets retained by the trust at that time.

Suppose a child with a vested interest in a GRAT transfers that interest to another trust for the benefit of that child's descendants. The transfer would be a gift, and presumably the child could allocate the child's own GST exemption to the transfer. Treas. Reg. §26.2652-1(5) provides examples concerning the identity of the transferor for GST purposes. Example 4 deals with a transfer of assets to a trust that pays income to child for life with remainder to grandchild. Child transfers the income interest to another. Because the transfer does not affect the remainder interest, parent remains the transferor. There is no example dealing with the transfer of a remainder interest. For safety's sake, the child might include non-skip persons as trust beneficiaries as well as the child's spouse. If the child makes a transfer shortly after the GRAT is created then the gift would be small.

l. Short-term vs. Long-term GRATs. As indicated above, the use of short-term (i.e., 2-year) GRATs have typically been more popular than using longer-term GRATs. The reasoning behind the preference for short-term GRATs is twofold. First, using a short-term GRAT reduces exposure to the risk that the senior family member will die during the term, which, as stated above, would cause all or a portion of the value of the GRAT assets to be included in the senior family member's gross estate. Second, a short-term GRAT minimizes the possibility that a year or two of poor performance of the GRAT assets will adversely impact the overall effectiveness of the GRAT. When funding a GRAT with volatile securities, a series of short-term GRATs typically perform better than a single long-term GRAT.

Notwithstanding the benefits of short-term GRATs illustrated above, in times of low interest rates, a longer-term GRAT may be more desirable because it allows the senior family member to lock in a low section 7520 interest rate for the duration of the GRAT term. In addition, with a longer-term GRAT, the client saves the expenses each time a new GRAT is made for a shorter term, and the client does not have to go through the process of forming and funding a new GRAT. In short, the simplicity of administration favors longer-term GRATs.

m. Other Limitations of GRATs. The 7520 rate generally exceeds the comparable AFRs for a given month, thus the "hurdle rate" for a GRAT is higher than for a sale. In addition, GRATs must make fixed annual payments. Unlike a sale, the grantor can't defer the bulk of the payments for years into the future by using a balloon note or otherwise pay when cash-flow is stronger. The biggest risk with a GRAT remains that the client might die before the trust ends. In that situation, all or part of the GRAT assets will be included in the client's estate and potentially subject to estate tax.

n. Things that Shouldn't Happen With a GRAT. We know that a GRAT is allowed to describe the annuity using a percentage of the initial funding value, which "protects" the grantor from valuation misstatements. However, the IRS challenged that notion in CCA 202152018. There, the IRS determined that a grantor never intended to receive a qualified annuity and thus made a gift of the full value of the assets contributed to the GRAT despite the apparent adequacy of the GRAT language.

Taxpayer owned a closely-held company and marketed it for sale. Three days after the bids came in (from five potential buyers) the taxpayer created a two-year GRAT. A few weeks later taxpayer contributed shares in the same company to a charitable remainder trust. The appraisals used for the two gifts were quite different. The CRT shares were appraised by a "qualified appraiser" as required to receive a charitable deduction. The GRAT annuity was based on an older appraisal as the CCA notes:

> The value of the shares of Company was determined based on an appraisal of Company on December 31, Year 1, a date approximately seven months prior to the transfer to Trust. The appraisal, which was obtained in order to satisfy the reporting requirements for nonqualified deferred compensation plans under § 409A of the Code, valued the shares of Company at $w per share.

During the GRAT term the appraisal process and sale of the company proceeded – described by the IRS as follows:

> Additional time was granted to the Corporations to submit final offers. The last offer was received on Date 3, almost three months after the initial offers. Corporations A through D raised their offers, while Corporation E withdrew from the bidding, expressing no further interest.
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> ***
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> Three months after the new offers were received and several weeks after the transfer to his charitable remainder trust, Donor accepted Corporation A's offer, which represented a 10 percent increase over its initial offer. Per the final offer, an initial cash tender offer was made of $x per share, an amount that was nearly three times greater than $w (the value determined as of December 31, Year 1). During the tender period, Donor tendered b shares, while Donor's charitable remainder trust also took advantage of the tender offer.
>
> On December 31, Year 2, Donor again had Company appraised for purposes of § 409A and the new appraised value was $y per share, which was almost twice the previous year's value of $w per share.2 These steps were repeated for a December 31, Year 3 appraisal with similar results. The December 31, Year 2 and Year 3 appraisals both included the following language: "[a]ccording to management, there have been no other recent offers or closed transactions in Company shares as of the Valuation Date." There was no such declaration in the December 31, Year 1 appraisal.
>
> In Year 4, approximately six months after the end of Trust's two-year GRAT term, Corporation A purchased the balance of the Company shares for $z per share, a price almost double the value of $y.

The IRS summarized the record about the appraisal discrepancy:

> The record as compiled to date supports the proposition that, as of Date 1, the hypothetical willing buyer of the Company stock could have reasonably foreseen the merger and anticipated that the price of Company stock would trade at a substantial premium over $w per share. When asked to explain the use of the

> outdated appraisal (as of December 31, Year 1) to value the transfer to the GRAT, as well as the use of a new appraisal to value the transfers to charity, the company that conducted the appraisal stated only that "[t]he appraisal used for the GRAT transfer was only six months old, and business operations had not materially changed during the 6-month period . . . For the charitable gifts, under the rules for Form 8283, in order to substantiate a charitable deduction greater than $5,000, a qualified appraisal must be completed. Because of this requirement an appraisal was completed for the donations of [Company] stock to various charities on [Date 4]."

The IRS had no difficulty concluding that the valuation of the shares in the GRAT was too low. However, instead of simply adjusting the annuity amount, which might have been the expected result, the IRS found the taxpayer didn't retain a qualified annuity at all:

> Section 25.2702-3(d)(1) provides that to be a qualified annuity interest, an interest must be a qualified annuity interest in every respect. Further, to be a qualified interest, the interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust.
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> In *Atkinson v. Commissioner*, 115 T.C. 26, 32 (2000), aff'd, 309 F.3d 1290 (11th Cir. 2002), a donor created a charitable remainder annuity trust (CRAT) but no payments were actually made from the trust to the donor during the two-year period between the creation of the trust and the donor's death. The Commissioner argued that the trust was not a valid CRAT under § 664(d)(1) and the corresponding regulations because the required annual annuity amount was never paid. The Tax Court agreed, concluding that although the terms of the trust met the letter of the statutory requirement providing for five percent annual distributions, the trust did not operate in accordance with those terms. Specifically, the Tax Court determined that the trust did not meet the express five percent requirement of the statute and could not qualify for treatment as a charitable remainder trust. On appeal, the estate argued that the deduction was being denied because of a "foot fault," or a minor mistake. The Court of Appeals disagreed, however, and affirmed the Tax Court, holding that the trust failed to comply with the rules governing CRATs throughout its existence. Because these rules in § 664(d)(1) and the corresponding regulations were not scrupulously followed throughout the life of the trust, a charitable deduction was not appropriate. *Atkinson*, 309 F.3d at 1295.
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> ***
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> In addition, although the governing instrument of Trust appears to meet the requirements in § 2702 and the corresponding regulations, intentionally basing the fixed amount required by § 2702(b)(1) and § 25.2702-3(b)(1)(i) on an undervalued appraisal causes the retained interest to fail to function exclusively as a qualified interest from the creation of the trust. The trustee's failure to satisfy the "fixed amount" requirement under § 2702 and § 25.2702-3(b)(1)(ii)(B) is an operational failure because the trustee paid an amount that had no relation to the initial fair market value of the property transferred to the trust; instead, the amount was based on an outdated and misleading appraisal of Company, at a time when Company had received offers in the multi-billion dollar range. When asked about the use of the outdated appraisal, the company that conducted the appraisal stated only that business operations had not materially changed during the 6-month period. In contrast, in valuing the transfer to the charitable trust, the company that conducted the appraisal focused only on the tender offer, and accordingly gave little weight to the business operations for valuation purposes.

> The operational effect of deliberately using an undervalued appraisal is to artificially depress the required annual annuity. Thus, in the present case, the artificial annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars. The cascading effect produced a windfall to the remaindermen. Accordingly, because of this operational failure, Donor did not retain a qualified annuity interest under § 2702. *See Atkinson*.

The obvious learning from the ruling is not to use outdated appraisals but the result is scary and perhaps contrary to the Code and regulations. What else may be done? A GRAT may be funded using a defined value clause. Further, a GRAT term that runs through the gift tax audit period adds validity to the argument that the trustee must and will adjust the annuity payment.

In 2019 there was another odd GRAT ruling, CCA 201939002. The co-founder and Chairman of a publicly-traded company funded a GRAT. Subsequently the company announced a merger and its stock appreciated. The ruling states:

> The Internal Revenue Service has reviewed the underlying transaction documents from the year preceding the merger. Such documents include the Corporation A and Corporation B exclusivity agreement, correspondence between Corporation A and Corporation B, and Board meeting minutes. The record as compiled to date supports the position that, as of Date 1, the hypothetical willing buyer of the stock could have reasonably foreseen the merger and anticipated that the price of Corporation A stock would trade at a premium.

The IRS concluded that the gift valuation could be adjusted notwithstanding that the stock was publicly traded. The ruling relies on Silverman – a case involving closely-held stock not yet publicly traded – and Ferguson – an assignment of income case:

> In Silverman v. Commissioner, T.C. Memo. 1974-285, aff'd, 538 F.2d 927 (2d Cir. 1976), cert. denied, 431 U.S. 938 (1977), the petitioners gifted shares of preferred stock while in the process of reorganizing with the intent to go public. The Tax Court rejected the expert testimony presented by the petitioners because the expert failed to take into account the circumstances of the future public sale.
>
> In Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999), aff'g 108 T.C. 244 (1997), the appellate court considered the issue of whether the Tax Court correctly held that taxpayers were liable for gain in appreciated stock under the anticipatory assignment of income doctrine. In Ferguson, taxpayers owned 18 percent of AHC and served as officers and on the board of directors. In late 1987 and early 1988, the AHC board of directors contacted and eventually authorized Goldman, Sachs & Co. to find a purchaser of AHC and to assist in the negotiations. By July 1988, Goldman, Sachs had found four prospective purchasers. Shortly thereafter, AHC entered into a merger agreement with DCI Holdings, Inc. With the taxpayers abstaining from the vote, the AHC board unanimously approved the merger agreement. On August 3, 1988, the tender offer was started. On August 15, taxpayers with the help of their broker executed a donation-in-kind record with respect to their intention to donate stock to a charity and two foundations. On September 9, 1988, the charity and the foundations tendered their stock. On September 12, 1988, the final shares were tendered and on October 14, 1988, the merger was completed. The court concluded that the transfers to charity and the foundations occurred after the shares in AHC had ripened from an interest in a viable corporation into a fixed right to receive cash and the merger was "practically certain" to go through. In particular, the court noted that "[t]he Tax Court really only needed to ascertain that as of [the valuation] date, the surrounding circumstances were sufficient to indicate that the tender offer and the

merger were practically certain to proceed by the time of their actual deadlines — several days in the future." Ferguson, 174 F.3d at 1004. Consequently, the assignment of income doctrine applied and the taxpayers realized gain when the shares were disposed of by charity and the foundations.

The current case shares many factual similarities with Ferguson, including the targeted search by the Board of Directors of Corporation A to find merger candidates, the exclusive negotiations with Corporation B immediately before the final agreement, the generous terms of the merger, and an agreement that was "practically certain" to go through. While the Ferguson opinion deals exclusively with the assignment of income doctrine, it also relies upon the proposition that the facts and circumstances surrounding a transaction are relevant to the determination that a merger is likely to go through. See Bank One and Kollsman, supra. The current case presents an analogous issue, that is, whether the fair market value of the stock should take into consideration the likelihood of the merger as of the Date 1 transfer of Shares to Trust. The Ferguson and Silverman opinions, as considered by the Tax Court and the Second and Ninth Circuit Courts of Appeal, support the conclusion that the value of stock in Corporation A must take into consideration the pending merger. Accordingly, a value determined on the basis of the selling price as provided under § 25.2512-2(b) does not represent the fair market value of Shares as of the valuation date; pursuant to § 25.2512-2(e), other relevant facts and elements of value must be considered in determining fair market value. Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of Date 1, would be reasonably informed during the course of negotiations over the purchase and sale of Shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger would undermine the basic tenets of fair market value and yield a baseless valuation.

[Emphasis added.]

The underlined statement will often be false. Many conditions may prevent the shareholder from discussing a merger, such as confidentiality agreements, securities law provisions. Further, suppose identical facts except that the shareholder was not an officer or director of the company and was not aware of the impending merger. Would that taxpayer's stock have been valued at the traded value, and, if so, why? Suppose the Chairman's spouse had funded a GRAT on the same date and the evidence was that the spouse never participated in or learned about business matters. Different valuation?

The ruling summarizes Treas. Reg. § 25.2512-2(e) as follows:

Section 25.2512-2(e) provides, in relevant part, that in cases in which it is established that the value per bond or share of any security determined on the basis of the selling or bid and asked prices as provided under § 25.2512-2(b) does not represent the fair market value thereof, then some reasonable modification of the value determined on that basis or other relevant facts and elements of value shall be considered in determining fair market value.

The full subsection reads as follows:

(e) ***Where selling prices or bid and asked prices do not represent fair market value.*** In cases in which it is established that the value per bond or share of any security determined on the basis of the selling or bid and asked prices as provided under paragraphs (b), (c), and (d) of this section does not represent the fair market value thereof, then some reasonable modification of the value determined on that basis or other relevant facts and elements of value shall be considered in

> determining fair market value. Where sales at or near the date of the gift are few or of a sporadic nature, such sales alone may not indicate fair market value. In certain exceptional cases, the size of the block of securities made the subject of each separate gift in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the donor can show that the block of stock to be valued, with reference to each separate gift, is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. Complete data in support of any allowance claimed due to the size of the block of stock being valued should be submitted with the return. On the other hand, if the block of stock to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to its true value.

The taxpayer petitioned the Tax Court for relief, in Baty v. Commissioner, filed June 23, 2021 (Docket No. 12216-21) and, based on public reports, the government conceded. The Company involved was Emeritus Senior Care.

7. Sale For A Note

Rather than (or in addition to) making gifts, the senior generation might consider selling assets to an intentionally defective grantor trust, or IDGT, for the benefit of the junior generation. The payoff is potentially greater than with many other strategies. A sale can provide a tax-advantaged way to pass assets to children and grandchildren while keeping the value of the trust's assets out of the estates of junior family members, as well as keeping growth of the assets that were sold out of the estates of senior family members. The senior family member may also appreciate the continuing income stream as a result of the interest payments.

a. The Technique. An IDGT is a trust typically established by senior family members for the benefit of junior family members. A grantor makes a gift to a trust, and the trust purchases assets from the grantor for a note. There is no magic amount of seed money but at least 10% is smart and more is desirable. Many people use IDGTs to purchase family businesses, farms, or homes. Sales of interests in family limited partnerships or limited liability companies are also popular. In times of low interest rates, some estate planners consider IDGTs to be the ultimate freeze technique. They combine the interest rate benefits of intra-family loans with the discounting benefits of lifetime gifts. As with outright gifts, this technique works especially well if the sale can be consummated when market values are depressed.

b. Structure of the IDGT. The key to the success of an IDGT transaction is the creation by senior family members of an irrevocable trust that (i) successfully avoids estate tax inclusion under sections 2036 through 2038; but (ii) which will be treated as a grantor trust for income tax purposes under sections 671 through 677. The so-called "string statutes" (statutes that cause trusts to be ignored if the grantor retains too many "strings") are similar in the income and transfer tax areas, but they are not the same. There are a number of "strings" on the list for grantor trusts that for income tax purposes have no counterpart when it comes to estate and gift taxes. As a result, clients can create an IDGT, which is ignored for income tax purposes but will be given full effect for gift and estate tax purposes. When the senior family members sell limited partnership interests or other appreciating assets to the IDGT (sometimes for an interest-only promissory note with a balloon payment although this is more aggressive planning), the sale is ignored for federal income tax purposes, meaning that no gain or loss is recognized on the transaction and no basis adjustment occurs. *See* Rev. Rul. 85-13; see also Rothstein v. United States, 735 F2d 704 (2d Cir. 1984) (allowing a basis adjustment, and in response to which, Rev. Rul. 85-13 was issued).

c. Seeding of Trust. The IRS has offered no official guidance, but most practitioners recommend that the trust have "equity" of at least 10% of the purchase price. Although not condoning this percentage, both the Tax Court and the 9th Circuit recognized this belief in footnotes in Estate of Petter v. Commissioner, TC Memo 2009-280, aff'd 653 F3d 1012 (9th Cir. 2011). In most cases, clients provide this "seed" money by making a taxable gift of cash or assets to the trust, typically sheltering the gift from tax by using some of their applicable exclusion amount. A gift tax return is filed, reporting both the seed gift and the sale, thereby starting the gift tax

statute of limitations running on the values used in the sale. Some clients can use an existing grantor trust which already has sufficient assets to provide the seed money. Keep in mind that the ideal IDGT is a trust that has been established and funded for some time prior to the sale transaction; otherwise, the IRS might argue that the funding of the trust and sale are a single transaction which would decrease any discounts that might otherwise be available for the transfers. See Pierre v. Comm'r, TC Memo 2010-106.

Sometimes it may be impractical for a trust to be seeded with the appropriate level of assets (e.g., the senior family member is unwilling to incur a sizable taxable gift). Instead of (or in addition to partially) seeding the IDGT, the beneficiaries could personally guarantee the promissory note. However, the beneficiaries should independently have sufficient net worth to cover the amount of the guarantee. There is an element of risk with the guarantee approach because the IRS might take the position that the guarantee constitutes a gift from the beneficiary to the grantor trust, or might argue that it raises questions as to the overall financial viability of the transaction. One way to reduce the risk of the gift argument is to have the trust pay the guarantor(s) a reasonable fee for the guarantee. Keep in mind that no "correct" way to determine the amount of this fee has been established.

d. Effect of Interest Rates. When interest rates are low, sales to IDGTs become very attractive, since any income or growth in the asset "sold" is more likely to outperform the relatively low hurdle rate set by the IRS for the note.

e. Servicing the Debt. The nature of this transaction is that there is a sale of assets for a note. In order to ensure that no unintended gift arises, it is important to ensure that the value of the note is equal to the value of the transferred property. The Tax court has held that section 7872 is the applicable provisions for valuing an intra-family promissory note, specifically for determining that a note carrying a section 7872 rate may be valued at its face amount. See Frazee v. Comm'r, 98 TC 554 (1992); see also, True v. Comm'r, TC Memo 2001-167, aff'd on other grounds, 390 F3d 1210 (10th Cir. 2004). The IRS and Treasury's Priority Guidance Plan for 2016-2017 (released on October 31, 2016 before the 2016 elections) included guidance on valuation of promissory notes under sections 2031, 2033, 2512, and 7872 as an item on its project list but this item has not appeared on subsequent Priority Guidance Plans. Will section 7872 be determinative for transfer tax purposes?

In order for the form of the transaction to be respected, all of the typical transaction documents are required, and it should go without saying that all of the formalities of the transaction should be followed by the parties as though it were a transaction entered into at arm's length. See the discussion above regarding intra-family loans for more information in this regard. It is recommended that the timing and amount of the note payments should not directly tie with the income earned by the assets that are sold. Payments should be made on time and appropriate measures taken if they are not. Otherwise, an argument may be raised that there was no reasonable expectation of repayment and that a gift has been made rather than a bona fide loan.

With regard to servicing the interest payments on the promissory note, the sale to the IDGT works especially well when rental real estate or other high cash-flow investments are sold. If these assets are contributed to a family limited partnership (or similar entity) prior to being sold to the IDGT, distributions of partnership rental or investment income to the IDGT can be used to service the note payments. As noted above, care should be taken to ensure that payments do not match income; otherwise, the IRS may use this fact in support of application of the step transaction doctrine. See Pierre v. Comm'r, TC Memo 2010-106 (IRS alleged that regular distributions made from a limited partnership in order to service debt incurred in order to purchase interests was a transfer with a retained right to income, causing partnership to be included in transferor's estate under section 2036).

f. Grantor Trust Implications. Senior family members must thoroughly understand the notion of a grantor trust. They should understand their obligation to pay tax on the IDGT's income, even if the IDGT does not have cash flow to make interest payments (or if the interest payments are insufficient to service the debt or pay these taxes). The tax payments are not considered a gift by the senior family member. Rev. Rul. 2004-64. In addition, since the sale transaction is ignored for income tax purposes, no basis adjustment is made at the time of the sale. See discussion in the next paragraph regarding termination of grantor trust status while the grantor is living.

g. Death of Note Holder. As with an intra-family loan, if the lender dies during the term of the loan, any unpaid balance with accrued interest will generally be included in the taxable estate of the lender. Treas. Reg. § 20.2031-4. Again, however, the value of the note is generally limited to the value of the collateral and the net

worth of the borrower, without regard to any amount the borrower might inherit. See Est. of Elizabeth V. Harper, 11 TC 717 (1948), acq., 1949-1 CB 2; TAM 9240003. If the grantor dies before the note is paid in full, or if grantor trust treatment is otherwise terminated before the note is paid off, there may be adverse income tax consequences, including recognition of gain on the sale, and future recognition of interest income on the note payments. See Madorin v. Comm'r, 84 TC 667 (1985); Treas. Reg. § 1.1001-2(c), Ex. 5; Rev. Rul. 77-402; cf. Est. of Frane v. Comm'r, 998 F2d 567 (8th Cir. 1993) (gain on SCIN recognized by *estate of payee* upon death of note holder); Peebles, *Death of an IDIT Noteholder*, 144 TR. & EST. 28 (2005); see also, CCA 220923024. The adverse tax consequences arising from the death of the note holder may be difficult to quantify with any degree of certainty, however in the almost 30 years since sales to grantor trusts became popular there has not been an IRS effort to treat the death of the grantor as a taxable event.

The basis of the note in the grantor/seller's estate will ordinarily be its fair market value. What about the basis of the assets owned by the grantor trust at the donor/seller's death? Basis is an income tax concept as is discussed in Rev. Rul. 2023-2 as follows:

> Section 1012(a) provides that the basis of property is its cost, except as otherwise provided in subchapter O of chapter 1 (subchapter O) (relating to gain or loss on disposition of property) and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses) of chapter 1. One of the provisions set forth in subchapter O is § 1014.

Rev. Rul. 2023-2 deals with the application of section 1014 to a grantor trust if the trust assets are not included in the grantor's estate at death. The Ruling deals with simple, yet every day, facts:

> In Year 1, A, an individual, established irrevocable trust, T, and funded T with Asset in a transfer that was a completed gift for gift tax purposes. A retained a power over T
>
> that causes A to be treated as the owner of T for income tax purposes under subpart E of part I of subchapter J of chapter 1 (subpart E). A did not hold a power over T that would result in the inclusion of T's assets in A's gross estate under the provisions of chapter 11. By the time of A's death in Year 7, the fair market value (FMV) of Asset had appreciated. At A's death, the liabilities of T did not exceed the basis of the assets in T, and neither T nor A held a note on which the other was the obligor.

The Ruling's analysis is equally straightforward:

> For property to receive a basis adjustment under § 1014(a), the property must be acquired or passed from a decedent. For property to be acquired or passed from a decedent for purposes of § 1014(a), it must fall within one of the seven types of property listed in § 1014(b). Asset does not fall within any of the seven types of property listed in § 1014(b).
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> First, upon A's death, Asset was not "bequeathed," "devised," or "inherited" within the meaning of § 1014(b)(1). A "bequest" is the act of giving property (usually personal property or money) by will. Black's Law Dictionary (11th ed. 2019). The Supreme Court defined "bequest" as a "gift of personal property by will" for purposes of the predecessor provision of § 102 that, as today, excluded gifts, bequests, devises, or inheritance from gross income for income tax purposes. United States v. Merriam, 263 U.S. 179, 184 (1923).
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> A "devise" is the act of giving property, especially real property, by will. Black's Law Dictionary (11th ed. 2019). Volume 97 of the *Corpus Juris*

Secundum notes that although "bequest" and "bequeath" strictly refer to a gift by will of personal property, the words may be given a broader meaning to include real property which, under the narrower definition, would be a devise. See 97 C.J.S. Wills § 1861 (2022).

An "inheritance" is property received from an ancestor under the laws of intestacy or property that a person receives by bequest or devise. Black's Law Dictionary (11th ed. 2019).

In Bacciocco v. United States, 286 F.2d 551, 554-55 (6th Cir. 1961), the court found that property transferred in trust prior to the decedent's death is not bequeathed or inherited because it did not pass either by will or intestacy. The court stated, "[w]e construe those terms [bequest and inheritance] according to their usual and normal meaning" and noted that the decedent's death did not transfer the assets to the trust. Id. at 554-56. This does not imply that property in a trust could never fall within the meaning of § 1014 (such as property included in the decedent's gross estate or property specifically described by §§ 1014(b)(2), (3), or (4)); however, in the facts outlined above, the trust property does not fall within the meaning of those terms.

The Congressional committee report explaining the basis of property acquired from a decedent for purposes of § 1014(b) (then designated § 113(a)(5) of the 1939 Code) stated that the provision "applies basically to property in the decedent's probate estate and includible in his gross estate under § 811(a) [the predecessor provision of § 2031(a)]. In addition, it applies to property acquired by certain specifically described methods of disposition which are treated as though the acquisition was by bequest, devise, or inheritance." H.R. Rep. No 83-1337 at 4407-08 (March 9, 1954). Citing that report, the court in Collins v. United States, 318 F. Supp. 382, 386 (C.D. Cal. 1970) stated, "[i]t seems clear that property cannot be said to come from a decedent by 'bequest, devise, or inheritance' unless it is part of the decedent's probate estate under the laws of the state of his domicile." [3] The court determined that payments made to a widow by her deceased husband's employers, under contracts negotiated by her husband, did not pass from the decedent under § 1014 and so would not acquire a basis determined by the contract's FMV at the decedent's death but instead were income with respect to a decedent that would not receive a basis adjusted to date of death value.

Second, Asset does not fall within any of the remaining types of property listed in § 1014(b). Asset is not described in §§ 1014(b)(2), (3), or (4) because A did not retain a power to revoke or amend T or hold a power to appoint Asset. Asset also is not described by § 1014(b)(6) because it is not community property. Finally, Asset is not described by §§ 1014(b)(9) or (10) because it is not included in A's gross estate under the provisions of chapter 11. Because at A's death Asset does not fall within any of the seven types of property listed in § 1014(b), Asset does not receive a basis adjustment under § 1014(a) at A's death.

The vast preponderance of practitioners familiar with this issue have always, or certainly for many years, held the view expressed in the Ruling.

When a sale is undertaken, it should include a strategy for getting rid of the notes if the grantor dies before the notes is paid off. For example, suppose the grantor's estate plan bequeaths the note to the obligor trust. In general, it would be better to dispose of the note before death.

h. Benefit to Heirs. The property in the IDGT net of the note obligation passes to the ultimate beneficiaries (typically junior family members, either outright or in further trust) with no gift tax liability. This is the goal of a sale to an IDGT. If the contributed assets grow faster than the interest rate on the IDGT's note, the excess growth passes to the IDGT beneficiaries with no additional gift or estate tax. With a sale to an IDGT, the IRS requires that the gift tax consequences be evaluated when the assets are sold in exchange for the note–not when the note is paid off–hence, the term "freeze technique" since the value of the grantor's estate is essentially frozen for transfer tax purposes.

i. GST Tax Issues. Unlike a GRAT, the senior family member can allocate GST tax exemption to the seed money contributed to the IDGT. As a result of that allocation, the IDGT could have a GST tax inclusion ratio of zero, which means that all of the assets in the IDGT (both the seed money and the growth) can pass on to grandchildren or more remote generations with no additional estate or gift tax, and without any GST tax. This multi-generational feature can make a sale to an IDGT a much more powerful transfer tax tool than other similar wealth-shifting techniques.

j. Discounted Assets. As noted above, in order to avoid any unintended gift, it is important that the total sales price paid (including any note given) is equal to the fair market value of the assets sold. An appraisal of the property may be needed or prudent, regardless of the client's resistance to incurring the additional cost. Valuation of the interest being sold is extremely important. If the interest transferred is undervalued, the IRS could argue that the interest sold was actually retained by the senior family member, thereby treating the transaction as a gift of the interest pursuant to section 2702. Appreciating or leveraged assets are an ideal candidate for sale.

As noted in the example above, use of lack-of-marketability and minority-interest discounts can provide more bang for the buck. The trust pays interest at favorable rates on the discounted value, while the underlying assets grow at full market rates. The IRS has continued to challenge these discounts with mixed results. For example, in Estate of Purdue v. Commissioner, TC Memo 2015-249, the decedent transferred marketable securities, a commercial building, a promissory note, and a certificate of deposit into a family LLC in exchange for ownership interests in the LLC proportional to the value of the property she contributed. The Tax Court found that the transfer was a bona fide sale for adequate consideration, so the value of the assets wasn't includable in her gross estate under section 2036(a). Although the decedent was advised of transfer tax savings during the planning, evidence, including testimony, her law firm's memorandum and the LLC's operating agreement, all showed that a significant purpose of the transfer was to consolidate investments into a family entity managed by a single advisor. Other factors considered included that the decedent wasn't financially dependent on LLC distributions, there was no commingling of her and the LLC's funds, and she was in good health at the time of the transfer. In light of these factors, the Tax Court ruled that the transfer wasn't merely an attempt to change the form in which the decedent held property and supported the bona fide nature of the transaction. Id.

In contrast, in Estate of Moore v. Commissioner, TC Memo 2020-40, the Tax Court included the assets of a limited partnership in the decedent's estate under section 2036(a)(1) because the transaction failed the bona fide sale test, finding that the decedent retained enjoyment and possession of the assets he transferred to the limited partnership. In Moore, Mr. Moore was negotiating to sell his farm and, at effectively the same time, he entered into a sales contract for $16.5 million and transferred an 80% interest in the farm to a limited partnership in exchange for a 95% limited partnership interest. The 1% general partner was an irrevocable management trust with two of Mr. Moore's children as the co-trustees. Mr. Moore and the trust then completed the sale. On the same day that the partnership and management trust were formed, Mr. Moore created an IDGT to which he gave $500,000 as seed money, and within a matter of weeks, he sold his 95% limited partnership interest to the trust at a 50% discount for $500,000 down and a $4.8 million promissory note. Despite his children's nominal control of the general partner interest, the court found that Mr. Moore exercised practical control over the partnership. He directed the transfers of $2 million of the sales proceeds to his revocable trust, $2 million to his children ($500,000 cash to each child in exchange for promissory notes that were disregarded by the court, so these transfers were treated as gifts), and $500,000 cash to a grandson as a gift. The court, in including the assets of the limited partnership in Mr. Moore's estate, found that the bona fide sale exception to section 2036(a) did not apply because no active management was required for the partnership, the children did not actually manage the sales proceeds, there were no legitimate creditor protection issues, and the entire plan involving the partnership had a "testamentary essence." A formula charitable deduction clause in Mr. Moore's revocable trust which purported to pass to a charitable lead trust an amount to "result in the least possible federal estate tax" did not save the transaction, since the specific wording of the formula limited the amount of the transfer, and the

amount passing to the trust was not ascertainable at the time of Mr. Moore's death because determining the final amount depended upon the results of an IRS audit and tax litigation. The court also ruled that the $2 million passing to the children were gifts. After a detailed review of the factors considered in finding whether a bona fide debt existed as described in Estate of Lillie Rosen v. Commissioner, TC Memo 2006-115 discussed above, the court found that few of those factors were found in the children's loans, and as a result, the transfers were intended as gifts.

Also instructive is the decision in Estate of Powell v. Commissioner, 148 TC 392 (2017), where the full Tax Court, in a reviewed opinion, applied section 2036(a)(2) (involving transfers with a retained right, either alone or in conjunction with any person, to designate the persons who possess or enjoy the transferred property or its income) to include the underlying undiscounted assets associated with a death-bed limited partnership in the decedent's estate, despite the fact that the decedent held only a limited partnership interest. The partnership was created by the decedent's son as his mother's agent under her power of attorney, and the decedent lived for a mere seven days after the partnership was formed. The Tax Court did not, however, state that the formation of the limited partnership pursuant to the agency relationship or shortly before death were relevant. Instead, the court found relevant that the decedent, in conjunction with all of the other partners, could dissolve the partnership, and that the decedent, through her son as the general partner and acting as her agent, could control the amount and timing of distributions. The U.S. Supreme Court, in the United States v. Byrum, 408 U.S. 125 (1972), had held that the fiduciary duty owed by business owners to one another normally prevented the application of section 2036(a) in this setting. Although the Powell court addressed the fiduciary duty of partners analysis that the Supreme Court articulated in Byrum, it adopted instead the analysis in Estate of Strangi v. Commissioner, TC Memo 2003-15, aff'd, 417 F.3d 468 (5th Cir. 2005), holding that under the facts of Powell, the fiduciary duty was "illusory." The court noted that the son, as general partner, also owed a fiduciary duty to the decedent as her agent under the power of attorney which outweighed that of a business owner. The court noted that the decedent was the sole limited partner and that the partnership conducted no meaningful business activities. As a result, the court disallowed the Byrum argument as it relates to fiduciary duty to avoid inclusion under section 2036(a)(2). In a more troubling aspect of the case, a majority of the Tax Court raised the possibility that in addition to including the undiscounted assets of the partnership in the estate pursuant to section 2036, the value of the partnership interest itself should be included in the decedent's estate under the general inclusion principles of section 2033, despite the fact that such a holding would effectively result in a double inclusion of the value of those assets. This position of the Tax Court was initiated by the court and was not raised or addressed by the parties. It is therefore unknown at this point, of course, if the IRS will take this decision as an invitation to raise the issue in other cases.

Selling the asset for less than full and adequate consideration may have income tax consequences in the long run as well. While Revenue Ruling 85-13 assures us that there are no income tax consequences at the time of the sale, income tax consequences may arise when grantor trust status terminates. If the assets are sold for less than full and adequate consideration, the IRS treats the transaction as two transactions, one a sale and the other a gift, otherwise known as a "bargain sale" (which may have also have implications in other transactions, such as self-cancelling installment notes, discussed below). Treas. Reg. § 1.1001-1(e). In that event, a sale occurs and gain is recognized to the extent that the consideration received exceeds the transferor's basis, but if the consideration received is less than that basis, no loss is allowed. Id. The transferee's basis is the greater of the amount paid or the transferor's basis, plus any gift tax payable by the transferor attributable to the appreciation of the property over the transferor's basis. Treas. Reg. § 1.1015-4; see also, Post v. Comm'r, 26 TC 1055 (1956).

8. Self-Cancelling Installment Note. Suppose the note issued by the trust disappears – is cancelled – at a grantor/seller's death. In order for the note to be worth the purchase price, the face value of the note, and thus the principal payments, or the interest rate, and thus the interest payments, must be increased to take into consideration the risk that the grantor will die and the note not be paid. Often it is assumed that the usual actuarial tables under section 7520 would be used to adjust for such mortality risk, but there appears to be no authority for such position. Using a professional actuary may be a more conservative approach.

9. Sale For An Annuity

Estate planners often consider another option for clients who are perhaps not expected to survive to their actuarial life expectancy. Instead of transferring assets in exchange for a note (self-cancelling or otherwise), these clients may consider selling assets to a junior family member in exchange for a promise to make an annuity payment for the lifetime of the senior family member, or for a period of years likely to exceed the actual life expectancy of the senior family member.

a. The Technique. A private annuity is similar to a self-cancelling installment note arrangement. Instead of giving a note, the buyer promises to make a fixed annual payment to the seller for life, no matter how long the seller lives. Because the annuity payment obligation terminates at death, no value is included in the seller's estate for any unpaid amounts. Of course, the amounts received by the seller during his or her lifetime (to the extent not consumed, given away, or otherwise disposed of) will be included in the seller's estate. The IRS publishes life expectancy tables that can be used to value the private annuity, so long as the seller isn't "terminally ill." Because of the income tax issues associated with private annuities, a grantor trust may be the preferred choice as an issuer of a private annuity. Prop. Treas. Reg. §§ 1.1001-1(j), 1.72-6(e). However, as discussed below, payment from a "limited fund" like a trust has its own issues.

b. Structure. Typically, the senior family member transfers assets to a junior family member in exchange for junior's promise to make fixed payments to senior for the remainder of senior's life. Because the annuity terminates upon the senior family member's death, it is not includible in his or her estate. For gift tax purposes, the value of the annuity payments is based on the section 7520 rate and the senior family member's life expectancy. Treas. Reg. § 1.7520-1. If the fair market value of the assets transferred from senior to junior equals the value of the annuity, there is no gift tax due. Treasury regulations expressly provide that the standard mortality tables of section 7520 may be used, provided that the taxpayer is not "terminally ill." Treas. Reg. § 25.7520-3(b)(3). The regulations provide that an individual is terminally ill if he or she has at least a 50% chance of dying within one year, but there is a rebuttable presumption that the individual is not terminally ill if he or she lives at least 18 months after the transfer. To overcome any issues regarding whether the senior family member was terminally ill at the time of the transaction, it is important to obtain an opinion from a qualified physician familiar with the grantor's medical condition.

c. Income Taxation of Annuity Payments. The IRS has treated a private annuity much like a note for income tax purposes, with the senior family member reporting any gain ratably over the annuity term. See § 72; see also Rev. Rul. 69-74 (annuity payments apportioned ratably among (i) recovery of basis; (ii) capital gain; and (iii) annuity components). However, under proposed regulations, the ratable recognition approach is not available in the context of a sale of property for a private annuity. Instead, for annuity contracts received after October 18, 2006, the senior family member is required to recognize gain at the time the assets are transferred in exchange for the annuity. Prop. Treas. Reg. § 1.1001-1(j), Treas. Reg. § 1.451-1(a). Note, however, that these regulations are merely proposed, and are not binding on taxpayers until they become final. Note also that if the assets are sold to a grantor trust, no gain is recognized on the sale, and therefore, the proposed regulations would have no effect.

d. The Exhaustion Test. Treasury regulations include a unique requirement for private annuities. In general, the regulations don't allow the use of a standard section 7520 valuation of the annuity stream if the annuity is payable from a trust, partnership, or other limited fund for the lifetime of one or more individuals unless, using the section 7520 interest rate at the valuation date of transfer, the fund is sufficient to make all required annuity payments until the annuitant reaches age 110. Treas. Reg. §§ 1.7520-3(b)(2)(i), 20.7520-3(b)(2)(i), 25.7520-3(b)(2)(i). In other words, in order to value a private annuity under section 7520, the annuity must meet this exhaustion test. This rule has the practical effect of either limiting the annuity term so that it doesn't exceed the term that would exhaust the trust, or "overfunding" the trust so that it holds a cushion of assets sufficient to continue payments until the transferor reaches age 110. Unless a trust is very well funded, guarantees by individuals may be needed, although there is no authority that a guarantee is by the same thing as a sale to, an individual.

e. Estate Tax Exposure. If the amount of the annuity closely approximates the income or cash flow from the transferred asset, especially if the only way to make the payments are from the transferred assets, the IRS might argue that in effect, the senior family member made a transfer of assets while retaining the right to the income from the property, which would cause the transferred property to be included in the estate of the senior family member under section 2036 of the Code. See Rev. Rul. 68-183 (transfer of stock paying a $40x-per-year dividend in exchange for a $40x-per-year annuity for life constitutes a transfer with a retained right to income requiring inclusion of the transferred stock in the estate of the transferor at death under section 2036); Fidelity-Philadelphia Trust Co. v. Smith, 356 U.S. 274 (1958); *Weigl v. Comm'r*, 84 TC 1192 (1985) (grantor of trust had not entered into a bona fide annuity transaction with trust and was therefore taxable on trust income pursuant to grantor trust rules); Trombetta v. Comm'r, TC Memo 2013-234. See also, Rev. Rul. 79-94. In order to avoid the application of section 2036, estate planners typically suggest that the transaction expressly (i) requires that the annuity payments be made without regard to whether the property transferred produces income (perhaps including a personal guarantee by trust beneficiaries where the transferee is a trust); (ii) provides for an annuity payment that is substantially different from the amount of

income produced by the transferred property; and (iii) arranges for the transferee to have assets in addition to those transferred in exchange for the annuity promise to ensure "coverage" for the annuity payments. Again, a large federal gift tax exclusion makes fulfilling these requirements more palatable for many clients.

f. Outliving the Tables. The payments under a private annuity need not end at a fixed maturity date (so long as the exhaustion test is met), but may be extended for the client's lifetime. This continuation of payments may be a comfort to clients who are concerned about giving away "too much," and not retaining enough to support themselves for the rest of their lives. Of course, a private annuity poses an estate tax risk that the payments made will actually add value to the senior family member's estate if he or she lives to maturity. In fact, if the private annuity is structured to require payments for the lifetime of the transferor, and if the senior family member lives well beyond his or her life expectancy, these additional payments can add substantial value (and taxable income) to the recipient's estate.

One way to guard against this possibility might be to structure the private annuity to last for the shorter of a term of years or life. Another option would be to structure the private annuity as a deferred annuity which would begin annuity payments after a specified time, realizing that those payments would be larger than if they began immediately; however, it may be difficult to meet the exhaustion test using this structure. In addition, if the deferral is too long, especially in light of the annuitant's health, the IRS might view the private annuity to be abusive. See Kite v. Comm'r, TC Memo 2013-43.

g. Income Tax Basis Planning. Step one, recognize the issue and let the client, the family, and all advisors know. Step two, death is by far the easiest way to obtain new basis. Accordingly, move assets around to ensure that assets that should have good basis are owned by someone who is near death or is likely to die sooner than others in the family group. Swapping assets with grantor trusts.

10. Using Special-Use Valuation Under Section 2032A

Section 2032A allows farmland to be valued as farmland even if the fair market value of the land would be higher if used for some other purpose. The maximum amount of the reduction is $1,310,000 for 2023, a number which is indexed for inflation. The usefulness of the 2032A reduction has declined as the applicable exclusion amount has increased. An election is made on the Form 706, which may be filed late so long as the election is made on the first 706 filed by an estate.

PLR 9407015 is illustrative. First, section 2032A, when properly elected, determines the value, for estate tax purposes, of the property for which the election is made (see Rev. Rul. 83-81). Thus, the section 2032A value is used in making the allocations required by a marital deduction formula clause. When the drafter anticipates use of section 2032A, the formula clause should use a pecuniary marital with a credit shelter residual disposition. Assume a decedent who owns a $1,000,000 farm, but which has a value for section 2032A purposes of $400,000. The decedent has $150,000 of other assets. If a pecuniary credit shelter is used, requiring distribution based on date of distribution values, not all of the farm will be "needed" and thus some will pass to the marital share. But, if a pecuniary marital is used, the entire farm, and other assets, will pass to the residue because no pecuniary amount need be set aside. Second, where a decedent creates a life estate for the family with remainder to charity, section 2032A cannot be used because the charity is not a qualified heir under section 2032A(e)(1) (see Rev. Rul. 81-220).

1. Real property may qualify for the election if:

a. The decedent was a U.S. citizen or resident at the time of death;

b. The real property is located in the United States;

c. At the decedent's death, the real property was used by the decedent or a family member for farming (or in a trade or business). Rental of the property, by the surviving spouse or a descendant, to a family member who uses the property for farming (or in a trade or business) counts if it were on a net cash basis;

d. The real property was acquired from or passed from the decedent to a "qualified heir" of the decedent;

e. The real property was owned and used in a qualified manner by the decedent or a member of the decedent's family during five of the eight years before the decedent's death;

f. There was material participation by the decedent or a member of the decedent's family during five of the eight years before the decedent's death; and

g. The property meets certain percentage requirements, as follows:

i. At least 50% of the adjusted value of the decedent's gross estate must consist of the adjusted value of real or personal property that was being used as a farm (or in a closely held business) and that was acquired from, or passed from, the decedent to a qualified heir of the decedent.

ii. At least 25% of the adjusted value of the decedent's gross estate must consist of the adjusted value of qualified farm or closely held business real property.

For these purposes, "adjusted value" is the value of property determined without regard to its special-use value. The value is reduced for unpaid mortgages on the property or any indebtedness against the property, if the full value of the decedent's interest in the property (not reduced by such mortgage or indebtedness) is included in the value of the gross estate. The adjusted value of the qualified real and personal property used in different businesses may be combined to meet the 50% and 25% requirements.

2. Special Definitions.

a. Qualified use. Qualified use means use of the property as a farm for farming purposes (or in a trade or business other than farming, and only if it is active – e.g. passive rental doesn't count, and nothing not engaged in for profit counts).

b. Ownership. To qualify as special-use property, the decedent or a member of the decedent's family must have owned and used the property in a qualified use for 5 of the last 8 years before the decedent's death. Ownership may be direct or indirect through a corporation, a partnership, or a trust. Directly owned property leased by the decedent to a separate closely held business is considered qualified real property if the business entity to which it was rented was a closely held business (as defined by section 6166) for the decedent on the date of the decedent's death and for sufficient time to meet the "5 in 8 years" test explained above. If the ownership is indirect, the business must qualify as a closely held business under section 6166. The indirect ownership, when combined with periods of direct ownership, must meet the requirements of section 6166 on the date of the decedent's death and for a period of time that equals at least 5 of the 8 years preceding death.

c. Qualified Real Property. Structures and other real property improvements. Qualified real property includes residential buildings and other structures and real property improvements regularly occupied or used by the owner or lessee of real property (or by the employees of the owner or lessee) to operate a farm or other closely held business. A farm residence that the decedent occupied is considered to have been occupied for the purpose of operating the farm even when a family member and not the decedent was the person materially participating in the operation of the farm. Qualified real property also includes roads, buildings, and other structures and improvements functionally related to the qualified use. Mineral rights not eligible for special-use valuation.

d. Property acquired from the decedent. Property is considered to have been acquired from or to have passed from the decedent if one of the following applies: (i) the property is considered to have been acquired from or to have passed from the decedent under section 1014(b) (relating to basis of property acquired from a decedent); (ii) the property is acquired by any person from the estate; or (iii) the property is acquired by any person from a trust, to the extent the property is includible in the gross estate.

e. Qualified heir. An individual is a qualified heir of property if the individual is a member of the decedent's family and acquired or received the property from the decedent. If a qualified heir disposes of any interest in qualified real property to any member of the qualified heir's family, that person will then be treated as the qualified heir for that interest.

f. Member of the family. A member of the family includes only (i) an ancestor (parent, grandparent, etc.) of the individual; (ii) the spouse of the individual; (iii) the lineal descendant (child, stepchild, grandchild, etc.) of the individual, the individual's spouse, or a parent of the individual; or (iv) the spouse or surviving spouse of any lineal descendant described above. Adopted children are treated the same as blood children.

g. Material Participation. To elect special-use valuation, either the decedent or a member of the decedent's family must have materially participated in the operation of the farm or other business for at least five of the eight years ending on the date of the decedent's death. The existence of material participation is a factual determination. Passively collecting rents, salaries, draws, dividends, or other income from the farm or other business is not sufficient for material participation, nor is merely advancing capital and reviewing a crop plan and financial reports each season or business year.

Children of a decedent whose farm was valued under section 2032A must continue to farm (i.e., use in a qualified use) the property for 10 years after the decedent's death. In general, when the children enter into a fixed cash rental arrangement with another party who assumes the "financial risks of farming," they cease to be in the farming business and became landlords. This triggers recapture of the estate tax savings. In Minter v. U.S., 19 F.3d 426 (8th Cir. 1994), the decedent's children entered into a fixed cash rental to a family farming corporation owned, after parent's death, by (directly or indirectly) the children. The court held:

> When we apply the test of substantial dependence on production to the undisputed facts in this case, we conclude the trustee's leases of the farmland to the family's farming corporation continued the use that qualified Mrs. Fisher's estate for preferential treatment when the estate tax return was filed. As the owners of the farmland and the family farming corporation, the sisters and their brother necessarily retained the financial risks of farming when their farmland was farmed by their corporation. The sisters' rent income, like their mother's rent income before them, depended on the farmland's productivity and the variable risks of weather, disease, and fluctuating prices. Unlike landowners entering into leases with another farmer who takes on the risks and agrees to pay fixed rent whether the farming operation is profitable or not, the sisters assumed substantially the same risks under the trustee's leases as they would have incurred by farming the land themselves. If the corporation's farming operation flourished, the sisters received their rent income; otherwise not. Indeed, the undisputed facts refute the Government's argument that the leases insulated the sisters from the risks of farming. During the period covered by the trustee's leases, the sisters each lost over $25,000 from the corporation's farming activities.

h. Brief Interludes. In determining whether the required participation has occurred, brief periods (that is, 30 days or less) during which there was no material participation may be disregarded, as long as such periods were both preceded and followed by substantial periods (more than 120 days) during which there was uninterrupted material participation.

i. Retirement or disability. If, on the date of death, the time period for material participation could not be met because the decedent was retired or disabled, a substitute period may apply. The decedent must have retired on social security or been disabled for a continuous period ending with death. A person is disabled for this purpose if the person was mentally or physically unable to materially participate in the operation of the farm or other business. The substitute time period for material participation for these decedents is a period totaling at least five years out of the eight year period that ended on the earlier of: (i) the date the decedent began receiving social security benefits, or (ii) the date the decedent became disabled.

j. By Surviving Spouse. A surviving spouse who received qualified real property from the predeceased spouse is considered to have materially participated if the surviving spouse was engaged in the active management of the farm or other business. If the surviving spouse died within eight years of the first spouse's death, you may add the period of material participation of the predeceased spouse to the period of active management by the surviving spouse to determine if the surviving spouse's estate qualifies for special-use valuation. To qualify for this, the property must have been eligible for special-use valuation in the predeceased spouse's estate, though it does not have to have been elected by that estate. TAM 9428002 provides a good discussion of the "qualified use" and "material participation" requirements. The IRS concluded that neither were met.

3. Valuation. In the view of the IRS, the primary method of valuing special-use property that is used for farming purposes is the annual gross cash rental method. If comparable gross cash rentals are not available, you can substitute comparable average annual net share rentals. If neither of these is available, or if you so elect, you can use the method for valuing real property in a closely held business. The instructions for the Form 706 describe a formula as follows:

> **Average annual gross cash rental.** Generally, the special-use value of property that is used for farming purposes is determined as follows.
>
> 1. Subtract the average annual state and local real estate taxes on actual tracts of comparable real property from the average annual gross cash rental for that same comparable property.
>
> 2. Divide the result in (1) by the average annual effective interest rate charged for all new federal land bank loans.
>
> The computation of each average annual amount is based on the 5 most recent calendar years ending before the date of the decedent's death.
>
> **Gross cash rental**. Generally, gross cash rental is the total amount of cash received in a calendar year for the use of actual tracts of comparable farm real property in the same locality as the property being specially valued. You may not use:
>
> - Appraisals or other statements regarding rental value or areawide averages of rentals,
> - Rents paid wholly or partly in-kind, or
> - Property for which the amount of rent is based on production.
>
> The rental must have resulted from an arm's-length transaction and the amount of rent may not be reduced by the amount of any expenses or liabilities associated with the farm operation or the lease.
>
> **Comparable property**. Comparable property must be situated in the same locality as the qualified real property as determined by generally accepted real property valuation rules. The determination of comparability is based on a number of factors, none of which carries more weight than the others. It is often necessary to value land in segments where there are different uses or land characteristics included in the specially valued land. You must specifically identify on the return the property being used as comparable property.
>
> The following list contains some of the factors considered in determining comparability.

- Similarity of soil.
- Whether the crops grown would deplete the soil in a similar manner.
- Types of soil conservation techniques that have been practiced on the two properties.
- Whether the two properties are subject to flooding.
- Slope of the land.
- For livestock operations, the carrying capacity of the land.
- For timbered land, whether the timber is comparable.
- Whether the property as a whole is unified or segmented. If segmented, the availability of the means necessary for movement among the different sections.
- Number, types, and conditions of all buildings and other fixed improvements located on the properties and their
- location as it affects efficient management, use, and value of the property.
- Availability and type of transportation facilities in terms of costs and of proximity of the properties to local markets.

Using section 2032A does not negate the application of other valuation principles, such as a minority discount. In Hoover v. Commissioner, 95-2 USTC 60,217 (10th Cir. 1996), the court allowed a minority discount and section 2032A. The land was owned by a corporation.

Comparability and valuation were at issue in Estate of Lewis S. Thompson, III v. Commissioner, T.C. Memo. 1998-325 where the Tax Court held that taxpayer's expert did not meet the regulatory requirements for a valid section 2032A election:

> Section 20.2032A-4(b)(2), Estate Tax Regs., describes the documentation required from the executor in order to value property under section 2032A(e)(7)(A). The regulation states that "The executor must identify to the Internal Revenue Service actual comparable property for all specially valued property and cash rentals from that property" for each of the 5 calendar years preceding the year of the decedent's death. Sec. 20.2032A-4(b)(2)(i) and (iv), Estate Tax Regs.
>
> The determination of whether property is comparable is a factual one and is made according to "generally accepted real property valuation rules". Sec. 20.2032A-4(d), Estate Tax Regs. Factors to be considered in such a determination include, but are not limited to, whether the property is situated in the same locality as the specially valued property; whether the property is segmented or unified; whether the property is subject to flooding; and, in the case of timberlands, the comparability of the timber to the timber located on the property to be specially valued. Sec. 20.2032A-4(d), Estate Tax Regs.
>
> Frazer [taxpayer's expert] utilized 8 timberland properties as comparables in his report. The report identified the lessor and lessee, the location of the property, the initial year of the lease, and the cash consideration paid for each of the 8 properties used as comparables. The report also listed the "Adjusted Net Lease

> Income/Acre" for the 8 properties and the "Average" thereof ($15). The report indicated no adjustments to any of the 8 properties used as comparables based on the factors set forth in section 20.2032A-4(d), Estate Tax Regs.
>
> For the following reasons, we conclude that the report is completely unreliable as to whether any of the 8 properties were indeed comparable to the subject property. The putative comparables ranged in size from 44 acres to 34,365 acres, yet no adjustment to any of them was made for size even though the substantially disparate sizes of the properties would appear to have some significance in terms of economies of scale. Frazer also did not make any adjustments for location, land quality, or timber type/maturity in his report. Moreover, no description of the properties was contained in the report, from which Frazer appears implausibly to be inferring that they were sufficiently similar so as to warrant none of the above adjustments.
>
> We are also not convinced that the special use valuation of the subject property was based on actual cash rents of the putative comparables as is called for under the regulations. Section 20.2032A-4(b)(2)(iii), Estate Tax Regs., provides that "appraisals or other statements regarding rental value as well as area-wide averages of rentals * * * may not be used under section 2032A(e)(7) because they are not true measures of the ACTUAL CASH RENTAL VALUE OF COMPARABLE PROPERTY in the same locality as the specially valued property." (Emphasis added.)
>
> Although in effect for the 5 years preceding decedent's death in 1992, the 8 timberland leases were entered into over the 27- year period from 1957 through 1984. For those leases which did not contain rent escalation clauses, Frazer claimed to have applied the "Producer Price Index" (PPI) to the consideration stated therein in an effort to calculate the market rental value of those properties for the 5-year period preceding decedent's death. The result was termed the "Adjusted Net Lease Income/Acre" in his report.

In Estate of Carolyn J. Rogers v. Commissioner, T.C.M. 2000-133, the court reached a different conclusion from that of Thompson:

> In Estate of Thompson v. Commissioner, T.C. Memo. 1998- 325, we concluded that the taxpayer had failed to identify comparable real properties and cash rentals within the meaning of section 2032A(e)(7), where the expert's adjusted net lease income per acre figures were more akin to an appraisal, which is expressly prohibited by section 20.2032A-4(b)(2)(iii), Estate Tax Regs., rather than an accurate calculation of actual cash rents.
>
> In Estate of Thompson we concluded that the expert's report was completely unreliable as to whether any of eight properties were indeed comparable to the subject property for the following reasons. First, the alleged comparable properties ranged in size from 44 acres to 34,365 acres, compared to the subject property of 2,929 acres. In addition, the expert made no adjustments due to differences in location, land quality, or timber type/maturity. Moreover, no description of the properties was contained in the expert's report.
>
> In decedent's estate here, five out of seven tracts share nine out of the nine applicable features set forth in section 20.2032-4(d), Estate Tax Regs. For decedent's estate, the range in size of comparables is much tighter: comparables of 261 to 1,665.28 acres (for subject properties ranging from 65-1670 acres). Furthermore, Dr. Haney excluded potential comparables because of differences in location, land quality, and timber type/maturity. Dr. Haney excluded the

potential comparable in Fayette County because of location; he excluded a Pickens County tract with somewhat different slope and soil. Further, Dr. Haney proposed a 10-percent reduction to four of the subject properties, because of the superior quality of timber on the five leased tracts. As noted previously, however, such a reduction is inappropriate as appraisals are not true measures of the actual cash rental value of comparable property. Moreover, petitioner provided detailed descriptions of the subject properties and the leased properties in the original estate tax return; more detailed descriptions of the leased properties are provided in the leases and Dr. Haney's reports.

The eight leases in Estate of Thompson were entered into over a 27-year period, some with no rent escalation clause. For those leases with no rent escalation clause, the expert claimed to have applied the "Producer Price Index" (PPI) in an effort to calculate the market rental value of those properties for the 5- year period preceding decedent's death. Petitioner requested that we take judicial notice of Report 807, Escalation and Producer Price Indexes: A Guide for Contracting Parties issued by the U.S. Department of Labor, Bureau of Labor Statistics in September 1991 for the purpose of establishing that the PPI can be applied to contract rents to calculate accurately fair market rents for future years in the absence of escalation clauses, as the expert claimed to have done. We determined in Estate of Thompson that:

> Report 807 does not support the proposition that market rents for the relevant period can be accurately calculated from contract rents entered into several decades beforehand via the application of the PPI for purposes of section 2032A(e)(7)(A) for those leases which do not themselves contain rent escalation clauses. Rather, Report 807 provides guidance to contracting parties with respect to the use of price adjustment clauses at the time the contract is entered into. * * *

In Estate of Thompson the average gross cash rental for the 5 years preceding the decedent's death was determined by the expert on the basis of his "personal knowledge * * * what I thought would be the indicated market rent for what I knew about the whole business, and that's it." Furthermore, the expert testified that he validated his estimate of the cash rental rate for the timberland by reference to the prevailing rate for cropland during the relevant period, of which there was no evidence.

In decedent's estate here, the special use valuation of the five estate tracts is based exclusively on actual cash rents from the five leased tracts for the 5 years preceding decedent's death. All five leases for the five leased tracts contain rent escalation clauses; as escalated, the leases constituted the prevailing rents during the statutory period on that type of land. Both the actual rents and State and local property taxes were explained and are fully substantiated with original source data. There is no adjustment to rents because petitioner used only actual current rents during the statutory period.

Respondent also asserts that the five estate tracts and the five leased tracts are not comparable in any manner in regard to the rental values. Respondent contends that the regulations require that "generally accepted real property valuation rules" be applied to determine comparability of the property. Sec. 20.2032A-4(d), Estate Tax Regs. Respondent asserts that the maximum period allowed under real estate valuation rules is 5 years prior to the valuation date. On brief, respondent states this argument as follows:

> Leases that establish the applicable rents are leases that would have been negotiated and entered into during the five-year period. Leases that were negotiated more than five years prior to the date of death do not accurately reflect the economic conditions at the date of death and the current rental values of comparable lands. Comparability must be based on numerous factors, no one of which is determinative. See sec. 20.2032A-4(d), Estate Tax Regs. All factors generally considered in real estate valuation are to be considered in determining comparability under section 2032A. See id. However, respondent seeks to exclude the comparable land on the basis of one factor and one factor only (the age of the leases — which is not even one of the factors enumerated in the regulations).

Neither the statute nor the regulations support respondent's position in that respect. In this case, the parties stipulated that the typical timber lease in effect in western Alabama between 1987 and 1991 was entered into in the 1950's, 1960's, and early 1970's and was a long-term timber lease. Respondent's argument would exclude every lease executed before August 19, 1987, which would effectively operate to prevent estates in Alabama from using section 2032A(e)(7) to value timberland since the typical timber lease in effect in western Alabama between 1987 and 1991 was entered into in the 1950's, 1960's, and early 1970's.

Respondent has submitted an original and two rebuttal reports from his expert, Richard Maloy. Mr. Maloy contends that, "Comparable leases must have been negotiated under recent (5-year period of analysis) dates to ensure comparability of economic conditions." Mr. Maloy is simply parroting respondent's primary legal argument that would inject an arbitrary requirement for application of section 2032A(e)(7) — that is, as a matter of law no lease can be considered unless it was executed within 5 years of the date of death. We have stated before, in Alumax v. Commissioner, 109 T.C. 133, 171 (1997): "We shall disregard any opinion of an expert that constitutes nothing more than that expert's legal opinion or conclusion about a particular matter."

Mr. Maloy further states the following: "Lease comparability under section 2032A(e)(7) would require recent leases, foreseeable within the 5-year average. This is relatively easy in row crop valuation, but generally eliminates the use of this section in timber land valuation."

Two consecutive paragraphs establish that the protection afforded farms by section 2032A was intended to apply to timberland. Section 2032A(e)(7) sets forth the "Method of valuing farms." Section 2032A(e)(4) and (5) leaves no doubt that timber operations are included under section 2032A(e)(7) and (8). Furthermore, factor (7) under section 20.2032A-4(d), Estate Tax Regs., obviously contemplates that rented timberland may be comparable property.

As stipulated, the leases represented the typical timber leases in effect in western Alabama during the 5-year statutory period. Moreover, the inflation-adjusted rents paid under these leases constituted the prevailing rents in effect during the statutory period. All of the leases on the five leased tracts have escalation clauses. Moreover, in contrast to the fatal "judgment call" as to the annual rents in Estate of Thompson v. Commissioner, T.C. Memo. 1998-325, the parties have stipulated the precise, actual annual gross rents for the statutory period.

Consequently, with their escalation clauses, the stipulated rents constitute the prevailing rents actually paid on comparable land in western Alabama under the

typical/standard lease in effect during the statutory period. Once the unleased and the leased land are determined to be comparable (as we have found), section 2032A(e)(7) permits petitioner to use for valuation purposes the average annual gross cash rents for the 5 calendar years preceding decedent's death.

4. Making the Election. If an estate elects special-use valuation for the estate tax, it must also elect special-use valuation for the GST tax and vice versa. Because the special-use valuation election creates a potential tax liability for the recapture tax of section 2032A(c), the estate must list each person who receives an interest in the specially valued property on Schedule A-1. In the columns "Fair market value" and "Special-use value," enter the total respective values of all the specially valued property interests received by each person.

In Estate of Joseph A. Sequeira, TCM 1995-450 (1995) the Tax Court found that substantial compliance with the section 2032A regulations was not present when the italicized items on the following list were not present:

(i) The decedent's name and taxpayer identification number as they appear on the estate tax return;

(ii) The relevant qualified use;

(iii) The items of real property shown on the estate tax return to be specially valued pursuant to the election (identified by schedule and item number);

(iv) The fair market value of the real property to be specially valued under section 2032A and its value based on its qualified use (both values determined without regard to the adjustments provided by section 2032A(b)(3)(B)[);]

(v) The adjusted value (as defined in section 2032A(b)(3)(B)) of all real property which is used in a qualified use and which passes from the decedent to a qualified heir and the adjusted value of all real property to be specially valued;

(vi) The items of personal property shown on the estate tax return that pass from the decedent to a qualified heir and are used in a qualified use under section 2032A (identified by schedule and item number) and the total value of such personal property adjusted as provided under section 2032A(b)(3)(B);

(vii) The adjusted value of the gross estate, as defined in section 2032A(b)(3)(A);

(viii) The method used in determining the special value based on use;

(ix) Copies of written appraisals of the fair market value of the real property;

(x) A statement that the decedent an/or [sic] a member of his or her family has owned all specially valued real property for at least 5 years of the 8 years immediately preceding the date of the decedent's death;

(xi) Any periods during the 8-year period preceding the date of the decedent's death during which the decedent or a member of his or her family did not own the property, use it in a qualified use, or materially participate in the operation of the farm or other business within the meaning of section 2032A(e)(6);

(xii) The name, address, taxpayer identification number, and relationship to the decedent of each person taking an interest in each item of specially valued property, and the value of the property interests passing to each such person based on both fair market value and qualified use;

(xiii) Affidavits describing the activities constituting material participation and the identity of the material participant or participants; and

(xiv) A legal description of the specially valued property.

[Emphasis added.]

5. GST. To figure the additional GST tax due upon disposition (or cessation of qualified use) of the property, each "skip person" (as defined in the instructions for Schedule R) who receives an interest in the specially valued property must know the total GST tax savings all interests in specially valued property received. The GST tax savings is the difference between the total GST tax that was imposed on all interests in specially valued property received by the skip person valued at their special-use value and the total GST tax that would have been imposed on the same interests received by the skip person had they been valued at their FMV.

Because the GST tax depends on the executor's allocation of the GST exemption and the grandchild exclusion, the skip person who receives the interests is unable to figure this GST tax savings. Therefore, for each skip person who receives an interest in specially valued property, you must attach a calculation of the total GST tax savings attributable to that person's interests in specially valued property.

Agreement to Special Valuation Under Section 2032A

The agreement to special valuation is required under sections 2032A(a)(1)(B) and (d)(2) and must be signed by all parties who have any interest in the property being valued based on its qualified use as of the date of the decedent's death.

An interest in property is an interest that, as of the date of the decedent's death, can be asserted under applicable law so as to affect the disposition of the specially valued property by the estate. Any person who at the decedent's death has any such interest in the property, whether present, future, vested, or contingent, must enter into the agreement. Included are the following.

- Owners of remainder and executory interests;
- Holders of general or special powers of appointment;
- Beneficiaries of a gift over in default of exercise of any such power;
- Joint tenants and holders of similar undivided interests when the decedent held only a joint or undivided interest in the property or when only an undivided interest is specially valued; and
- Trustees of trusts and representatives of other entities holding title to or any interests in the property.

An heir who has the power under local law to challenge a will and thereby affect disposition of the property is not, however, considered to be a person with an interest in property under section 2032A solely by reason of that right. Likewise, creditors of an estate are not such persons solely by reason of their status as creditors.

If persons required to enter into the agreement desire that an agent act for them or cannot legally bind themselves due to infancy or other incompetency, or due to death before the election under section 2032A is timely exercised, a representative authorized by local law to bind persons in agreements of this nature may sign the agreement on the person's behalf.

> The IRS will contact the agent designated in the agreement on all matters relating to continued qualification under section 2032A of the specially valued real property and on all matters relating to the special lien arising under section 6324B. It is the duty of the agent as attorney-in-fact for the parties with interests in the specially valued property to furnish the IRS with any requested information and to notify the IRS of any disposition or cessation of qualified use of any part of the property.

6. Protective Election. A protective election may be made to specially value qualified real property where the election ultimately depends on final values (after IRS audit) and whether the IRS agrees the land subject to the election qualifies. To make a protective election, the Form 706 is filed without using section 2032A values. Then, if the estate turns out to qualify for special-use valuation based on the values as finally determined, the estate must file an amended Form 706 (with a complete section 2032A election) within 60 days after the date of the determination.

7. Development as Disposition. In Estate of James C. Gibbs, Sr. v. United States, 82 AFTR2d ¶ 98-5557 (3rd Cir. 1998), the court held that granting a development easement to the state of New Jersey was a disposition of qualified farm property that triggered recapture of estate tax under section 2032A(c)(1). The court's rationale was that the heir benefitted from the property's "highest and best use" through the grant of the easement. Stated differently, the court viewed the land as a bundle of two rights — the land's agricultural use, plus non-agricultural development rights. In order to obtain special use valuation the estate had to warrant that only agricultural use would be made during the 10-year recapture. By granting the easement the owner benefitted from the development value of the land.

In TAM 9433003, the National Office allowed land which was being used in the house boarding and riding lessons business at the decedent's death to be valued under section 2032A even though the land was to be used for residential development, because:

> . . . at no time during the Decedent's life was any physical action taken (no lots were sold, no sewer lines placed, and no roads were made) that prevented the land from being used in the ongoing trade or business of horse boarding and riding lessons. In summary, the horse business was not interrupted or restricted by the plan to develop the land. Thus, we conclude that the §2032A requirement that land be used in a trade or business is satisfied for the open fields that are used for training, pasture, and riding lessons.

D. Income Tax and Basis Planning

1. Powers of Appointment For Basis Purposes Generally

a. Generally. Consideration should be given to using a "circumscribed general power" that has the following characteristics: (1) a testamentary power, (2) in favor of the creditor of the powerholder's estate, (3) with the consent of a non-adverse party, (4) only over assets with a fair market value in excess of basis, and (5) capped such that the amount subject to the power when added to the other assets of the powerholder produces a total that is $10,000 less than the powerholder's Basic Exclusion Amount.

b. Creditors. The rights of creditors to property over which a powerholder has a testamentary general power is worth considering. The majority view at common law is that the powerholder of a power, conferred on the powerholder by another, is treated as the beneficial owner of the appointive property for purposes of creditors' rights only if (1) the power is general *and* (2) the powerholder exercises the power. No distinction is made between a testamentary and a presently exercisable power. Creditors of a powerholder of a *non*general power, on the other hand, cannot reach the appointive assets even if the power was effectively exercised. The theory is that the donor who creates a nongeneral power did not intend to benefit the powerholder.

When the powerholder of a general power exercises the power by will, the view that the appointed property is treated as if it were owned by the powerholder means that the creditors of the powerholder's estate can reach the appointed property for the payment of their claims. See, e.g., Clapp v. Ingraham, 126 Mass. 200 (1879). The rule

prevails even if this is contrary to the expressed wishes of the donor of the power. See, e.g., State Street Trust Co. v. Kissel, 19 N.E.2d 25 (Mass. 1939).

The exercise of the power by will does not confer actual beneficial ownership of the appointive assets on the powerholder for all purposes. The assets do not ordinarily become part of the powerholder's probate estate. Thus, in terms of priority, the powerholder's own estate assets are ordinarily used first to pay estate debts, so that the appointive assets are used only to the extent the powerholder's probate estate is insufficient.

Under the majority view at common law, the powerholder's creditors can reach the appointive assets only to the extent the powerholder's exercise was an effective exercise. A few states, however, follow the view that even an ineffective exercise entitles the powerholder's creditors to reach the appointive assets. See, e.g., Estate of Breault, 211 N.E.2d 424 (Ill. App. Ct. 1965). Moreover, even in states adhering to the majority view, an ineffective exercise can sometimes "capture" the appointive assets for the powerholder's estate, in which case the appointive assets become part of the powerholder's probate estate for all purposes, including creditors' rights.

When the powerholder of a general power makes an inter vivos appointment, treating the appointed assets as if they were owned by the powerholder does not automatically mean that the powerholder's creditors can subject the appointed assets to the payment of their claims. If the appointment is in favor of a creditor, the powerholder's other, unsatisfied creditors can reach the appointed assets only by having the appointment avoided as a "preference" in bankruptcy proceedings. Apart from bankruptcy, the powerholder can choose to pay one creditor rather than another with his or her owned assets, and the same is true with respect to appointive assets. If the appointment is in favor of a volunteer (i.e., the appointment is gratuitous), the powerholder's creditors can reach the appointed assets only if the transfer is the equivalent of a fraudulent transfer under applicable state law.

In a minority of jurisdictions, the powerholder of a general power, conferred on him or her by another, is not treated as the owner of the appointive property even if the power is exercised. See, e.g., St. Matthews Bank v. DeCharette, 83 S.W.2d 471 (Ky. 1935). Of course, if the powerholder exercises the power in favor of himself or herself or his or her estate, the appointed property becomes owned in the technical sense, and creditors even in states adhering to the minority view would be able to subject the assets to the payment of their claims to the same extent as other property owned beneficially by the powerholder. A few states have enacted legislation that affect the rights of the powerholder's creditors. The legislation is not uniform. Some of the legislation expands the rights of the powerholder's creditors and some contracts them.

The Uniform Powers of Appointment Act takes the following position. If the power is conferred by another, the rights of the powerholder's creditors depend on whether the power is general or nongeneral. If the power is general, the appointive property is subject to a claim of (1) a creditor of the powerholder, to the extent the powerholder's property is insufficient, if the power is presently exercisable (whether or not actually exercised), and (2) a creditor of the powerholder's estate, to the extent the estate is insufficient, subject to the right of a decedent to direct the source from which liabilities are paid. See Uniform Act §502. If the power is nongeneral, the general rule is that creditors have no rights in the appointive property. See Uniform Act §504(a). Some states (including Kentucky) have reversed this rule when adopting the act.

c. Power of Appointment Not Subject to Fiduciary Standard. In In re Estate of Zucker, 2015 WL 5254061 (Pa. Superior Ct. 2015), decedent's wife, Syma, exercised a power of appointment in favor of two of three children. The third, Wendy, objected claiming:

> Wendy alleged that Syma's appointment was not a proper exercise of the power as it was done "in bad faith, based on hate and malice toward Wendy, contrary to [the Decedent's] intent to benefit his issue equally (absent a good faith reason to the contrary) and the duty imposed on Syma to act in good faith when exercising a testamentary power imposed by Pennsylvania law."

The court disagreed, declining even to impose a good faith standard. The opinion states:

> We have reviewed the language contained in Decedent's will and in the codicil to Syma's will in which she directed that the principal contained in the marital trust be divided into two trusts for the benefit of Scott and Karyn and their issue. We have also reviewed the case law provided by the parties and the orphans' court. We conclude that none of the cases, in which challenges to the exercise of the power of appointment were raised, direct that the appointments must be made in good faith. Rather, we state again that a donee's duty is to the donor and the donee must exercise that power within the donor's established conditions. Moreover, the donee has the right to select some of the potential appointees to the exclusion of others. See Estate of Kohler, 344 A.2d at 472. No duty of good faith has been established. Therefore, we conclude that the orphans' court's grant of Scott and Karyn's motion for judgment on the pleadings was proper. The orphans' court did not commit an error of law.

The court notes that Syma was not the trustee. Does that matter? Suppose she had been; her exercise of a testamentary power of appointment would seem to occur after service as trustee ended. May a trustee exercise an inter vivos power without following a fiduciary standard?

The California Court of Appeals held in Tubbs v. Berkowitz, 47 Cal.App.5th 548 (Cal.App. 2020), that where a surviving spouse is named both as trustee of a marital trust and is given a lifetime general power of appointment over the marital trust assets, the surviving spouse could exercise the nonfiduciary power of appointment even while serving as trustee. The opinion states:

> A trustee "has a duty to administer the trust according to the trust instrument ...." (§ 16000.) A trustee also only has the powers conferred by the trust instrument and the powers conferred by statute, unless limited by the trust instrument. (§ 16200.) Here, the very language of the Marital Trust allowed Berkowitz to act in his capacity as the surviving spouse (not the trustee) and designate himself as the recipient of the Trust assets. The Marital Trust then required the trustee to distribute the assets to any person designated by the surviving spouse, including the surviving spouse himself. Thus, under the plain terms of the Marital Trust, Berkowitz (acting as the trustee) was required to transfer the assets once he exercised the power of appointment in his favor. He could not possibly have breached any fiduciary duties by doing something that was expressly authorized and required under the terms of the Marital Trust. (*Hearst v. Ganzi* (2006) 145 Cal.App.4th 1195, 1207-1208, 52 Cal.Rptr.3d 473 [trustees did not breach their fiduciary duties where their actions were explicitly authorized by the trust].)
>
> Finally, we note that Berkowitz's exercise of his power of appointment would have been unobjectionable if he had resigned as trustee before exercising the power. In that scenario, the successor trustee (Tubbs) would have been required to transfer the assets to Berkowitz once he exercised the power of appointment in his favor. Tubbs claims "those are not the facts before this Court," but we see no reason why the result should be different where Berkowitz was both the donee and the trustee who had no discretion but to follow the terms of the power of appointment.

No authority is cited on the point (either way).

To the contrary is Peterson v. Peterson, 835 S.E.2d 651 (Ga. App. 2019), a much litigated matter whose facts were described as follows:

> Charles Hugh Peterson died testate in 1994 and was survived by his wife, Mary, and their three sons Alex, David, and Calhoun. Mr. Peterson's will, which was

probated in 1995, created two testamentary trusts: a marital trust for the primary benefit of Mary, and a residual "by-pass" trust for the benefit of Mary and the couple's three sons. Mary and her three sons were each designated a co-executor of the will and a co-trustee of both the marital and by-pass trusts. Item 5 of Mr. Peterson's will created a marital trust for Mary, while Item 6 created a by-pass trust for Mary and their three sons. The relevant portion of the will creating the terms of the by-pass trust reads as follows:

> Trustees shall hold and manage the property in this trust and ... may encroach on such part of the principal thereof as the Trustees may deem necessary to provide for the support in reasonable comfort of my wife and to provide for the proper support and education of my descendants[.] To the extent practicable, however, I request the Trustees in making encroachment for the benefit of my wife to encroach first on any trust created for my wife ... before encroaching on this trust for my wife[.]
>
> My primary desire is that my wife be supported in reasonable comfort during her lifetime and that my children be supported in reasonable comfort during their lives; my secondary desire is that the principal of this trust be preserved as well as possible consonant with the consummation of my primary objective[.]
>
> [My wife] shall have no power to appoint [trust] property to herself, to her estate, to her creditors, or to the creditors of her estate.
>
> * * *
>
> Sometime after the will was probated, a dispute arose between the co-executors and co-trustees over the administration of the estate and the by-pass trust, pitting Mary and Calhoun against Alex and David. Alex and David filed petitions for accounting and damages for breach of duties as executors and trustees against Mary and Calhoun, and sought the removal of Mary and Calhoun as executors and trustees in probate court. Mary and Calhoun each moved for summary judgment on all claims, and the superior court granted their motions. Alex and David appealed those rulings.
>
> In the first appearance of this case before this Court, we reversed the trial court's grant of summary judgment to Calhoun in an unpublished opinion. See *Peterson I*. One month later, the Supreme Court of Georgia in *Peterson II* reversed the trial court's grant of summary judgment to Mary for similar reasons. Both cases held that material issues of fact remained with respect to Appellees' failure to fully fund the trusts at issue in the case and whether Appellees wasted assets. See *Peterson I*, slip op. at pp. 7-8, 10; *Peterson II*, 303 Ga. at 215-217 (3), 811 S.E.2d 309.

The trial court had held that Mary did not owe the other beneficiaries a fiduciary duty when exercising the power of appointment. Mary cited a Connecticut case, Connecticut Bank & Trust Co. v. Lyman, 170 A.2d 130 (Conn. 1961) but the Georgia court noted in Lyman the powerholder was not a trustee. The Georgia Court of Appeals went the other way, deciding Mary did have a fiduciary duty:

> In the present case, the potentiality of conflicts of interests with respect to Mary's requests for conveyance of all property in the by-pass trust to Calhoun is well documented in the litany of litigation that has transcended decades among the co-trustees and co-beneficiaries. As we find no law which could excuse Mary from her fiduciary duty under the trust, even if acting solely as a beneficiary under the trust, we find that the trial court erred in concluding that Mary could act

> exclusively in her capacity as a beneficiary of both trusts in exercising her appointment power to convey trust assets.

In In re Trust Under Deed of Trust of Neil G. Jack, Settlor, 284 A.3d 451 (Sup. Ct. Pa. 2022), the Pennsylvania Superior Court reversed the Orphans' Court and held that a trustee could exercise a power of appointment. The opinion states:

> "A power of appointment is a power that enables the donee of the power to designate recipients of beneficial ownership interests in[,] or powers of appointment over[,] the appointive property." Restatement (Third) of Property (Wills & Don. Trans.) § 17.1 (2011); ***accord*** 20 Pa.C.S.A. § 7703, cmt. "In exercising the power, the donee must observe strictly its provisions and limitations." *Estate of duPont*, 475 Pa. 49, 379 A.2d 570, 571 (1977), quoting *Rogers' Estate*, 218 Pa. 431, 67 A. 762, 762 (1907). A donee's duty is to the donor and the donee must exercise the power within the donor's established conditions. *In re Estate of Zucker*, 122 A.3d 1112, 1117 (Pa. Super. 2015). The holder of a power of appointment is a beneficiary of a trust, and not a trustee or other fiduciary, and is not bound by a duty of good faith. *Id.* at 1116-17. Where the language of the document so provides, a donee may select some of the potential appointees to the exclusion of the others. *Id.* at 1117. Put another way, in exercising a power of appointment, the donee is limited only by the terms of the document under which the power was granted.
>
> Here, Article I, Section 2.2 of the Trust ("Special Power of Appointment") provides as follows:
>
>> During the lifetime of Christine [ ] or upon her death, the Trustees shall distribute the Trust Estate to or for the benefit of such one or more of the issue of Christine [ ] as Christine [ ] may appoint by specific reference in a deed or in her will to this power; provided, however, that Christine [ ] shall have no authority hereunder to discharge any legal obligation she may have.
>
> Irrevocable Trust of Nell G. Jack, 5/29/81, at Article I, § 2.2. By using the clause "such one or more," Settlor granted Christine an exclusionary power of appointment, allowing her to select, in her discretion, amongst the potential appointees. Her power is limited only by the prohibition against using the power of appointment to discharge a legal obligation. Because Christine holds an exclusionary power of appointment in her individual capacity and is not bound by duty of good faith in her exercise of that power, *see In re Estate of Zucker*, *supra*, the Orphans' Court erred by issuing an injunction limiting her exercise of the power based on allegations regarding her conduct as a fiduciary.

We often do not think of powerholders as trust beneficiaries. The court must not have been disturbed by the two hats worn by Christine, one fiduciary and one not, because the opinion does not discuss any potential conflict.

Because the holder of a power of appointment is not a fiduciary, the holder of a lifetime power may have his or her actions attributed to a grantor or beneficiary. In the 1970s two cases dealing with the Goodwyn family established the principle that if a trust agreement prohibited the grantor from acting as de facto trustee the mere fact that the grantor did in fact act as de facto trustee would not established a retained interest under section 2036, Estate of Goodwyn, T. C. Memo. 1973-153, nor a power for the grantor trust provisions of sections 671ff, Estate of Goodwyn v. Commissioner, T.C. Memo. 1976-238:

> Under the terms of the deeds creating these trusts, the trustees were granted broad discretionary powers with respect to both the distribution of income to the beneficiaries and the investment and management of the corpus of the trusts.

> Notwithstanding the designation of Richards and Russell as trustees, it further appears that at all times from the establishment of the trusts until his last illness, the decedent exercised complete control with respect to the purchase and sale of trust assets, investment of any proceeds, and the determination of the amounts, if any, to be distributed to the respective beneficiaries.
>
> The assets of the various trusts, together with other trusts, as well as property owned by the decedent, were accounted for by a single set of records maintained in the offices of the decedent. Except for the Federal income tax returns prepared and filed by the decedent on behalf of the various trusts, no separate records were maintained showing the assets and income of any of these trusts.
>
> The respondent argues that the decedent should be treated as trustee, in fact, possessing such rights and powers as to cause the inclusion of the assets thereof in his gross estate, relying on sections 2033, 2036 (a)(2), and 2038. Section 2033 requires a finding that the decedent had an interest in the assets of the trusts at the time of his death. There is no basis for such a finding. Section 2038(a)(1) relates to "a power" exercisable by the decedent "to alter, amend, revoke, or terminate," the trusts. No such power was reserved by the decedent. Accordingly, in the final analysis the respondent's position is predicated on the determination that by reason of the de facto control exercised by the decedent the trusts are includable in his estate pursuant to section 2036(a)(2).[5] It is clear that the powers granted to the trustees would, if reserved by the decedent, be such as to require the inclusion of the assets of the trusts in the estate of the decedent. *United States v. O'Malley* [66-1 USTC ¶ 12,388], 383 U.S. 627 (1966). Does the fact that the decedent was able to exercise such powers through the cooperation of unrelated trustees require a different result? The question thus presented for decision is whether the value of such trusts is includable in the estate of the decedent by reason of the de facto control over the trusts exercised by the decedent, notwithstanding that no power to exercise such control was reserved to or by the decedent once he resigned his duties as trustee of certain of these trusts.

[footnotes omitted]

The Goodwyn rationales appear to be based on a trustee having authority; if an advisor who is not a fiduciary can direct a trustee, and the trustee must follow the direction, then will Goodwyn protect the grantor whose advisor follows the grantor's advice regularly. Similarly, where a grantor gives an inter vivos power of appointment to someone during the grantor's lifetime the Goodwyn rationale is inapplicable.

2. Accidentally Perfect Grantor Trusts

In recent years, what may be termed upstream estate planning has evolved. One approach is the Accidentally Perfect Grantor Trust (APGT). Others include the UPSPAT and POAST. For more recent descriptions and discussions of the UPSPAT, or upstream sale to a power of appointment trust, see Berry, Blattmachr, and Harrington, *Powers of Appointment in the Current Planning Environment*, 53 U. Miami Heckerling Inst. On Est. Pl. ch. 11 (2019), and of the POAST, or power of appointment support trust, see Law and Zaritsky, *Basis After the 2017 Tax Act – Important Before, Crucial Now*, 53 U. Miami Heckerling Inst. On Est. Pl. ch. 1 (2019), and the discussion in the following sections.

The easiest way to conceptualize the important point is to consider why you don't include circumscribed general powers of appointment in your Crummey and other gift trusts. In other words, "if rich children have "poorer" parents then when those rich children create a trust for their children, shouldn't they give the poorer parents general parents general powers of appointment so that when the poorer parents die the assets in the trusts receive new basis?

a. The Technique. An APGT is a trust established by a junior family member, typically for the benefit of his or her children or other descendants. The trust may also provide benefits for the grantor's parents or more senior family members. Junior gives low-basis or highly appreciating assets to the trust. Alternatively, junior structures the trust as an IDGT, contributes appropriate "seed" money, and loans money to the trust for the trust to buy an asset with lots of appreciation potential from junior.

Regardless of whether the trust is funded primarily by a gift or a sale of assets, this trust has a twist. From day one, the trust has language built into it that causes the trust assets to be *included in the estate of a senior generation family member for federal estate tax purposes*. As a result, upon the death of the senior family member, the trust assets will receive a new cost basis. A similar result could be achieved by having the junior family member simply give property to the senior family member with the hope that the senior family member bequeaths the property back to junior in trust. The APGT, however, may allow junior to (i) protect assets from the creditors of the senior family member; (ii) use less of junior's gift tax exclusion (by selling assets to the IDGT for a note); and (iii) allow junior to prescribe the terms of the trust into which the assets pass upon the death of the senior family member. In addition, depending upon the structure, the resulting trust may be a grantor trust as to junior even after the senior generation family member is gone, providing a vehicle for future tax planning.

> Example: Jenny owns the stock in a closely held business that she thinks is about to explode in value. She would like to transfer future appreciation to her children, but does not want to give up all of the value, and doesn't like the fact that the stock will have such a low cost basis. Jenny's mom Mary has a net worth of perhaps $500,000. Jenny recapitalizes the company so that it has 1 voting share and 999 non-voting shares. Jenny then sets up an IDGT, or APGT, for the benefit of her children (and perhaps Mary), and sells the non-voting stock to the trust for its current appraised value of $1 million. She uses a combination of seed money and a guarantee by Mary and the children to make sure that the sale is respected for income and gift tax purposes. The trust has language that grants Mary a general testamentary power to appoint the trust property to anyone she chooses. Mary signs a new will that leaves the trust property to a dynasty trust for Jenny and her descendants, naming Jenny as the trustee. (The IDGT contains the same type of dynasty trust to receive the property if Mary fails to exercise her power of appointment, although this dynasty trust may be only for Jenny's descendants.) When Mary dies four years later, the stock has appreciated to $5 million in value. Because the APGT assets are included in Mary's estate, the stock gets a new cost basis of $5 million. The value of the trust assets, when added to the value of Mary's other assets, is well below Mary's applicable estate tax exclusion amount. Mary's executor uses some of Mary's GST tax exemption to shelter the APGT assets from estate tax when Jenny dies. Despite the fact that Jenny, or perhaps only Jenny's descendants, will now have the lifetime use of the new trust's property: (i) it can't be attached by the beneficiaries' creditors; (ii) it can pass to children of the beneficiaries, or whomever they wish to leave it to, without estate tax; (iii) principal from the trust can be sprinkled, at the trustee's discretion, among the beneficiaries and the beneficiaries' descendants without gift tax; and (iv) if the trust isn't a grantor trust as to Jenny, income from the trust can be sprinkled, at the trustee's discretion, among the beneficiaries and their descendants, thereby providing the ability to shift the trust's income to taxpayers in lower income tax brackets.

b. Structure of the APGT. Although the term "accidentally perfect" distinguishes this trust from an "intentionally defective" trust, there is nothing accidental about it. The key to the success of an APGT is the creation by a junior family member of an irrevocable trust that (i) successfully avoids estate tax inclusion for the junior family member under sections 2036 through 2038; but (ii) will intentionally cause estate tax inclusion for a senior family member who has estate tax exclusion (and GST tax exemption) to spare. The APGT would typically be structured as an IDGT as to the junior family member, and if a sale is involved, it would buy rapidly appreciating assets from the junior family member. It would maintain grantor trust status as to the junior family member at least until the purchase price is paid. The difference is that the agreement establishing the APGT also grants a senior family member a circumscribed general power of appointment over the trust, thereby ensuring inclusion of the trust assets in his or her taxable estate (and thereby ensuring a new cost basis at the time of the senior family member's death). Because the senior family member is given a general power of appointment, it is essential to evaluate the creditor exposure of the senior family member and whether he or she may be a candidate for governmental benefits – both of which could be affected. The amount of the APGT's property subject to the general power could be limited by a formula to ensure that (i) only appreciated non-IRD assets could be appointed; and (ii) inclusion of those assets in the

senior family member's taxable estate doesn't cause estate tax to be payable when that person dies. When the junior family member sells appreciating assets to the APGT, the trust's IDGT provisions ensure that the sale is ignored for federal income tax purposes. *See* Rev. Rul. 85-13. Nevertheless, the assets are subject to estate tax (with the attendant income and GST tax benefits) upon the death of the senior family member.

For the basis adjustment to be recognized, the general power of appointment has to exist. Clients sometimes want tax provisions in their trusts to be like an often-expressed wish for children (to be seen but not heard). For example, clients often insert typical *Crummey* withdrawal rights in trusts with the hope that although granted, they will not be exercised. We don't want the IRS to argue that the senior family member's general power is illusory. Cf. Cristofani v. Comm'r, 97 TC 74 (1991) (IRS argued that *Crummey* withdrawal rights granted to persons with no other interest in the trust were illusory). This issue suggests that the powerholder should perhaps be a permitted distributee of trust income and/or principal during his or her lifetime, a feature that many grantors will desire in any event. Remember, though, that it is the *existence* of the general power that gives rise to the basis adjustment – not its exercise. The IRS has historically had every incentive to recognize and give effect to general powers since they have traditionally produced more revenue from estate tax than they lost due to basis adjustments. Courts have agreed, finding general powers to exist even where the holders of the powers didn't know they existed, or couldn't actually exercise them due to incapacity. See, e.g., Fish v. United States, 432 F2d 1278 (9th Cir 1970); Est. of Alperstein v. Comm'r, 613 F2d 1213 (2nd Cir 1979); Williams v. United States, 634 F2d 894 (5th Cir. 1981). In the APGT context however, one should expect that the general power will be known about, and in some cases even exercised.

c. Basis Issues. If the senior family member exercises the general power of appointment, the assets of the APGT receive a new cost basis pursuant to section 1014(b)(4). But even if the power of appointment is not exercised, the assets of the APGT are included in determining the value of the estate of the senior family member under section 2041(a)(2). As a result, those assets receive a new cost basis in the hands of the taxpayer to whom they pass. § 1014(b)(9). If the junior family member gives assets to a senior family member, and those same assets pass by inheritance to the donor (or the donor's spouse) within one year, there is no step-up in the basis of the assets. § 1014(e). With an APGT, however, upon the death of the senior family member, the assets do not pass back to the donor/junior family member, but to a different taxpayer–a dynasty trust of which the donor/junior family member may be a beneficiary. Although the IRS has privately ruled otherwise, (*see, e.g.*, PLR 200101021), the fact that the recipient of the property is a trust, and not the donor, should permit a basis adjustment, even if the senior family member dies within a year of the assets being transferred to the APGT. Of course, if the senior family member survives for more than a year, the limitations under section 1014(e) won't apply. Suppose that the junior family member sold assets to the trust for a note. If the asset is worth $1 million, but is subject to a debt of $900,000, then presumably only $100,000 is includable in the senior family member's estate. Nevertheless, the basis of the asset should be adjusted to its $1 million value, and not just $100,000. See Crane v. Comm'r, 331 U.S. 1 (1947).

There are two areas that may raise issues regarding a full basis adjustment at death, one in the case of a sale of assets to the APGT and one in the case of property being depreciated where the senior member does not exercise the power of appointment. Despite the clear holding in Crane, the first issue is found in Treas. Reg. § 20.2053-7. The regulation provides that a decedent's estate will include the full value of property for which the estate is liable for any indebtedness on the property, whereas only the net value of the property *need be returned* if the estate is not liable. Although the regulation appears to address a reporting position only and does not provide that the full value of the property may not be reported, it is prudent to have the senior family member personally guarantee the payment of the debt to ensure that all of the property and not just the net value will be reportable as part of his or her estate. Regarding the second issue, note that if the power of appointment is not exercised by the senior family member, the basis adjustment arises under section 1014(b)(9) instead of section 1014(b)(4). Unlike the other provisions of section 1014, as mentioned above, section 1014(b)(9) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent prior to the decedent's death. Because the APGT is a grantor trust, the junior family member is presumably "the taxpayer" for this purpose. The section 1014(b)(9) limitation would appear to apply to any depreciation deductions taken by the junior family member prior to the death of the senior family member. As a result, if the APGT remains a grantor trust as to the junior family member after the senior family member's death, then the amount of the basis adjustment might be reduced by the amount of the depreciation deductions allowed to the junior family member prior to the senior family member's death. See Treas. Reg. § 1.1014-6.

d. Effect of Interest Rates. As with IDGTs, when interest rates are low, sales to APGTs become very attractive, since any income or growth in the asset "sold" is more likely to outperform the relatively low

hurdle rate set by the IRS for the note. Remember, in a sale context, it is the growth in excess of the purchase price (plus the AFR on any part of the deferred purchase price) that is kept out of the estate of the junior family member, and instead ultimately lands in a dynasty trust for the junior family member.

e. Benefit to Heirs. The property in the APGT passes to a new dynasty trust for the ultimate beneficiaries (typically one or more generations of junior family members). With a sale to an APGT, if the purchased assets grow faster than the interest rate on the note, the excess growth is held in the APGT, ultimately becoming available to the beneficiaries of the APGT. The goal of an APGT is the same regardless: The assets ultimately pass for the benefit of the grantor and/or his or her descendants in a creditor-proof, estate-tax exempt, and GST-tax exempt trust, with a new cost basis equal to the fair market value of the trust assets at the time of the senior family member's death, all without estate tax, and possibly without gift tax.

f. Income Tax Issues. During the lifetime of the senior family member, the trust typically remains a grantor trust as to the junior family member. If, however, the senior family member has a general power of appointment exercisable during lifetime (i.e., an inter vivos general power), and that power is exercisable solely by the senior family member, the trust would be treated as a grantor trust as to the senior family member. §§ 678(a), (b). What is the income tax status of the dynasty trust that is formed after the death of the senior family member? If the junior family member is a beneficiary, and the successor dynasty trust arises as a result of the failure of the senior-generation family member to exercise the power of appointment, one can make a compelling argument that the trust can be characterized as a grantor trust as to the junior family member, since he or she is the only transferor of property to the trust. Treas. Reg. § 1.671-2(e)(5). On the other hand, if the successor trust arises as a result of the senior family member actually exercising the power of appointment, then the senior family member will be treated as the grantor of the successor dynasty trust for federal income tax purposes, even if the junior family member was treated as the owner of the original trust. *Id*. The regulations thus appear to provide a choice, to be made by the selection of language in the senior generation family member's will, to decide whether the successor trust will be a "defective" trust as to the junior family member after the death of the senior family member. If grantor trust treatment is maintained, the resulting trust would have the features of a so-called "beneficiary defective grantor trust" but without the attendant requirement that the trust always remain a grantor trust after the death of the senior family member.

g. Estate Tax Issues. As noted above, estate tax inclusion in the estate of the senior family member (with its resulting basis adjustment) is one of the goals of the APGT. But can the IRS argue that the dynasty trust that arises for the benefit of the junior family member after the death of senior is includable in junior's estate? As noted above, junior may be treated as the grantor of the resulting trust for income tax purposes. For estate tax purposes, however, because the senior family member has a power of appointment should cause the senior family member to be a new transferor. So long as the resulting trust is drafted as a typical descendant's or dynasty trust which limit junior's rights with respect to the trust (e.g., limiting junior's right to make distributions to him- or herself by an ascertainable standard, and allowing only limited powers of appointment), there should be no inclusion of the trust's assets in junior's estate at the time of his or her later death. See, Est. of Ford v. Comm'r, 53 TC 114 (1969); PLR 200210051; see also PLRs 200403094, 200604028.

In a somewhat analogous setting, the IRS argued that an asset (a life insurance policy) transferred from husband to his wife, and passed at her death into a trust of which he was the trustee, should be included in husband's estate upon his later death. Both the Tax Court and the Second Circuit analyzed the case under sections 2036 and 2038. The Second Circuit held that section 2036 was clearly not triggered because it applies only to a power retained by the grantor over the income from property transferred to another. In analyzing section 2038, the court noted that cases cited by the IRS were all cases in which the decedent retained the power, and distinguished those cases from the situation where the decedent acquires the power long after he had divested himself from all interests in the transferred property, noting that the "difference between powers retained by a decedent and powers that devolved upon him at a time subsequent to the assignment is not merely formal, but has considerable substance." Skifter v. Comm'r, 468 F2d 699, 703-04 (2d Cir. 1972). The court found when the power comes about later or through the action of another, it is difficult to construe this later-acquired power as a testamentary substitute to which section 2038 was aimed, and held for the taxpayer that the property was not included in the decedent's estate. After Skifter, the IRS issued Revenue Ruling 84-179 in which the IRS essentially conceding the court's holding if the original donor was not involved in the reacquisition of the property. Specifically, the Revenue Ruling conditioned exclusion on a finding that the devolution of powers over the property to the donor is not part of a prearranged plan involving participation of the donor. This suggests that the senior family member should have independent advice about whether to exercise the general power.

In some states, since the APGT was originally created by junior, a court might be empowered to award trust assets to junior's creditors if junior becomes a beneficiary of the trust. In that event, the IRS might assert that section 2041(a)(2) of the Code (transfer with a retained right to appoint property to one's creditors) applies to subject the resulting trust to estate tax in junior's estate. States with domestic asset protection trust statutes may avoid this concern. In addition, other states may have features in their spendthrift statutes or otherwise to provide protection in this circumstance. *See, e.g.,* TEX. PROP. CODE § 112.035(g)(3)(B) (beneficiary's possession of general power of appointment precludes trust contributions from being treated as being made by grantor for purposes of applying Texas spendthrift protection).

h. GST Tax Issues. The donor can allocate GST tax exemption to any gift to the APGT, but if the entire trust is expected to be included in the taxable estate of the senior family member, the donor would probably not do so. To maximize the benefits, the executor of the estate of the senior family member can allocate GST tax exemption to property subject to the general power of appointment. *See* § 2652(a)(1)(A); Treas. Reg. § 26.2652-1. As a result of allocation, the dynasty trust that receives the APGT assets will have a GST tax inclusion ratio of zero, which means that all of those assets (both any seed money and the growth) can pass into trust for the APGT grantor, and ultimately on to grandchildren or more remote generations, with no additional estate or gift tax. This multi-generational feature makes a sale to an APGT a very powerful transfer tax tool.

i. Selling Discounted Assets. As discussed above with sales to more traditional IDGTs, rapidly appreciating or leveraged assets are ideal candidates for sale. The use of lack-of-marketability and minority-interest discounts can increase the benefits of the technique.

j. Combining with Other Techniques. The APGT is outlined here as a tool for use with a sale to an IDGT, but its application need not be limited to this structure. The senior family member's otherwise-wasted estate tax exclusion and GST tax exemption might be put to good use in other contexts, limited only by the imagination of the estate planner (combined with a healthy dose of caution). For example, grantor retained annuity trusts and charitable remainder unitrusts, each discussed below, are valuable estate planning tools, especially when interest rates are low, but neither of them are efficient vehicles for allocating the grantor's GST tax exemption. Consider whether, on the termination of these trusts, the assets might pour into a trust over which a senior family member holds a formula general power of appointment. Upon the powerholder's death, otherwise wasted GST tax exemption might be applied to exempt the trusts' assets from GST tax while generating a favorable basis adjustment. The same approach might be used for gift trusts in general, especially for example, a trust of which a spouse is a beneficiary (and hence the ETIP rules of section 2642(f) prevent allocation of the grantor's GST tax exemption). Even older trusts might benefit. Consider, for example, a trust that is intended to be a grantor trust under section 674 because someone has been granted the power to add beneficiaries to the trust. Perhaps this power might be exercised to add a senior family member as a beneficiary and grant that individual a formula general power of appointment. Even absent such authority, perhaps the addition could be effected under state decanting laws. In either event, a basis adjustment could result.

3. Section 678 and a Presently Exercisable General Power of Appointment as a Planning Device (BDIT, BDOT).

a. Section 678 provides:

> (a) General Rule. —A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
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> > (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or
> >
> > (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

(b) Exception Where Grantor Is Taxable. Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

[emphasis added]

b. Section 678(a)(2) has long been the basis for estate tax planning: a parent contributes $5000 to a trust that gives the child a 30 day withdrawal right and gives the child other powers that would have made the trust a grantor trust if the child had contributed the $5000 to the trust. The child would appear to be the owner of the entire trust (assuming that parent has no rights in the trust that would make the parent the grantor) and thus Rev. Rul. 85-13 would treat the child and the trust as the same taxpayer. Such trusts are often referred to as BDITs – Beneficiary Deemed Inheritor's Trusts – and have been the subject of wide discussion and controversy. See, e.g., Jerome M. Hesch, Lawrence Brody, Richard A. Oshins & Susan P. Rounds, *A Gift From Above: Estate Planning on a Higher Plane — The Unique Design of a BDIT Minimizes — Even Eliminates — Many Tax and Non-Tax Problems*, 150 Tr. & Est. 17 (Nov. 2011); but also Areas In Which Rulings Or Determination Letters Will Not Ordinarily Be Issued*,* in Rev. Proc. 2022-3, Section 4 (42) which provides:

(42) Section 678.—Person Other than Grantor Treated as Substantial Owner.— Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under § 671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of § 2041. if the trust purchases the property from that person with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased.

c. Section 678(a)(1) has given rise to a different kind of planning. Suppose a beneficiary may withdraw an amount equal to all of the trust's taxable income in any given year (from all of the trust assets) but not the entire trust assets. Ed Morrow refers to this as the BDOT; IRC 678(a)(1) the "*Beneficiary Deemed Owner Trust*" (BDOT), LEIMBERG ESTATE PLANNING NEWSLETTER #2516 (Sept. 5, 2017). The BDOT appears clearly effective for income shifting, but it is not quite as clear whether it makes the person with the right to withdraw the owner of the entire trust for Rev. Rul. 85-13 purposes.

The regulations governing the grantor trust rules (sections 671-679) clearly provide that the reference to "income "unless specifically limited, refers to income determined for tax purposes and not to income for trust accounting purposes. Treas. Reg. §1.671-2(b). In order for the beneficiary to be treated as the owner of the entire trust for income tax purposes under section 678(a)(1), the withdrawal power must apply to all net taxable income during the year, including capital gains. If a beneficiary may withdraw "income" then under applicable state law the concern would be that the trust means income determined for trust accounting purposes which would not typically include extraordinary dividends or capital gains.

To cause the taxable income attributable to the corpus portion of the trust also to be treated as owned by the beneficiary, the withdrawal power must apply with respect to an amount equal to all of the net taxable income. Having the corpus portion of the trust being treated as owned by the beneficiary for income tax purposes is extremely important if the beneficiary wishes to sell assets to the trust and have the transfer treated as a non-recognition event under the reasoning of Rev. Rul. 85-13. In Campbell v. Commissioner, T.C. Memo 1979-495, beneficiaries had the power to cause the trustee to distribute capital gains; beneficiaries did not request and the trustee did not distribute the capital gains income to the beneficiaries, but they were deemed to be the owners of the capital gains income under section 678(a)(1). PLR 201633021 also supports this result.

Income is taxable to a powerholder under section 678(a)(1) whether or not the amount is actually withdrawn. If it is withdrawn, such withdrawal is generally a non-taxable event because it is not a distribution that is reported under the distribution rules for non-grantor trusts. Rev. Rul. 67-241. For instance, section 678(a)(1) applies if the powerholder is a minor for whom a guardian who could exercise the power has not been appointed. Rev. Rul. 81-6

(child could withdraw all income until age 25; minority status irrelevant); Trust No. 3 v. Commissioner, 285 F.2d 102 (7th Cir. 1960)(minor beneficiaries could terminate a trust; that no guardians had been appointed was irrelevant).

What happens if the power is not exercised, as will often be the case? The trust agreement may provide that failure to withdraw the taxable income amount in a particular year would lapse and could not be exercised in a later year. If so, and if the lapsed power exceeds the greater of "(A) $5,000, or (B) 5 percent of the aggregate value, at the time of such lapse, of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could have been satisfied," the power holder will be treated as having made a gift of the excess amount (unless it is an incomplete gift because of retained powers over the trust), which will mean the property will be included in the powerholder's estate. Note that if the person with the withdrawal right is not an individual the "5 x 5 exception" may not apply; section 2514(e), which creates the exception, applies by its terms to an "individual."

Generally, the net taxable income of a trust will be less than 5% of the trust value. To use the full trust value to measure the 5% amount, the beneficiary ought to be able to withdraw the net taxable income amount from all of the trust assets. In Rev. Rul. 66-87 the beneficiary had the power to withdraw accounting income and the 5% element was calculated based just on the accounting income, not all trust assets. Fish v. U.S., 432 F.2d 1278 (9th Cir. 1970), held that the 5% amount, when applied to a power to withdraw "all or part of the net income of the trust for that year" was only 5% of the income, not 5% of the trust assets. The taxpayer argued that because the income payable to the decedent would have been payable either from corpus or income, the entire trust represents "assets out of which, or the proceeds out of which, the exercise of lapsed powers could be satisfied." The court disagreed because for federal tax purposes the distribution would have been a distribution of income.

The IRS cited Fish in Rev. Rul. 85-88 to hold that where a power of appointment is limited to annual trust income the 5 percent test is based on annual trust income, not the amount of trust corpus. Neither Fish nor the Ruling considered the result if the withdrawal right could be from any trust assets. Prudence suggests that a beneficiary should be authorized to withdraw the greater of the net taxable income or 5% of the trust corpus from any of the income or out of the entire corpus of the trust. The right to withdraw may also hang.

Other issues to consider are the rights of creditors of the powerholder and the presence of a true grantor under sections 671-677 which trump section 678. See S. Alan Medlin & F. Ladson Boyle, *Creditors' Rights in Property Subject to a Beneficiary's Right of Withdrawal*, 57 REAL PROP., TR. & EST. L. J. 140 (2022).

If the Fish problem can be solved, almost any trust may be taxed to a designated person, for example a person in a state without an income tax. That may not mean the trust is a wholly grantor trust with the benefits of Rev. Rul. 85-13. Does the grantor have rights over corpus? Treas. Reg. § 1.671-3(a)(1) indicates one person can own "income" but not own corpus. Put another way, what does the term "portion" mean in section 678? It could mean the "income" portion as opposed to the "corpus" portion or it could mean the undivided interest portion of the trust that a person with a right of withdrawal could withdraw, whether income or corpus. Treas. Reg. § 1.671-3 provides as follows:

> **(a)** When a grantor or another person is treated under subpart E (section 671 and following) as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example:
>
> > **(1)** If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.
> >
> > **(2)** If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part

I, subchapter J, chapter 1 of the Code. Items that relate both to the portion treated as owned by the grantor and to the balance of the trust must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent.

(3) If the portion of a trust treated as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally the fair market value of the trust corpus at the beginning of the taxable year in question. The share not treated as owned by the grantor or other person is governed by the provisions of subparts A through D. See the last three sentences of paragraph (c) of this section for the principles applicable if the portion treated as owned consists of an interest in part of the ordinary income in contrast to an interest in corpus alone.

(b) If a grantor or another person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus. For example:

(1) Only ordinary income is included by reason of an interest in or a power over ordinary income alone. Thus, if a grantor is treated under section 673 as an owner by reason of a reversionary interest in ordinary income only, items of income allocable to corpus will not be included in the portion he is treated as owning. Similarly, if a grantor or another person is treated under sections 674-678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion. (See paragraph (c) of this section to determine the treatment of deductions and credits when only ordinary income is included in the portion.)

(2) Only income allocable to corpus is included by reason of an interest in or a power over corpus alone, if satisfaction of the interest or an exercise of the power will not result in an interest in or the exercise of a power over ordinary income which would itself cause that income to be included. For example, if a grantor has a reversionary interest in a trust which is not such as to require that he be treated as an owner under section 673, he may nevertheless be treated as an owner under section 677(a)(2) since any income allocable to corpus is accumulated for future distribution to him, but items of income included in determining ordinary income are not included in the portion he is treated as owning. Similarly, he may have a power over corpus which is such that he is treated as an owner under section 674 or 676 (a), but ordinary income will not be included in the portion he owns, if his power can only affect income received after a period of time such that he would not be treated as an owner of the income if the power were a reversionary interest. (See paragraph (c) of this section to determine the treatment of deductions and credits when only income allocated to corpus is included in the portion.)

(3) Both ordinary income and other income allocable to corpus are included by reason of an interest in or a power over both ordinary income and corpus, or an interest in or a power over corpus alone which does not come within the provisions of subparagraph (2) of this paragraph. For example, if a grantor is treated under section 673 as the owner of a portion of a trust by reason of a reversionary interest in corpus, both ordinary income and other income allocable to corpus are included in the portion. Further, a grantor includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated under section 674 or 676 as an owner because of a power over corpus which can affect income received within a period such that he would be treated as an owner under section 673 if the power were a reversionary interest. Similarly, a grantor or another person includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated as an owner under section 675 or 678 because of a power over corpus.

(c) If only income allocable to corpus is included in computing a grantor's tax liability, he will take into account in that computation only those items of income, deductions, and credit which would not be included under subparts A through D in the computation of the tax liability of the current income beneficiaries if all distributable net income had actually been distributed to those beneficiaries. On the other hand, if the grantor or another person is treated as an owner solely because of his interest in or power over ordinary income alone, he will take into account in computing his tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income. If the grantor or other person is treated as an owner because of his power over or right to a dollar amount of ordinary income, he will first take into account a portion of those items of income and expense entering into the computation of ordinary income under the trust instrument or local law sufficient to produce income of the dollar amount required. There will then be attributable to him a pro rata portion of other items entering into the computation of distributable net income under subparts A through D, such as expenses allocable to corpus, and a pro rata portion of credits of the trust. For examples of computations under this paragraph, see paragraph (g) of § 1.677(a)-1.

d. Where one trust can withdraw all of the assets of the other trust, the trust with the withdrawal right seems clearly the owner of the whole trust for income tax purposes. But with a more limited withdrawal right the result is uncertain. An example of a power to vest "the income therefrom" is described in Private Letter Ruling 201633021. The ruling involved Trust 1 and Trust 2 which were non-grantor trusts because the grantor had died. The assets of Trust 1 and Trust 2 are held for the benefit of the same beneficiaries. The governing document of Trust 2 provides that Trust 1 retains the power, solely exercisable by Trust 1, to revest the net income of Trust 2 in Trust 1; provided, however, that such power shall lapse on the last day of such calendar year. Trust 2 further provides that income includes (i) any dividends, interest, fees and other amounts characterized as income under section 643(b) of the Code, (ii) any net capital gains realized with respect to assets held less than twelve months, and (iii) any net capital gains realized with respect to assets held longer than twelve months. The ruling provides that the trustee "proposes to transfer funds from Trust 1 to Trust 2."

The IRS concluded:

Trust 1 will be treated as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a). Accordingly, Trust 1 will take into account in computing their tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which enter into the computation of distributable net income. Additionally, Trust

> 1 will also take into account the net capital gains of Trust 2." The ruling unfortunately does not provide any insight on what the income tax consequences would be when Trust 1 "transfers funds" to Trust 2. The language of the ruling implies the Trust 1 will be treated as a beneficiary of Trust 2 but also "as the owner of the portion of Trust 2 over which they have the power to withdraw under § 678(a).

The language doesn't necessarily (but it could) mean that Trust 1 is the deemed owner entirely of Trust 2 and all of its assets. If Trust 1 is treated as the owner entirely of Trust 2, then theoretically Trust 1 could engage in a sale of the assets of Trust 1 to Trust 2 in exchange for an installment note, and the transaction would be disregarded for income tax purposes under Revenue Ruling 85-13. This would be the result if Trust one could withdraw all the assets of Trust 2 at any time.

If, however, Trust 1 is merely an entity that must report the income, capital gain, expenses, and other items used to compute DNI, then such a transaction could, in part, be considered a taxable event. Even if the latter interpretation is correct, if Trust 1 is a non-GST exempt trust and Trust 2 is a GST exempt trust, the tax liability borne by Trust 1 from all of Trust 2's income and capital gain could significantly increase Trust 2's trust assets over time and decrease the assets in Trust 1.

e. In PLR 202022002, the trust agreement of Trust 1 prohibited the distribution of shares (perhaps of a closely-held company) to the beneficiaries, but allowed for the distribution of the proceeds from the sale of the shares. Trust 1 contributed all of its shares to an LLC, a newly formed entity classified as partnership for Federal tax purposes, in exchange for a membership interest in the LLC. The same restrictions on the shares were placed on the membership interests of LLC. Trust 1 then transferred a portion of its LLC interest to a Subtrust for the sole benefit of A. After A reached the age of 40, A exercised a withdrawal right to take all of the Subtrust's assets, except the LLC interests. The Subtrust agreed to sell a portion of its LLC interests to Trust 2 in exchange for cash and a promissory note. Trust 2 is a grantor trust with respect to A. A also had the authority to withdraw the cash and promissory note from Subtrust after the sale. The IRS concluded, "because A has a power exercisable by herself to vest the proceeds of Subtrust's LLC interest in herself and that those proceeds are Subtrust's only asset, A will be treated as the owner of Subtrust under § 678. Consequently, the transfer of the LLC interests to Trust 2 is not recognized as a sale for federal income tax purposes because Trust 2 and Subtrust are both wholly owned by A."

When doing trust to trust transactions, if the trusts are not grantor trusts, it would be safer to have one trust have a withdrawal right over all assets of the other trust rather than just "income" however defined.

E. Dealing With Valuation Uncertainty.

There are three general approaches to reducing the risk of gift tax by limiting the amount of a gift to a preset amount. First, the donor may make a gift subject to donee's agreement to return any excess. In Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), that was held to be an end run around the gift tax and the return of assets was ignored when the IRS adjusted the value of the gift and assessed tax.

Second, the donor may make a gift that is to be allocated between taxable and non-taxable beneficiaries. Several cases have approved this approach where the non-taxable beneficiary is a charity. John H. Hendrix et ux. v. Commissioner, T.C. Memo. 2011-133; Estate of Anne Y. Petter et al. v. Commissioner, (9th Cir. 2011); Christiansen, 130 T.C. 1 (2008) affirmed 586 F.3d 1061 (8th Cir. 2009). The donor has parted with all dominion and control over the gift and an independent party is in charge of the allocation. Of course, it would be important the that the trustee and the charity actually be independent. Such a clause could state:

Upon receipt of assets by gift in 2023, Trustee will allocate the first $_________ to the trust administered by Article __ for my descendants and will allocate any additional assets to WORTHY CHARITY, INC., to be added to the Named Donor Fund created thereunder (or, if such organization is not in existence or is not described in sections 170(b)(1)(A), 170(c), 2055(a), and 2522(a) of the Internal Revenue Code, at such time, then to another organization which is so described selected by Trustee within 60 days of such allocation). The allocation will be made as a fractional share of all assets added to the Trust by gift and Trustee may make a preliminary allocation with subsequent adjustment if desirable.

A GRAT or a QTIP may be substituted for the charity as the over-flow beneficiary if desired. Again, independence is key. Having some amount be allocated to the over-flow beneficiary may help demonstrate the reality of the allocation.

Third, the gift may be described as a fraction of certain property. For example, such a clause could read:

I own certain real property known as Golden Acre Farm. I give to trustee a fraction of such farm, the numerator of which is $1,000,000 and the denominator of which is the fair market value of such farm, as finally determined for federal gift tax purposes.

This approach was approved in Joanne M. Wandry et al. v. Commissioner, T.C. Memo. 2012-8, non-acquiesced in by the IRS. An important issue is whether fair market value in the formula is defined with reference to "as finally determined for federal gift tax purposes."

A recent case involving a formula gift is Sorensen v. Commissioner, Tax Court Docket Nos. 24797-18, 24798, 18, 20284-19, and 20285-19, which was settled in the Fall of 2022. The IRS claimed each donor spouse owed tax of $13.6 million; the settlement was for $4.03 million each. No accuracy related penalty was assessed. The case related to the challenge of defined clauses in irrevocable stock powers that read as follows:

> [A] specific number of nonvoting shares in FIREHOUSE RESTAURANT GROUP, INC., a Florida corporation (the "Company"), that have a fair market value as finally determined for federal gift tax purposes equal to exactly $5,000,000. The precise number of shares transferred in accordance with the preceding sentence shall be determined based on all relevant information as of the date of transfer in accordance with a valuation report that will be prepared by the Dixon Hughes Goodman, LLP ("DHG"), Jacksonville, Florida, an independent third-party professional organization that is experienced in such matters and appropriately qualified to make such a determination. However, the determination of fair market value is subject to challenge by the Internal Revenue Service ("IRS"). While the parties intend to initially rely upon and be bound by the valuation report prepared by DHG, if the IRS challenges the valuation and a final determination of a different fair market value is made by the IRS or a court of law, the number shares transferred from the transferor to the transferee shall be adjusted accordingly so that the transferred shares have a value exactly equal to $5,000,000, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or court of law.

The Commissioner's Pretrial Memorandum discussed Procter, Wandry and other cases as follows:

> **5. The "Irrevocable Stock Power" language attempting to "adjust" the number of nonvoting shares of FRG that were transferred by Petitioners on December 31, 2014 is a condition subsequent and violates Public Policy.**
>
> In Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), the Fourth Circuit rejected a clause that adjusts part of a gift to "automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of [the taxpayer]" because the adjustment is triggered only by a "final judgment or order of a competent federal court of last resort that any part of the transfer . . . is subject to gift tax." Id. at 827.
>
> Petitioners' Irrevocable Stock Powers state that "[t]he precise number of shares transferred in accordance with the preceding sentence shall be determined based on all relevant information as of the date of transfer in accordance with a valuation report that will be prepared by Dixon Hughes Goodman, LLP ('DHG'),

Jacksonville, Florida, an independent third-party professional organization that is experienced in such matters. . . ." DHG's Return Appraisal, which was attached to Chris Sorensen's 2014 gift tax return, concludes that the per share value of FRG stock is $532.79 as of December 31, 2014. Petitioners then failed to follow their transfer clause since each petitioner reported on his respective 2014 gift tax returns that he transferred 9,385 shares of FRG stock ($5,000,234.15 according to DHG's Return Appraisal) on December 31, 2014, which does not equal $5,000,000.

In Procter, the Fourth Circuit found a gift adjustment clause similar to the one at issue in this case to be void as contrary to public policy. Id. at 827; see also Rev. Rul. 86-41 and Rev. Rul. 65-144. In Procter, the taxpayer made a present gift on the condition that, if a court of last resort found the gift was subject to gift tax, the part of the gift that was subject to the gift tax would be void. Procter, 142 F.2d at 827. The clause at issue in the Irrevocable Stock Power functions in the same manner as the clause in Procter. If the savings clause at issue in this case is interpreted in the manner that petitioners advance, then any part of the gift subject to gift tax is void. The Fourth Circuit found that the clause in Procter was contrary to public policy because the clause discouraged the collection of gift tax since any attempt to enforce the gift tax would defeat the gift. Id. The Fourth Circuit also found that the effect of the clause "would be to obstruct the administration of justice by requiring the courts to pass upon a moot case." Id. The Fourth Circuit found that the effect of the clause would neutralize any final judgment of a court; that is, the condition in the clause would not become operative until there was a judgment that the donor was liable for the gift tax, but after the judgment had been rendered, the condition could not become operative because the matter involved was concluded and rendered moot by the judgment. Id. at 827-28. See also TOT Property Holdings, LLC v. Commissioner, 1 F.4th 1354, 1365 (11th Cir. 2021); Belk v. Commissioner, 774 F.3d 221, 229 (4th Cir. 2014); Estate of Christiansen v. Commissioner, 130 T.C. 1, 13-14 (2008), aff'd on other issues, 586 F.3d 1061 (8th Cir. 2009); Ward v. Commissioner, 87 T.C. at 109-16.

Giving effect to petitioners' "shall be adjusted accordingly" clause presents the same issue as in Procter: it precludes respondent from enforcing the gift tax or engaging in any efforts to collect the gift tax. Moreover, it also precludes respondent from enforcing the valuation misstatement penalties.

Further, the Eleventh Circuit, the circuit to which appellate venue lies in the subject case, supports respondent's interpretation of the legal result pertaining to petitioners' "shall be adjusted accordingly" clause. In TOT Property Holdings, LLC v. Commissioner, 1 F. 4th 1354 (11th Cir. 2021), the Commissioner disallowed a conservation-easement deduction due to the taxpayer's failure to meet applicable regulation requirements. Id. at 1357. The Eleventh Circuit concluded that language in the deed conveying the conservation easement conflicted with applicable regulation requirements, and the deed language purporting to bring the easement into compliance with the relevant regulations "if different" was an unenforceable savings clause. Id. at 1357, 1365-68.

The Eleventh Circuit relied on the Fourth Circuit's decision in Procter, including the discussion in Procter about the public policy concerns precluding enforcement of a clause retroactively voiding part of a transfer subject to the gift tax. Id. at 1365-68. Although the deed language in TOT Property was "not conditioned on any adverse action by the IRS or a court," that was a "clear necessity" for the clause to apply. Id. at 1367. As such, the clause presented "the same sort of catch-22 situation that leads to the 'trifling with the judicial process,' that case law has held to be unenforceable." Id. at 1368 (citing Procter, 142 F.2d at 827).

This is not to be confused with the cases in which the donor transferred a fixed number of units in a closely-held entity subject to the condition that the units be reallocated among the donees based upon unit values as finally determined for transfer tax purposes. See Estate of Petter v. Commissioner, 653 F.3d 1012, 1015-16 (9th Cir. 2011); Estate of Christiansen v. Commissioner, 586 F.3d 1061, 1062 (8th Cir. 2009); Succession of McCord v. Commissioner, 461 F.3d 614, 619 (5th Cir.2006); Hendrix v. Commissioner, T.C. Memo. 2011-133, at *19-22. In these cases, there was no question that the donor had given up dominion and control over a fixed number of units and no possibility that any of those units could return to the donor. As the Fifth Circuit explained,

> While the formula-clause cases might give the appearance of reopening a transaction in just such a fashion, that is not the case. A gift is considered complete, and thus subject to the gift tax, when "the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or the benefit of another." 26 C.F.R. § 25.2511-2(b) (2021). For tax purposes, the "value . . . at the date of the gift shall be considered the amount of the gift." 26 U.S.C § 2512(a). With a formula clause, the transaction is still closed even if a reallocation occurs. That reallocation simply works to ensure that a specified recipient "receive[s] those units [he or she was] already entitled to receive." Est. of Petter, 653 F.3d at 1019. Similarly, the value of the gift existed and could be determined at the time of the transfer. "The number of . . . units" transferred [to a specified recipient] is "capable of mathematical determination from the outset, once the fair market value [is] known." Id. The reallocation clauses thus allow for the proper number of units to be transferred based on the final, correct determination of valuation. Est. of Petter, 653 F.3d at 1019.

Nelson v. Commissioner, 17 F.4th at 561.

Therefore, petitioner's "shall be adjusted accordingly" clause, which adjusts the transferred shares between the donor and the donee, as opposed to among the donees, should be disregarded, and the Court should find that each petitioner transferred 9,385 nonvoting shares of FRG to his respective Family Trust on December 31, 2014.

The facts of this case are clear — each petitioner transferred 9,385 shares of FRG on December 31, 2014. Petitioners cannot claim that two mutually exclusive facts are true at the same time — that they transferred 9,385 shares of FRG on December 31, 2014 and that they did not transfer 9,385 shares of FRG on December 31, 2014. That is "the same sort of catch-22 situation that leads to the 'trifling with the judicial process,' that case law has held to be unenforceable." TOT Property Holdings, LLC v. Commissioner, 1 F.4th at 1368 (citing Procter, 142 F.2d at 827). Thus, each petitioner made a gift of 9,385 shares of FRG on December 31, 2014.

B. The Wandry Opinion Improperly Focused on the Donor's Subjective Intent in Contradiction of the Applicable Statutes and Regulations

This Court, in Wandry v. Commissioner, T.C. Memo. 2012-88, a case that was submitted under T.C. Rule. 122, found that a defined value clause controlled the amount of the gift. In Wandry, the donors transferred "a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes

shall be [stated dollar amounts].” Wandry, T.C. Memo. 2012-88 at *4-5. The transfer documents in Wandry stated that:

> If, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount [stated in the transfer documents].

Id.

The Court, citing Estate of Petter, T.C. Memo. 2009-280, differentiated between a “savings clause” and a “formula clause.” Id. at *20-21. The Court stated a “savings clause” is void because it creates a donor that tries to “take property back,” whereas a “formula clause” is valid because it transfers in the first instance a “fixed set of rights with uncertain value,” and the difference between the two “depends on an understanding of just what the donor is trying to give away.” Id. The Court pointed to the transfer document language to find that the taxpayers' intent was to transfer “a predefined Norseman percentage interest expressed through a formula” to each donee, and the transfer document does not allow taxpayers to “take property back” but correct the allocations. Id. at *25.

Respondent issued an Action on Decision regarding Wandry. 2012-46 I.R.B. 543, 2012 WL 5473819 (November 13, 2012). As explained in the Action on Decision, respondent disagrees with the result in Wandry because the application of the gift tax is based on the objective facts and circumstances of when the donor relinquishes dominion and control over the gifted property, as detailed in Section II. above, and not upon the subjective donative intent of the donor. The evidence in Wandry showed that the donors parted with dominion and control over the gifted Norseman Capital, LLC units, although the number of units was unclear from the record (as pointed out by the Court). The transfer documents in Wandry created a condition subsequent to the donees' ownership of the gifted Norseman Capital, LLC units by subjecting the gift to reallocation if “a final determination of a different value is made by the IRS or a court of law.” However, a condition subsequent cannot change the fact the gift was complete as of the date the donors gave up control of the Norseman Capital, LLC units to the donee. See Smith, 318 U.S. at 181; Robinette, 318 U.S. at 187; Estate of Kolb, 5 T.C. at 593; Mack, 39 B.T.A. at 229.

The Wandry opinion also failed to acknowledge that adjusting or “reallocating” the donors' and donees' capital accounts in Norseman Capital, LLC affects each partner's economics in the partnership since capital accounts under Treas. Reg. § 1.704-1 (I.R.C. § 704(b) book capital accounts) are used to track a partner's economic share of the underlying partnership assets. Thus, a reduction to a partner's capital account is a reduction to the partner's economic share of the partnership's assets, it is not simply an adjustment to the partnership's internal accounting, as the Wandry decision alludes.

The Wandry opinion also discusses the donor and donees' competing interests, but, unlike a situation where a donor is gifting property to a third-party, there are no real competing interests where the donor is gifting property to a spouse and/or children for estate planning purposes. In Estate of Petter and other cases where a donor gifts property to charities, the directors of charitable foundations have fiduciary duties to their organizations to ensure appraised values of gifts are acceptable, and for a donor to receive a charitable contribution deduction the

charities acknowledge the appraised value of the gift before the IRS by signing Form 8283. Contrast that situation with Wandry, in which donors are gifting property to family members and there are no competing interests. Donors are incentivized to transfer as much as possible to remove the assets from the transfer tax base and the donees would like to receive as much as possible. See Tiffany B. Carmona, Tye J. Klooster, Wandry v. Commissioner, the Secret Sauce Estate Planners Have Been Waiting for?, Probate & Property, November/December 2012, at 10, 14. Thus, the Wandry opinion's rationale that the donor and donees had competing interests at the time the gift was completed, similar to donors who gift property to charities, is inherently flawed.

The focus upon the donor's subjective intent also subverts Congressional intent regarding the valuation misstatement penalties in gift tax matters. For example, if a donor is allowed to control the dollar amount of property it transfers to a donee, then this Court is not deciding the amount of gift tax on the property transferred but rather is only determining the property that should be returned to the donor. In such a scenario, there can never be a valuation misstatement penalty because the donor's intent to avoid gift tax, rather than the value of the property transferred, controls the donor's gift tax liability, and thus avoids any valuation misstatement penalties. The Supreme Court in Helvering v. Mitchell, 303 U.S. 391, 401 (1938), explained that penalties are "a safeguard for the protection of the revenue and to reimburse the Government for the heavy burden of investigation." More important, respondent relies "on the risk of civil and criminal penalties — and a large measure of good faith — to maintain public compliance with the tax code." See Harrison v. Internal Revenue Serv., No. 20-CV-828 (CRC), 2021 WL 930266, at *1 (D.D.C. Mar. 11, 2021) (citing United States v. Bisceglia, 420 U.S. 141, 145 (1975)). Permitting taxpayers' subjective intent to set a predetermined value on the transfer of gifted property precludes respondent from imposing such valuation misstatement penalties and takes away the safeguard to maintain public compliance with the tax code. Therefore, focusing on the donor's subjective intent, rather than focusing on the cessation of dominion and control over the property transferred, gives donors an incentive to undervalue the gifted property with no risk of additional gift tax or penalties.

The Wandry opinion improperly focused on the donors' intent rather than the donors' relinquishment of dominion and control over gifted property, as required by the statutes and regulations thereunder. Therefore, to the extent necessary to resolve this issue, this Court should find Wandry was wrongly decided, and petitioners owe additional gift tax to the extent that the value of 9,385 nonvoting shares of FRG exceeds petitioners' annual exclusions and lifetime exemption equivalents. See I.R.C. §§ 2501(a); 2503(b); and 2505(a).

C. The Facts in This Case are Distinguishable from the Facts in Wandry

One glaring distinction between this case and Wandry is respondent's ability, in this case, to identify the specific property that petitioners gifted and the shift in the benefits (for example, distributions) and burdens with respect to that specific property. In Wandry, the opinion does not describe the specific number of units in the limited liability company transferred by the donors. In this case, respondent can show that the Irrevocable Family Trusts each own a set number of shares of FRG stock as of December 31, 2014. Indeed, the parties agree that petitioners gifted shares to their respective Irrevocable Family Trusts as of December 31, 2014, and the shareholders of FRG were as follows:

Shareholder	Voting	Nonvoting	Total	% Interest
Robin Sorensen's Living Trust	3,200	19,415	22,615	25.13%
Robin Sorensen's Irrevocable Family Trust	0	9,385	9,385	10.43%
Chris Sorensen's Living Trust	3,200	19,415	22,615	25.13%
Chris Sorensen's Irrevocable Family Trust	0	9,385	9,385	10.43%
Other Shareholders	2,600	23,400	26,000	28.88%
Total	**9,000**	**81,000**	**90,000**	**100.00%**

See First SOF ¶ 23-25; see also First SOF ¶ 39, Exhibit 23-J.

FRG reported, on its 2015 Form 1120S, that each Irrevocable Family Trust owned 9,385 shares, a 10.4278% interest, in FRG as of December 31, 2015. See First SOF ¶ 33, Exhibit 17-J, p. 28. Also, FRG issued Schedule K-1s (Form 1120S) to each Irrevocable Family Trust reporting that trust's share of FRG's current year income, deduction, credits, distributions, and other items of the S corporation based on the trusts' ownership of 9,385 shares of stock. Further, each Irrevocable Family Trust retained the 9,385 shares until it transferred the shares on December 9, 2021. Therefore, unlike in Wandry, where the units transferred were uncertain, the parties agree, and the documents prove, that each petitioner transferred 9,385 nonvoting shares in FRG to his respective Irrevocable Family Trust on December 31, 2014.

Unlike the donors in Wandry, petitioners failed to follow their own transfer clauses. The descriptions of the gifts within petitioners' respective 2014 Gift Tax Returns state that each transferred nonvoting shares equal to $5,000,000 and further stated one nonvoting share was valued at $532.79. Yet, each petitioner transferred 9,385 nonvoting shares in FRG to his respective Family Trust. The result of multiplying 9,385 nonvoting shares in FRG by $532.79 is $5,000,234.15, which is greater than, not equal to $5,000,000. Accordingly, these facts align more with Knight v. Commissioner, 115 T.C. 506, 515-16 (2000), than with Wandry.

* * *

D. Petitioners and the Irrevocable Family Trusts are Unable to "Adjust" the Number of Gifted FRG Shares; Thus, the Number of Shares Gifted is Final

Cases that approve the use of defined value clauses, as "formula clauses," in the gift tax realm reason that the donor is gifting a fixed set of rights, although the value of said rights passing to any given donee is unknown. See Estate of Petter, 653 F.3d at 1015-16; Estate of Christiansen, 586 F.3d at 1062; Succession of McCord, 461 F.3d at 619; Hendrix, T.C. Memo. 2011-133, at *19-22. The reallocation of the transferred property among the donees based on a redetermination of the value of the transferred property does not result in the donor taking back property but rather, ensures that each donee receives the property that the donee was always entitled to receive. This logic, however, is severely flawed when applied to the facts of this case.

> Petitioners argue that if the value of 9,385 nonvoting shares in FRG as of December 31, 2014 exceeds $5,000,000 (which petitioners themselves exceeded with their initial transfer), then they do not owe additional gift tax because the shares "shall be adjusted accordingly" between the donor and the donee. No adjustment of the shares can occur in this case, however, since neither petitioners nor their respective Irrevocable Family Trusts now own shares in FRG.
>
> Even if petitioners' respective Living Trusts and Irrevocable Family Trusts still held the nonvoting shares of FRG, this Court, being a court of limited jurisdiction, could not enforce any "adjustment" after finality of the case. A "shall be adjusted accordingly" adjustment would substantially affect the rights of the Irrevocable Family Trusts given the wide disparity in the value of the FRG shares at issue in this case, as well as the substantial distributions that the Irrevocable Family Trusts have received from December 31, 2014 through December 2021. The trustees of the Irrevocable Family Trusts bear a fiduciary duty to the beneficiaries of the Irrevocable Family Trusts, and not to petitioners. The trustees are not a party to this case. Moreover, there is no evidence that the trustees ever agreed to be party to such an adjustment, or even that petitioners intend to pursue such an adjustment in a state law proceeding.
>
> The realities of a transaction must control the tax implications. Petitioners are asking this Court to ignore a transaction that occurred eight years ago and find that petitioners' tax wishes control the tax implications of petitioners' gifts. The transaction at hand, however, shows that each petitioner gifted 9,385 nonvoting shares in FRG stock to his respective Irrevocable Family Trust by relinquishing dominion and control over the shares on December 31, 2014. Therefore, petitioners' gifts are taxable to the extent that the value of 9,385 nonvoting shares of FRG exceeds each petitioner's annual exclusions and lifetime exemption equivalents. See I.R.C. §§ 2501(a); 2503(b); and 2505(a).

Several lessons may be drawn from this case. First, assigning a fraction of all the units the donor owns limits the "transfer back" element and reduces comparison with Procter. Second, if possible having a fiduciary with a duty to someone beyond the donor and donees is helpful. A transfer to a trust with a charitable allocation clause would be an example. Third, ensuring that if "too many" shares or units were transferred before the IRS adjustment then the excess can, will, and must be readjusted seems very important. Having said all of that, the settlement of the case suggests that the IRS is skittish about a case that might uphold define value clauses.

F. Charitable Planning

An individual donor who itemizes deductions is entitled to an income tax charitable deduction for contributions to qualified charitable organizations. § 170(a). The deduction, however, is subject to numerous limitations and qualifications which in most cases depend upon: (i) the classification of the charitable organization; (ii) the type of assets contributed to the charitable organization; (iii) the donor's contribution base (essentially, the donor's adjusted gross income or "AGI"); and (iv) the donor's receipt of proper substantiation for the contribution.

1. Public Charities and Private Foundations. As discussed in more detail below, there are numerous types of charitable entities. For federal income tax purposes, however, practitioners frequently think of two broad classes of organizations, sometimes called "50% charities" and "30% charities." These names are derived from the traditional limit on the deduction available to donors for cash gifts made to each type of entity, expressed as percent of the donor's contribution base. A donor is generally entitled to deduct the full amount of the contribution up to 50% of the donor's contribution base for a gift of cash (or unappreciated property) to a "50% charity." The contribution limit for cash gifts to 50% charities is increased to 60% of the donor's contribution base for contributions made between 2018 and 2025, and if the donor so elects, 100% of the contribution base for cash contributions made in 2020 and 2021 to most 50% charities. These entities are generally organizations described in section 501(c)(3) of the Code and classified as section 509(a)(1), (a)(2), or (a)(3) organizations. These are generally public charities, private operating foundations, and conduit private foundations (but not most other private foundations). More specifically, a 50% charity

includes: (i) churches and conventions and associations of churches; (ii) schools, colleges, universities; (iii) organizations that are organized and operated exclusively to hold investments and make expenditures for the benefit of a college or university, are an arm of state or local government, and normally receive substantial parts of their support from governments and contributions from the general public; (iv) hospitals and organizations carrying on medical research in conjunction with hospitals; (v) federal, state, and local governments; (vi) organizations receiving substantial parts of their support (apart from revenues generated in the performance of charitable or other exempt purposes) in the form of contributions from the general public or government subsidies; (vii) organizations that normally receive more than one third of their support from gifts, grants, contributions, membership fees, and gross receipts from activities related to the organizations' exempt purposes and do not normally derive more than one third of their support from investment income and after-tax income from unrelated trades or businesses; (viii) satellite organizations of publicly supported charities; and (ix) private foundations that (a) are operating foundations; (b) expend or distribute contributed funds within two and one-half months after the close of the year in which received; or (c) pool contributions in common funds from which donors may direct income and corpus to public charities. § 170(b)(1)(A).

A donor is generally entitled to deduct the full amount of the contribution up to 30% of the donor's contribution base for a gift of cash (or unappreciated property) to a "30% charity." These organizations are typically private foundations, other than private operating foundations or a conduit private foundations. The 30% limitation also applies to gifts by an individual "for the use of" (as opposed to gifts directly to) a 50% charity. § 170(b)(1)(B).

So how do you tell what category a specific charity belongs to? One method is to ask the charity for a copy of its IRS "determination letter" which is the notification the charity received from the IRS confirming its charitable status. Another method is to do an on-line search of the IRS's web site that includes its cumulative list of charitable organizations. Note that this list excludes most churches and church-affiliated organizations, which are classified as public charities. The IRS site is

https://apps.irs.gov/app/eos/mainSearch.do;jsessionid=HQa8CjDKOYIyRE5caIVrMA__?mainSearchChoice=pub78&dispatchMethod=selectSearch

which may also be located by going to your favorite web browser and searching for "**IRS cumulative list of tax-exempt organizations**" or, even easier, "**Publication 78**."

2. Assets Contributed. Gifts of cash are generally subject to the limitations mentioned above and outlined in more detail below. When property other than cash is contributed, however, the nature of the contributed property becomes important. Three types of property merit special attention.

a. Capital Gain Property. First, if the donor contributes capital gain property (that is, property which, if sold by the donor on the date of contribution, would result in long-term capital gain) to a 50% charity, the donor may deduct the full fair market value of the gift only up to 30% of the donor's contribution base. § 170(b)(1)(C). For gifts of such property to a private foundation, the deduction is limited to 20% of the donor's contribution base. § 170(b)(1)(D). Moreover, if an individual contributes capital gain property to a 30% charity, the amount of the deduction is limited to the lesser of the property's basis or its fair market value. § 170(e)(1)(B)(ii). However, there is a special exception for publicly traded securities. In particular, a donor is allowed to deduct the fair market value (rather than tax basis) for a contribution of "qualified appreciated stock" (i.e., stock for which market quotations are readily available on an established securities market). § 170(e)(5).

b. Tangible Personal Property. If a donor makes a contribution of tangible personal property, the donor is entitled to a charitable deduction equal to the greater of fair market value or basis for a contribution of tangible personal property only if the use of that property is related to the donee's exempt purpose. If the property is not related to the donee's exempt purpose, the donor's deduction is limited to the lesser of the property's fair market value or basis. § 170(e)(1)(B)(i). Thus, for example, if a donor contributes an appreciated painting to a private operating foundation that operates a museum, she can deduct the full fair market value of the painting. In contrast, if the donor contributes her yacht to the museum and the museum will sell the yacht because it is not related to its charitable purposes, the donor is limited to deducting the lesser of the yacht's fair market value or the donor's basis in the yacht.

c. Ordinary Income Property. If a donor makes a contribution of property the sale or exchange of which would produce a gain other than a long-term capital gain, the amount of the donor's deduction is reduced by the amount of the non-long-term gain. § 170(e). Thus, a donor's deduction is limited to basis if the donor contributes items which if sold would generate ordinary income, such as inventory, crops, dealer property, and works created by the donor. In the case of a painting donated by the artist, for example, the deduction is limited to the cost of the artist's materials. Note that since only long-term gain is considered when measuring the deduction, the basis limitation applies not only to property that would yield ordinary income, but also to property the sale of which would yield a short-term capital gain. In general, this limitation means that if the asset is not a long-term capital asset, a charitable deduction is limited to the asset's basis (its fair market value less its non-long-term capital gain, if sold).

3. The Contribution Base. In general, a donor's "contribution base" is the donor's adjusted gross income as defined in section 62, but computed without regard to (that is, ignoring any deduction for) any net operating loss carryback to the taxable year under Section 172 of the Code. § 17(b)(1)(H).

4. Substantiation Requirements. Charitable contributions must be substantiated in order to be deductible for federal income tax purposes. § 170(f)(8). The degree of substantiation varies with the amount and nature of the gift. First, if the gift is by cash, check, or other monetary amount, the donor must maintain a bank record or written communication from the charity showing the name of the charity, the date of the contribution, and the amount of the contribution. Contributions of less than $250 must generally be substantiated by a written document. If cash is given, a cancelled check will suffice. Treas. Reg. § 1.170A-13(a). If property with a value less than $250 is contributed, a receipt from the charity is generally required. If a receipt is not available (e.g., if clothing or household goods are left at an unattended Goodwill site), other written documentation of the contribution is acceptable. Treas. Reg. § 1.170A-13(b)(1). Absent these records, the deduction may be disallowed. Treas. Reg. § 1.170A-1(h); Luczaj & Assoc. v. Comm'r, TC Memo. 2017-42.

Contributions of $250 or more require a written receipt from the charity executed not later than the date that the tax return for the year of the gift is filed (or due, if earlier). The receipt must state whether or not the charity provided any goods or services as consideration for the contribution, and if goods or services were provided, the receipt must also contain a description and good faith estimate of the value of the consideration. § 170(f)(8). These requirements are "strictly enforced.

If the donor makes non-cash contributions valued at more than $500 but not more than $5,000, the donor must maintain written documentation describing how and when the property was acquired and information relating to the basis of the contributed property. In addition, the taxpayer must complete IRS Form 8283 ("Noncash Charitable Contributions") if the amount of the deduction for each noncash contribution is more than $500, or if the taxpayer contributes a group of similar items for which a total deduction of over $500 is claimed.

Similar requirements apply for contributions of publicly traded stock with a claimed value in excess of $5,000. Treas. Reg. 1.170A-13(b)(3). The donor must also include a description of the property. Special reporting requirements apply to gifts of cars, boats, and planes. § 170(f)(12)(A). One such requirement is a contemporaneous written acknowledgement of the contribution from the donee organization that meets the requirements of § 170(f)(12)(B*).* *See, e.g.,* Izen v. Comm'r, 148 TC 5 (2017) (no charitable contribution deduction allowed for contribution of interest in used aircraft to aeronautical heritage society where donor failed to satisfy contemporary written acknowledgement requirement by submitting Copy B of Form 1098-C or otherwise). See Chiarelli v. Comm'r, T.C. Memo. 2021-27 (2021) (where IRS Forms 8283 submitted by taxpayer were almost entirely incomplete, and lacked signatures from donor, donee, and appraiser, taxpayer did not comply, either strictly or substantially, with regulatory reporting requirements for noncash charitable contributions).

For contributions the value of which exceed $5,000, the donor must obtain a qualified appraisal and appraisal summary, unless the donated property is cash or publicly traded securities. Treas. Reg. § 1.170A-13(b)(3). The appraisal must be received by the donor before the due date, including extensions, of the return on which a deduction is first claimed. Treas. Reg. § 1.170A-17(a)(8). The requirement that a contemporaneous written acknowledgment be obtained for charitable contributions of $250 or more is a strict one. In the absence of the receipt of a timely acknowledgment meeting the statute's demands, "[n]o deduction shall be allowed." § 170(f)(8)(A); see also French v. Comm'r, T.C. Memo. 2016-53 ("If a taxpayer fails to meet the strict substantiation requirements of section 170(f)(8), the entire deduction is disallowed.") The doctrine of substantial compliance does not apply to excuse failure to obtain

a contemporaneous written acknowledgment meeting the statutory requirements. Id.; Durden v. Comm'r, T.C. Memo. 2012-140. Failure to follow this statutory requirement can have disastrous results to donors. See, e.g., 15 West 17th Street LLC v. Comm'r, 148 TC 557 (2016) (claimed deduction of $64.49 million disallowed). If the contribution is comprised of non-publicly traded stock valued in excess of $5,000 but less than $10,000, or of publicly traded stock (regardless of value) the donor need only obtain a partially completed appraisal summary, a contemporaneous receipt from the charity, and maintain certain records. Treas. Reg. § 1.170A-13(c)(2)(ii). For contributions over $500,000, the donor must not only obtain a qualified appraisal but must also attach the appraisal to the income tax return, unless the gift consists of money, publicly traded securities, inventory, and certain cars, boats and planes. Treas. Reg. § 1.170A-16(e). See, e.g., Pankratz v. Comm,'r, T.C. Memo. 2021-26 (March 3, 2021) (deduction for taxpayer's gift of over $500,000 in oil and gas interests to church denied for failure to obtain qualified appraisal.

5. Benefits Received by Donor. If the donor receives a benefit in exchange for the contribution to the charity, special rules apply. Specifically, whenever the donor receives a benefit and the amount received by the charity is more than $75, the charity must provide the donor with a written receipt estimating what amount is attributable to goods and services received by the donor in exchange for the gift. § 6115. The deduction must be reduced by the value of the goods or services received. If the taxpayer receives a substantial benefit in exchange for its contribution and does not report or specify the value of the benefit it received, then no charitable deduction will be available. See, e.g., Triumph Mixed Use Invs. III v. Comm'r, TC Memo. 2018-65 (May 15, 2018). The requirements for substantiation by the charity are subject to a number of exceptions. See IRS Publication 526.

A charitable deduction will be reduced by the amount of any state or local tax credit that the taxpayer receives in return for his contribution but will generally not be reduced by the receipt of a state or local tax deduction (unless the deduction exceeds the value of the contribution). There is an exception for state or local tax credits that do not exceed 15 percent of the value of the charitable contribution. Treas. Reg. § 1.170A-1(h)(3).

If the charity receives property with a value in excess of $5,000 (other than publicly traded securities) and then sells the property within three years, the charity must report to the IRS: (1) the name, address, and TIN of the donor; (2) a description of the property; (3) the date of the contribution; (4) the amount received on the disposition; and (5) the date of disposition. § 6050L. If the gift to charity is part of an estate planning transaction, then waiting for three years before the charity sells the property may be advisable.

If a donor receives contemporaneous written acknowledgment from the charity, the donor may generally rely on the charity's acknowledgment for the fair market value of the consideration received in exchange for the charitable contribution. Treas. Reg. § 1.170A-1(h)(5). If, however, if the donor knows or has reason to know that the valuation is unreasonable, then the donor may not rely on it. Id.

6. Deduction Carry-Forwards. If a donor's gifts to a 50% charity exceeds the limitation for any taxable year, the excess can be carried forward for as many as five years. § 170(d)(1); Treas. Reg. § 1.170A-10(b). The carry-forward is deductible in the next succeeding year in an amount equal to the excess of (1) 50% of the contribution base for the carry-forward year, over (2) the sum of the contributions to 50% charities for the carry-forward year and carry-forwards from earlier years. Any amount that the donor cannot deduct in the first carry-forward year is then carried forward to the second year, where it is deductible subject to the same limitation, and so on, for the third, fourth, and fifth years after the year of the gift. If the taxpayer has carry-forwards from two or more years, the oldest carry forward is used first. Similarly, if gifts for the use of 50% charities and contributions to or for the use of 30% charities exceed the 30% ceiling, the excess is carried forward for up to five years and is deductible in the carry-forward years, starting with the immediately succeeding year, to the extent the 30% ceiling for the carry-forward year exceeds current gifts subject to the ceiling. § 170(b)(1)(B); Treas. Reg. § 1.170A-10(c). A carry-forward of a contribution to a 50% limit organization must be used before contributions in the current year to organizations other than 50% limit organizations. A comprehensive example of the limitations on using multiple carry-forwards is set out in Treasury Regulation Section 1.170A-10(c)(2).

7. Transfer Taxes. The rules applicable to outright gifts to charity for gift, estate, and generation-skipping transfer taxes are relatively straight-forward unless so-called "split interest" transfers (such as charitable lead and charitable remainder trusts) are involved. For those techniques where the rules are more complex, the discussion below describes these consequences in more detail. In summary, however, the following rules apply.

a. Gift Tax. Section 2522 provides an unlimited gift tax deduction for lifetime transfers to qualifying recipients for public, charitable, religious and other similar purposes. In effect, the deduction operates as an exclusion. With minor exceptions, the definition of eligible recipients and qualifying transfers are identical to those applicable for federal estate tax purposes, discussed below. Note that the instructions for IRS Form 709 "United State Gift (and Generation-Skipping Transfer Tax) Return" provide, "If you are required to file a return to report noncharitable gifts and you made gifts to charities, you must include all of your gifts to charities on the return." This is instruction is probably most often "honored in the breach." However, clients that are filing gift tax returns for hard-to-value assets that are seeking to ensure that the returns meet the adequate disclosure rules for taxable gifts may wish to report all charitable gifts as well. See Treas. Reg. § 301.6501(c)-1(f). Where an interest in property is split between charitable and noncharitable recipients (for example, in charitable lead or charitable remainder trusts), special rules apply, which are discussed below in connection with those techniques. § 2522(c)(2). If consideration is received for the gift (or a liability is assumed by the charity), the amount of the gift is reduced by the amount of the consideration (or liability). § 170(f)(5). Treas. Reg. § 1.170A-1(h).

b. Estate Tax. Section 2055 provides an unlimited deduction from a decedent's gross estate for bequests, legacies, devises and transfers to qualifying recipients for public, charitable, religious, and other similar purposes. Qualifying organizations are detailed in section 2055(a). There is no distinction for estate tax purposes as to whether the recipient charity would, for income tax purposes, be a 50% charity vs. a 30% charity. For federal estate tax purposes, bequests to either form are generally deductible in full. The amount of the deduction may not exceed the value of the transferred property that is required to be included in the gross estate. IRS § 2055(d). The transfer to charity must be if transferred to a charitable donee "by the decedent during his lifetime or by will." Treas. Reg. § 20.2055-1(a). No deduction is allowed where the donation turns upon the actions of the decedent's beneficiary or an estate's executor or administrator. See, e.g., Est. of Moore v. Comm'r, TC Memo 2020-40; Est. of Engelman v. Comm'r, 121 T.C. 54, 70-71 (2003); Est. of Marine v. Comm'r, 97 T.C. 368, 378-79 (1991), aff'd, 990 F.2d 136 (4th Cir. 1993). A charitable transfer must be certain in fact and its value must be ascertainable at a decedent's date of death. Ithaca Tr. Co. v. United States, 279 U.S. 151, 154 (1929) (transfers to a charity must be "fixed in fact and capable of being stated in definite terms of money"); Est. of Marine, 97 T.C. at 375. If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is "so remote as to be negligible." Treas. Reg. § 20.2055-2(b)(1). Moreover, the amount of the charitable deduction must be reduced by the amount of any estate, succession, legacy or inheritance taxes that are, either by the terms of the Will or local law, assessed against an otherwise deductible transfer. § 2055(c). Where an interest in property is split between charitable and noncharitable recipients, special rules apply, which are discussed below. § 2055(e)(2).

c. The Generation-Skipping Transfer Tax. Section 2642(a) provides that in determining the inclusion ratio for purposes of the generation-skipping transfer tax, the denominator of the fraction is reduced by "any charitable deduction allowed under section 2055 or 2522 with respect to such property." The effect of this provision is to eliminate charitable gifts and bequests from the equation for purposes of calculating the generation-skipping transfer tax.

8. Popular Charitable Planning Ideas.

Set forth below, arranged roughly in order of complexity, are eight common charitable giving techniques that your clients might consider in the current tax and economic environment. The first three tools are quite straight-forward, while the five that follow require a bit more elaboration.

a. Cash Gifts. Cash gifts to charities are deductible, subject to the contribution limits and substantiation requirements outlined above. These gifts are perhaps the most straight-forward and most common form of charitable giving. Cash gifts offer the fewest limits on gifting in terms of percentage limitations. A cash gifts can be as simple as dropping cash into a collection plate or donation box. Checks and wire transfers are also treated as cash gifts. A contribution is considered made in the year when a completed gift of the contributed cash is made. Generally, a gift is completed in the year when it is unconditionally delivered to the charitable donee or its agent, and the taxpayer may take the deduction for that year. If a check is mailed that clears in due course, the contribution is treated as having been made on the date that the check is mailed. Treas. Reg. § 1.170A-1(b). A mere pledge or promise

to make a contribution is not deductible until it is actually paid. Rev. Rul. 68-174. A contribution made by credit card is deductible when the charge is made, regardless of when the credit card bill is paid. Rev. Rul. 78-38.

b. Gifts of Appreciated Property.

(i) Gifts to Public Charities. Gifts of appreciated property to public charities or other 50% charities are generally deductible up to 30% of the donor's contribution base. § 170(b)(1)(C). If the contributed property is long-term capital gain property (i.e., a capital asset the sale of which for fair market value at the time of contribution would result in long-term capital gain) the donor is permitted to deduct its full fair market value. However, a donor may elect instead to increase the limit on the deduction for long-term capital gain to 50% of the contribution base, but must then reduce the value of the gift by the long-term gain. § 170(b)(1)(C)(iii). The deduction for contributions of short-term capital gain property (i.e., property the sale of which would produce a short-term capital gain) is reduced by the amount of the short-term gain. § 170(e). In other words, the deduction for contributions of short-term capital gain property is generally limited to basis. By the way, most donors choose not to donate depreciated property (i.e., property for which the income tax basis exceeds its fair market value). Instead, most donors choose to sell such property to enable the donor to realize the tax loss, with the net sales proceeds thereafter being contributed to charity.

(ii) Gift to Private Foundations. Gifts of appreciated property to private foundations other than operating foundations and conduit foundations are deductible up to 20% of the donor's contribution base. § 170(b)(1)(D). These gifts are generally limited to the amount of the donor's basis in the contributed property. Note, however, there is an exception to this rule for gifts of appreciated securities. Despite the limitation on the deductibility of gifts of appreciated property to 30% charities, contributions to those charities of "qualified appreciated stock" (i.e., stock for which market quotations are readily available on an established securities market) can be deducted at fair market value instead of being limited to the donor's basis. § 170(e)(5). Making a gift of qualified appreciated stock in effect permits the donor to realize the benefit of the stock's appreciation (by virtue of a higher income tax deduction), without recognizing the built-in gain associated with the stock. Such a mismatch in the tax law is rare, and is frequently taken advantage of by savvy donors.

(iii) Pre-Arranged Sales. Under the anticipatory assignment of income doctrine, a taxpayer who earns or otherwise creates a right to receive income will be taxed on any gain realized from that right if, based on the realities and substance of events, the receipt of income is practically certain to occur, even if the taxpayer transfers the right before receiving the income (see Lucas v. Earl, 281 U.S. 111 (1930)). The related step transaction doctrine similarly prevents a taxpayer from escaping taxation by collapsing a series of substantially linked steps into a single overall transaction (see Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987)).

In Palmer v. Commissioner (62 T.C. 684 (1974), aff'd on other grounds, 523 F.2d 1308 (8th Cir. 1975), acq, 1978-1 C.B. 2), the Tax Court held that a taxpayer's gift of stock in a closely-held corporation to a private foundation, followed by a redemption, would not be characterized as a sale or redemption between the taxpayer and the corporation followed by a gift of the redemption proceeds to the foundation, because the foundation was not legally obligated to redeem the stock at the time it received the shares. In Revenue Ruling 78-197, the Service announced that it would treat the proceeds of a stock redemption under facts similar to those in the Palmer case as income to the donor only if the donee is legally bound or can be compelled by the corporation to surrender the shares for redemption. The "bright line" test of Palmer and Revenue Ruling 78-197 is not haze free.

In Blake v. Commissioner, 42 T.C.M. 1336 (1981), aff'd, 697 F.2d 473 (2d. Cir. 1982), the donor contributed stock to a charity with the understanding that the charity would permit the corporation to redeem the stock and the charity would then use the proceeds to buy the donor's yacht at an inflated price. The yacht was sold shortly thereafter by the charity for less than 50 percent of the price it had paid the donor. The Second Circuit Court of Appeals found the "understanding" enough to re-characterize the transaction as a sale of stock by the donor, followed by a contribution of the yacht to charity. Note that, unlike in other situations, there was a quid pro quo required by the donor in order for the donor to make the stock gift.

In Ferguson v. Commissioner, 108 T.C. 244, (1997), aff'd, 174 F.3d 997 (9th Cir. 1999), there was a gift of stock followed by a redemption pursuant to the terms of a merger agreement. The donors were directors and minority shareholders of Company A. On day 1, Company A entered into an agreement and plan of merger with Company B.

Company A's board of directors (the donors abstaining) approved the merger and recommended it to the shareholders. On day 6, Company B made its tender offer. By day 34, more than 50 percent of the shareholders had tendered their shares. On day 43, the donors donated some of their Company A stock to a charity, which in turn immediately tendered the stock to Company B. On day 46, Company B announced its acceptance of all the tendered shares and purchased all of the shares on day 47. The Tax Court found that the donors were taxable on the gain from the stock transferred to charity because by the date of the gift the donors' interest had been converted from an interest in a viable corporation to a fixed right to receive cash. The Ninth Circuit Court of Appeals affirmed, holding that the transaction had "ripened" into a right to receive sale proceeds once 50 percent shareholder approval for the merger had been reached.

The application of Revenue Ruling 78-197 again arose in Gerald A. Rauenhorst, et al. v. Commissioner, 119 T.C. No. 9 (2002). In that case, Arbeit (a partnership) owned warrants enabling it to purchase NMG stock. On September 28, 1993, WCP (a corporation) offered to purchase all NMG stock. On November 9, 1993 the partnership assigned some warrants to four charities. On November 19 Arbeit sold its remaining warrant to WCP, and the charities sold their warrants to WCP. On November 22, 1993, WCP and NMG agreed on a sale of all the NMG stock. The government argued that the bright-line test of Revenue Ruling 78-197 was not controlling. The court held that, based on the facts of the case and the "no legal obligation" test of Palmer and Revenue Ruling 78-197, there was no prearranged sale, and in the process took a very dim view of the government's urging to ignore the ruling:

> While this Court may not be bound by the Commissioner's revenue rulings, and in the appropriate case we could disregard a ruling or rulings as inconsistent with our interpretation of the law, see Stark v. Commissioner, 86 T.C. 243, 251 (1986), in this case it is respondent who argues against the principles stated in his ruling and in favor of our previous pronouncements on this issue. The Commissioner's revenue ruling has been in existence for nearly 25 years, and it has not been revoked or modified. No doubt taxpayers have referred to that ruling in planning their charitable contributions, and, indeed, petitioners submit that they relied upon that ruling in planning the charitable contributions at issue. Under the circumstances of this case, we treat the Commissioner's position in Rev. Rul. 78-197, 1978-1 C.B. 83, as a concession. Accordingly, our decision is limited to the question whether the charitable donees were legally obligated or could be compelled to sell the stock warrants at the time of the assignments.

A footnote to the opinion states as follows:

> The record indicates that no agreement was entered into by the donees before Nov. 19, 1993, the date they signed the warrant purchase and sale agreement. On Nov. 16, 1993, NMG's legal counsel sent letters to each of the donees enclosing a warrant purchase and sale agreement. Those letters state that pursuant to the warrant purchase and sale agreement, the donees would agree to sell their reissued warrants to WCP and "to abstain from either exercising its Warrant or selling or otherwise transferring it to any other party through Dec. 31, 1993." Certainly, the formality of having the donees enter into the warrant purchase and sale agreements suggests that they had not entered into any binding agreements before Nov. 19, 1993.

Subsequent to Rauenhorst, the government reiterated its intention, generally, to follow its own rulings in litigation. In PLR 200230004, a husband and wife proposed to transfer 495 of 500 shares of a C corporation to a charitable remainder unitrust and asked whether the redemption would be treated as an assignment of income. The ruling first describes Palmer and Revenue Ruling 78-197 and then states as follows:

> In the present case, at the time X shares are transferred to Trust, X will be under no legal obligation to redeem the contributed stock. There is no agreement among the parties under which X would be obligated to redeem, or Trust would be obligated to surrender for redemption, the stock. Trust is not legally obligated to accept any offer of redemption made by X. Accordingly, any redemption by X of the stock contributed by Grantors to Trust will be respected.

> Based on the representations submitted and information described above, we conclude that a purchase by X of the stock transferred by Grantors to Trust will be treated as a redemption of the stock from Trust, and will not be treated as a redemption of stock from Grantors or a distribution by X to Grantors. Therefore, the sale or redemption by Trust of its X stock will not result in the capital gain in such sale or the redemption price being attributed for tax purposes to Grantors.

In PLR 200321010, a retired officer of a corporation intended to give shares of the corporation to a charitable remainder unitrust. The transfer would trigger an option under a shareholder agreement, giving the company the right to purchase the stock for a formula price. The ruling described the "bright-line" test of Palmer, cited Rauenhorst, and concluded as follows:

> Consequently, the test for purposes of this ruling request, is whether the CRUT will be legally bound or can be compelled by Company to surrender the stock for redemption at the time of the donation. Here, X proposes to transfer the Company stock to the CRUT. Under the restrictions contained in each year's stock restriction agreement, the CRUT must first offer the stock to Company at a set formula price should the CRUT propose to dispose of the shares. This provision amounts to a right of first refusal. However, it does not mean that the CRUT is legally bound or can be compelled by Company to surrender the stock to Company at the time of the donation. The information submitted contains no indication that the CRUT will be legally bound, or could be compelled by Company, to redeem or sell the gifted stock. That all or a portion of the gifted stock was subject to restrictions upon transfer to a third party by X, and thus by the CRUT following the transfer, does not give Company the ability to compel its redemption or sale from the CRUT. The CRUT is free to retain title to and ownership of the stock indefinitely.
>
> Because the CRUT is not legally bound and cannot be compelled by Company to redeem or sell the stock, we conclude that the transfer of the Company stock by X to the CRUT, followed by any subsequent redemption of the stock by Company, will not be recharacterized for federal income tax purposes as a redemption of the stock by Company from X followed by a contribution of the redemption proceeds to the CRUT. See Palmer v. Commissioner, supra, and Rev. Rul. 78-197, supra. The same principles apply if the stock is sold by the CRUT rather than redeemed by Company. Thus, provided there is no prearranged sale contract whereby the CRUT is legally bound to sell the stock upon the contribution, we conclude that any subsequent sale will not be recharacterized for federal income tax purposes as a sale of the stock by X, followed by a contribution of the sale proceeds to the CRUT. Accordingly, any redemption proceeds or sales proceeds received by the CRUT for the stock will not be treated as taxable income received by X.

See also PLR 200821024 to the same effect.

In Dickinson v. Commissioner, T.C. Memo. 2020-128, Judge Greaves reached the right result but the language is not perfect for the taxpayer. The CFO of a private company donated shares to a donor advised fund (DAF) when the board allowed the transfer of shares, on three occasions. The board was comfortable allowing the transfers because the DAF had a policy of trying to sell closely-held shares quickly which meant, as a practical matter, offering the shares back to the company. In fact, after each donation the company redeemed the shares.

The IRS treated the donation and redemption as an integrated whole to claim the taxpayers in effect sold the stock and contributed the proceeds. Why is puzzling. One would have thought that Rev. Rul. 78-197 would have been dispositive for the taxpayers but apparently not. The opinion discusses that ruling as follows:

> The parties point us to Rev. Rul. 78-197, 1978-1 C.B. 83, a "bright-line" rule the IRS applies in cases like Palmer, which focuses on the donee's control over the

> disposition of the appreciated property. See Rauenhorst v. Commissioner, 119 T.C. at 165. This Court has not adopted Rev. Rul. 78-197, supra, as the test for resolving anticipatory assignment of income issues, see Rauenhorst v. Commissioner, 119 T.C. at 166, and does not do so today. The ultimate question, as noted in Palmer, is whether the redemption and the shareholder's corresponding right to income had already crystallized at the time of the gift. See Palmer v. Commissioner, 62 T.C. at 694-695. Regardless of whether the donee's obligation to redeem the stock may suggest the donor had a fixed right to redemption income at the time of donation, See Rauenhorst v. Commissioner, 119 T.C. at 166-167, respondent does not allege that petitioner husband had any such right in this case. Accordingly, respondent's resort to Rev. Rul. 78-197, supra, is unavailing.

The opinion relies on a two-prong approach set forth in Humacid Co. v. Commissioner, 42 T.C. 894 (1964), which respected the form of the transaction if the taxpayer (1) gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale.

The court determined both prongs were easily met. Even a "preexisting understanding among the parties that the donee would redeem donated stock does not convert a postdonation redemption into a predonation redemption."

The opinion notes:

> Furthermore, neither a pattern of stock donations followed by donee redemptions, a stock donation closely followed by a donee redemption, nor selection of a donee on the basis of the donee's internal policy of redeeming donated stock suggests that the donor failed to transfer all his rights in the donated stock. See, e.g., Grove v. Commissioner, 490 F.2d at 242–245 (respecting form of transaction where donee needed to fundraise to support its operations, and over a decade consistently redeemed annual donations of stock for which donor remained entitled to dividends); Carrington v. Commissioner, 476 F.2d at 705–706 (respecting form of transaction where donee redeemed stock eight days after it was donated); Palmer v. Commissioner, 62 T.C. 684, 692–693 (1974), (respecting form of transaction where, pursuant to a single plan, the taxpayer donated stock to a foundation and then caused the corporation to redeem the stock from the foundation the day after the donation), aff'd, 523 F.2d 1308 (8th Cir. 1975). Petitioners' contemporaneous documentary evidence of an absolute gift, and respondent's failure to assert facts indicating any genuine controversy on this point, lead us to conclude that petitioner husband's donations satisfy the first Humacid requirement.

With respect to second prong, the court follows a "practically certain" analysis which is squishier that the bright-line test of Rev. Rul. 78-197:

> Where a donee redeems shares shortly after a donation, the assignment of income doctrine applies only if the redemption was practically certain to occur at the time of the gift, and would have occurred whether the shareholder made the gift or not. See Palmer v. Commissioner, 62 T.C. at 694–695; see also Ferguson v. Commissioner, 174 F.3d 997, 1003–1004 (9th Cir. 1999) (finding that the shareholder recognizes income from a stock sale where acquisition is "practically certain to occur", rather than the subject of "a mere anticipation or expectation", before the shareholder donates stock), aff'g 108 T.C. 244 (1997). In Hudspeth v. United States, 471 F.2d 275, 276 (8th Cir. 1972), for example, the court recast a stock donation as a taxable stock sale and donation of the sale proceeds where the taxpayer donated stock after the issuing corporation's directors and shareholders had adopted a plan of complete liquidation. See also Jones v. United States, 531 F.2d 1343, 1343–1344 (6th Cir. 1976); Allen v. Commissioner, 66

> T.C. 340, 347 (1976).2 By contrast, there was no assignment of income in Palmer v. Commissioner, 62 T.C. at 687–688, 695, even though all parties were related and anticipated the redemption before the donation, because "no vote for the redemption had yet been taken" when the shareholder donated the stock. As in Palmer, the redemption in this case was not a fait accompli at the time of the gift.

In Keefer v. United States, 2022 WL 2473369 (N. D. Texas 2022) the court addressed several procedural questions with a charitable contribution of a 4% interest in Burbank HHG Hotel, LP to a donor advised fund operated by the Pi Foundation, including whether it was a pre-arranged sale. With respect to that issue, the opinion states:

> Generally, analysis of the second *Humacid* prong focuses on whether a legal right to income from redemption of the appreciated stock vested before the donor transferred ownership and control of the asset. *C.f. Rauenhorst*, 119 T.C. at 163–64 (citing *Harrison v. Schaffner*, 312 U.S. 579, 582 (1941)) (explaining that the question is whether the "right to receive income has vested" before the assignment); *Caruth Corp.*, 865 F.2d at 649 (considering whether the assignor had any legal right to a later-declared dividend before he assigned the stock shares to the assignee who received the dividend).
>
> In a few cases, courts have extended this doctrine to situations where the stock's redemption was so imminent and certain that "the shareholder's corresponding right to income had already crystallized at the time of the gift." *Dickinson*, 2020 WL 5249242, at *3 (emphasis omitted) (citing *Palmer v. Comm'r*, 62 T.C. 684, 694–95 (1974)); *see Ferguson v. Comm'r*, 174 F.3d 997, 1001–02 (9thCir. 1999). These courts have generally drawn the line where the corporation's shareholders or directors have already voted to redeem shares, creating a "binding obligation" of redemption. *See Dickinson*, 2020 WL 5249242 at *3. But the Ninth Circuit has extended this principle to situations where, considering the facts and circumstances of a particular deal, redemption is "practically certain to proceed" without a binding obligation. *See id.* at *3 n.2 (quoting *Ferguson*, 174 F.3d at 1004).
>
> The Government urges this Court to follow the Ninth Circuit's more expansive approach, as set out in *Ferguson*, in applying *Humacid* to this limited partnership interest. Doc. 68, Gov't's Br., 17.
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> The Court declines to extend the *Ferguson* approach to the real estate transaction at issue here. The uncontroverted evidence shows that the Keefers executed the agreement to assign the partnership interest to Pi on June 18, 2015. Doc. 69-5, Assignment Int., 19–20. The partnership executed the contract for sale of the Hotel on July 2, 2015. Doc. 69-4, Purchase Contract, 48–55; Doc. 69-5, Purchase Contract, 1–2. So, at the time of the assignment on June 18, 2015, the Hotel was not even under contract. And while Apple had sent an LOI to Burbank before that date, the LOI was nonbinding and was never signed by Burbank. Doc. 66, Appraisal, 54; *see* Doc. 69-1, Keefer Dep., 11; Doc. 69-1, LOI, 47–49. Moreover, even after the contract with Apple was signed, it provided Apple a 30-day review period. Doc. 69-4, Purchase Contract, 54. Until that review period elapsed, Apple had no binding obligation to close and the deal was not "practically certain" to go through. *See id.*
>
> Under these circumstances, the Partnership's right to the income from the Hotel sale had not yet vested when the Keefers assigned the interest to Pi. Thus, the pending sale—even if very likely to occur considering the presence of backup

> offers and as reflected in the appraiser's estimate that the risk of no sale was only 5%—does not render this donation an anticipatory assignment of income. *See* Doc. 66, Appraisal, 55; *cf. Caruth Corp.*, 865 F.2d at 649 ("The IRS . . . makes recourse to Justice Holmes['s] metaphor, and urges that we hold Caruth taxable upon the dividend because here the fruit was exceptionally ripe . . . . We fail to see why the ripeness of the fruit matters, so long as the entire tree is transplanted before the fruit is harvested.").

The most recent case dealing with the assignment of income is Estate of Scott M. Hoensheid v. Commissioner, T.C. Memo. 2023-34, which perhaps brings some clarity – but not welcome clarity as it turns out – for taxpayers and charitable donees. In a nutshell, the IRS argued, and the Tax Court agreed, that the bright line test of Palmer and Rev. Rul. 78-197, apply only where stock is being redeemed from a charity by a company. The opinion states:

> The anticipatory assignment of income doctrine is a longstanding "first principle of income taxation." *Commissioner v. Banks*, 543 U.S. 426, 434 (2005) (quoting *Commissioner v. Culbertson*, 337 U.S. 733, 739– 40 (1949)). The doctrine recognizes that income is taxed "to those who earn or otherwise create the right to receive it," *Helvering v. Horst*, 311 U.S. 112, 119 (1940), and that tax cannot be avoided "by anticipatory arrangements and contracts however skillfully devised," *Lucas v. Earl*, 281 U.S. 111, 115 (1930). A person with a fixed right to receive income from property thus cannot avoid taxation by arranging for another to gratuitously take title before the income is received. *See Helvering v. Horst*, 311 U.S. at 115–17; *Ferguson*, 108 T.C. at 259. This principle is applicable, for instance, where a taxpayer gratuitously assigns wage income that the taxpayer has earned but not yet received, *see Lucas v. Earl*, 281 U.S. at 114–15, or gratuitously transfers a debt instrument carrying accrued but unpaid interest, *see Austin v. Commissioner*, 161 F.2d 666, 668 (6th Cir. 1947), *aff'g* 6 T.C. 593 (1946).
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> We must also initially address the role of the Commissioner's prior issued guidance, which petitioners have raised. In *Rauenhorst v. Commissioner*, 119 T.C. 157, 173 (2002), we held that, "[u]nder the circumstances" of that case, the Commissioner was bound not to argue against his own subregulatory guidance, as expressed in Rev. Rul. 78-197, 1978-1 C.B. 83.[21] In *Rauenhorst*, we treated Rev. Rul. 78-197 as a binding concession by the Commissioner that precluded him from relying in that case on factors other than the donee's obligation to sell contributed property in his anticipatory assignment argument.
>
> However, we also recognized in *Rauenhorst*, 119 T.C. at 171, the axiom that "revenue rulings are not binding on this Court, or other Federal courts." *See Dickinson*, T.C. Memo. 2020-128, at *10 ("This Court has not adopted Rev. Rul. 78-197 as the test for resolving anticipatory assignment of income issues and does not do so today." (citations omitted)). For a taxpayer to rely on a revenue ruling, the facts of the taxpayer's transaction must be "substantially the same as those considered in the revenue ruling." *Barnes Grp., Inc. v. Commissioner*, T.C. Memo. 2013-109, at *37–38, *aff'd*, 593 F. App'x 7 (2d Cir. 2014); *see Syzygy Ins. Co. v. Commissioner*, T.C. Memo. 2019-34, at *47–48; *see also* Statement of Procedural Rules, 26 C.F.R. § 601.601(d)(2)(v)(*a*), (*e*). On the particular facts of this case, we do not find respondent's arguments to be sufficiently contrary to Rev. Rul. 78-197 to constitute a disavowal of his published guidance. *See* Rev. Rul. 78-197, 1978-1 C.B. at 83 (describing its application as only to "proceeds of a redemption of stock under facts similar to those in *Palmer*"); *cf. Rauenhorst*, 119 T.C. at 182–83 (focusing on Commissioner's argument that courts are not

bound by revenue rulings and his reliance on a case[22] that had been distinguished by the Commissioner in a prior private letter ruling).

While we consider a donee's legal obligation to sell as "significant to the assignment of income analysis," *Ferguson*, 108 T.C. at 259, it "is only one factor to be considered in ascertaining the 'realities and substance' of the transaction," *Allen*, 66 T.C. at 348 (quoting *Jones*, 531 F.2d at 1345). Instead, "the ultimate question is whether the transferor, of all the circumstances, had a fixed right to income in the property at the time of transfer." *Ferguson*, 108 T.C. at 259; *see Dickinson*, T.C. Memo. 2020-128, at *10. We thus took to several other factors that bear upon whether the sale of shares was virtually certain to occur at the time of petitioners' gift. In this case the relevant factors include (1) any legal obligation to sell by the donee, (2) the actions already taken by the parties to effect the transaction, *see Ferguson*, 106 T.C. at 264, (3) the remaining unresolved transactional contingencies, *see Robert L. Peterson Irrevocable Tr. #2 v. Commissioner*, T.C. Memo. 1986-267, 51 T.C.M. (CCH) 1300, 1316, *aff'd sub nom. Peterson v. Commissioner*, 822 F.2d 1093 (8th Cir. 1987), and (4) the status of the corporate formalities required to finalize the transaction, *see Estate of Applestein*, 80 T.C. at 345–46.

[Footnote 21 - In Rev. Rul. 78-197, 1978-1 C.B. at 83, in the wake of our decision in *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd on other issue*, 523 F.2d 1308 (8th Cir. 1975), the Commissioner advised that, "under facts similar to those in *Palmer*," he would treat a charitable contribution of stock followed by a redemption as an anticipatory assignment of income "only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption." *Palmer* involved a taxpayer's contribution of shares of stock in his controlled corporation to a charitable foundation of which he was a trustee, followed by a redemption of the shares by the corporation.]

[Footnote 22 - *Blake v. Comm* , 480–81 (2d Cir. 1982) (declining to rely on Rev. Rul. 78-197), *aff'g* T.C. Memo. 1981-579.]

So what standard does the Tax Court apply?

We apply a two-part test when determining whether to respect the form of a charitable contribution of appreciated property followed by a sale by the donee. The donor must (1) give the appreciated property away absolutely and divest of title (2) "before the property gives rise to income by way of a sale." *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964). The first prong incorporates the section 170(c) requirement that the taxpayer make a valid gift of property, *see Jones v. Commissioner*, 129 T.C. 146, 150 (2007), *aff'd*, 560 F.3d 1196 (10th Cir. 2009), while the second prong incorporates the anticipatory assignment of income doctrine, *see Dickinson*, T.C. Memo. 2020-128, at *8. Accordingly, we first must determine whether petitioners made a valid gift of the CSTC shares to Fidelity Charitable and, if so, on what date the gift was made. We must then determine the tax consequences, including eligibility for a charitable contribution deduction, of any gift by petitioners.

On the facts, the court found about a one month gap between when the taxpayer said the gift was made and when it was made:

We start with petitioner's contemporaneous emails and the contemporaneous transactional documents, which we consider to be especially probative evidence with respect to his intent. On June 1, petitioner first expressed in an

> email that he wanted to wait to make the gift of the shares to Fidelity Charitable until the last possible moment, when he was "99% sure" that the sale to HCI would close. Petitioner's subsequent actions and communications were consistent with that intent. On June 11, petitioner and his two brothers executed the Consent to Assignment agreement, an act that demonstrated petitioner's generalized future intent to make a gift. However, the Consent to Assignment cannot establish that, as of June 11, such an intent was sufficiently present and specific. *See Czarski v. Bonk*, 124 F.3d 197, 1997 WL 535773, at *4 (6th Cir. 1997) (unpublished table decision) (applying Michigan law and finding no evidence establishing purported donor's "specific intent" with respect to the particular property). On its face, the Consent to Assignment agreement failed to specify a number of shares to be contributed, suggesting that petitioner had not yet decided that key detail. Similarly, the original stock certificate, which was prepared on or sometime after June 11, failed to specify an effective date, again suggesting that a date would be decided upon later. On July 6, petitioner stated in an email that he was still "not totally sure of the shares being transferred to the charitable fund yet." That email confirms that, as of July 6, the details of the contribution were still in flux. Indeed, three days later, on July 9, Mr. Bear emailed Mr. Boland to inform him that "it looks like Scott has arrived at 1380 shares."
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> At trial, petitioner testified that he believed the number of shares to be donated was set at 1,380 on June 11. That testimony is squarely contradicted by the Consent to Assignment agreement, petitioner's July 6 email, and Mr. Bear's July 9 email. *See, e.g.*, *Richardson v. Commissioner*, T.C. Memo. 1984-595, 49 T.C.M. (CCH) 67, 73–74 (concluding that taxpayer's characterization of date of contribution was not credible where in conflict with "documents written contemporaneously with the donation"). Petitioner also testified that his July 6 email was referring to a potential donation of a second tranche of shares, a theoretical event which apparently never took place. The record contains no evidence supporting the claim that petitioners attempted to make (or even contemplated) two separate gifts of CSTC shares. We find petitioner's self-serving testimony as to his intent to be incredible.
>
> The record does not support a finding of present intent to make a gift until July 9 when petitioner settled on a number of 1,380 shares. From that point on, petitioner took a number of actions that confirmed his present intent to transfer. On July 9 or 10 petitioner delivered the physical stock certificate to Ms. Kanski's office. Similarly, on July 10 petitioner created an online giving account with Fidelity Charitable. Taken together, these actions provide sufficient credible evidence of petitioner's intent. W , petitioner had present intent to make a gift.

The court did not find convincing evidence of delivery or acceptance before July 13. Unfortunately for the taxpayers, whatever sale contingencies existed on June 9 had disappeared – said the court – by July 13. Thus, the taxpayers were taxed as if they owned the gifted property.

But it got worse for the taxpayer. The court agreed that the acknowledgment of the state law property interest transferred to charity was adequate for contemporaneous written acknowledgment purposes. However, as so often happens the appraisal did not satisfy the "qualified appraisal" rules:

> Petitioners' appraisal is deficient with respect to several key substantive requirements. We start with Mr. Dragon's status as an appraiser. We have previously described the requirement that an appraiser be qualified as the "most important requirement" of the regulations. *Mohamed v. Commissioner*, T.C. Memo. 2012-152, 2012 WL 1937555, at *4. Respondent argues that Mr. Dragon was not a qualified appraiser, asserting that Mr. Dragon performed valuations infrequently, did not hold himself out as an appraiser, and has no certifications

from a professional appraiser organization. Petitioners counter that Mr. Dragon was qualified because he has prepared "dozens of business valuations" over the course of his 20+ year career as an investment banker, including some valuations of closely held automotive businesses.

Mr. Dragon's mere familiarity with the type of property being valued does not by itself make him qualified. *See, e.g.*, *Brannan Sand & Gravel Co. v. Commissioner*, T.C. Memo. 2020-76, at *9–10, *15 (finding that attorney's familiarity with type of property being valued and awareness of typical asking price was insufficient to satisfy qualified appraiser requirement). Mr. Dragon does not have appraisal certifications and does not hold himself out as an appraiser. We found Mr. Dragon's own words at trial about his appraisal experience to be particularly instructive. Mr. Dragon testified that he conducted valuations "briefly" and only "on a limited basis" before starting at FINNEA in 2014—the year before the appraisal. Mr. Dragon also testified that he now performs (presumably gratis) business valuations for prospective clients "once or twice a year" in order to solicit their business for FINNEA. We find Mr. Dragon's uncontroverted testimony sufficient to establish that he does not "regularly perform[] appraisals for which [he] receives compensation." *See* § 170(f)(11)(E)(ii)(II). Petitioners have failed to show that Mr. Dragon was a qualified appraiser.

(iv) Transferred by the Donor Subject to an Obligation to Sell. If a donor gives an asset to charity subject to an obligation of the charity to sell the asset the pre-arranged sale analysis will be applied. This result is contrary to the donor's common objectives of (1) avoiding inclusion of the appreciation element of the donated property in gross income for federal income tax purposes; (2) obtaining a charitable contribution deduction for the fair market value of the property; and (3) in the case of a redemption, enabling the corporation to proportionately reduce its earnings and profits upon the redemption of the shares held by the charity. But as above, a preexisting understanding among the parties that the donated stock would be redeemed does not convert a post-donation redemption into a pre-donation redemption. See Behrend v. U.S., 31 AFTR 2d 73-406 (4th Cir. 1972). Neither a pattern of stock donations followed by donee redemptions, a stock donation closely followed by a donee redemption, nor selection of a donee on the basis of the donee's internal policy of redeeming donated stock suggests that the donor failed to transfer all his rights in the donated stock. See, e.g., Grove v. Comm'r, 490 F.2d 241, 242-245 (2d Cir. 1973) (respecting form of transaction where donee needed to fundraise to support its operations, and over a decade consistently redeemed annual donations of stock for which donor remained entitled to dividends); Carrington v. Comm'r, 476 F.2d 704, 705-706 (5th Cir. 1973) (respecting form of transaction where donee redeemed stock eight days after it was donated). But also note the cases above.

c. Tax-Free IRA Distributions. The Pension Protection Act of 2006 adopted what was originally a temporary measure that generally permits charitable contributions of up to $100,000 to be made directly from IRAs to public charities. The temporary measure, later extended by various legislation, was made permanent as part of the "Protecting Americans from Tax Hikes (PATH) Act of 2015" (P.L. 114-113). If the requirements outlined below are met, distributions from the IRA to charity count against minimum required distributions that the donor is otherwise obligated to make. By making these distributions directly to charity (as opposed to taking the distribution into income and making a cash gift to charity), the donor derives a double benefit. First, the distribution is not treated as an itemized charitable deduction, and so can benefit donors who are utilizing their full standard deduction without itemizing. Second, the distribution is not taken into account in computing the donor's adjusted gross income, which could thereby increase the availability of deductions that are tied to AGI such as medical expenses. As a bonus, the exclusion of the distributed amount to charity is not subject to limitation based upon the donor's contribution base.

The Technique. Clients who hold funds in individual retirement accounts and who have charitable objectives have a special opportunity to make distributions directly from the IRA to one or more qualified charities once they attain age 70 ½. Although the SECURE Act increased the age for required minimum distributions to age 72, the eligibility age for the IRA-to-charity technique did not change. These distributions are made by instructing the IRA custodian to make distributions from the participant's IRA directly to a qualified charity. For clients who have attained age 72, these distributions count as a part (or all) of the donor's minimum required distributions from the IRA for the

year of the distribution. See Committee Report for JCX-38-06, HR4, Technical Explanation of H.R. 4, The Pension Protection Act of 2006, Title XII, A.1.

Specifics

A. Structure. For an IRA distribution to charity to be excluded from the IRA owner's income, the transfer must meet several requirements. First, funds must be distributed by the IRA trustee directly from the IRA to the charity (distributions to an individual who then transmits the funds to a charity do not qualify). § 408(d)(8)(B)(i). Second, the recipient of the transferred funds must be a charity described in Section 170(b)(1)(A) (other than an organization described in Section 509(a)(3) or a donor-advised fund, as defined in Section 4966(d)(2)). Id. As a result, the technique does not apply to distributions to all 50% charities, including donor-advised funds, or to private foundations, supporting organizations, or split interest trusts, such as charitable remainder trusts or charitable lead trusts. Id. Third, the transfer must be made on or after the date that the taxpayer attained the age of 70 ½. § 408(d)(8)(B)(ii). Note that the provision of the SECURE Act that increased the age for minimum required distributions to 72 did not amend the age to qualify for this rule. Nevertheless, for taxpayers who have attained the age of 72, a distribution to charity that qualifies under this rule will be taken into account for purposes of determining the taxpayer's minimum required distribution. Fourth, the qualifying charitable distribution cannot exceed $100,000 (not indexed for inflation) in any year. Distributions in excess of that amount are subject to income taxation. § 408(d)(8)(A). Fifth, only distributions from regular or rollover IRAs qualify. Distributions from simplified employee pensions (SEPs) and Savings Incentive Match Plan for Employees (SIMPLE) IRAs are excluded from this special treatment. § 408(d)(8)(B). Sixth, the exclusion is available only for distributions that would be included in gross income. Id. Thus, the rules do not apply to the portion of distributions that would be nontaxable, such as certain Roth IRA distributions and distributions attributable to nondeductible contributions. For distributions of those amounts, the normal charitable deduction rules are applicable to the non-taxable portion of the distributions. Finally, the charitable deduction is available only for contributions that are fully deductible (determined without regard to the percentage limits). Reduction of the charitable deduction for any reason prevents special treatment. § 408(d)(8)(B). Thus, for example, as noted above, the charitable deduction will be denied if the taxpayer fails to obtain proper substantiation or receives a benefit in exchange for the contribution.

With the passage of the SECURE Act, IRA account owners must now reduce their intended qualified charitable contributions by any deductible amounts contributed into their IRAs after age 70 ½, to the extent they have not already been used to reduce prior contributions. In other words, IRA contributions made after age 70 ½ for which a taxpayer claims an income tax deduction cannot be used to obtain an exclusion by means of contributions to charities. § 408(d)(8)(A). The rules effectively require a last-in, first-out ("LIFO") treatment that ensures post-age-70 ½ contributions will be used first to reduce charitable contributions. Under this rule, taxpayers that make deductible post-age-70 ½ contributions to an IRA must apply four steps to compute the allowed exclusion: (1) Determine current-year distributions made directly to charity; (2) compute cumulative deductible contributions made by the account owner after reaching age 70 ½, minus any charitable exclusions disallowed in prior years; (3) compute the current-year distributions that will be denied exclusion (which will be the lesser of the amount determined in steps 1 and 2); and (4) determine current-year distributions which will be treated as a excludable from income (the step 1 amount less the step 3 amount). This provision is meant to prevent individuals from deducting traditional IRA contributions (above-the-line deductions that reduce a taxpayer's AGI) and then donating those contributions on a pre-tax basis.

A possible obstacle for clients who wish to make small gifts to numerous charities is a practical one. IRA custodians may be reluctant (or charge a fee) for making numerous small gifts—for example, $20 or $50—from an IRA. One solution offered by some custodians is a so-called "IRA checkbook," where each check is a distributed directly from the IRA. The IRA account owner simply writes a check for any dollar amount and then mails the IRA check to the charity. The funds are transferred directly from the IRA to charity, but the IRA checkbook alleviates the administrative burden that would otherwise be imposed on the IRA custodian. *See* Hoyt, "A Wake-Up Call to Senior Clients—Make Charitable Gifts from IRAs," 157 TR. & EST. 40 (June 2018).

B. Income Tax Considerations. As noted above, direct transfers of IRA distributions to charity can achieve not only the donor's charitable objectives, but can also provide distinct income tax benefits to the donor. These benefits come in at least three areas. First, a taxpayer who directs IRA distributions to charity is able to exclude those funds from taxable income without regard to whether he or she itemizes. Second, because the

distributions are excluded from the donor's income, other income tax benefits based upon the taxpayer's AGI may be enhanced. Third, limitations based upon a percentage of the donor's contribution base do not apply.

It is noteworthy that, except for certain cash gifts made after 2019 of up to $300 (up to $600 for married taxpayers filing jointly for gifts made after 2020 who elect not to itemize), charitable contributions are generally of no income tax benefit to taxpayers who do not itemize their income tax deductions. The combined effect of TCJA 2017's increase of the standard deduction combined with its $10,000 limitation on the deduction for state and local taxes, has resulted in an enormous decline in the number of persons claiming itemized deductions. Direct distributions to charity allow taxpayers over the age of 70 ½ to benefit from these distributions without itemizing, and without impacting their otherwise available standard deduction.

d. Donor Advised Funds. Donor Advised Funds ("DAFs") can make charitable giving over time to multiple charities simple. A DAF is a cost-effective charitable vehicle that allows a donor to make charitable gifts to multiple charities over a period of time with little administrative responsibility, while obtaining an up-front benefit of maximum charitable income tax deductions. Traditionally, donors have established private foundations, discussed below, to undertake long-term gifting. However, it may take from several weeks to a few months to draft documents to establish a private foundation, file any documents with the state, and apply to the IRS for a tax exemption. Legal and accounting fees may be significant. Then, the donor must comply with extensive reporting rules, being ever-mindful to avoid the excise tax transactions (or to quickly correct any that are violated). Once established, the private foundation will likely be treated as a 30% charity. In contrast, establishing a DAF typically involves completing and signing some simple governing documents provided by a sponsoring public charity. The public charity typically has staff available to assist with the paperwork to make the donor's intention clear, and to ensure that all of the technical requirements that apply to DAFs are followed, at no cost to the donor. Moreover, the DAF is treated as a 50% charity for most purposes.

The Technique**.** A DAF is a separate fund that is created and maintained by a qualified sponsoring organization, which in turn, is a public charity. The public charity provides the charitable income tax exemption for the DAF and it handles all of the administrative paperwork associated with maintaining the DAF's charitable tax-exempt status. As the "Donor Advised" part of the moniker suggests, the donor(s), or someone designated by the donor(s), can "advise" the public charity about how much to distribute from the fund, to whom, and when. Technically, when a donor transfers funds to a DAF, the sponsoring charity has legal control over the funds. However, the donor or the donor's designated agent or agents retains advisory control over how the funds are ultimately distributed. The donor or the donor's agent makes grant recommendations, which are virtually always followed; however, the public charity ultimately retains the final say in disbursing funds. Unlike a private foundation, which generally must distribute at least five percent of the value of its assets each year, regardless of its income, a DAF does not legally have to distribute a certain percentage of its funds each year to charitable beneficiaries. This means that a donor may make a contribution in any given year to a DAF and take the charitable income tax deduction in that year, but can delay making distributions to charities from the DAF until a future date. In addition, for large or most non-cash donations, the more favorable 50% charity rules apply to DAF contributions, instead of the more limited 30% charity rules applicable to most private foundations. Note, however, that unlike with a private foundation, the donor does not get to control the specific investments made by the fund, which are controlled by the sponsoring charity (although some sponsors allow donors to choose among various funds or types of investments).

Specifics

(i) Structure. To qualify as a DAF, the sponsoring organization must be a public charity (other than a state or political subdivision), not a private foundation, and must maintain one or more district funds that are separately identified by reference to contributions of a donor or donors. § 4966(d)(1). The sponsoring organization must separately identify contributions, own and control the fund, and provide advisory privileges to the donor or the donor's designee. § 4966(d)(2)(A). The sponsoring organization cannot make distributions only to a single identified organization or governmental entity. *Id.* In addition, the organization cannot be an organization described in section 2555(a)(3)-(5) (i.e., war veterans organization, lodge or cemetery corporation), or a Type III supporting organization that is not functionally integrated. §§ 170(f)(18), 2055(e)(5), 2522(c)(5). As noted above, while the sponsoring charity has legal control over the funds, the donor or the donor's designated agent or agents make grant recommendations, which are typically followed by the sponsoring organization. Donors often enter into an agreement with the sponsoring charity which outlines procedures for making distribution recommendations, and in many cases

permits the donor to designate one or more alternate distribution advisors (if the donor dies or becomes incapacitated). Designated alternate advisors may allow the DAF to last for multiple generations (although typically not in perpetuity, as might be the case with a private foundation).

(ii) Gift Tax Considerations. Gifts made to an eligible DAF after February 13, 2007 are fully deductible for federal gift tax purposes. § 2522(c)(5). A gift tax charitable deduction that is otherwise allowable for a contribution to a DAF is allowed only if the taxpayer obtains a contemporaneous written acknowledgment from the sponsoring organization (as defined in section 4966(d)(1)) of the DAF that the organization has exclusive legal control over the assets distributed. For this purpose, a "contemporaneous written acknowledgment" is determined under rules similar to the section 170(f)(8)(C) substantiation rules discussed above that apply for income tax charitable deduction purposes, which provide that a written acknowledgment is treated as contemporaneous if it is obtained on or before the earlier of (1) the date the taxpayer files a return for the tax year in which the contribution was made, or (2) the due date (including extensions) for filing the return. § 170(f)(8)(C).

(iii) Estate Tax Considerations. Similarly, assets passing to a DAF as a result of a donor's death are eligible for a federal estate tax charitable deduction without limitation. § 2055(e)(5).

(iv) Income Tax Considerations. Gifts made to a DAF after February 13, 2007 are deductible to the donor for federal income tax purposes, subject to the limits on deductions applicable to 50% charities. §§ 170(f)(18). The donor must obtain a contemporaneous written acknowledgement from the sponsoring organization that the organization has exclusive legal control over the assets contributed. *Id.* Importantly, because the donee sponsoring organization is a public charity, the contributions are subject to the more favorable income tax limitations associated with public charities rather than the limitations imposed upon contributions to private foundations. Namely, cash contributions to a public charity are deductible up to 50% of a donor's AGI (or 60% for cash contributions made between 2018 and 2025–the 100% limitation for cash gifts in 2020 and 2021 does not apply to gifts to DAFs), and contributions of appreciated property to a public charity are deductible up to 30% of AGI. In addition, a donor may generally deduct the full fair market value of appreciated capital gain property contributed to a 50% charity (although deductions for contributions of items appreciated tangible personal property that do not relate to the exempt purpose of the charity are limited to the donor's basis). For taxpayers who typically rely on taking the standard deduction (and therefore do not typically get to deduct their charitable contributions), a DAF can be a useful tool. Cash flow permitting, a donor could accelerate the next, say, five or ten years' worth of gifts by contributing them to a DAF, itemizing deductions for that year as a result of the large charitable deduction. In succeeding years, the donor returns to taking a standard deduction, having the DAF make the scheduled contributions to the donor's intended charities.

(v) Excise Tax Considerations. DAFs are subject to a number of rules. Most importantly, the Pension Protection Act of 2006 added a provision making DAFs subject to the excess business holdings rules under section 4943. As a result, if the donor who advises the fund, together with attributed family members, owns 20% or more of stock or interests in a business donated to the DAF, or 35% or more of the stock or interests in a third-party controlled entity donated to the DAF, the excess business holdings rules will apply. § Sec. 4943(e)(2). These rules generally require the business interests to be sold by the DAF within five years of the contribution. The holding period can be extended to ten years with approval from the state Attorney General and the IRS. If the interests are not disposed of within the appropriate time frame, a tax of 10% of the value of the holdings will apply. § 4943(a)(1). If, after the initial tax is levied, the holdings are not sold by the end of the taxable period, an additional tax equal to 200% of the excess business holdings will be imposed. § 4943(b).

The second excise tax of concern to donors relates to the incidental benefit rule. A distribution by a DAF that provides more than an incidental benefit to the person that advises the DAF results in an excise tax of 125% of the distribution. § 4967(a)(1). In IRS Notice 2017-73, the IRS noted that a DAF's payment of part of a ticket price for a charity event would relieve the donor of the obligation to pay the full ticket price and could thereby result in more than an incidental benefit to the donor. The same notice addressed whether a DAF distribution that satisfies a donor's charitable pledge would confer an incidental benefit to the donor. The IRS noted that it would be difficult for sponsoring organizations to distinguish between binding and non-binding pledges, and hence it adopted some practical guidance. The proposed guidance sets out a three-part test. First, the distribution from the DAF cannot reference the existence of a pledge. Second, the donor may not receive any benefit that is more than incidental. Third, the donor must not claim a charitable deduction for the distribution from the DAF. If all three of the above requirements are met, a contribution made in fulfillment of a pledge will not be treated as a violation of the insubstantial benefit rules

and the donor will not be subject to a 125% excise tax. Notice 2017-73 specifically permits such DAF distributions "regardless of whether the charity treats the distribution as satisfying the pledge," and expressly permits donors to rely on the Notice pending the issuance of regulations or other guidance.

e. Private Foundations. Despite some complexity, forming a private foundation can be an excellent way to establish a legacy for carrying out charitable objectives. As a grant-making organization, a private foundation may enable its founders to control assets and direct efforts to support charitable work. In addition to fulfilling charitable objectives, a private foundation often provides a means to teach younger family members about the importance of philanthropy, about stewardship of assets, and about management and investment techniques and strategies. Private foundations are subject to numerous requirements to ensure that they are operated for purely charitable purposes. In addition, as outlined above, the income tax deductibility of donations to private foundations may have lower limits and more restrictions than contributions to public charities. Nevertheless, private foundations remain popular vehicles for charitable giving.

The Technique**.** A private foundation is a legal structure (sometimes a trust, but often a non-profit corporation) that is typically controlled by the donor and his or her family, and as to which most of the contributions typically originate from the donor and/or his or her family. Most private foundations are 30% charities that don't undertake charitable activities directly. Rather, they use their resources to make distributions to publicly supported charities. Contributions by an individual to a private foundation qualify for charitable income, estate, and gift tax deductions, subject to a number of technical restrictions regarding deductibility for income tax purposes. The major advantage of a private foundation is that the founders (and others designated by them, often being their family members) can control the contributed funds, and decide on an annual basis how those funds will be invested and applied to accomplish charitable goals. One of the primary advantages of establishing a private foundation is that it offers the donor's family an opportunity to manage an entity that can have a lasting impact on the family's local community, or on the charitable area of their choice. Working together, the older generation has the chance to teach younger family members management and investment techniques and strategies, while instilling their views on the importance of philanthropy. As a result, a private foundation, in addition to serving its charitable purpose, often serves an educational purpose for the younger generation. The private foundation affords a valuable opportunity for younger family members to carry on the goals of the older generation after the older members of the family are gone.

Specifics

(i) Structure. In most cases, creating a private foundation involves either preparing a specialized trust agreement, or filing articles of incorporation with the Secretary of State or other appropriate state office to create a non-profit corporation. In addition, to obtain status as a tax-exempt entity, a private foundation must file an application with the IRS (IRS Form 1023) to review and approve the private foundation's organizational documents, budget, and plan for contributions and distributions. The corporate structure usually offers more flexibility than a trust because the corporate documents may be easily amended to take into account changing circumstances. Also, unlike a trust instrument, corporate documents can provide for the election of new officers and the formation of new committees to restructure the corporation's internal governance. If corporate purposes are amended, those changes may require the approval of various state officials. An additional advantage of the corporate structure is that the standard of care to which a director is held is often less rigorous than that applicable to a trustee. A trustee may be liable for negligence, but a director benefits from the protection of the business judgment rule, which generally provides that a director is liable only for acts of self-dealing, willful misconduct, or gross negligence. Most states now have statutes that extend the ability of a non-profit corporation to indemnify its directors. Although there are a number of significant advantages to the corporate structure, there are certain advantages to using a trust. A trust normally can be established more quickly than a corporation. Depending on applicable state law, a trust may have fewer annual filing requirements, so fewer annual fees and less paperwork may be required. There is no requirement that a trust hold annual meetings or keep minutes of meetings held by the trustees. The creator of the trust may reserve the right to amend the trust to provide for new charitable purposes, and no approval will be required for this type of amendment. For donors who fear that their charitable goals may be altered by future generations, a trust may provide more certainty, since trust modifications typically require court action and notification of the state's attorney general or other agency monitoring charities.

Broadly speaking, there are three types of private foundations. The "standard private foundation" is the most common type of private foundation and is sometimes referred to as a "family foundation." The standard private foundation, a 30% charity, usually does not carry out any charitable activity itself but is created to hold funds. A portion of these funds must be used each year to make contributions or grants to other charities (or, in some cases, to make grants to individuals). Most standard private foundations receive their funds from one or only a few sources (e.g., an individual, a family, or a corporation). A standard private foundation does not, therefore, generally engage in any sort of fundraising, nor does it typically apply to receive grants from other charities. The standard private foundation is subject to all the excise tax rules in Sections 4940 through 4945 of the Code (discussed below), and it is subject to the strictest limitations on income tax deductibility.

In contrast to a standard foundation, a "private operating foundation" is a foundation that itself engages in charitable activities rather than merely making grants to other charitable organizations or individuals. Typically, private operating foundations operate museums, libraries, nursing homes, and historic preservation sites. Although a private operating foundation is subject to most of the same excise tax rules applicable to private foundations, a major benefit to donors is that a private operating foundation is typically a 50% charity. As a result, donors may take advantage of significantly more liberal income tax deduction rules generally applicable to gifts to publicly supported charities. An additional benefit of a private operating foundation, as opposed to a standard private foundation, is that the requirements for the charitable payments it must make each year are less onerous, so that it need not invade corpus in years when it has a poor investment return.

A third type of foundation may be thought of as a "conduit" or "pass-through" foundation. This type of foundation is one through which all contributions must flow out to charitable entities within two and one-half months after the end of the conduit foundation's tax year in which the contributions were received. Although a conduit foundation, like a standard private foundation, is subject to all the excise tax rules outlined below, the more favorable rules available to 50% charities governing the deductibility of contributions to publicly supported charities apply to contributions to a conduit foundation. Because of the flow-through requirement, the endowment of a conduit foundation can never grow, and therefore, many of the advantages of creating and maintaining a standard private foundation are unavailable.

(ii) Gift Tax Considerations. Gifts made by a donor to a private foundation are eligible for an unlimited federal gift tax charitable deduction. § 2522(a). To obtain a gift tax charitable deduction, the foundation must be organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), including the encouragement of art and the prevention of cruelty to children or animals. *Id.* The exemption is unavailable if any part of the foundation's net earnings inure to the benefit of any private shareholder or individual, if the private foundation is disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, or if the foundation participates in, or intervenes in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office. § 2522(a)(2).

(iii) Estate Tax Considerations. Testamentary bequests or other transfers of assets included in a donor's estate that pass to a private foundation upon the donor's death are generally subject to an unlimited federal estate tax charitable deduction. § 2055. To be eligible, the private foundation must be organized and operated according to the rules for eligibility for gift tax purposes outlined above. § 2055(a)(2). Assets transferred to a private foundation during the donor's lifetime are generally not subject to inclusion in the donor's estate for federal estate tax purposes. However, if the donor effectively controlled the private foundation at death (or within three years of his or her death), the assets contributed by the donor are technically included in the estate. § 2036; Rev. Rul. 72-552. The inclusion is offset by a corresponding estate tax charitable deduction under section 2055, so no estate tax should be due on those assets. Inclusion does, however, have two incidental effects. First, the necessity to file an estate tax return for the donor's estate is determined based upon the value of the gross estate (plus adjusted taxable gifts). § 6018(a)(1). Inclusion of private foundation assets could thereby require the filing of an estate tax return if the value of those assets causes the donor's gross estate to exceed the filing threshold. Second, because those assets are included in the donor's estate, the assets held by the foundation will receive a new cost basis. § 1014(b)(9). Although private foundations are generally exempt from paying income tax, a private foundation's investment income, on which they may pay a 1.39 percent excise tax, includes capital gains. § 4940(a). The basis adjustment resulting from including the foundation's assets in the donor's estate may thus minimize this tax on the sale of appreciated assets.

(iv) Income Tax Considerations to the Donor. A gift to a private foundation may qualify for an income tax charitable deduction based upon the nature of the property given. However, contributions to private foundations (at least to standard grant-making foundations) are subject to a number of restrictions relating to income tax deductibility. As noted above, cash contributions are generally deductible up to 30% of the donor's contribution base, while contributions of appreciated property are generally deductible up to only 20% of the donor's contribution base. If the 20% or 30% limitation is exceeded, the excess deduction may be carried forward for five years. In addition to the percentage ceiling placed on deductions, a donor's deduction is limited for contributions of some types of appreciated property to a standard grant-making private foundation. In particular, if a donor contributes property other than money or publicly traded securities, the donor is generally limited to deducting the cost basis for all contributions of long-term capital gain property.

(v) Income Taxation of the Private Foundation. A private foundation is generally exempt from paying federal income tax on the income it receives. § 501(c). However, private foundations (other than operating foundations) are subject to a 1.39 percent excise tax on their net investment income. Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and net capital gains, reduced by expenses incurred to earn this income. § 4940(a). Prior to 2020, the excise tax was imposed at a rate of two-percent, reduced to one percent in any year in which a foundation exceeded the average historical level of its charitable distributions.. The excise tax rate was reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes) equaled or exceeded the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year. §§ 4940(e), (g). In addition, the foundation could not have been subject to tax in any of the five preceding years for failing to make the minimum qualifying distributions require under section 4942. *Id.*

In addition, section 511 provides that a private foundation must pay tax on its "unrelated business taxable income," or "UBTI," which is defined as net income from any trade or business activity that is not related to the exempt purposes of the private foundation. In general, if a private foundation generates any revenues other than passive investment income (rents, royalties, dividends, and interest) or, if it generates investment revenues from property that was acquired or improved by means of third-party borrowing, the foundation could be subject to this income tax. See §§ 512(b)(1), (4). Capital gains are also typically exempt if the acquisition of the property generating the capital gain is not debt-financed. See §§ 512(b)(4), (5). Investments in pass-through entities, notably partnerships and LLCs, can be problematic. If the pass-through entity generates income from a trade or business that would be UBTI if realized directly by the private foundation, the private foundation's share of that income will be taxable as UBTI.

(vi) Excise Tax Considerations. Standard private foundations and private operating foundations, and their managers, are subject to a number of rigorous rules regarding their governance, known as the "excise tax provisions." These provisions, contained in Sections 4940 through 4945 of the Code, impose harsh penalties on foundations that do not comply with the rules. Congress adopted the excise tax provisions to correct perceived abuses of privately controlled foundations, and to ensure that a minimum percentage of a foundation's assets are distributed each year. The 1.39% tax on net investment income described above is generally thought of as being used to pay for the IRS's cost in administering these rules. The excise tax provisions preclude a substantial contributor to a private foundation from committing certain acts of "self-dealing." In addition, a private foundation is limited as to the percentage of an active trade or business it may hold. Furthermore, the assets of a private foundation may not be invested in such a way that would jeopardize those assets nor may the private foundation expend its assets in other than a certain prescribed manner. In addition to these excise taxes, private foundations and their managers can be subject to enhanced penalties (in the form of very high – 100% or 200%) excise taxes for failing to cure violations. If there are repeated or flagrant violations, a third-tier tax, which is in the nature of an income tax, is assessable at any time. Ultimately, willful repeated and flagrant violations can result in the involuntary termination of private foundation status. § 507(a)(2).

Excise Tax on Investment Income. As noted above, under Section 4940 of the Code, an excise tax of 1.39% is generally imposed on the net investment income of a standard private foundation each year. The tax due is reported on IRS Form 990-PF. Certain private operating foundations are exempt from the 1.39% excise tax. §§ 4940(d), (e). A private foundation must file IRS Form 990-PF each year by the 15th day of the fifth month following the end of its fiscal year (e.g., May 15 for private foundations on a calendar year). Form 990-PF reports financial information about

the foundation, including contributions received for the year, capital gains, investment income, expenses, and "qualifying distributions" made by the foundation for the year. A "qualifying distribution" is generally any amount paid to a charitable organization or to carry out or accomplish a charitable, religious, educational, or scientific purpose, or any other purpose set forth in Section 501(c)(3). Prior to the application of the flat 1.39% rate in 2020, the rate was 2%, but standard private foundations could reduce their tax rate to only a 1% if they made qualifying distributions during the tax year at least equal to the sum of: (1) the foundation's assets for that year multiplied by the average percentage payout for the five preceding tax years plus (2) 1% of the foundation's net investment income for the year. Former § 4940(e). For example, assume a private foundation had assets of $1 million and an average payout of 7% for the five preceding years. If the foundation made qualifying distributions of $70,000 plus 1% of its net investment income for the tax year, the excise tax payable by the foundation would have been 1% rather than 2%. A foundation was not eligible for the excise tax rate reduction if in any of the five preceding years it failed to make sufficient qualifying distributions. Former § 4940(e)(2)(B).

Tax on Self-Dealing. Section 4941 of the Code sets forth a list of specific forbidden acts of self-dealing between a private foundation and certain donors to a private foundation, as well as members of the donor's family, other individuals like foundation managers, and entities controlled by them. §§ 4941(a)(1), (2). These individuals are defined as "disqualified persons." The self-dealing rules impose an excise tax not only on the foundation, but also on any disqualified person who knowingly engages in any act of self-dealing. The rate of taxation begins at 10% of the amount involved with respect to the act of self-dealing and increases to 200% of the amount involved if the act is not corrected within a designated period of time. §§ 4941(a)(1), (2), 4941(b). Any foundation manager who knows of the self-dealing and allows it to continue is also subject to imposition of the excise tax on self-dealing, up to 50% of the amount involved in the self-dealing. *Id.* The maximum tax imposed on the foundation manager, however, is $20,000 for any single act of self-dealing. § 4941(c)(2). A disqualified person is defined in Section 4946 of the Code as:

[1] a substantial contributor to the foundation (i.e., generally, anyone who contributes more than $5,000 to a private foundation if that amount is more than 2% of the total contributions received by the foundation for its taxable year);

[2] a foundation manager (i.e., any officer, director, trustee, or certain employees or agents of the private foundation);

[3] the owner of more than 20% of a corporation, partnership, trust, or unincorporated enterprise that is a substantial contributor to the foundation;

[4] a member of the family of any individual described in (1) through (3) above;

[5] a corporation, partnership, trust, or estate, if a person listed in (1) through (4) above holds more than a 35% interest in the entity; or

[6] a government official.

§ 4946(a). Under Section 4941 of the Code, "self-dealing" includes the following acts, whether direct or indirect: (1) the sale, exchange, or leasing of property between a private foundation and any disqualified person; (2) the lending of money between a private foundation and any disqualified person; (3) the furnishing of goods, services, or facilities between a private foundation and any disqualified person; (4) the payment of compensation by a private foundation to a disqualified person; and (5) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation. § 4941(d)(1). In most cases, the "fairness" of a self-dealing transaction is not relevant. For example, if a company that is controlled by a disqualified person leases office space to her private foundation for $1 per year, that transaction is a prohibited act of self-dealing, even though the rent is substantially below market rates. The Treasury regulations related to Section 4941 of the Code set forth a number of exceptions to these all-encompassing rules against self-dealing. § 4941(d)(2). One of the most important exceptions allows a private foundation to pay compensation to a disqualified person for personal services actually performed by that person, as long as the services are reasonable and necessary to carrying out the exempt purpose of the private foundation, and as long as the compensation is reasonable. § 4941(d)(2)(E). As a result, the creator of a private foundation or members of the founder's family may be employed by the foundation and paid reasonable compensation. Employment by the foundation may be an additional advantage to consider in creating a private foundation. Care must be exercised in

determining a reasonable salary, however, because salaries paid must be reported on Form 990-PF and will be scrutinized by the IRS. Industry groups review and publish compensation averages that may be viewed as a guide to the reasonableness of compensation paid. (See, for example, the Council on Foundations at www.cof.org.)

Tax on Undistributed Income. A standard private foundation may not accumulate all of its income. Each year, it is required to make certain qualifying distributions as set forth in Section 4942 of the Code. If the foundation does not comply with the rules governing the qualifying distributions, it is subject to an excise tax. § 4942(a)(1). Like the tax on self-dealing, the tax imposed on a private foundation for failure to make adequate distributions increases if the foundation fails to cure the problem within a specified time. § 4942(a)(2). Part of the calculation of the amount that a standard private foundation must distribute each year is its "minimum investment return." In general, the minimum investment return equals 5% of a foundation's net investment assets. § 4942(e). Specifically, the minimum investment return is calculated by multiplying the aggregate net fair market value of the foundation's assets that are not used directly for charitable purposes by 5%. *Id.* The minimum amount that a standard private foundation must distribute each year to be in compliance with Section 4942 of the Code (the "distributable amount") is the foundation's minimum investment return, less any excise tax it pays pursuant to Section 4940 of the Code, and less any UBTI tax it pays. § 4942(d). If a standard private foundation makes qualifying distributions that exceed its distributable amount, the excess distributions may be carried over and used to reduce the amount the foundation would otherwise be required to pay out over the following five years. § 4942(g)(2). If the foundation fails to make its required distribution, the initial excise tax equals 30% of the income of the private foundation not distributed as required within the tax year or within the next tax year. § 4942(a)(1). A second-tier tax, equal to 100% of the undistributed income, is imposed if the foundation fails to make the necessary qualifying distributions within a specified period of time. § 4942(a)(2). A third-tier tax may be imposed by the IRS if there have been previous violations or if the violation for which the current tax is imposed is willful. *Id.*

Tax on Excess Business Holdings. Section 4943 generally provides that for any corporation conducting a business that is not substantially related to the charitable purposes of a private foundation, the combined holdings of the private foundation and all disqualified persons are limited to 20% of the voting stock in the corporation. In addition, the combined holdings of a private foundation and all disqualified persons in any unincorporated business (other than a sole proprietorship) that is not substantially related to the exempt purposes of the foundation are limited to 20% of the beneficial or profits interest in the business. § 4943(c). In the case of a sole proprietorship, a private foundation can have no permitted holdings unless the business of the sole proprietorship is substantially related to the exempt purposes of the foundation. *Id.* If unrelated third parties have effective control of the business, the percentage limitation on the combined holdings of the private foundation and all disqualified persons is increased to 35%. § 4943(c)(2)(B). The provisions related to excess business holdings are subject to a variety of exceptions and special rules that must be examined in detail if the 20% (or 35%) limitation is exceeded. Regardless of the holdings of disqualified persons, if the private foundation itself (together with any related private foundations) holds an interest of 2% or less in an unrelated business, it will not be required to divest its holdings. § 4943(c)(2)(C). If the private foundation acquires excess business holdings by gift or bequest, it will generally have five years to dispose of those holdings before any excise tax is imposed. § 4943(c)(7).

Taxes on Investments that Jeopardize Charitable Purpose. Section 4944 of the Code provides that a private foundation may not invest its assets in any manner that could jeopardize the carrying out of any of its exempt purposes. If the foundation does make "jeopardizing investments," a tax equal to 10% of the amount so invested is imposed initially and a second-level penalty of 25% may be imposed if the situation is not corrected before the 10% excise tax is assessed or a notice of deficiency for that tax is mailed. § 4944(a), (b). No investment is unacceptable *per se*, but the following types of investments may be carefully scrutinized as evidencing a lack of reasonable business care and prudence: trading in securities on margin; trading in commodity futures; investing in working interests in oil and gas wells; buying "puts," "calls," and "straddles;" buying warrants; and selling short. *See* Treas. Reg. § 53.4944-1(a)(2). To correct a jeopardizing investment, a private foundation must sell or otherwise dispose of the investment, and the proceeds of the sale or disposition must not be invested in a way that jeopardizes the carrying out of the foundation's exempt purposes. § 4944(e)(2). Section 4944 of the Code does not apply to an investment given to (as opposed to being purchased by) the private foundation. In addition, it does not apply to "program-related investments," i.e., investments, the primary purpose of which is to accomplish one or more of the private foundation's charitable purposes, and no significant purpose of which is the production of income or the appreciation of property. § 4944(c).

Taxable Expenditures. Standard private foundations typically achieve their charitable aims by distributing funds to qualified public charities. Section 4945's taxable expenditure rules play a central role in the operation of a private foundation. These rules preclude a private foundation from making expenditures: (1) to carry on propaganda or to attempt to influence legislation; (2) to influence the outcome of any specific public election or to carry on any voter registration drive; (3) as a grant to an individual or to another private foundation, unless certain rigorous requirements are met; or (4) for any purpose other than the charitable purposes described in the Code. § 4945(d). The taxable expenditure rules impose significant burdens on a private foundation's ability to make grants (including providing scholarships) to individuals. To make a grant to an individual, the private foundation must obtain advance approval from the IRS that its grant-making procedure awards grants on an objective and nondiscriminatory basis. § 4945(g). In addition, the private foundation must show that the grant constitutes a scholarship, fellowship, prize, or award, or that the purpose of the grant is to: (i) achieve a specific objective; (ii) produce a report or other similar product; or (iii) improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee. Id. In addition, if a private foundation makes a grant to another private foundation, the grantor foundation must exercise what is known as "expenditure responsibility." § 4945(h). This means that the grantor foundation is responsible for exerting all reasonable efforts to establish adequate procedures to: (1) see that the grant is spent solely for the purpose for which it was made; (2) obtain full reports from the grantee as to how the funds are spent; and (3) make detailed reports as to such expenditures to the IRS. Id. If the foundation makes a distribution to an individual without having prior IRS approval of its grant-making procedure, or if the foundation makes a distribution to another foundation without exercising expenditure responsibility, an initial tax of 20% is imposed on a private foundation's taxable expenditures. § 4945(a). In addition, a tax of 5% (up to a maximum of $10,000) is imposed on a foundation manager who knowingly agrees to the expenditure. If the improper expenditure is not corrected, a second-level tax of 100% of the amount of the taxable expenditure is imposed on the foundation. §§ 4945(a), (b). A second-level tax of 50% (up to $20,000) is also imposed on a foundation manager who does not agree to the correction. Id.

A table summarizing some of the differences between DAFs and private foundations is as follows:

Feature	**Donor Advised Fund**	**Private Foundation**
Start-up Time	May be established immediately.	May take several weeks to a few months to draft documents to establish the foundation, file the documents with the State, and apply to the IRS for a tax exemption.
Start-up Costs	None, although the financial service company charges a fee to the donor advised fund.	Legal and accounting fees may be significant to prepare the legal documents and IRS tax exemption applications.
Creating the Fund	Established by the public charity supporting the donor advised fund.	Non-profit corporation or trust must be established.
Tax Exempt Status	Donor advised fund borrows the supporting public charity's tax-exempt status.	Must apply to the IRS to obtain tax exempt status.
Recommended Size	$25,000.	Substantial assets (typically $500,000 +) required to justify cost.
Limitation on Charitable Income Tax Deduction for Cash Gifts and Marketable Securities (Subject to Carryforward for Any Excess Contributions)	50% of adjusted gross income for cash (60% for years 2018 – 2025 for cash only contributions); 30% of adjusted gross income for appreciated stock.	30% of adjusted gross income.
Limitation on Charitable Income Tax Deduction for Gifts of Appreciated Real Estate (Subject to Carryforward for Any Excess Contributions)	Tax deduction available for full fair market value of real property, limited to 30% of adjusted gross income.	Tax deduction for property other than cash and marketable securities limited to lower of cost or fair market value, and limited to 20% of adjusted gross income.

Donor Control	Donor makes grant recommendations, which are typically always followed; however, final decision rests with public charity supporting the donor advised fund. Donor has no control over investments.	Donor retains complete control over investments and grant-making, subject to IRS requirements.
Public Disclosure	No required public disclosure; donor may make anonymous gifts or receive recognition if desired.	Annual tax returns and filings disclosing gifts are open for public inspection.
Annual Distribution Requirements	None.	Must pay out at least 5% of asset value each year for charitable purposes, regardless of annual income.
Annual Taxes	None.	Generally, exempt from income tax, but subject to an excise tax of 1.39% of net investment income, including net capital gains.
Annual Tax Filing	Public charity supporting the donor advised fund files an annual return, which includes the information regarding the donor advised fund.	Must file IRS Form 990-PF. May be required to file IRS Form 4720 and pay excise taxes on certain activities or income.

f. Charitable Lead Annuity Trusts. A charitable lead annuity trust ("CLAT") is a trust designed to benefit charity for a specified period of time, with any trust assets remaining at the end of the trust's term passing to non-charitable beneficiaries. When interest rates are low, a properly structured CLAT can ultimately pass most of its investment gains to heirs, while reducing or eliminating gift and estate taxes. A CLAT may be thought of as a charitable analog to a grantor retained annuity trust or "GRAT" that returns an annuity payment to the grantor. But unlike a GRAT, a donor who establishes a CLAT typically gives everything away, first to charity for a set period of time, and then to the donor's favorite non-charitable beneficiaries (typically, junior family members or other loved ones).

The Technique. Most CLATs are created by a senior family member who establishes a trust that provides for annual payments, typically of a fixed amount, to charity for a fixed term. Whatever is left in the trust at the end of the term is generally earmarked for junior family members or other loved ones. Of course, it makes little sense for a client to set up a CLAT unless he or she is charitably inclined. But for clients with charitable objectives who own assets that they expect to appreciate at rates higher than current IRS interest rates, these trusts can be better than giving the assets away outright, because they can also permit a tax-free (or at least tax-advantaged) transfer of wealth to the next generation. There is more than one way to structure a CLAT. For example, the trust terms and tax treatment will vary, depending on whether the client wants to receive an upfront income tax charitable deduction. The availability of the deduction can be especially important to clients who will have a "liquidity event" (with resulting high taxes) in a single year. The trade-off, however, is that taxes payable in later years may potentially go up.

Specifics

(i) Structure. In the usual case, senior family member transfers assets to the CLAT. The trust pays a fixed dollar amount to one or more charities for a specified number of years. Alternatively, the CLAT may be structured to last for the life or lives of (a) the senior family member; (b) his or her spouse; and/or (c) a lineal ancestor (or spouse of a lineal ancestor) of all of the remainder beneficiaries (or a trust in which there is less than a 15% probability that individuals who are not lineal descendants will receive any trust corpus). Treas. Reg. § 1.170A-6(c)(2)(i)(A).

Unlike a GRAT (or a charitable remainder trust), a CLAT is not subject to any minimum or maximum payout. The CLAT may provide for an annuity amount that is a fixed dollar amount, but which increases during the annuity period, as long as that the value of the annuity is ascertainable at the time the trust is funded. *See* Rev. Proc. 2007-45. Instead of paying a fixed dollar amount, the trust can be set up to pay a set percentage of the value of its assets each year, in which event it is called a "charitable lead unitrust" or "CLUT." In inflationary times, a CLAT tends to pass more property to remainder beneficiaries than a CLUT, so a CLAT is the more common structure. The CLAT can be

created during the senior family member's lifetime or upon his or her death pursuant to his or her Will or revocable trust.

The charity receiving payments may be a public charity or a private foundation, but in the case of a private foundation in which the grantor is involved, the grantor cannot participate in any decisions regarding the property distributed from the CLAT to the private foundation or the distribution of that property from the private foundation to the ultimate charity. In order to prevent this participation, the foundation's organizational documents should be reviewed and modified accordingly. *See* §§ 2036(a)(2), 2038; Treas. Reg. § 25.2511-2(b); PLRs 200537020, 200138018, 200108032. The IRS has issued annotated sample trust forms and alternate provisions that meet the requirements for inter vivos and testamentary CLATs. *See* Rev. Proc. 2007-45 (inter vivos CLATs); Rev. Proc. 2007-46 (testamentary CLATs).

(ii) Gift on Formation. When the senior family member contributes assets to a CLAT, he or she makes a taxable gift equal to the present value (based on IRS tables) of the remainder interest that will pass to the non-charity beneficiaries. § 2522(c)(2)(A); Treas. Reg. §25.2522(c)-3(c)(2)(vii). The gift of a remainder interest to a CLAT is a gift of a future interest, so no annual exclusion can be used to shelter the gift tax. § 2503(b)(1). CLATs can be structured so that the gift or estate tax on the remainder interest will be small or non-existent. This result is accomplished simply by ensuring that the present value of the payments to be made to charity (using IRS rates at the time the trust is formed) is very nearly equal to the value of the initial contribution.

(iii) Setting the Interest Rate. The value of the non-charity beneficiaries' interest is calculated using the section 7520 rate in effect for the month that the assets are transferred to the CLAT. The transferor has the option, however, to use the section 7520 rate in effect for either of the two months preceding the transfer. § 7520(a). To make the election, the grantor attaches a statement to his or her gift tax return identifying the month to be used. Treas. Reg. § 25.7520-2(b). Because IRS rates are published around the third week of each month, the grantor in effect has the option of picking from four months of section 7520 rates (including the rate in the current month, the preceding two months, and by delaying the transfer for a week or two, the succeeding month).

(iv) Income Tax Issues. An important consideration related to the structure of a CLAT is the income tax effect. If the CLAT is structured as a grantor trust for income tax purposes, then the grantor is entitled to receive an up-front income tax charitable deduction equal to the present value, based on IRS tables, of the interest passing to charity. § 170(f)(2)(B). The charitable deduction is typically subject to the 30%-of-AGI deduction limitation, since the gift is treated as a gift for the use of charities. Treas. Reg. § 1.170A-8(a)(2). Beware of other limits on the income tax deduction if property other than cash, such as marketable securities, is contributed to the CLAT. See § 170(e). Of course, to get this deduction, the CLAT has to be a grantor trust, which means that the grantor must pay tax on all of the CLAT's income during its term. § 170(f)(2)(B). If a grantor trust structure is chosen, the grantor gets no additional deduction for amounts paid by the trust to the charity during the term of the CLAT. In addition, if the grantor toggles off grantor trust treatment, the consequence is the same as if the grantor died during the term of the CLAT, as described below. Id.

More commonly, the CLAT is *not* structured as a grantor trust, so the grantor is not entitled to any income tax charitable deduction for amounts paid to charity. *Id*. Instead, the CLAT is responsible for the payment of the income taxes attributable to any income earned by the CLAT, and the CLAT itself receives an income tax deduction for the amount paid to charity each year. § 642(c)(1). This structure is much simpler and certain.

(v) Death During Term. If the grantor dies during the term of the CLAT, none of the trust assets will be included in the grantor's estate, since the grantor has not retained any interest in the trust. However, as noted above, estate inclusion might occur if the grantor is involved with the decisions regarding distribution of the property from CLAT to a private foundation in which the grantor is involved or distribution of that property from the private foundation to the ultimate charity. §§ 2036(a)(2), 2038; see also, e.g., PLR 200537020. If grantor trust treatment was used to give the grantor an initial income tax deduction, and if the grantor dies (or grantor trust treatment is otherwise terminated) during the trust term, the grantor must recapture income equal to the value of the deduction he previously received less the present value of trust income on which he paid tax, discounted to the date of contribution to the trust. § 170(f)(2)(B).

(vi) Benefit to Heirs. At the end of the annuity term, the assets remaining in the CLAT pass to one or more non-charity beneficiaries, such as the senior family member's children or other family members (or to one or more trusts for their benefit). If, over the annuity term, the CLAT generates total returns higher than the section 7520 rate in effect when the CLAT was created, the excess growth passes to the non-charity beneficiaries free from any estate or gift tax. This benefit is especially attractive in a low interest rate environment. For example, for a trust established in March 2022, all investment returns in excess of 2.0% per year ultimately pass to the donor's intended non-charity beneficiaries with no gift or estate tax! The gift is enhanced if the CLAT is structured as a grantor trust, since such a trust retains all of its income and gains in excess of the annuity payment, unreduced by any federal income tax.

(vii) GST Tax Issues. The grantor is technically permitted to allocate a portion of his or her GST tax exemption to the CLAT at the time the CLAT is funded in an amount equal to the taxable gift. *See* § 2632(a); Treas. Reg. § 26.2632-1(a), (b)(4). If the CLAT is structured so that the taxable gift is small or non-existent, the GST tax exemption allocated to the CLAT would be nearly zero. Unfortunately, the actual amount of GST tax exemption allocated to the CLAT is determined not when the CLAT is funded, but when the CLAT terminates. § 2642(e)(1). The amount of GST tax exemption allocated upon funding is treated as having grown at the Section 7520 rate in effect for the month of the funding, and not at the actual rate of growth of the trust assets. § 2642(e)(2). Therefore, there is at least some adjustment to the exemption that was initially allocated. If (as is hoped!) the value of the non-charity remainder interest exceeds the GST tax exemption initially allocated to the CLAT, as increased by the prevailing Section 7520 rate, the grantor can allocate any portion of his or her then-remaining GST tax exemption to the excess at the time the charitable interest terminates. As a practical matter, this means GST exemption cannot be leveraged with a CLAT. Further, "work arounds" like a child assigning the remainder interest are prohibited.

(viii) CLATs and Business Interests. There can be complications if the CLAT is funded with interests in a closely held entity such as a family limited partnership ("FLP"), membership units in an LLC, or (non-voting) shares in a private corporation. CLATs generally are subject to the same rules as private foundations. If the charitable portion of the CLAT is valued at greater than 60% of the fair market value of the assets contributed to the CLAT, the "excess business holding" rules will apply. §§ 4943, 4947(b)(3)(A); Treas. Reg. § 1.170A-6(c)(2)(i)(D). In that case, for example, the CLAT may face an excise tax if it does not divest itself of the FLP units within five years of their contribution to the CLAT. § 4943(c)(6). An attempt to sell the FLP units may prove to be difficult for the CLAT because the only willing buyers may be members of the donor's family. The rules against self-dealing (which apply even if the value of the charitable interest is less than 60% of the fair market value of the CLAT) would prevent a sale to a family member. § 4941. Furthermore, if a valuation discount is applied in valuing a gift of FLP units to a CLAT, additional complications may arise if the charitable beneficiary of the CLAT is a private foundation that is controlled by the donor or his or her family. In that event, an overly aggressive discount, which substantially reduces the required annuity payments to the foundation, may be viewed as an act of self-dealing on the part of the trustees of the CLAT.

g. Charitable Remainder Trusts. A charitable remainder trust ("CRT") is somewhat akin to a CLAT, but with the roles of charitable and non-charity beneficiaries reversed. This fundamental difference means that CRTs serve a different purpose, and are subject to their own unique set of rules. Like a CLAT, a CRT is a split-interest trust with both charitable and non-charity beneficiaries. With a CRT, however, one or more non-charity beneficiaries receive the initial term interest (sometimes called the "lead" interest) in the form of annuity or unitrust payments (described below) for the lifetime of one or more persons or for a fixed term of not more than 20 years, with any remaining property passing to one or more charities at the end of the trust term as the remainder beneficiary. The donor establishes the trust by transferring cash or other property to the trust and establishing the trust's terms, including naming the trustee and specifying the beneficiaries. The donor may retain the term interest, or may give the term interest to another non-charity beneficiary. Unlike a CLAT, a properly structured CRT is exempt from federal income tax (although non-charity beneficiaries may be taxed on CRT distributions described below). § 664(c)(1). Since the roles of charitable and non-charitable beneficiaries are reversed, as one might expect, CRTs transfer the most to non-charity beneficiaries when interest rates are high.

The Technique. CRTs are often created by senior family members who establish a trust that provides for annual payments, typically of a fixed amount, to themselves or other non-charity beneficiaries for a fixed term. Whatever is left in the trust at the end of the term passes to a qualified charitable organization. Of course, it makes little sense for a client to set up a CRT unless he or she is charitably inclined. But for clients with charitable objectives

who own assets that they intend to ultimately benefit charity, or who hold appreciated assets that they intend to sell and who wish to defer recognition of the capital gain, a CRT may serve as an important tool. The term interest payable to the non-charity beneficiary must be in the form of annuity or unitrust payments and may not simply be an income interest. Congress was presumably concerned that if the term interest were structured so that a non-charity beneficiary would receive all the income of the trust, the trustee could manage the assets so as to maximize income (for the donor's family) and minimize the long-term growth of the assets ultimately passing to charity. This could result in abuse with very little correlation between the amount of the charitable deduction and the amount ultimately passing to charity. By requiring an annuity or unitrust interest, Congress has ensured that donors would receive charitable deductions only for amounts very likely passing to charity.

> Example: Craig and Cristin, both age 70, have a condo that they bought years ago as a vacation property. As their children got older and moved away, they converted it into a rental property. Although it provides cash flow of about $30,000 per year (taxed as ordinary income), it also provides Craig and Cristin with the headaches that come with being landlords. The current value is about $1 million and their cost basis is only $200,000. As a result, if they were to sell the property, they would recognize a gain of $800,000. Even if depreciation recapture doesn't result in tax at a higher rate, the capital gain tax on the sale would be $160,000 (20% of the $800,000 gain), leaving them only $840,000 to invest. Craig and Cristin have always been charitably inclined. After talking the issues over with their estate planner, they decide to contribute the condo to a Charitable Remainder Unitrust ("CRUT") and let the trustee sell the property. Because the CRUT is tax-exempt, no capital gains will be due on the sale, and the trust will be able to invest the entire $1 million sales proceeds. After crunching some numbers, Craig and Cristin decide to take back a 6% annuity ($60,000 per year) from the CRUT for their joint lives. Based upon their other investments, Craig and Cristin think that the trust could average about a 7% return on its investments, so the 6% payment will actually grow a bit over time. In any event, $60,000 is twice their current income from this asset, and is more than the amount they would receive if they simply invested their net $840,000 sales proceeds at 7%. Contributing the condo to the CRUT in March 2022 allows Craig and Cristin to compute their charitable deduction using the March, 2022 section 7520 rate of 2.0%. Using these figures, the present value of the amount passing to charity will generate a current income tax charitable deduction of $89,546. In addition, distributions in excess of the CRUT's current annual ordinary income will be taxed at favorable capital gains rates until Craig and Cristin have received total capital gain distributions of $800,000. Distributions in excess of cumulative ordinary income and capital gains will be tax free to Craig and Cristin. If Craig and Cristin live to their projected life expectancy (18 years), their favorite charity will receive over $1.3 million, even after the CRUT pays Craig and Cristin $60,000 plus per year. In addition, even if they outlive their life expectancies, they will still receive the unitrust payment until they both die.

Specifics

(i) Structure. As noted above, the interest passing to non-charity beneficiaries must take the form of a fixed annuity or a fixed percent of the trust's assets. A charitable remainder annuity trust ("CRAT") is a CRT in which the annual payments to the non-charity beneficiary are in the form of a fixed annuity. The annuity is expressed in terms of a fixed dollar amount or a fixed percentage (between 5 and 50%) of the fair market value of the assets on the date the trust is established. Thus, regardless of how the trust assets appreciate or depreciate, the amount passing to the non-charity beneficiary is fixed. In other words, the charity alone, as the remainderman, participates in the appreciation or depreciation of the trust assets. If the trust assets grow faster than the section 7520 rate, more wealth passes to the charity than what was calculated at the time the trust was created. Of course, if the assets depreciate significantly, the charity may not receive anything at all. A charitable remainder unitrust ("CRUT") is a CRT in which the annual payments to the non-charity beneficiary are in the form of a fixed unitrust. The unitrust is expressed in terms of a fixed percentage (between 5 and 50%) of the fair market value of the assets revalued on the same day each year of the trust term. Thus, the amount paid to the non-charity beneficiaries each year may increase or decrease as the assets appreciate or depreciate each year. In other words, both the non-charity beneficiary and the charity participate in the appreciation or depreciation of the trust assets. CRTs more often take the form of a CRUT than a CRAT. With either structure, unlike a non-grantor CLAT, the CRT does not generally pay income tax on taxable income it receives. Instead, when distributions are made to the non-charity beneficiaries, those beneficiaries

report the distributions as income to the extent that the trust has received but has not previously distributed taxable income, according to the "worst in-first out" ("WIFO") hierarchy described below.

(ii) Variations on the Payout Theme. Instead of describing the payment to the non-charity beneficiaries strictly in terms of a unitrust or an annuity, a CRT may cap distributions based upon the trust's income as measured under state law. One version of this technique is a "net income with make-up" charitable remainder unitrust ("NIMCRUT"). A NIMCRUT is a CRUT in which the non-charity beneficiary's payment each year is the *lesser* of the unitrust amount or the trust's net income, measured under state fiduciary income tax principles rather than federal income tax principles. Any excess fiduciary accounting income in a particular year may be used to make up for years in which the income was less than the unitrust amount. Thus, for example, assume that in year 1 the unitrust amount is $100,000 but the net income is only $30,000. The non-charity beneficiary would receive only $30,000 (a difference of $70,000). Then, if in year 2, the unitrust amount is $110,000 but the net income is $140,000, the non-charity beneficiary will receive $140,000 (the unitrust amount of $110,000, plus a $30,000 "make-up" as a result of the $70,000 deficit in year 1. If in year 3 the unitrust amount is $120,000 but the net income is $200,000, the non-charity beneficiary will receive $160,000, equal to the unitrust amount of $120,000, plus a "make-up" amount equal to the remaining $40,000 of the $70,000 deficit in year 1. The economics of the NIMCRUT can be very powerful if the trust assets are managed appropriately, thereby giving the non-charity beneficiary a mechanism for deferring income tax. For example, in the early years of the NIMCRUT, the trustee might invest trust assets in long-term growth assets that produce little or no fiduciary accounting income. In that event, the non-charity beneficiary would receive little or no annual payments but would accrue a large "make up" amount for future distributions. Since CRTs are generally exempt from income tax, in the early years, little or no income tax will be paid. Then, in the later years of the trust term (perhaps when the non-charity beneficiary is retired and in a lower income tax bracket), the trust assets could be invested in high-yield assets, producing income well in excess of the unitrust amount. If the trust yield is high enough in those later years, the non-charity beneficiary could then cash in on the "make up" accruals and receive large distributions from the trust. Only the actual receipt of distributions in later years (e.g., during retirement) triggers income tax to the non-charity beneficiary. While to a certain extent, using a NIMCRUT may permit the trustee to control investments in a manner designed to modify distributions, the IRS had expressed its concerns about the potential for the abuse of such discretion. In Rev. Proc. 97-23, the IRS announced it would not issue rulings on whether a contribution to a NIMCRUT qualifies for an income tax deduction under section 664 where the grantor, trustee, beneficiary, or a person related or subordinate to any of them controls the timing of the CRT's receipt of trust income from a partnership or a deferred annuity contract. A properly structured and administered NIMCRUT entitles the donor to the same income, gift, and estate tax charitable deductions as the donor would receive for a CRUT with the same unitrust percentage.

(iii) Gift on Formation. If the donor creates a CRT during lifetime and retains the lead interest, no taxable gift is made at the time the CRT is established. However, if the lead interest is set up to benefit one or more of the donor's family members or other non-charity beneficiaries, the present value of the lead interest is a taxable gift made by the donor at the time the trust is established. The present value of the charitable remainder interest qualifies for the gift tax charitable deduction. § 2522(c)(2)(A). As noted above, because of the mechanics of how the present value of the lead interest is calculated, CRTs are particularly attractive when interest rates are high. The present value of the remainder interest essentially reflects growth of the trust assets at the assumed interest rate under section 7520. The value of the lead interest is essentially what is left after subtracting the value of the remainder interest from the total value of the assets transferred to the trust. Thus, if the section 7520 rate is high, the present value of the remainder interest will also be high and the value of the lead interest will be low. As a result, CRTs are usually more attractive when the section 7520 rate is high.

(iv) Setting Interest Rate to Value the Gift. As described above with a CLAT, the value of all non-charity beneficiaries' interest is calculated using the Section 7520 rate in effect for the month that the assets are transferred to the CRT. The transferor has the option, however, to use the section 7520 rate in effect for either of the two months preceding the transfer. § 7520(a). To make the election, the donor attaches a statement to his or her gift tax return identifying the month to be used. Treas. Reg. § 25.7520-2(b). Because section 7520 rates are published around the third week of each month, the donor has the option of picking from four months of section 7520 rates (including the rate in the current month, the preceding two months, and the succeeding month). Remember, though, that the interest rate used to value the gift has nothing to do with the interest rate used to measure the payout rate to the non-charity beneficiary, which must be between 5 and 50% of the initial trust value for a CRAT, or between 5 and 50% of the annual trust value for a CRUT.

(v) Income Tax Issues for the Donor. If the CRT is established during the donor's lifetime, the donor will receive an income tax charitable deduction in the year the CRT is established. § 170(f)(2)(A). In general, contributions to charitable organizations can be deducted for federal income tax purposes in an amount up to 50% of the donor's contribution base. For cash contributions to public charities made between 2018 and 2025, TCJA 2017 increased the annual limit to 60% of the taxpayer's contribution base. § 170(b)(1)(G). A special 30% limitation applies to contributions of capital gain property other than publicly traded stock, and to contributions "for the use of" any charitable organizations. §§ 179(b)(1)(C), 170(e). The 30% limit can be avoided by the donor agreeing to include any capital gain portion of the transferred property in the donor's income. § 170(b)(1)(C)(iii). This election could be beneficial if the capital gain is taxed at 20 percent and the increased charitable deduction offsets ordinary income taxed at 37 percent (the top income tax rates applicable in 2022). Remember that gifts of cash or ordinary income property to most private foundations are deductible only up to 30% of the donor's base. § 170(b)(1)(B). Furthermore, contributions of capital gain property (other than publicly traded securities) to most private foundations are subject to an even more stringent percentage limitation – 20% of the donor's contribution base. §§ 170(b)(1)(D), (e)(5).

The donor's charitable income tax deduction will be based upon the actuarially determined present value of the remainder interest passing to charity, as computed using a complex calculation taking into account the value of the contributed property (or its basis for capital gain property other than marketable securities), the section 7520 rate (i.e., assumed rate of growth), and the amount of the annuity or unitrust percentage. *See* § 7520(a). However, neither the donor nor the donor's estate will receive an income tax deduction if the CRT is created as a testamentary gift. The percentage limitation on the donor's income tax deduction for amounts passing to charity varies depending upon whether the charitable remainder beneficiary is a 50% (public) charity or a 30% charity (private foundation). In other words, CRTs generally borrow their status as 50% charities or 30% charities based upon the status of the charitable remainder beneficiary. That is, if the charitable remainder beneficiary must in all events be a public charity, the donation to the CRT is subject to the rules for 50% charities. If, however, the remainder beneficiary is (or an alternate charitable beneficiary might be a) private foundation, the more restrictive rules for donations to 30% charities control. *See, e.g.,* Rev. Rul. 79-368; PLR 9818028.

(vi) Income Tax Issues for the CRT. If properly formed, a CRT is generally not subject to income tax on any taxable income that it receives during its term. § 664(c)(1). However, if the CRT receives unrelated business taxable income ("UBTI"), as described in section 512, it is subject to an excise tax on that income *equal to 100% of the UBTI.* § 664(c)(2)(A). This confiscatory income tax means that trustees of CRTs must be able to identify and avoid trust investments that produce UBTI. The UBTI rules are technical, but to note, investments in dividend-paying stock or interest-bearing obligations don't produce UBTI unless the acquisition of the investment is financed by debt. See §§ 512(b)(1), (4). Gain on the sale of the investment will also be exempt if the acquisition is not debt-financed. See §§ 512(b)(4), (5). However, there are some types of investments that can cause a CRT to have income that would be treated as UBTI, which have can prove to be traps for unwary trustees. It is unlikely that a CRT would directly operate a business that could generate UBTI. In addition, a CRT is not eligible to hold stock in an S corporation. § 1361(e)(1)(B)(iii). As a result, corporate stock held by a CRT should be C corporation stock, the dividends from which will not be treated as UBTI (unless the acquisition of the stock is financed by debt). However, investments in other pass-through entities, notably partnerships and LLCs, can be problematic. If the pass-through entity generates income from a trade or business that would be UBTI if realized directly by the CRT, the CRT's share of that income will be UBTI to the CRT. As noted above, another problem area for CRTs is debt-financed income. Income from investments that are subject to acquisition indebtedness, as defined in section 514, is treated as UBTI, even if the income is passive in nature. § 512(b)(4). Debt-financed income includes income from investing in securities traded on margin. See, e.g., Bartels Trust v. United States, 617 F.3d 1375 (Fed. Cir. 2010). Investing in a real estate investment trust ("REIT") might permit indirection ownership of debt-financed property without generating UBTI. See PLR 199952071 (income from REIT is treated as dividend income and therefore not taxable as UBTI).

(vii) Income Tax Issues for Non-Charity Beneficiaries. Distributions to non-charity beneficiaries are frequently taxed to those beneficiaries. Distributions assume the same tax character in the hands of the non-charity beneficiaries as they have in the hands of the trust, applying a flow-through analysis. However, unlike simple and complex trusts, distributions are not deemed to come pro rata from each class of income earned by the trust. Rather, distributions are deemed to have been made from different categories of income received by the trust *from its inception* and not previously distributed, in the following order: ordinary income, capital gain, and tax-exempt income. § 664(b). In addition, short-term capital gains are deemed to be distributed before long-term capital gains. Treas. Reg. § 1.664-1(d)(1)(i)(b). After all these categories of receipts have been distributed, distributions are deemed

to come from trust principal. § 664(b). As one can see, the hierarchy has the effect of forcing out income taxed at the highest effective income tax rate first, with distributions taxable at lower rates being deemed distributed only after all higher rate income received by the trust has been subject to tax. This hierarchical system is hence sometimes referred to as a "worst in-first out" or "WIFO" allocation of income.

(viii) Complying with Technicalities. The IRS is a stickler for technical details related to preparing a CRT agreement and administering the trust. There must be a written trust agreement, the trust must have its own taxpayer ID number, and the trustee must file annual information returns. Two of the private foundation excise tax rules applicable to private foundations apply as well to CRTs (those imposing excise taxes on self-dealing and taxable expenditures), and the trust agreement must contain provisions that prohibit a trustee from violating these rules. §§ 508(e), 4947(a)(2). The CRT must have at least one non-charity beneficiary. § 664(d)(2)(A). The remainder beneficiaries must be one or more charities described in section 170(c) to which contributions are income tax deductible. §§ 664(d)(1)(D), (2)(D). While the exact charity does not have to be named in the governing instrument, the character of the charity must be specified. If specific charities are named, the trust instrument must provide that if named charities are not qualified at the time the trust distributes its assets on termination, the trustee must instead distribute the funds to a qualified alternative charity elected in a manner set out in the trust agreement. Treas. Reg. §§ 1.664-(2)(a)(6), -3(a)(6). *See also* Rev. Rul. 76-7 (allowing grantor to retain a special power of appointment to change identity of charitable beneficiary who would take at death of non-charity beneficiary); be careful about allowing a private foundation to be the new beneficiary. In addition, the term of the CRT must be for a term not to exceed 20 years or the lives of one or more persons. §§ 664(d)(1)(A), (2)(A). A CRAT must distribute a fixed amount or fixed percentage between 5 and 50% of the *initial* trust value each year, and a CRUT must pay a fixed percentage between 5 and 50% of the net fair market value of the trust's assets valued each year. §§ 664(d)(1)(A), (2)(A). In either event, the charity's interest in the trust cannot be nominal. For contributions to CRTs after July 28, 1997, the present value of the remainder interest in a CRT must at its inception be a least 10% of the net fair market value of the property contributed to the trust. §§ 664(d)(1)(D), (2)(D). The IRS has provided sample provisions that may be included in the governing instrument of a CRAT providing for annuity payments payable for one or more measuring lives followed by trust assets being distributed to one or more charitable remaindermen. Rev. Proc. 2016-42. Unlike a CRUT, a CRAT will be disqualified if the value and length of the annuity create more than a 5% probability that the remainder will not exist when the non-charity interest terminates. Rev. Rul. 77-374. Having all the right features in the trust agreement is not by itself determinative. If the trust instrument is not administered in accordance with its terms, the IRS may disqualify the CRT. See Est. of Atkinson v. Comm'r, 115 TC 26 (2002, aff'd 309 F.3d 1290 (11th Cir. 2002). Note that certain promoters suggested a transaction in which, after the formation of the CRT, all of the non-charity beneficiaries could sell their interest in the CRT to a third party, thereby receiving the value of their interest with very little or no taxable gain. In Notice 2008-99, the IRS called into question this technique, labeling it as a "transaction of interest" to the extent that it sought questionable tax benefits by manipulation of the uniform basis rules under Treasury Regulation Section 1.1015-5. In 2017, the Treasury amended those regulations to essentially eliminate the touted benefit of the transaction. *See* Treas. Reg. § 1.1014-5(b).

(ix) Benefit to Heirs. If the grantor retains the non-charity interest in the CRT, then there is no direct benefit from the CRT to the grantor's family. At the end of the annuity term, the assets remaining in the CRT pass to charity. That means, of course, that the children or other non-charity estate beneficiaries will receive less from the grantor than if the property donated to the CRT was not otherwise earmarked for charity. However, if the donor has a taxable estate, the loss to the non-charity beneficiaries is only 60% of the value of the property (using the current estate tax rate of 40%). If the donor wishes to minimize this loss, he or she might consider using some or all of the income tax savings that result from the formation of the CRT to fund a life insurance policy (perhaps owned by an irrevocable life insurance trust) to restore the wealth that would otherwise pass to those beneficiaries. Of course, if the non-charity beneficiaries of the CRT are family members or other loved ones, those beneficiaries receive a direct benefit in the form of the annuity or unitrust payments made to them.

(x) Estate Tax Issues. The actuarial value of the charity's remainder interest in the CRT qualifies for the federal estate tax deduction. § 2055(e)(2)(A). If the CRT does not meet the technical requirements for deduction, the Code provides that the deduction may nevertheless be obtained if a "qualified reformation" of the trust is undertaken in a timely fashion. § 2055(e)(3)(A). A qualified reformation is generally defined as a change of a governing instrument by reformation, amendment, construction, or otherwise that changes a reformable interest into a qualified interest, but only if (i) any difference between the actuarial value (determined as of the date of the decedent's death) of the qualified interest, and the actuarial value (as so determined) of the reformable interest does not exceed

five percent of the actuarial value (as so determined) of the reformable interest; (ii) in the case of a CRT, the nonremainder interest (before and after the qualified reformation) terminated at the same time, or in the case of any other interest, the reformable interest and the qualified interest are for the same period, and (iii) the change is effective as of the date of the decedent's death. § 2055(e)(3)(B); *See* PLR 201949007.

(xi) GST Tax Issues. A transfer to a CRT is a taxable gift (or if occurring at death, is a taxable transfer) to the extent of the actuarial value of the non-charity beneficiary's interest. However, the transfer itself is not a generation-skipping transfer, even if all of the non-charity beneficiaries are grandchildren or other skip persons, because the interest held by the charity is treated as being held by a non-skip person. *See* §§ 2612(c)(1), 2652(c)(1)(C). Moreover, a CRT is not a "GST Trust" for purposes of the deemed allocation rules of section 2632(b). § 2632(c)(3)(B)(5). However, distributions to grandchildren are taxable distributions under section 2611(a)(1). Accordingly, unless the grantor (or the executor of a deceased grantor's estate) allocates GST exemption in an amount equal to the taxable transfer, GST tax will be payable. Thus, for example, assume that Grandma contributes $1,000,000 to a CRUT for her granddaughter, to pay a 6% annuity for 20 years, with the remainder then passing to charity. Assume further that the amount of the gift that qualifies for the gift tax charitable deduction is $296,783. As a result, Grandma will have made a taxable gift of $703,217. If Grandma allocates $703,217 of her GST tax exemption to the transfer, the trust's inclusion ratio will be zero, so no GST tax will be owed when distributions are made from the CRUT to the granddaughter.

(xii) CRTs and Business Interests. In addition to the potential exposure to the 100% tax on UBTI described above, there can be other complications if a CRT is funded with interests in a closely held entity such as a family limited partnership ("FLP"), membership units in an LLC, or shares in a private corporation. In particular, like CLATs, CRTs generally are subject to many of the excise tax rules that are imposed upon private foundations. If the charitable portion of the CRT is valued at greater than 60% of the fair market value of the assets contributed to the CRT, the "excess business holding" rules will apply. §§ 4943, 4947(b)(3)(A); Treas. Reg. § 1.170A-6(c)(2)(i)(D). In that case, the CRT may face an excise tax if it does not divest itself of the offending ownership interests within five years of their contribution to the CRT. § 4943(c)(6). However, as noted above with respect to CLATs, attempts to sell FLP or other interests in closely held businesses may prove to be difficult, because the only willing buyers may be members of the donor's family. The rules against self-dealing (which apply even if the value of the charitable interest is less than 60% of the fair market value of the CRT) typically prevent a sale to a family member. § 4941.

(xiii) No Crops In A CRAT. In Furrer v. Commissioner, T.C. Memo. 2022-100, the taxpayer thought it was a good idea to transfer crops to two CRATs. It wasn't. The crops were corn and soybeans. The taxpayers were worse off after they went to appeals court than before. The opinion states:

> During the examination petitioners raised, as an affirmative issue, their alleged entitlement to noncash charitable contribution deductions for portions of the crops they transferred to the CRATs. The examining agent allowed such deductions. By timely amended answer, respondent contends that the examining agent erred and that these deductions should be disallowed. Because this is a "new matter," respondent bears the burden of proof on this point. *See* Rule 142(a)(1). We conclude that respondent has carried his burden and that the deductions are impermissible.
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> Petitioners did not satisfy (and do not contend that they satisfied) these substantiation requirements. At no time did they secure an appraisal—"qualified" or otherwise—of the crops they transferred to the CRATs. They did not attach to their 2015 or 2016 return a completed Form 8283 substantiating the gifts. And they did not maintain the written records required by the regulations.
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> ***
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> Even if petitioners had complied with the statutory substantiation requirements, they would not be entitled to charitable contribution deductions for donating to

> the CRATs bushels of soybeans and corn, which were ordinary income property in their hands. Section 170(e)(1)(A) provides that the deduction otherwise allowable for a contribution of property shall be reduced by "the amount of gain which would not have been long-term capital gain . . . if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution)."
>
> Inventory held primarily for sale to customers in the regular course of a trade or business is ordinary income property. No portion of the gain from the sale of such property could be long-term capital gain. § 1221(a)(1). Thus, the deduction for a contribution of ordinary income property is typically limited to the donor's cost basis in the property. *See Jones v. Commissioner*, 560 F.3d 1196, 1199 (10th Cir. 2009), *aff'g* 129 T.C. 146 (2007); *Strasburg v. Commissioner*, T.C. Memo. 2000-94, 79 T.C.M. (CCH) 1697, 1704 ("The allowable charitable contribution deduction for ordinary income property is limited to the basis of the property donated.") Accordingly, if a taxpayer has zero basis in ordinary income property, section 170(e)(1)(A) "require[s] that the deduction for donating that property be reduced by the property's entire value—leaving the taxpayer with no deduction at all." *Jones v. Commissioner*, 560 F.3d at 1199; see *Lary v. United States*, 787 F.2d 1538, 1540–41 (11th Cir. 1986); *Conner v. Commissioner*, T.C. Memo. 2018-6, 115 T.C.M. (CCH) 1013, 1023, *aff'd*, 770 F. App'x 1016 (11th Cir. 2019).
>
> Petitioners were engaged in the farming business, and the corn and soybeans grown on their farm constituted ordinary income property. Thus, any charitable contribution deduction would be limited to their cost or adjusted basis in the crops. *See Jones v. Commissioner*, 560 F.3d at 1199. As petitioner husband conceded when filing the 2015 and 2016 gift tax returns, petitioners' basis in the corn and soybeans transferred to the CRATs was zero. *See supra* p. 3. That was because petitioners had fully expensed, on their 2015 and 2016 income tax returns, all the costs of growing the crops. *See supra* p. 3. In order to have a basis in the donated crops, petitioners would have had to incur, with respect to those crops, farming expenses in addition to those deducted on their 2015 and 2016 income tax returns. They do not allege that they incurred any such additional farming expenses. Accordingly, the available deduction for the transfers of corn and soybeans to the CRATs is reduced to zero under section 170(e)(1)(A).

Presumably either the taxpayers received poor tax advice or disregarded the opportunity to take good advice.

Gladys L. Gerhardt v. Commissioner, 160 T.C. No. 9, is another CRAT case. The facts were simple, if farfetched:

> TORO, *Judge*: In these consolidated cases, petitioners (collectively, Gerhardts) contributed high-value, low-basis properties to charitable remainder annuity trusts (CRATs). The CRATs promptly sold the properties, purchased immediate annuities with most of the proceeds, and designated the Gerhardts as the recipients of the payments under the annuity contracts. In 2016 and 2017, the Gerhardts received payments from the CRAT-funded annuity contracts. The principal issue before us (which affects all petitioners) is whether those annuity payments are taxable to the Gerhardts. We conclude they are.
>
> The Gerhardts maintain, essentially, that selling the high-value, low-basis properties through the CRATs and having the CRATs buy immediate annuities for their benefit allowed them to have most of the sale proceeds returned to them tax free over time. That view finds no support in the law governing CRATs or elsewhere. Rejecting the Gerhardts' "too good to be true" arguments and consistent with our holding in *Furrer v. Commissioner*, T.C. Memo. 2022-100,

we conclude that the annuity payments they received in 2016 and 2017 are distributions from the CRATs and taxable to them as ordinary income under section 664.

The court explained how CRATs work as follows:

As we have already discussed, distributions from a CRAT typically are taxable in the hands of noncharitable beneficiaries to the extent of the CRAT's income. *See* I.R.C. § 664(b). Each of the CRATs here received appreciated property from the Gerhardts. The Gerhardts did not recognize gain on the transfers to the CRATs, and the CRATs have the same bases in the properties as the Gerhardts did before the contributions.[32] *See* I.R.C. § 1015(a) and (b); *Veterans Found. v. Commissioner*, 38 T.C. 66, 72 (1962), *aff'd*, 317 F.2d 456 (10th Cir. 1963); Treas. Reg. §§ 1.1015-1(a)(1), 1.1015-2(a)(1).[33] After receiving the properties, the CRATs sold them and used the proceeds to purchase SPIAs. The Gerhardts then received annual distributions from the CRATs in the form of annuities paid by the CRAT-funded SPIAs.

The CRATs realized gains on the sales of the contributed properties. *See* I.R.C. § 1001(a). Although the CRATs did not have to pay tax on those gains because of section 664(c), under section 664(b), the income they earned was relevant for determining the character of the distributions the Gerhardts received. *See* Treas. Reg. § 1.664- 1(d)(1)(ii)(*a*); *see also Alpha I, L.P.*, 682 F.3d at 1015 ("[T]he income of a CRUT is taxable to its income beneficiaries upon distribution."); Fox, *supra*, ¶ 25.50.

As we have already discussed, the character of CRAT distributions to noncharitable beneficiaries follows the character of the income to the CRAT. *See* I.R.C. § 664(b). The distributions are characterized in the following order: (1) ordinary income, (2) capital gains, (3) other income, and (4) trust corpus. *Id.* Here, the Commissioner determined that the income the CRATs earned was ordinary income because the properties the CRATs sold were subject to the rules of section 1245—a point not disputed by the Gerhardts.

***

The Gerhardts resist the straightforward analysis set out above. In their telling, the Code does a lot more than exempt the CRATs from paying tax on built-in gains realized when contributed property is sold. According to the Gerhardts, the Code also relieves them from paying tax on the distributions that were made possible by the CRATs' realization of the built-in gains. As they put it, "all taxable gains (on the sale of the asset[s contributed to the CRATs]) *disappear* and the full amount of the proceeds [is] converted to principal to be invested by the CRAT." Pet'rs' Opening Br. 6–7 (emphasis added). In the Gerhardts' view, "[i]t becomes obvious that Congress intended [this treatment] to promote charitable giving while offering large tax benefits as incentives." *Id.* at 7. The gain disappearing act the Gerhardts attribute to the CRATs is worthy of a Penn and Teller magic show. But it finds no support in the Code, regulations, or caselaw.

(xiv) CRAT Requires Annuity, Not Income. Section 664(d)(1) of the Internal Revenue Code describes, and defines, a CRAT as follows:

Section 664(d)(1) generally defines a CRAT as a trust with the following four characteristics:

> A. "[A] sum certain (which is not less than 5 percent nor more than 50 percent of the initial fair market value of all be paid, not less often than annually," to the income beneficiaries, at least one of which is not a charitable organization. In the case of individual beneficiaries, the annuity may last for either a set period of years (not to exceed 20) or the individual's remaining lifetime. I.R.C. § 664(d)(1)(A).
>
> B. No payments other than the annuity may be made to the noncharitable beneficiaries. I.R.C. § 664(d)(1)(B).
>
> C. At the end of the annuity period, the entire remainder is to be transferred to one or more charitable organizations. I.R.C. § 664(d)(1)(C); see also Treas. Reg. § 1.664-2(a)(6)(i).
>
> D. The present value of the remainder interest, determined at the time of the trust's funding, is at least 10% of the initial fair market value of the trust assets. I.R.C. § 664(d)(1)(D); see also Treas. Reg. § 1.664-2(c).[7]

> A "sum certain" is defined by Treasury Regulation § 1.664-2(a)(1)(ii) to mean "a stated dollar amount which is the same either as to each recipient or as to the total amount payable for each year of [the annuity] period."
>
> A trust that qualifies as a CRAT is exempt from income taxation (although it is subject to an excise tax on unrelated business taxable income, as defined in section 512). I.R.C. § 664(c).

The language above was taken from Estate of Susan R. Block v. Commissioner, T.C. Memo. 2023-30, in which the charitable trust provided a different non-charitable formula:

> Article 4.1 of the Trust instrument states that Ms. Block intends the Katz Trust to be "a charitable remainder annuity trust, within the meaning of Rev. Proc. 2003-57 and § 664(d)(1) of the Code, and the terms of this Section shall be construed to give maximum effect to such intent." Article 4.1(A) directs that an "annuity amount" be paid to Harriet during her life (or to I.W. if he survives her), in an amount "equal to the greater of: (a) all net income, or (b) the sum of Fifty Thousand Dollars ($50,000), at least annually." In addition, Article 4.1(I) of the Trust instrument provides:
>
> > Following [Ms. Block's] death this entire Trust, including THE HARRIET KATZ TRUST, shall be irrevocable. However, the Trustee shall have the power, acting alone, to amend THE HARRIET KATZ TRUST from time to time in any manner required for the sole purpose of ensuring that THE HARRIET KATZ TRUST qualifies and continues to qualify as a charitable remainder annuity trust within the meaning of § 664(d)(1) of the Code. The Trustee may not, however, change the annuity period, the annuity amount, or the identity of the Recipient [of the annuity amount].

Obviously, the trust was not a CRAT; so the question was whether it could be reformed to qualify for an estate tax charitable deduction. The court summarized the reformation rule as follows:

> If a trust initially fails to qualify as a CRAT or a CRUT, the settlor's estate still may take a charitable deduction if there is a "qualified reformation" of the trust. I.R.C. § 2055(e)(3)(A). A qualified reformation cannot occur unless the remainder interest is a "reformable interest" under section 2055(e)(3)(B), meaning that in

> the pre-reform trust (1) the remainder interest is exclusively charitable and (2) all payments to the noncharitable beneficiaries are "expressed either in specified dollar amounts or a fixed percentage of the fair market value of the property." I.R.C. § 2055(e)(3)(C)(i) and (ii). There is an exception to the "specified dollar or fixed percentage" requirement: An initially nonfixed interest will be excused if, within 90 days after the due date for the estate tax return, a judicial proceeding is commenced that results in the trust qualifying as a CRAT or a CRUT, retroactive to the date of the decedent's death. § 2055(e)(3)(C)(iii). In such a case, the remainder is deemed a reformable interest just so long as the pre-reform trust designated it as exclusively charitable.

The co-trustees of the trust attempted to eliminate the income piece of the formula with an amendment in August, 2017, but she had died in October 2015. The opinion states:

> The Estate argues that the First Amendment to the Trust instrument effected a qualified reformation. However, since the First Amendment could not have done so under the default rules, the only remaining possibility was a judicial reformation. Yet the exception for judicial reformations clearly does not apply here. First, the First Amendment was executed sometime after August 2017, far beyond the 90-day period following the due date for the estate tax return (July 21, 2016). Second, the amendment was instituted by the co-trustees alone, rather than by a court. Therefore, the First Amendment fails both components of the exception.
>
> Petitioners ask us to deem the Estate to have substantially complied with the exception. We decline to do so. As we have previously observed, Congress made clear that the rules for qualified reformations are to be construed strictly, in order to prevent abuse of the charitable deduction. *See Estate of Tamulis*, 92 T.C.M. (CCH) at 192–93. Specifically, Congress was concerned that if the reformation regime were overly lenient, taxpayers would not reform trusts to comply with the split-interest rules unless and until the IRS discovered defects upon audit. As the reports of both the House Committee on Ways and Means and the Senate Finance Committee explained:
>
> > In order to prevent [such strategic wait-and-see tactics] from occurring, the committee believes that, in order for a governing instrument of a charitable split-interest contribution to be reformable, either (1) the creator had to make a bona fide attempt to comply with the 1969 Act rules [requiring the trust to be either a CRAT or a CRUT] or (2) the taxpayer must initiate reformation proceedings before the Internal Revenue Service could reasonably be expected to begin audit. The committee believes that these rules will permit the correction of major, obvious defects (such as where the "income" interest is not expressed as an annuity interest or a unitrust interest) so long as the taxpayer initiates reformation proceedings before audit, while allowing the correction of minor defects (such as defects in determining the correct payout in short taxable years, in years of additional contributions, etc.) upon audit so long as there was a good faith attempt to comply with the 1969 Act rules (i.e., the payout is basically expressed as an annuity interest or a unitrust interest).
>
> H.R. Rep. No. 98-432, pt. 2, at 1516–17 (1984); Staff of the S. Comm. on Fin., 98th Cong., Deficit Reduction Act of 1984: Explanation of Provisions Approved by the Committee on March 21, 1984, S. Prt. No. 98-169, vol. 1, at 731–32 (Comm. Print 1984).

> Accordingly, this Court strictly construes the exception for judicial reformations. *See, e.g.*, *Estate of Hall v. Commissioner*, 93 T.C. 745 (1989) (finding no qualified reformation of a trust that required net income payments to the income beneficiary, because a judicial proceeding was not timely commenced); *Estate of Tamulis*, 92 T.C.M. (CCH) 189 (finding no qualified reformation of a trust that required net income payments to income beneficiaries, despite statement of intent on estate tax return for payments to be limited to 5% of trust assets). Even if we were to find that the First Amendment was effective for purposes of Connecticut law, it did not effect a qualified reformation for purposes of section 2055(e).
>
> Congress provided no exception for cases, like this one, where the income payment would likely never vary from a fixed amount (based on the initial size of the trust assets and the wording of the income payment provision), or where the co-trustees have in fact always paid the income beneficiaries a fixed amount. We cannot craft an exception that Congress did not provide for. *See Henry Schein, Inc. v. Archer & White Sales, Inc.*, 139 S. Ct. 524, 530 (2019).

h. Charitable Gift Annuities.

A charitable gift annuity is a deferred charitable giving technique somewhat like a charitable remainder trust in that the donor makes a current gift which provides a lifetime benefit to a non-charitable beneficiary, with any funds donated in excess of the cost of the transfer to the non-charitable beneficiary passing to charity. Rather than establishing a trust, however, a charitable gift annuity is simply a contract between the donor and a charity, akin to an annuity contract entered into with an insurance company. The donor may fund the charitable gift annuity with cash, appreciated securities, or possibly other assets. In return, the non-charitable beneficiary (typically the donor and/or the donor's spouse) receives a fixed stream of payments from the charity for the rest of the non-charitable beneficiary's life (or the lives of two non-charitable beneficiaries). At the same time, the donor is entitled to take a tax deduction for a portion of the donation (the amount given, less the value of the retained annuity). A charity may lose its tax-exempt status if it is engaged in the business of offering commercial annuities. However, the Code makes an exception which permits a charity to offer a donor a charitable gift annuity in exchange for a contribution if certain technical requirements are met. § 501(m)(5).

The Technique. Many large nonprofit organizations, including a number of universities, offer charitable gift annuities. First, the donor makes a donation to a single charity and enters into an agreement with the charity to provide a lifetime annuity payment to one or more "annuitants" for life. Typically, the annuitants are the donor, or the donor and the donor's spouse. The charity may set the gift aside in a reserve account which it invests. Based upon the age(s) of the annuitants at the time of the gift, and upon prevailing interest rates, the annuitant(s) receive a fixed monthly, quarterly, or annual payout for the rest of the annuitants' lives. Unlike a charitable remainder trust, the charity does not need to wait for the annuitants to die before it receives the donated property. It does, however, take on the obligation to pay the annuity. Charitable gift annuities are typically established by individuals or couples, who are typically the annuitants. Depending on the charity, the annuity can be funded with cash donations, but it may also be funded with gifts of securities or other assets. Minimum gifts for establishing a charitable gift annuity may be as low as $5,000, but are often much higher. In addition to obtaining an income stream for life, the donor(s) may also be eligible to take an income (and gift) tax charitable deduction at the time of the original gift, based on the estimated amount that will eventually go to the charity after all the annuity payments have been made. A portion of the payment received by the annuitant(s) is typically income tax-free for a period of time based upon the annuitant's actuarial life expectancy.

Specifics

(i) Structure. A donor may make a gift to charity and receive in exchange therefor a contractual agreement to pay one or more persons (often the donor or the donor and the donor's spouse) an annuity for life. Such an arrangement, known as a charitable gift annuity, is similar to a charitable remainder annuity trust discussed above. However, here, no trust is involved, and the gifted assets are typically not segregated from the charity's general assets. The donor and the charity simply enter into a contract that spells out the terms of the annuity. The annuity is typically expressed as a fixed percentage of the fair market value of the assets on the date the gift is

made. Regardless of how the donated assets appreciate or depreciate, the amount passing to the non-charity beneficiary is fixed. In other words, the charity alone enjoys the benefits of (or suffers the detriment of) appreciation or depreciation of the donated assets. The value of the property donated, less the value of the annuity, is a charitable gift eligible for an income tax charitable deduction and a gift or estate tax charitable deduction.

(ii) Gift on Formation. If the donor is the annuitant, and if the annuity is properly structured to be eligible for the gift tax charitable deduction, there is no taxable gift when the annuity contract is entered into. If the donor names someone other than the donor as the annuitant, the present value of the annuity is a taxable gift at the time the contract is entered into. If the annuitant is or includes the donor's spouse, the gift may qualify for a gift tax marital deduction. § 2523(f)(6). The value of the annuity is ordinarily determined by reference to the IRS tables for annuities. Factors determining the value of the annuity are: (1) the life expectancy of the annuitant(s), (2) the amount of the annuity, (3) the section 7520 rate, (4) when the annuity begins, and (5) how often the annuity is payable. With regard to the section 7520 rate, the donor can elect the rate for the month of transfer or the rate for either of the two months preceding the transfer. *See* § 7520(a). Donors wanting to maximize their current charitable deductions will want to choose the highest of those rates to minimize the present value of the annuity. As noted below, the present value of the charitable remainder interest qualifies for the gift tax charitable deduction. § 2522(c)(2)(A). Although the charitable deduction for the issuance of a charitable gift annuity is lower when the section 7520 rate is low, the amount of each payment excluded from income under section 72 will be higher. With the higher standard deduction, fewer taxpayers are benefited by itemizing deductions, and non-itemizer will often care more about how much income is tax free than about the charitable deduction. Those donors will want to elect to use the *lowest* available section 7520 rate.

(iii) Setting the Annuity Rate. A charity that will buy property or accept cash in exchange for a gift annuity is free to bargain for any type of ratio of contribution to sale features. The donor's charitable income tax deduction and the amount of the annuity payment excluded from the donor's income will vary with the agreed-up annuity rate, but there is no limitation on how this rate is chosen as far as the donor is concerned. Commonly, a charity will offer an annuity rate under a gift annuity so as to receive a contribution the actuarial value of which is at least one half of the property involved. The terms and rates used by most charities are those established by the American Council on Gift Annuities (formerly the Committee on Gift Annuities). See acga-web.org. The rates set by that organization are determined by market rates of interest and the age of the annuitant(s). Generally, these rates produce a charitable deduction of between 40 percent and 60 percent of the value of the transferred property.

(iv) Income Tax Issues for the Donor. If a properly structured charitable gift annuity is established during the donor's lifetime, the donor will receive an income tax charitable deduction in the year the annuity is established. The deduction is measured by the value of the property contributed, less the value of the non-charitable annuity. § 170(f)(10)(D). Treas. Reg. § 1.170A-1(d)(1). The charitable income tax deduction is computed using a complex calculation taking into account the value of the contributed property (or its basis for capital gain property other than marketable securities), the section 7520 rate (i.e., assumed rate of growth) for the month of the gift (or at the donor's option for either of the two preceding months), and the amount of the annuity. *See* § 7520(a). The percentage limitation on the donor's income tax deduction for amounts passing to charity varies depending upon whether the charitable is a 50% (public) charity or a 30% charity (private foundation). The charity must provide a written statement that informs the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of the amount of any money and the value of any property other than money contributed by the donor over the value of the goods or services provided by the organization, and must provide the donor with a good faith estimate of the value of the goods or services. § 6115(a). When annuity payments are received, the annuitant must report a portion of each annuity payment as a return of the donor's basis, a portion as ordinary income, and if appreciated property is given in exchange for the annuity, a portion as capital gain. This approach means that the donor avoids recognition of the entire capital gain in the year of the contribution. In fact, only a portion of the capital gain will ever be recognized. Specifically, the donor's basis must be allocated between the gift and sales portions of the transaction. The percentage of the capital gain attributable to the charitable deduction is not recognized. Treas. Reg. § 1.1011-2(a)(4). The payments under a charitable gift annuity may start immediately, or be deferred for a stated number of years in order to increase the payments to the annuitant once they begin. See, e.g., PLRs 200449033, 9743054. The allocation of the payments received on a deferred annuity between ordinary income and capital gains is somewhat different from that of payments on an immediate annuity because the present value of the annuity is different. Payments under a deferred annuity will be larger, and will usually produce a somewhat greater

amount of ordinary annuity income than an immediate charitable gift annuity. Property with debt, or a commercial annuity produce many additional complications.

(v) Securing the Annuity. Typically, the obligation to pay the annuity is simply a general unsecured obligation of the charity. In those cases, the donor should understand that the certainty of receiving annuity payments is entirely dependent upon the creditworthiness of the charity issuing the annuity. By the same token, the charity takes a risk that the annuitant(s) may outlive life expectancy by a long period, or that investment returns on the contributed assets (or other charity investments) might under-perform. The donor cannot generally collateralize the payment of the annuity with the property contributed. Section 2522(c)(2) provides that where a donor transfers a remainder interest in property to a charitable organization and has retained an interest in the same property, no gift tax charitable deduction is allowed for the interest passing to charity unless it is in a qualified form (charitable remainder annuity trust, charitable remainder unitrust or a pooled income fund). However, so long as the annuity is payable from the general assets of the charity and not from the assets transferred, the IRS has ruled that the donor has not retained an interest in the transferred property and the donor will receive a gift tax charitable deduction for the value of the property transferred less the present value of the annuity received. Rev. Rul. 80-281. When charities receive donations to fund charitable gift annuities, the vast majority simply invest the proceeds in a balanced investment portfolio of stocks, bonds and cash, allocated similarly to their endowment. It is possible for charities (and to some extent donors) to put off the financial and actuarial risks associated with a charitable gift annuity by having the charity acquire a commercial annuity from a highly rated insurance company (sometimes called "reinsuring" the gift annuity liability). Reinsurance is typically done by the charity's purchase of a commercial single premium immediate annuity. A fully reinsured life-only immediate annuity pays the charity an amount equal to the contractual gift annuity payment as long as the annuitant is alive. As a result, both the investment and longevity risks are transferred to the life insurance company issuing the commercial annuity. However, the commercial annuity is paid to charity (which may have other obligations to pay) and not directly to the annuitant, so the annuity payment itself is not fully guaranteed. See PLR 200884014.

(vi) Income Tax Issues for Non-Charity Beneficiaries. Unlike a CLAT, distributions to non-charity beneficiaries do not depend upon post-gift income earned from the contributed assets, nor do they depend upon the character of that income in the hands of the charity. Rather, the tax treatment of annuity distributions are fixed at the time the annuity is entered into, based upon a modified application of the annuity rules under section 72. If a donor makes a gift of cash to fund a gift annuity, a portion of each distribution from the annuity is taxed as ordinary income and a portion of the annuity is a tax-free return of principal. § 72(b)(1). The division of the interests in the annuity between the charitable and non-charitable interests is critical in determining how the annuity will be taxed. For purposes of making the computation, the investment in contract is the amount of consideration paid for the annuity. § 72(c)(1). The charitable deduction represents the value of the contributed property less the present value of the annuity. The share of the annuity which funds each of these present values dictates how the annuity is taxed. In general, a three-step approach is used: First, calculate the life expectancy of the single annuitant or the joint life expectancy of the two annuitants. This life expectancy is also the number of full annuity payments the gift annuity is expected to make during its term without taking into account the payment frequency. In gift annuity circles, this value is called the "expected return multiple." § 72(c)(3). Second, calculate the expected return to be paid. This is the total face value of all the annuity payments expected to be made during the annuity term. This total equals the annuity amount multiplied by the expected return multiple. § 72(b)(1). Third, calculate the exclusion ratio, which is the fraction of each annuity payment that is considered excluded income rather than ordinary income. The exclusion ratio equals the investment in contract divided by the expected return. § 72(b); Treas. Reg. § 1.72-1(c)(1). The exclusion ratio is merely spreading out the return of the dollars used to buy the annuity (investment in contract) over the annuitant's life expectancy. If the annuity is funded with cash, the excluded portion is treated as a completely non-taxable return of principal. The rest of the annuity, not included in the excluded portion, is taxable at the annuitant's ordinary income tax rate. § 72(a). If a donor uses appreciated property to purchase the gift annuity, a portion of the capital gain must be realized. If the donor is not the primary annuitant, the donor must report the capital gain in the year of the gift. Treas. Reg. § 1.1011-2(a). For most gift annuities, however, the donor is the primary annuitant and is able to recognize any gain proportionally over his or her life expectancy, rather than in the year the gift is made. To receive this treatment, the donor must be the only annuitant or the donor and a designated survivor annuitant must be the only annuitants, and the annuity must not be assignable except to the charity. Treas. Reg. § 1.1011-2(a)(4). In that event, the donor's basis is allocated between the investment in contract and the charitable gift (the deduction). The donor must recognize the amount of capital gain that bears the same ratio to the donor's total gain in the funding asset as the investment in contract bears to the fair market value of the property. In other words, reportable gain = total gain x

(investment in contract/fair market value). The total reportable gain is expressed as a percentage of the investment in contract and equals the percentage of gain in the funding asset. This percentage is multiplied by the excluded portion of each year's annuity payment in order to determine the capital gain to be reported for the year. Capital gain is reported only until all reportable gain has been recognized; afterwards, the capital gain portion of the annuity becomes tax-free income until the donor's entire basis in the contributed property is recovered. *See* Treas. Reg. § 1.1011-2(c), Ex. 8. Any amounts received after the expiration of the life expectancy of the annuitant(s) are taxed as ordinary income. § 72(b)(2). If all the annuitants die (or the annuity is assigned to the charity) before all of the investment in the contract is recovered, a deduction is allowed to the annuitant on his or her final income tax return. IRC§ 72(b)(3). In addition, if the annuitant dies before the entire capital gain has been reported, then the unreported gain is not taxed. However, if the donor dies before the entire amount of gain has been reported, a surviving annuitant must continue to report gain until all the gain has been reported. Treas. Reg. § 1.1011-2(a)(4)(iii). In most cases, in determining the period over which gain may be reported, the life expectancy of the survivor annuitant may not be taken into account. Treas. Reg. § 1.1011-2(a)(4)(ii). For gifts of joint or community property where the annuity is paid to both donors and then to the survivor, since both annuitants are donors, presumably the gain may be recognized proportionally over the joint life expectancy of the two donors.

(vii) Tax Issues for the Charity. While there are no set federal rules for structuring charitable gift annuities from the donor's standpoint, if a charity acquires property in exchange for debt, then, subject to certain exceptions, the income earned from that debt-financed property (including gains recognized on its sale) constitutes "unrelated business taxable income," which is taxed to the otherwise tax-exempt charity. § 513. Fortunately, the Code provides an exception for charitable gift annuities. To come within the safe harbor for this arrangement, however, the arrangement must meet five requirements: (1) the annuity paid to the annuitant(s) must be the only consideration given for the gift; (2) the value of the annuity must be less than 90 percent of the value of gift; (3) the annuity must be payable over the lifetime of one or two persons who are living at the time that the annuity is issued; (4) the annuity agreement cannot guaranty a minimum amount of payments or specify a maximum amount of payments; and (5) the payments cannot be adjusted by reference to the amount of income earned from the contributed property. § 514(c)(5). As a result, charitable gift annuities are structured to comply with these rules. As noted above, because a charitable deduction is involved, the donor can elect to use a section 7520 rate from one of the preceding two months, but that election may not be binding for purposes of the 10% test as applied to the charity because the test is performed "at the time of the exchange" of property for the gift annuity.

(viii) Benefit to Heirs. If the donor retains the annuity, then there is no direct benefit from the charitable gift annuity to the donor's family. At the end of the annuity term, the annuity simply ends, and the donated assets belong to the charity. That means that the children or other non-charity estate beneficiaries will receive less from the donor than if the property donated in exchange for the annuity was not otherwise earmarked for charity. However, if the donor has a taxable estate, the loss to the non-charity beneficiaries is only 60% of the value of the property (using the current estate tax rate of 40%). As with a CRT, if the donor wishes to minimize this loss, he or she might consider using some or all of the income tax savings that result from creation of the charitable gift annuity to fund a life insurance policy (perhaps owned by an irrevocable life insurance trust) to restore the wealth that would otherwise pass to those beneficiaries. Of course, if the non-charity beneficiaries of the charitable gift annuity are family members or other loved ones, those beneficiaries receive a direct benefit in the form of the annuity payments made to them.

(ix) Estate Tax Issues. If the charitable gift annuity is created at the death of the donor, the value of the contributed property, less the actuarial value of the annuity, qualifies for a federal estate tax charitable deduction. Analogous to the gift tax rule, the limitations on split-interest gifts under section 2055(e)(2) do not apply to charitable gift annuities, since there is no split gift. The annuitants retain no interest in the contributed property. The contribution is simply offset by the value of the consideration paid (the present value of the annuity).

(x) GST Tax Issues. A transfer to a charity in exchange for a charitable gift annuity may give rise to a taxable gift (or if occurring at death, is a taxable transfer) to the extent of the actuarial value of the annuity if the annuitants(s) are someone other than the donor. If the annuitant(s) are not skip persons, the transfer is not a generation-skipping transfer. However, if the annuitant(s) are grandchildren or other skip persons, the donor (or decedent) will have made a generation-skipping transfer at the time of the annuity agreement based upon the present value of the annuity. Factors mitigating against payment of GST tax include the fact that with interest rates very low,

few charitable gift annuities pass the 10 percent test desired by the charity if the annuitants are very young. In addition, the transferor can always allocate available generation-skipping transfer tax exemption to the transfer.

Funding a Charitable Gift Annuity with an IRA. As noted in the next section, the SECURE Act generally requires that in most cases, for persons dying after 2019 who name a non-spouse Designate Beneficiary, the entire plan or account must be distributed to the beneficiary on or before the last day of the year containing the tenth anniversary of the account owner's death. "Stretch IRAs" were thus eliminated for most Designated Beneficiaries. A possible way to continue a long-term payout to a beneficiary may involve using the IRA to fund a charitable gift annuity at the death of the IRA owner. In Private Letter Ruling 200230018, a taxpayer proposed to enter into an agreement with a qualified charity which provided that the IRA owner would name the charity as the sole beneficiary of his IRA. In exchange, the charity agrees to pay a third party an annuity over the life expectancy of the third party, beginning upon the death of the IRA owner. The IRS noted that the IRA would be fully includable in the IRA owner's estate for federal estate tax purposes, but the owner's estate would receive a federal estate tax charitable deduction equal to the value of the IRA, less the actuarial value of the annuity to be paid to the third party as of the IRA owner's date of death. PLR 200230018.

(xi) Charitable Distributions From Trusts. Suppose a trust does not provide for distribution to charity but the beneficiaries desire such distributions to occur. If the trust is modified validly under state law to allow charitable distributions, will that allow the trust to take a section 642(c) deduction? In CCA 201651013 the IRS concluded no because the trust after modification was not the "governing instrument." The ruling states:

> In Old Colony Trust Company v. Commissioner, 57 S.Ct. 813 (1937), the Supreme Court reversed a decision of the First Circuit (87 F. 2d 131). A trust document authorized but did not require the trustees to make current charitable payments if they could do so without jeopardizing the payment of annuities from the trust to non-charitable beneficiaries. The Board of Tax Appeals denied most of the income tax charitable deduction under the predecessor of § 642(c)(1) because it found that the taxpayer had not met its burden of proof regarding whether most of the payments were actually made from trust income during the year made. The First Circuit denied the entire deduction because the charitable payments were "not imperatively directed" by the trust. If the trustee exercised discretion in making the payments, they were not "pursuant to" the terms of the trust. The Supreme Court referred to the plain dictionary meaning of "pursuant to" as "acting or done in consequence or in prosecution (of anything), hence, agreeable; conformable; following; according," which standard was met by the authorization in the trust instrument.
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> In Crown Income Charitable Fund v. Commissioner, 8 F.3d 571, 573 (7th Cir. 1993), *aff'g* 98 T.C. 327 (1992), the Seventh Circuit addressed the issue of commutation. The trust at issue in Crown contained a provision permitting the trustees to commute the charitable interest only if, as a matter of law, it was clear that doing so would not adversely affect the maximum charitable deduction otherwise available. The trustees of the Crown Income Charitable Fund distributed trust assets in excess of the annuity amount to the charitable beneficiary over a number of years and deducted, under § 642(c), the full amount distributed to the charitable beneficiaries. Both the Seventh Circuit and the Tax Court held that the excess distributions were not deductible under § 642(c) because those instruments were not made pursuant to the terms of the governing instrument.
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> In Brownstone v. United States, 465 F.3d 525 (2nd Cir. 2006), a deceased husband's will created a marital deduction trust, which granted the husband's surviving wife a general testamentary power of appointment. When the wife died, she exercised her power in favor of her estate, the residue of which passed to charitable organizations. The trustee of the marital deduction trust distributed $1 million to the wife's estate and claimed a charitable contribution deduction under

§ 642(c), because the $1 million distribution passed entirely to the charitable beneficiaries under the wife's will.

The Second Circuit in Brownstone held that the distribution to the charities was made pursuant to the wife's power of appointment and not pursuant to the governing instrument, the deceased husband's will. The Second Circuit interpreted the definition of governing instrument narrowly, stating that an instrument subject to the creating instrument (the wife's will) could not combine with the creating instrument (the husband's will) and qualify as the governing instrument. The sole governing instrument in Brownstone was the husband's original will; therefore, the marital deduction trust was not entitled to a deduction under § 642(c) since the distribution was made pursuant to the wife's will.

In Lyeth v. Hoey, 305 U.S. 188 (1938), the Supreme Court held that property received in the settlement of a bona fide will contest is treated for federal income tax purposes as passing to the beneficiaries by inheritance. In Middleton v. United States, 99 F.Supp. 801 (D.C. Pa. 1951), the court held, applying principles derived from Lyeth, that amounts distributed to a charity pursuant to an agreement compromising a will contest were made "pursuant to the terms of the will." The court concluded that the income from the property that was distributed to the charity was permanently set aside for a charitable purpose and allowed a deduction for these amounts for the years prior to the year that the parties entered into the settlement agreement. See also Estate of Wright v. United States, 677 F.2d 53 (9th Cir. 1982), cert. denied, 459 U.S. 909 (1982).

In Emanuelson v. United States, 159 F.Supp. 34 (D.C. Conn. 1958), decedent left two conflicting wills -- one which left 2/3 of the residue of decedent's estate to certain charities, and another which left the entire residue to non-charitable legatees. After decedent's death, a controversy arose among the beneficiaries of the two wills. The controversy was resolved in a written compromise agreement between the two sets of beneficiaries, under which 52/480 of the residue passed to the charities named in one of the wills. Payments made to the charities under the written compromise agreement were held to be made pursuant to the will. Rev. Rul. 59-15, 1959-1 C.B. 164, citing Emanuelson, held that a settlement agreement arising from a will contest qualifies as a governing instrument.

In the current case, the taxpayer makes a summary argument that the payments qualify under § 642(c) because they are pursuant to the governing instrument, citing to Old Colony. They do not address the authorities concerning deductions under modified trust instruments. Here there was no conflict with respect to Trust B subsequent to the division of Parent Trust. The trust terms were unambiguous. The purpose of the court order was not to resolve a conflict in Trust B but to obtain the economic benefits which the parties believe they will receive from the modification of the Parent Trust. Neither Rev. Rul. 59-15 nor Emanuelson hold that a modification to a governing instrument will be construed to be the governing instrument in situations where the modification does not stem from a conflict of some sort. Additionally, both Crown and Brownstone have a narrow interpretation of what qualifies as pursuant to a governing instrument. Therefore, any payments to Foundation 1 and Foundation 2 after the modification of Trust B would not be considered to be made pursuant to the governing instrument, and Trust B is not entitled to a deduction for such payments under § 642(c).

The IRS also held that a 661, DNI, deduction would not be available. This result is controversial as the ruling notes. Commentators are divided, for instance:

> One standard treatise supports them on two policy grounds: "All of the courts but one [U.S. Trust District Court] that have considered this issue have sustained these regulations, even though they substantially exceed the scope of the statutory language . . . The cases supporting the regulations take the appropriate view because a contrary rule has the effect of giving both an estate tax deduction (for the charitable disposition) and an income tax deduction (for the item distributed to charity) for the same payment. "Also, as a result of deducting distributions of corpus to charity, the non-charitable legatees in effect receive the estate's income tax-free. The benefit of the income tax deduction inures to the noncharitable legatees, rather than to the charity, so the court decisions favoring the regulation seem fundamentally sound." [citations omitted] Danforth, Robert T., et al., Federal Income Taxation of Estates and Trusts [current through 2016], at 4.07[1]
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> However, at least as many secondary sources in this area disagree with the disallowance under § 661(a), at least under some facts. Another standard treatise, Ferguson, M. Carr, et al, Federal Income Taxation of Estates, Trusts, & Beneficiaries (current through 2016), states at § 6.10: "The analysis [explaining why a single payment should not allow double deduction under §§ 642(c) and § 661(a)] does not, however, answer the question whether amounts that pass to charity in such a way as not to qualify for the deduction under § 642(c), such as amounts that pass to nonqualified quasi-charitable organizations or are used for purposes that are not exclusively charitable, escape the proscription of § 663(a)(2). Obviously, such amounts do *not* qualify 'for the deduction provided in § 642(c).' Are they therefore deductible as distributions under § 661? A literal reading of the statute strongly suggests that many such amounts should be. Even an undisputedly charitable beneficiary would be treated the same as any other beneficiary under the distribution rules, if it were not for §§ 642(c) and 663(a)(2). When no deduction is available under § 642(c), § 663(a)(2) seems to plainly not apply."

The regulations and history only add to the confusion:

> Section 1.663(a)-2 provides that any amount paid, permanently set aside, or to be used for the charitable, etc., purposes specified in § 642(c) and which is allowable as a deduction under that section is not allowed as a deduction to an estate or trust under § 661 or treated as an amount distributed for purposes of determining the amounts includible in gross income of beneficiaries under § 662. **Amounts paid, permanently set aside, or to be used for charitable, etc., purposes are deductible by estates or trusts only as provided in § 642(c).** For purposes of this section, the deduction provided in § 642(c) is computed without regard to the provisions of §§ 508(d), 681, or 4948(c)(4). [emphasis added]
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> Section 663(c) provides that for the sole purpose of determining the amount of DNI in the application of §§ 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts. Rules similar to the rules of the preceding provisions of § 663(c) shall apply to treat substantially separate and independent shares of different beneficiaries in an estate having more than one beneficiary as separate shares. The existence of such substantially separate and independent shares and the manner of treatment as separate trusts or estates, including the application of subpart D [the "throwback" rules of §§ 665-668], shall be determined in accordance with regulations prescribed by the Secretary.

Sections 661(a), 663(a)(2), and 663(c) were enacted as part of the original Internal Revenue Code of 1954. The only subsequent change relevant to the current issue was the amendment of § 663(c) by § 1307 of the Taxpayer Relief Act of 1997, P.L. 105-34, to apply to estates as well as trusts. Section 642(c), discussed under Issue 1, was also included in the original Code, and was bifurcated by § 201 of the Tax Reform Act of 1969, P.L. 91-172, into current §§ 642(c)(1) and (2), dealing respectively with deductions for current payments to charity and deductions for amounts "permanently set aside" for later payment.

The 1954 legislative history is not entirely clear on the purpose and scope of § 663(a)(2). Whereas the charitable and distribution deduction provisions had general counterparts under the 1939 Code (§§ 162(a) and (b), respectively), § 663(a)(2) was a new provision, as was the entire DNI mechanism. In general, under the 1939 Code, distribution deductions had to be actually traced to the trust's gross income, whereas such tracing is unnecessary under the 1954 and 1986 Codes, since § 661 distributions automatically take out DNI which then is generally taxable under § 662 to the beneficiaries. The tracing requirement formerly applying to all trust and estate distributions now only survives for the charitable deduction under § 642(c).

The House and Senate Reports on the 1954 Code (H.R. 8300) each explain the exclusion of § 642(c) amounts from §§ 661 and 662 with reference to the "additional" deduction which the entity would be able to claim if not for this provision, suggesting that § 663(a)(2) is meant simply as an anti-duplication measure, not that there is an underlying policy of § 642(c) exclusivity.[4] The American Bar Association's submission regarding the bill also supports the adoption of this provision as preventing an "additional" deduction for distributions for which a deduction would already be allowed under proposed § 642(c). See Senate Finance Comm. Hearings on H.R. 8300, 83d Cong., 2d Sess. 438[5]

However, the example in the Senate Report demonstrating the application of §§ 661-663 (S. Rep. 1622 at 351-353) suggests the opposite interpretation. The terms of a testamentary trust require that half of the trust income be distributed currently to the grantor's wife for life. The remaining half in the trustee's discretion may either be paid to the grantor's daughter, paid to designated charities, or accumulated. At the wife's death, the entire trust principal will be payable to the daughter. In the given year, the trust income consisted of dividends, rentals, and tax-exempt interest, of which the trustee distributed half to the wife and one-quarter each to the daughter and a charity. In determining the § 661(a) distribution deduction, the example excludes the amount distributed to the charity since it was allowed as a deduction under § 642(c) to the extent that it was included in the trust's gross income. However, the entire amount paid to the charity is not deductible under § 642(c) because a ratable part of it is attributable to the tax-exempt interest which does not enter into gross income and thus fails one prong of the § 642(c) test. The example does not add the disallowed portion of the charitable payment back into § 661 for determining the distribution deduction, thus indicating that payments to charity are deductible, if at all, only under § 642(c). The example in the Senate Report was substantially adopted as the example illustrating §§ 661-662 in § 1.662(c)-4. That section and § 1.663(a)-2 were both published as part of the original subchapter J regulations, T.D.6217 (12/19/56). The latter originally only referred to limits on charitable deductions under § 681, and was later amended to include the limits under §§ 508(d) and 4948(c)(4) added by the 1969 Act.

The taxpayer attempted to inspire the IRS to accept a bona fide state court modification to the trust instrument as being the "governing instrument" but the IRS rejected inspiration in CCA 201747005. The taxpayer and the IRS settled the case but the IRS did not concede the point.

There is no evidence that this is part of a larger exercise to limit the tax effect of prospective state court modifications (for instance, adding general power for basis). If a trust cannot be effectively amended, what can be done to obtain a charitable deduction for trust income? The assets of the trust could be contributed to an S corp. and the trust could become an ESBT (see discussion of the 2017 Tax Act). Or, distributions could be made to a 501(c)(4) organization, for which a section 661 deduction is allowable. A third way is that Rev. Ruling 2004-05 may help.

Gifts by partnerships or LLCs are deductible proportionately by the partners or members. section 702(a)(4). Rev. Rul. 96-11 holds that when a partnership makes a charitable contribution of property, the basis of each partner's interest in the partnership should be decreased, but not below zero, by the partner's share of the partnership's basis in the property contributed. Similarly, a partner's charitable deduction for the contribution of appreciated property by the partnership does not seem to be limited to her share of the partnership's basis in the assets. See PLR 8405084. Thus, contributions of appreciated property by partnerships preserve the tax benefit of receiving a deduction at fair market value for the contribution of appreciated property; the unrealized appreciation is not transferred to the partner's interest in the partnership.

Rev. Rul. 2004-05 provides that a trust which is a partner will benefit from a charitable contribution made by the partnership even if the trust itself has no charitable beneficiaries. The Ruling does not state how the trust came to be a partner. May a trust with no charitable beneficiaries become a partner in a partnership which allows charitable contributions without the consent of the trust partner? Presumably the answer is yes so long as the beneficiaries are agreeable. See also PLR 200208019, in which the IRS considered whether the members of a partnership were entitled to a charitable deduction on account of the partnership's grant of a conservation easement to a charitable organization. The IRS concluded that each partner was entitled to a charitable deduction equal to each partner's distributive share of the gift. A trust could not benefit from that deduction because §642(c) allows only deductions for income.

PLR 201225004 involved a trust claiming the section 642(c) deduction for income distributed to charity and the requirement that the income be distributed "pursuant to the terms of the governing instrument." Here, the distribution was directed by a beneficiary's exercise of a lifetime special power of appointment and the IRS determined that satisfied the "pursuant to" requirement even though the governing instrument did not specify a charitable bequest. It only authorized exercise of the power in favor of charity. In PLR 9821029, an individual exercised a lifetime nongeneral power of appointment over a trust to create a charitable remainder trust for a term of years with the trust as the unitrust beneficiary. The IRS allowed the trust to be the beneficiary and allowed the charitable remainder trust to be created by the exercise of the power.

If a charity is given the right to withdraw a portion of the income and gains from a trust then the charity is the owner of that portion under section 678 which avoids the need for a section 642(c) deduction. This is a "BDOT solution" (see discussion of BDOTs).

9. Disclaimer to a Charitable Fund.

a. Tax Benefits.

The deduction is allowed for an amount that becomes or is added to a charitable bequest or transfer as a result of a "qualified disclaimer" under section 2518. Where the disclaimer is described by a formula significant tax savings may be achieved as well as a form of audit insulation. This issue arose in Estate of Helen Christiansen v. Commissioner, 130 T. C. No. 1 (2008) (reviewed), aff'd, 586 F.3d 1061 (8th Cir. 1061).

Helen Christiansen died leaving everything to her only child, Christine Hamilton. Any amounts Christine Hamilton disclaimed would go 75% to a charitable lead annuity trust and 25% to a private foundation. Ms. Hamilton disclaimed a fraction of the estate the numerator of which was the fair market value of the estate, before payment of debts, expenses, and taxes, less $6,350,000, and the denominator of which was the fair market value of the estate, before payment of debts, expenses, and taxes. Fair market value was defined using the willing buyer, willing seller

formula and referencing the value as finally determined for Federal estate tax purposes. The estate included some cash and real estate but also 99% interests in two limited partnerships. The estate tax return reported a total value of $6,512,223.20; in the litigation the parties agreed that the value of the estate was $9,578,895.93.

The government argued that the disclaimer to the Foundation should generate an estate tax charitable deduction only for the amount originally set forth on the estate tax return, not the amount agreed to after audit. The Court disagreed. The government first argued that the increase amount passed as a result of a contingency - - the IRS audit increasing the value of the estate - - but the Court noted that merely because "the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of dependent for its occurrence on a future event."

The government also argued public policy, Procter like, grounds for disallowing an increased charitable deduction. The majority opinion in the Tax Court rejected that contention holding:

> This case is not Procter. The contested phrase would not undo a transfer, but only reallocate the value of the property transferred among Hamilton, the Trust, and the Foundation. If the fair market value of the estate assets is increased for tax purposes, then property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case.
>
> We do recognize that the incentive to the IRS to audit returns affected by such disclaimer language will marginally decrease if we allow the increased deduction for property passing to the Foundation. Lurking behind the Commissioner's argument is the intimation that this will increase the probability that people in Hamilton's situation will lowball the value of an estate to cheat charities. There's no doubt that this is possible. But IRS estate-tax audits are far from the only policing mechanism in place. Executors and administrators of estates are fiduciaries, and owe a duty to settle and distribute an estate according to the terms of the will or law of intestacy. See, e.g., S.D. Codified Laws sec. 29A-3-703(a) (2004). Directors of foundations--remember that Hamilton is one of the directors of the Foundation that her mother created--are also fiduciaries. See S.D. Codified Laws sec. 55-9-8 (2004). In South Dakota, as in most states, the state attorney general has authority to enforce these fiduciary duties using the common law doctrine of parens patriae. Her fellow directors or beneficiaries of the Foundation or Trust can presumably enforce their observance through tort law as well. And even the Commissioner himself has the power to go after fiduciaries who misappropriate charitable assets. The IRS, as the agency charged with ruling on requests for charitable exemptions, can discipline abuse by threatening to rescind an exemption. The famed case of Hawaii's Bishop Estate shows how effectively the IRS can use the threat of the loss of exempt status to curb breaches of fiduciary duty. See Brody, "A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?", 21 U. Haw. L. Rev. 537 (1999). The IRS also has the power to impose intermediate sanctions for breach of fiduciary duty or self-dealing. See sec. 4958.

The Eighth Circuit had no difficulty upholding the Tax Court. The government made two arguments described by the Court as follows:

> First, the Commissioner argues that because the overall value of the estate was not finally determined at the time of Christine's death, but only after the Commissioner's partially successful challenge, the transfer to the foundation was, ultimately, "dependent upon the performance of some act or the happening of a precedent event" in violation of Treasury Regulation § 20.2055-2(b)(1). The Commissioner identifies as the purported "precedent event" or contingency the

challenge mounted against the estate's initial return and the ultimate process of settling the estate's value.

> As a second argument, the Commissioner asserts policy concerns related to the incentives and disincentives that exist regarding the decision to conduct audits in any given case. In particular, the Commissioner argues that we should disallow fractional disclaimers that have a practical effect of disclaiming all amounts above a fixed-dollar amount. According to the Commissioner, such disclaimers fail to preserve a financial incentive for the Commissioner to audit an estate's return. With such a disclaimer, any post-challenge adjustment to the value of an estate could consist entirely of an increased charitable donation. Because this scenario would provide no possibility of enhanced tax receipts as an incentive for the Commissioner to audit the return and ensure accurate valuation of the estate, the Commissioner argues such disclaimers should be categorically disqualified as against public policy.

The Court rejected the first argument as follows:

> Regarding the first argument, we are unable to accept the Commissioner's interpretation of Treasury Regulation § 20.2055-2(b)(1). The regulation is clear and unambiguous and it does not speak in terms of the existence or finality of an accounting valuation at the date of death or disclaimer. Rather, it speaks in terms of the existence of *a transfer* at the date of death. See Treas. Reg. § 20.2055-2(b)(1) ("If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible."); see also 26 U.S.C. § 2518(a) (providing that a qualifying disclaimer relates back to the time of death by allowing disclaimed amounts to pass as though the initial transfer had never occurred); S.D. Codified Laws § 29A-2-801 (b) (same). Here, all that remained uncertain following the disclaimer was the valuation of the estate, and therefore, the value of the charitable donation. The foundation's right to receive twenty-five percent of those amounts in excess of $6.35 million was certain.
>
> In pressing his current argument, the Commissioner fails to distinguish between events that occur post-death that change the actual value of an asset or estate and events that occur post-death that are merely part of the legal or accounting process of determining value at the time of death. The Commissioner cites several cases in which courts disallowed deductions because future contingent events might have defeated a transfer or a charitable contribution. See Comm'r v. Sternberger's Estate, 348 U.S. 187, 199 (1955) (deduction disallowed where bequest to charity was dependent upon testator's daughter dying without descendants); Henslee v. Union Planters, 335 U.S. 595, 600 (1949) (deduction disallowed where a bequest to charity was the remainder of trust and where the trust's primary beneficiary had the right to invade the trust corpus, therefore making not only the value of the bequest contingent, but making the existence of the charitable bequest non-ascertainable); Bookwalter v. Lamar, 323 F.2d 664, 669-70 (8th Cir. 1963) (marital deduction disallowed where surviving spouse's continued survival was a condition upon disposition of the estate, thus creating "a 'terminable interest' within the meaning of § 2056 of the 1954 [Internal Revenue] Code."). In each cited case, however, the actual contingencies under scrutiny were outside the legal or accounting process of determining a date-of-death value for the estate or an asset. None of these cases stand for the proposition that deductions are to be disallowed if valuations involve lengthy or disputed appraisal efforts or if the

> Commissioner's actions in challenging a return result in determination of an adjusted value.
>
> * * *
>
> It seems clear, then, that references to value "as finally determined for estate tax purposes" are not references that are dependent upon post-death contingencies that might disqualify a disclaimer. Because the only uncertainty in the present case was the calculation of value to be placed on a right to receive twenty-five percent of the estate in excess of $6.35 million, and because no post-death events outside the context of the valuation process are alleged as post-death contingencies, the disclaimer was a "qualified disclaimer." 26 U.S.C. § 2518(a). We find no support for the Commissioner's assertion that his challenge to the estate's return and the ultimate valuation process and settlement are the type of post-death events that may disqualify a partial disclaimer.

More interesting was the Circuit Court's wholesale rejection of the argument that this sort of disclaimer planning interfered with the ability to audit estates:

> For several reasons, we disagree with the Commissioner's argument that we must interpret the statute and regulations in an effort to maximize the incentive to audit. First, we note that the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws. [citations omitted]
>
> Second, we find no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the Commissioner to challenge or audit returns. The relevant policy in the present context is clear, and it is a policy more general in nature than that articulated by the Commissioner: Congress sought to encourage charitable donations by allowing deductions for such donations. See 26 U.S.C. § 2055(a)(2); Sternberger's Estate, 348 U.S. at 190 n.3 ("The purpose of the deduction is to encourage gifts to the named uses."). Allowing fixed-dollar-amount partial disclaimers supports this broad policy.
>
> Third, and importantly, even if we were to find a general congressional intent regarding a need to maximize the incentive-to-audit, no corresponding rule of construction would be necessary in the present context to promote accurate reporting of estate values. The Commissioner premises his policy argument on the assumption that executors and administrators will purposefully undervalue assets in order to take advantage of his marginally decreased incentive to audit. In the present context, however, there are countless other mechanisms in place to ensure that fiduciaries such as executors and administrators accurately report estate values. State laws impose personal liability on fiduciaries, and state and federal laws impose financial liability or, in some circumstances criminal sanctions, upon false statements, fraud, and knowing misrepresentations. See, e.g., S.D. Codified Laws § 29A-3-703(a) ("A personal representative is a fiduciary. . . ."); id. § 55-9-5 (providing that the attorney general is the representative of beneficiaries of charitable foundations and has a duty to enforce their rights in court actions); 18 U.S.C. 1001 et seq. (criminalizing various acts of fraud and knowing misrepresentations); Ward v. Lange, 553 N.W.2d 246, 250 (S.D. 1996) ("[T]he fiduciary has a 'duty to act primarily for the benefit' of the other.") (quoting High Plains Genetics Research, Inc. v. J K Mill-Iron Ranch, 535 N.W.2d 839, 842 (S.D. 1995)).

In addition, with a fixed-dollar-amount partial disclaimer, the contingent beneficiaries taking the disclaimed property have an interest in ensuring that the executor or administrator does not under-report the estate' value. Such beneficiaries, therefore, have an interest in serving a watchdog function.[3] Further, in this case Hamilton was not only the primary beneficiary who made the contested partial disclaimer, she was the executor of the estate and a board member for the foundation. Because she owed a fiduciary obligation to both the estate and the foundation, any self-dealing in this instance would be a clear violation of her general state-law fiduciary obligation to put the interests of the foundation above her own interests and possibly a violation of state and federal statutory prohibitions on certain forms of self-dealing. See Ward, 553 N.W.2d at 250; S.D. Codified Laws § 55-9-8 ("The trustee of a trust described in § 55-9-7 shall not engage in any act of self-dealing which would give rise to any liability for the tax imposed by section 4941 (a) of the Internal Revenue Code."); id. § 55-9-7 (defining trusts to include private foundations). In general, and on the specific facts of the present case, then, there are sufficient mechanisms in place to promote and police the accurate reporting of estate values beyond just the threat of audit by the Commissioner, thereby undercutting the Commissioner's policy-based argument.

b. Non-Tax Benefits.

The idea of creating a charitable fund over which descendants have control has long been used in planning for the wealthiest families. However, recently the idea has been refined to become more useful for families of more moderate wealth.

The issue confronting the parent and the descendant is whether the descendant would be better off with a charitable fund, unreduced by estate or gift taxes, or with a personal fund from which estate or gift taxes have been paid. For simplicity, assume a combined 50% Federal and state bracket for both estate and generation-skipping tax. A parent must begin with $200,000 in order to set aside $100,000 for a child's use. Is the child better off with a charitable fund of $200,000 or a personal fund of $100,000? Similarly, in order to generate $100,000 in a personal trust for a grandchild, a grandparent must begin with about $300,000 in order to pay estate tax of about $150,000 and generation skipping tax of about $50,000 (on a tax exclusive basis). Would the grandchild be better off with a charitable fund of $300,000 or a personal fund of $100,000?

The answer to these questions will depend in large part, of course, on the economic circumstances of the family. If the child or grandchild will inherit only the assets in question, then a personal fund will almost certainly be more desirable, but if the assets in question are only a small part of the total inheritance, then a charitable fund becomes more attractive. The position of the child or grandchild in the community, the family situation of the child or grandchild, and perhaps the economic circumstances of the spouse of the child or grandchild are other factors to be considered.

A major impediment to creation of such charitable funds is the concern on the part of parents (and grandparents) that descendants be treated fairly. Where one descendant, or group of descendants, might like a charitable fund but another would not, a charitable fund is often not created. This "lowest common denominator" estate planning can be combated through a charitable fund created by disclaimer.

Suppose parent or grandparent provides for a sum to be set aside for the child or grandchild which will bear its own estate and generation skipping taxes (if any). If the child or grandchild disclaims the sum, the sum would pass into a charitable fund to be named for the child or grandchild the income from which can be "used" on an annual basis for charitable giving. The child or grandchild has a choice: accept the sum as a bequest or disclaim it into a charitable fund (or disclaim only part). If the child or grandchild disclaims, then the amount disclaimed passes into the charitable fund free of estate or generation skipping tax. If the child or grandchild accepts the bequest then all applicable estate and generation skipping taxes are paid from the bequest.

Each child or grandchild may make his or her own decision and each decision affects the child or grandchild alone. A disclaimer is a formal legal document that must be executed within nine months after the death of the parent or grandparent, and prior to executing the disclaimer the child or grandchild must not have received any benefits from the amount disclaimed. For this reason, establishing a specific sum as to which the disclaimer may apply is often a good idea—the child or grandchild may receive income from the general assets of the estate during the initial nine month period without jeopardizing the disclaimer.

The charitable fund may be created either in a private foundation or as a donor advised fund in a community foundation. The latter mechanism is more flexible because of a special rule having to do with disclaimers, namely that the disclaiming party may not direct the ultimate disposition of the disclaimed funds. Where the disclaimed assets pass to a private foundation, the child or grandchild who has disclaimed must ensure that he or she does not control the distribution of the assets or the income from them. The IRS has discussed the limited role the disclaiming party may play in PLRs 200616026, 9320008 and 9008011.

On the other hand, where the charitable fund is created as a donor advised fund in a community foundation, the problems are greatly minimized. Because the community foundation, through its board of directors, has ultimate authority over the distribution of the assets and the income, the disclaiming party does not have control. The IRS has required that the disclaiming party not vote as a member of the board of the community foundation on any distribution from the charitable fund created with the disclaimed assets. In PLR 200518012, several beneficiaries under a decedent's revocable trust proposed to disclaim interests which would, as a result, pass under the terms of the trust into a donor advised fund maintained by a public charity not subject to the control or influence of the disclaiming beneficiary. The IRS ruled the disposition would qualify for an estate tax charitable deduction. See also PLR 9532027 to the same effect.

c. Remainder Interest in Personal Residence or Farm.

In many cases the donor's personal residence will be the only real estate that she owns. As long as the donor wishes to continue to occupy the residence, an outright gift is not possible. Even if the residence is about to be sold, an outright gift may not be prompted by tax planning considerations because, in many cases, the donor can avoid the taxation of any gain under section 121.

The partial-interest rules, however, contain a special exception that makes gifts of personal residences attractive. Under this exception, the donor can give a personal residence (or a farm) to charity and retain the right to live in the residence for the rest of her lifetime. The donor receives an income tax deduction for the present value of the remainder interest. See sections 170(f)(3)(B)(i), 2055(e)(2) and 2522(c)(2) and PLRs 8711038, 9538040.

(i) What Is a Personal Residence? The property must be used by the donor as a residence but need not be the donor's principal residence; a vacation home may be a personal residence. Treas. Reg. § 1.170A-7(b)(3); Rev. Rul. 75 420. A personal residence includes all the land used in connection with the residence (77+ acres in one instance). See, e.g., PLR 8202137 donation of remainder interest in 77.33 acres of a 173.78-acre property held to be deductible.

A personal residence includes stock in a cooperative housing corporation or a condominium, provided the donor uses the property as her residence. Treas. Reg. § 1.170A 7(b)(3). A yacht, houseboat, or house trailer may be a personal residence provided it contains facilities for cooking, sleeping and sanitation and the donor actually uses it as a residence. See PLR 8015017 (yacht qualified as principal residence for purposes of section 1034); Treas. Reg. § 1.1034-1(c)(3)(i) (houseboat or house trailer qualifies as principal residence for purposes of section 1034).

The value of the remainder interest in any furnishings contributed is not deductible because these items do not constitute real property.

(ii) What Is a Farm?

[1] A farm is land and buildings used by the donor or the donor's tenant for the production of crops, fruits, agricultural products or sustenance of livestock; it includes the farmhouse and other improvements such as barns, sheds and corrals. Treas. Reg. § 1.170A-7(b)(4).

[2] A farm may include acreage with or without the farmhouse. Thus, in the case of a farm, a donor may convey a remainder interest in separate parcels at different times, e.g., a gift of remainder interests in Parcel A consisting of 10 acres of the farm in 1996, Parcel B consisting of 25 acres of the farm in 1997, and Parcel C consisting of five acres of the farm and the farmhouse in 1998. See Rev. Rul. 78-303.

(iii) Term of Reserved Interest. The gift must be an irrevocable remainder interest (not in trust) that follows a life estate in the donor and/or another, or which follows an interest for a term of years.

(iv) Gift of a Remainder Interest in the Proceeds of Sale. The IRS originally took the position that the gift of a remainder interest must be an interest in the property itself; it may not consist of the right to the proceeds of sale of the property. See Rev. Rul. 77 169 (estate tax deduction disallowed for gift of remainder interest in personal residence where will directed that, on death of life tenant, the residence was to be sold and the proceeds paid to charity); Rev. Rul. 76 543 (deduction denied where charity received only a portion of sale proceeds). The Tax Court, however, has held that a remainder interest in the proceeds from the sale of a residence will qualify for the charitable deduction, and the Service has conceded that, if local law gives a charity the option of taking the property itself despite the terms of the gift, the gift of a remainder interest in the proceeds will be treated as a deductible gift of the residence. See Estate of Blackford v. Comm'r, 77 T.C. 1246 (1981), acq. in result 1983-2 C.B. 1; Rev. Rul. 83-158; PLR 8141037. See also Rev. Rul. 84-97 in which a gift of a remainder interest in a farm was determined to qualify for an estate tax charitable deduction even though the applicable state mortmain statute required the charitable recipient to dispose of the farm within 10 years of acquisition.

To illustrate, suppose a donor gives a remainder interest in the donor's personal residence to a DAF. The DAF sells the remainder interest to a family trust for the fair market value of the remainder interest. At the donor's death, the residence passes to the DAF which has pre-sold it to the trust (and executes a deed to the trust to clean up title). The donor's estate receives an estate tax deduction. The donor has funds in the DAF to give away during the donor's lifetime.

(v) Gift of a Portion of the Remainder Interest. Similarly, the IRS used to argue that on the expiration of the life estate(s), the charity or charities must receive the entire residence outright and that a deduction was not available for a gift of a fractional interest in the remainder. See Rev. Rul. 76-544 (deduction disallowed where, upon termination of life estate, property vested in charity and individual as equal tenants in common). See also PLR 8341009. This position was clearly at odds with the principle that a gift of an undivided fractional interest is deductible; in 1987 the Service reversed its position and held that a gift of a 10 percent remainder interest was a deductible interest even though 90 percent of the interest passed to an individual, since the gift was of an undivided fractional interest. See GCM 39628 (5/18/87) and Rev. Rul. 87-37, expressly revoking Rev. Rul. 76-544. The ruling suggests that the value of the remainder interest must be reduced to reflect an appropriate valuation discount for the co-tenancy arrangement. In PLR 93366002, the IRS ruled, in connection with the valuation of a one-half interest in real property for estate tax purposes, that a discount to reflect dual ownership is generally limited to the estimated cost of a partition of the property.

(vi) Gift of the Remainder Interest Coupled with a Gift of a Partial Present Interest. A donor may make a deductible gift of the entire remainder interest, plus a fractional interest in the retained life estate, by giving a charity the right to use the property for a proportional period of each year. In Rev. Rul. 75-420 the donor conveyed vacation property (including a house, tennis court, swimming pool, gym, barn and caretaker's cottage) to a neighboring university, reserving the right to use the property from August 1 to September 15 of each year and to store his personal property year round in the home. The university could make no changes to the property without the donor's consent and could not sell its interest in the property until the later of 10 years from the date of the gift or the donor's death. The donor was held to be entitled to deduct the value of the interest contributed; the retained year round rights were held not to be substantial and the contribution qualified as a deductible gift of an undivided interest and a deductible gift of a remainder interest in the residence.

(vii) Restrictions on Disposition. The gift of the remainder interest may not be subject to restrictions as to its disposition unless the restrictions are so insubstantial in nature as to have no effect on the value of the contributed property. See Darling v. Comm'r, 43 T.C. 520 (1965) (in addition to reserving life estate, donors reserved right to determine when and whether the property should be sold as well as terms of sale; deduction for gift of remainder disallowed because donors' retained rights made it impossible to value). See Rev. Rul. 75-66. For example, the IRS has taken the position that the deduction will be lost if the life tenant can compel a charity to join in a sale of the property and divide the proceeds. See Rev. Rul. 77-305 (no deduction allowable for gift of remainder interest in residence where donors required charity to join in sale and receive cash for its interest if donors decided to sell residence). Cf. PLR 9436039 (transfer of a remainder interest was a valid gift despite various restrictions on the disposition of the residence, because the acts which could cause the gift to be revoked were not dependent on any act of the donors). The rationale for this position is highly questionable, for in such a case the charity would presumably receive value equivalent to the value of the donor's charitable deduction, and it is hard to see what purpose is gained by forcing the life tenant to continue the life estate. The position of the IRS seems to be based on the premise that the donor's reserved right to force the sale of the property makes it impossible to value the remainder interest, a premise that does not make much sense. Thus, as long as the donor cannot compel a charity to do so, it should be permissible for the life tenant and the charity, as an independent matter, after the gift has been made, to agree to sell jointly and to divide the proceeds in proportion to the value of their respective interests. See PLR 8134106. If the life tenant wishes to avoid the realization of gain on the sale of the life interest, it appears that this could be accomplished by conveying the life interest in the property to an income-only unitrust which can then sell the life interest without paying a tax on the gain.

(viii) Bargain Sale of Remainder Interest. The donor may sell the remainder interest to a charity for less than its value, in which case the bargain-sale rules will apply, and the donor will be entitled to a deduction for the difference between the value of the remainder and the amount paid by the charity. The payment for the remainder may take the form of a gift annuity. See PLRs 8120089, 8305060 and 8806042.

(ix) Valuation. The calculation of the deduction for the gift of the remainder interest begins with the fair market value of the property at the time the remainder interest is given. If the deduction claimed exceeds $5,000, then, as discussed above in Chapter 4, the donor must obtain a qualified appraisal to substantiate the income tax deduction. The $5,000 threshold is based on the value of the remainder interest rather than the value of the property itself. Treas. Reg. § 1.170A-13(c) states: "The amount claimed or reported . . . for an item of property is the aggregate amount claimed or reported as a deduction . . . for such items of property and all similar items of property . . . by the same donor for the same taxable year . . . ."

Once the fair market value of the property has been established by an appraisal, the present value of the remainder interest is calculated by discounting the fair market value to reflect the term of the life estate at the interest rate in effect when the gift is made. Section 7520 of the Internal Revenue Code requires that, for purposes of valuing all forms of remainder interests, the Treasury Department must issue monthly tables using a rate that represents 120 percent of the "applicable mid-term federal rate" under section 1274(d)(1). That rate is based on the interest rates paid on medium term (three to nine years) government securities. The donor may choose the discount rate in effect for the month in which the gift is made or for either of the two preceding months.

The low interest rate environment of recent years has had a dramatic impact at times on donors making a charitable gift. While a donor giving to a charitable remainder unitrust or charitable lead unitrust, the value of which moves up and down with the value of the underlying trust assets, will experience little or no impact on the deduction for a charitable gift due to changes in the federal rate, certain other charitable gifts have been dramatically affected.

When valuing a remainder interest in depreciable real estate for income tax purposes, the remainder interest also must be discounted to reflect straight-line depreciation. Section 170(f)(4). The computation with respect to the depreciable portion uses a special method. Depreciation need not be taken into account for gift or estate tax purposes. See Rev. Rul. 76-473 (gift tax deduction for gift of remainder interest in personal residence is calculated without taking depreciation into account; hence, gift tax deduction will be higher than the income tax deduction).

(x) Avoiding Unnecessary Gift Tax. If, in addition to reserving a personal life estate, the donor wishes to permit another person to use the property after the donor's death for the surviving person's lifetime, the gift of the successor life estate represents a gift of a future interest that does not qualify for the $17,000 annual gift tax

exclusion. Section 2503(b). Moreover, if the successor life estate is given to the donor's spouse, it does not qualify for the marital deduction because it is not a present interest. Section 2523(f); the spouse does not receive the interest "for life" because it does not take effect until the donor's death. The donor can avoid making a taxable gift of a future interest by reserving the right (to be exercised in the donor's will) to revoke the successor life estate. For gift tax purposes, this renders the gift of the successor life estate incomplete until the donor's death, at which time it will be taxable as a part of the donor's estate.

(xi) Effect of Mortgages. A gift of property subject to a mortgage is treated as though the property were sold to charity for the amount of the outstanding mortgage. While the donor ought to be able to avoid the bargain-sale rules by agreeing to hold the charity harmless, the value of the property will be reduced by the amount of the mortgage for purposes of computing the deduction. Although most residences are subject to a mortgage, there is a curious dearth of authority dealing with a gift of a remainder interest in a mortgaged residence. This may be due to the fact that donors of remainder interests have reached a stage in life where they have paid off the mortgage; but it may also reflect the fact that the issue is very complicated. Thus the law is, at best, unclear. There are at least three potential analyses:

Ignore the Life Estate.

If a donor gives a charity a remainder interest in a residence that is subject to a mortgage, the transaction might be taxed as though the donor had sold the property to the charity for the full amount of the indebtedness and the deduction might be reduced by that amount, ignoring the fact that the donor had reserved a life estate. It seems that this result would be in conflict with the economic reality of the transaction. The donor will continue to live in the residence and will make the mortgage payments during the balance of her lifetime. The gift of the remainder interest does not relieve the donor of any liability for the mortgage payments that fall due during the donor's life expectancy.

Apportion the Mortgage Between the Life Estate and the Remainder.

An alternative approach might be to apportion the mortgage between the life estate and the remainder on the basis of the fair market value of each. In this approach the donor would be deemed to have sold the property to charity for an amount equal to that portion of the mortgage equivalent to the ratio of the value of the remainder interest to the fair market value of the property. While this approach is more rational, it assumes, in effect, that the mortgage is a permanent liability and does not reflect the fact that the mortgage may, in fact, be paid off by the time the remainder interest passes to the charity.

Take the Life Estate Fully into Account.

It would seem that the most rational solution is to compare the length of the retained life estate with the remaining period of the mortgage. If the life estate is longer than the mortgage payment period so that the mortgage should be paid off in full before the remainder interest falls in, the transaction ought not to be treated as a bargain sale. As long as the donor agrees to hold the charity harmless against any liability on the mortgage, the donor ought to be entitled to a full deduction for the value of the remainder interest. In this situation, the obligation to make the mortgage payments is, in effect, similar to the donor's obligation to maintain the property during the life term.

If, on the other hand, the mortgage period extends beyond the donor's life expectancy, the gift of the remainder interest is technically subject to a liability, for if the donor dies "on schedule" the remainder interest passing to the charity will be subject to an unpaid liability. In this situation, the donor ought to be able to avoid the impact of the bargain-sale rules by agreeing to hold the charity harmless with respect to any liability arising under the mortgage. However, since the remainder interest is potentially subject to the liability for the principal portion of the mortgage payments that will fall due after the death of the donor, the donor's deduction probably ought to be reduced by the amount of that liability. As in the case of an outright gift, the donor's agreement to hold the charity harmless against the liability is, in effect, a non-deductible pledge.

(xii) Other Factors: Repairs, Insurance, Taxes, Improvements. Other factors to consider when making a gift of a remainder interest in real estate include arrangements for maintenance, insurance, repairs and improvements. Under state laws the life tenant is responsible for maintaining the property and for paying all current

operating costs (utilities, taxes, etc.). To protect the value of the property, it is advisable for the donor to agree to keep the property insured with a policy that identifies the remainder interest of the charity. The tax clause in the donor's will should be reviewed and, if necessary, revised to ensure that the property is not subjected to death taxes.

If the donor makes a capital improvement (as opposed to a repair) that increases the value of the property, the donor should be entitled to a further deduction based on the increased value of the property (which will not necessarily be measured by the cost of the improvement). In PLR 9329017, in connection with the gift of a remainder interest in real property, the Service held that the remainder interest in any improvements made to the real estate by the donor would be charitable contributions, but did not state how to value such contributions. The increase in value should be determined by an appraisal that compares the value of the property before and after the improvement. If the increase in value is greater than the cost of the improvement, the amount of the deduction should arguably be limited to cost on the theory that the donor has not "held" the improvements for the requisite long-term holding period. However, since the improvements become a part of the basic property, which if sold, would not produce any short-term capital gain, there should be a strong case for the proposition that the reduction rule of section 170(e)(1) ought not to apply. Once the appropriate value of the improvement has been determined, the deductible portion is determined by applying the appropriate remainder and depreciation factors for the donor's age at the time the improvement is made.

(xiii) Form of the Gift. A simple deed of the property to charity reserving a life estate in the donor is sufficient; it is normally good practice to cover the responsibilities for taxes, repairs and expenses in a separate-letter agreement. Since local practices for recording and perfecting title to property vary widely, a donor should consult local counsel who is knowledgeable about the local conveyance requirements.

d. Estate Income Tax Deduction. Where a decedent lacks a taxable estate, but wants to make a charitable bequest, consideration should be given to providing that the first dollars of income of the estate go to charity in an amount equal to the amount of the bequest. The estate will receive an income tax deduction if the estate has sufficient income.

PLANNING CHART

TYPE OF GIFT	DONOR BENEFITS	FAMILY BENEFITS	CHARITY BENEFITS	PREFERRED TYPE OF CHARITY
Outright Gift of Undiscounted Assets	Full income tax deduction. No payments to donor.	-0-	Charity receives income and appreciation on the contributed assets from the date of gift.	For cash and marketable securities differences are minimal. For closely-held and real estate assets, private foundation gifts are less desirable.
Outright Gift of Discounted Assets followed by family purchase or redemption	Full income tax deduction. No payments to donor. Note that the restrictions on the gift could create a future interest thus eliminating the income tax deduction	Potential value received by the family through the purchase or redemption of assets that are discounted from pro rata value.	Charity receives income and appreciation on the contributed assets from the date of gift. However, enjoyment may be postponed if the assets are illiquid.	Donor advised fund or some supporting organizations are most desirable. Public charity is a good donee but may lack experience to handle the gift efficiently. Private foundation is undesirable because of self-dealing rules.
Defined value / charitable allocation clause transfer	Full income tax deduction. No payments to donor.	Potential for discounted assets to pass to the family transferring additional value.	Charity receives income and appreciation on the contributed assets from the date of gift. However, enjoyment may be postponed if the assets are illiquid.	Donor advised fund or some supporting organizations are most desirable. Public charity is a good donee but may lack experience to handle the gift efficiently. Private foundation is undesirable because of self-dealing rules.
Bequest	No income tax deduction. No payments to donor.	-0-	Assets available at an undetermined future date.	No substantial differences. Bequests to a private foundation may be "bought out" by the family using the Probate Exception.
Disclaimer to a Charitable Fund	No income tax deduction. No payments to donor.	Potential for discounted assets to pass to the family transferring additional value.	Assets available at an undetermined future date.	Donor advised fund or some supporting organizations are most desirable. Public charity is a good transferee but may lack experience to handle the gift efficiently. Private foundation is undesirable because of self-dealing rules regardless of the probate exception.

TYPE OF GIFT	DONOR BENEFITS	FAMILY BENEFITS	CHARITY BENEFITS	PREFERRED TYPE OF CHARITY
Gift Annuity	Partial income tax deduction. Annuity payments to donor.	-0-	Assets available immediately, subject to an obligation to make annuity payments.	Public charity is almost always the best choice.
Charitable Remainder Trust	Partial income tax deduction. Annuity or unitrust payments to donor.	-0-	Assets available in the future, date may or may be fixed. Asset may be monetized through a fair market value sale.	The income tax deduction for gifts to private foundations is limited and monetizing the interest of a private foundation may be difficult.
Remainder interest in house or farm	Partial income tax deduction. Donor may use the house or farm for life.	If remainder interest is purchased by the family, potential for value to transfer depending on the appreciation rate of the asset and the length of the donor's life.	Assets available in the future at a date that is not fixed. Asset may be monetized through a fair market value sale.	Private foundations are undesirable recipients.
Charitable Lead Trust - - Constant Annuity	Typically no income tax deduction but income is removed from the donor's taxable income base. No payments to donor.	Assets available in the future, date may or may not be fixed.	Annuity or unitrust payments to charity.	Any charitable donee. Private foundations do not have to include the assets of the lead trust when calculating the annual 5% distribution.
Charitable Lead Trust - - Increasing Annuity or Shark-Fin CLAT	Typically no income tax deduction but income is removed from the donor's taxable income base. No payments to donor.	Assets available in the future, date likely to be fixed at the end of a specified term.	Annuity payment to charity largely deferred until the end, or close to the end, of the trust term. Minimal payments until then.	Private foundations less desirable because the charitable donee must be free to challenge the investment of trust assets during the term, and to ensure that all trustee actions are independent.

G. **Planning for Retirement Assets**.

Let us remind ourselves why retirement benefits are so unique so as to warrant a disproportionate amount of our planning time.

- During a participant's life, retirement plan assets, while enjoying terrific income tax deferral options, remain "pregnant" with future income tax liability.
- Maximum funding of retirement plan assets is a very effective asset protection technique.
- The mere completion of a beneficiary designation form, which happens on too many occasions with the assistance of someone who provides no tax or planning advice whatsoever, may greatly impact the amount and the timing of income taxation on the distribution of these benefits.
- Unlike any other asset, directing retirement benefit assets to a trust involves a myriad of complicated rules and planning implications, as well as potential non-sensical income tax results (albeit a different set of implications under the SECURE Act).
- Unlike most items of inheritance, every dollar distributed from a qualified retirement plan to a non-charitable beneficiary is subject to income tax.
- In some states, a beneficiary's interest in a deceased participant's retirement plan can continue to enjoy creditor protection.
- Retirement plan benefits open the door for a variety of proactive charitable planning techniques (especially after the SECURE Act!)

1. How to reduce your clients RMDs.

a. Your client can buy a qualified longevity annuity contract inside his or her IRA. This contract does not start paying the client an annuity until the client attains age 85. The funds used to purchase the annuity will have many years to accumulate and grow, so the income eventually received will be larger. Normally, such a delayed annuity is not permitted for IRAs, as the minimum distribution rules require RMDs no later than the RBD. The IRS has made an exception for qualified longevity annuities with up to the lesser of $200,000 or 100% of the IRA owner's total IRA balance.

b. If a client is still working after attaining age 73, he or she may be entitled to reduce compensation income by tax deductible contributions to some type of retirement plan. These tax deductible contributions provide a current tax deduction reducing the income tax effect of his or her RMDs from other IRAs. If the client is self-employed, the client can adopt a SEP-IRA, to which such contributions may be made.

c. If your client works for a non-profit entity, or a for-profit company if the client has less than 5% ownership in that company, and such entity has a qualified retirement plan that accepts rollovers from IRAs, the client can rollover his or her IRA into the company plan and then not have to take RMDs from that plan until actual retirement from that employer.

d. If the client participates in an employer's qualified retirement plan, and has "after-tax money" in that plan, then upon retirement from that company the client should request that the plan send a direct rollover of all pre-tax money to a traditional IRA and the after-tax money to a Roth IRA. In essence, this is a tax-free Roth IRA conversion.

e. Of course, there is always the plain old Roth conversion of the client's traditional IRA, as Roth IRAs do not require RMDs during the owner's life. However, the client must be willing to pay tax on the amount converted as though it were distributed from the plan at that time.

f. We also have the ability to make a Qualified Charitable Distribution, discussed in more detail later in this outline.

2. Distributions After Death if the Spouse is Beneficiary.

a. The concept of a spousal rollover was NOT changed by the SECURE Act. We are all familiar with the rules enabling a spouse to roll over retirement benefits upon the death of his or her spouse, and they will not be repeated here. However, there are a few recent developments in this area that are worth discussing.

b. In 2009, the ACTEC Estate Planning for Employee Benefits Committee initially requested that the IRS issue a revenue ruling with respect to spousal rollovers of qualified plan and IRA benefits when an estate or trust is named beneficiary of a decedent's interest.

(i) This request was repeated in 2010 and every year thereafter, and guidance on this issue has been requested in connection with the ACTEC recommendations for the IRS Guidance Priority Plan in each of the last several years. So far, this has fallen upon deaf ears.

(ii) Several hundred favorable private letter rulings have been issued over the last ten years, and it makes no sense for taxpayers to expend the filing fee required for a private ruling.

(iii) As an example, in PLR 201511036, the IRS allowed spousal rollover treatment when the decedent's estate was named as beneficiary of several IRAs, and the spouse was the executor of the estate, the Trustee of decedent's trust, and was the income beneficiary and had a general power of appointment over the trust which was ultimately to receive the IRA proceeds.

(iv) The most recent rulings in this regard include PLR 201821008, wherein the "default" beneficiary was the IRA owner's estate, and the surviving spouse was the personal representative of the decedent's estate and the sole beneficiary of the estate. This favorable ruling was issued even though the IRA provider withheld taxes on the IRA distribution prior to paying the net amount over to the estate. The spouse received good advice, as she deposited the amount of the net proceeds plus the amount of the taxes withheld into a spousal rollover IRA in her name. In PLR 201831004, the IRS approved a spousal rollover when the beneficiary was the decedent's "Survivor's Trust" under a joint spousal trust, under which the surviving spouse was the sole income and principal beneficiary and had an unlimited power of appointment over the Trust. A similar result was more recently obtained in PLR 201923002.

(v) PLR 201839005, wherein the decedent did NO estate planning, the IRS examined a ruling request involving decedent's retirement plan under which the decedent failed to designate any post-death beneficiary. The plan provided that, in such event, the plan benefit was payable to decedent's estate. Under applicable state law, decedent's estate would be split between surviving spouse and children. The children all executed valid disclaimers of their interests in the decedent's estate, leaving spouse as the sole beneficiary of the estate. The IRS blessed spousal rollover treatment, after all of these timely post-death maneuvers.

(vi) PLR 201901005 involved similar facts as PLR 201839005, except a Trust was named as IRA beneficiary. Trust timely disclaimed its interest, and then son and two grandchildren all timely disclaimed their respective interests in decedent's estate, leaving only the spouse as a beneficiary of the estate. IRS again blessed spousal rollover treatment.

(vii) PLR 201944003 reached a similar result with respect to a Survivor's trust share of a joint community property trust.

c. The immediate spousal rollover is not always the best strategy.

(i) If the surviving spouse is under 59 ½ years of age, he or she should consider delaying the rollover until he or she attains the age of 59 ½ years. In that manner, he or she can take some distributions prior to that date of attainment without paying a premature withdrawal penalty.

(ii) If the surviving spouse is older than the decedent, who died before attaining age 73, then the survivor can continue tax-free deferral and do a delayed rollover.

d. The Impact of the Windsor Ruling.

(i) As we all know, on June 26, 2013, the U.S. Supreme Court held in U.S. v. Windsor, 133 S.Ct. 2675 (2015) that Section 3 of the Defense of Marriage Act "DOMA" is unconstitutional.

(ii) The IRS issued follow-up guidance for same-sex marriages in Revenue Ruling 2013-17 and Notice 2014-19.

(iii) Generally, participants and their spouses who are in same-sex marriages must be treated as married for all purposes under a qualified retirement plan as of June 26, 2013.

(a) A sponsor of a qualified retirement plan may elect to recognize same-sex marriages as of a date that is prior to June 26, 2013, for some or all purposes under the plan. A plan amendment would be required to implement this optional retroactive effective date.

(b) If a qualified plan defines "spouse", "legally married spouse", "spouse under federal law", etc. in a manner consistent with Windsor, or does not define those terms, then the plan does not need to be amended so long as the plan has been properly administered.

(c) However, if the plan's definitions of these terms are not consistent with the holding in Windsor, then the plan must be amended.

(iv) For ERISA, Internal Revenue Code, and DOL Regulation purposes, the following is true:

(a) The term "spouse" includes an individual married to a person of the same gender IF he or she is lawfully married under state law (including foreign jurisdictions).

(b) The term "marriage" includes a marriage between individuals of the same gender.

(c) The term "spouse" does not include an individual in a registered domestic partnership or a civil union, and the term "marriage" does not include a registered domestic partnership or a civil union.

(d) A same-sex marriage validly entered into in a state or foreign jurisdiction that permits same-sex marriages will be recognized regardless of whether the couple moves to or lives in a state that does not permit or recognize same-sex marriages.

(v) In Schuett v. FedEx Corporation, et al., No. 15-CV-0189, N.D. Calif., 2016 U.S. Dist. LEXIS 224, the Federal District Court in the Northern District of California applied Windsor retroactively, allowing a lesbian widow to pursue her claim to spousal benefits under her deceased spouse's pension plan. This same sex couple was married on June 19, 2013, and one of the spouse's passed away one (1) day later. Six (6) days later, the United States Supreme Court issued its decision in Windsor.

e. The impact of the Obergefell holding.

(i) Following in the wake of Windsor in 2013, on June 26, 2015, the United States Supreme Court in Obergefell v. Hodges, 135 S.Ct. 2584 (2015) held that same-sex married couples are entitled to equal protection under the laws of every state, and that their marriages must be recognized nationwide. As such, any state prohibitions against the recognition of a same-sex marriage were held to violate the 14th Amendment and were invalidated.

(ii) Because state laws banning same sex marriage are effectively invalidated, after Obergefell, same-sex couples are afforded the same spousal rights that other couples enjoy. Spousal rights that occur independent of proactive planning and that are now equally granted to same-sex couples include, among others, (i) spousal survivorship rights under state pension or other retirement benefits, even in states that previously did not recognize same-sex marriage and the ability to file tax returns as a married couple and (ii) take advantage of the married couple's state estate tax exemption where applicable.

(iii) After Windsor, same-sex married couples are to receive equal treatment under federal law and are to be treated the same as any other married couple for federal tax purposes and for other benefits under federal law (including spousal rights under ERISA, etc.). Now, in the aftermath of Obergefell, same-sex couples have been elevated to equal stature with other marriages and are entitled to equal protection under the laws of every state.

3. Distributions After Death if a Non-Spouse is Beneficiary

a. If someone other than the spouse is the beneficiary, under the SECURE Act, the beneficiary's RMD now depends on whether there is a (1) "Designated Beneficiary" ("DB"), (2) "Eligible Designated Beneficiary" ("EDB"), or (3) "non-Designated Beneficiary" ("non-DB") of the account.

b. The term "Designated Beneficiary" is specifically defined in Treasury Regulation § 1.401(a)(9)-5, and was not changed by the SECURE Act. Although individuals qualify as Designated Beneficiaries, estates, states, charities, and business entities do not qualify as Designated Beneficiaries for these purposes. Treas. Reg. § 1.401(a)(9)-4. As discussed in more detail later in this outline, only certain trusts qualify as a Designated Beneficiary.

c. The term "Eligible Designated Beneficiary" has been introduced by the SECURE Act. An Eligible Designated Beneficiary is:

(i) The surviving spouse of the participant.

(ii) A minor child of the participant (not just any minor child). The life expectancy payout applies to the child until the child attains the age of majority…..then the ten year rule starts. There was lots of uncertainty created by the SECURE Act itself as to when the age of majority is reached. The proposed regulations provide a bright line rule that age 21 is the age of majority.

(iii) A disabled individual (as defined in section 72(m)(7)). The life expectancy payout applies to the disabled individual, and upon his death, the ten year rule starts.

(iv) A chronically ill individual (as defined in section 7702B(c)(2)). The life expectancy payout applies to the chronically ill individual, and upon his death, the ten year rule starts.

(v) An individual who is less than ten years younger than the participant. The life expectancy payout applies to this beneficiary, and upon his death, the ten year rule starts. The proposed regulations modify this provision by basing the less than ten years younger determination on actual dates of birth.

d. A trio of 2016 private letter rulings illustrate the rigidity of the Designated Beneficiary rules. In each of these letter ruling fact patterns, the taxpayer had designated a beneficiary on his IRA showing three separate trusts, each of which qualified as a Designated Beneficiary. Later that year, the taxpayer's financial advisors joined another firm and became affiliated with a different custodian, which required new IRA documents. At that time, the custodian had the taxpayer sign new beneficiary forms, which named the taxpayer's estate as the primary beneficiary. Upon the owner's death, this error was discovered and the trustees of the trusts petitioned the local probate court to reform the beneficiary designation retroactive to the time before the mistaken form was executed by the decedent which relief was granted by the local court. However, in each of these rulings, the IRS refused to recognize the reformed designations, and held that the estate was the beneficiary at the time of the taxpayer's death, and therefore, none of the IRAs had a Designated Beneficiary.

e. If there is a Designated Beneficiary -

(i) If the taxpayer died before the taxpayer's RBD, then the beneficiary's interest must be withdrawn within ten (10) years after the participant's death. The proposed regulations confirm that the "ten-year rule" shall be applied in the same manner as the older "five-year rule." There is NO requirement of annual distributions, as long as the entire interest is paid out by the end of the calendar year which includes the tenth anniversary of the participant's death.

(ii) If the taxpayer died after the taxpayer's RBD, the proposed regulations provide that BOTH (i) the ten (10) years after the participant's death rule applies; and (ii) the taxpayer's life expectancy from the Single Life Table, based on the taxpayer's age in the calendar year of the taxpayer's death ("the ghost life expectancy") rule applies. In other words, the designated Beneficiary must take annual distributions based on the "ghost life expectancy" beginning in the year following the year of the participant's death, AND in any event, the entire account must be distributed by the end of the tenth year. In a very confusing twist, the proposed regulations further provides that in applying the "ghost life expectancy," the denominator is the greater of the participant's remaining life expectancy, or the beneficiary's life expectancy.

f. If there is an Eligible Designated Beneficiary –

(i) For most of the Eligible Designated Beneficiaries, a life expectancy payout may still be taken, using existing IRS life tables. Upon the death of the Eligible Designated Beneficiary, the ten-year payout rule then ensues. However, the proposed regulations provide that annual distributions are required during the ten year period!

(ii) The proposed regulations provide that an Eligible Designated Beneficiary of a participant who dies before his or her RBD can elect to use the 10 year rule in lieu of the life expectancy payout.

(iii) For a minor child of the participant, a life expectancy payout is used until the earlier of the death of the child or the child attaining the age of majority. Thereafter, a ten-year payout rule is used.

(iv) For a "disabled" or "chronically ill" beneficiary, the documentation of such status is a critical issue.

(a) If the named beneficiary has already been determined disabled for purposes of Social Security disability benefits purposes, the beneficiary does not need to convince the IRS of his or her disability. An individual who has attained age 18 as of the participant's death is "disabled" if, as of that date, such individual is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result on death or be of long-continued and indefinite duration.

(b) If such individual is under age 18, he or she is disabled if that person has a medically determinable physical or mental impairment that results on marked and severe functional limitations and can be expected to result on death or be of long-continued and indefinite duration.

(c) TO QUALIFY AS AN EDB, the beneficiary who is either disabled or chronically ill must provide the plan administrator documentation of the disability or chronic illness no later than October 31 of the year following the year of the participant's death, and for chronically ill beneficiaries, such documentation must also include a certification from a licensed health care practitioner.

(d) Many disabled beneficiaries do not qualify for "SSDI", and therefor do not have an SSDI determination.

(e) ACTEC has made a couple of key recommendations for revising these proposed regulations in this regard. First, we suggest the usage of the regulations under the "ABLE" tax law in lieu of the SSDI determination. Second, we suggest that the determination of disability of a minor be deferred until the minor attains the age of 21 years.

g. If there is <u>no</u> Designated Beneficiary –

(i) If the taxpayer died before the taxpayer's RBD, then the beneficiary must withdraw all of the retirement account within 5 years of the taxpayer's death.

(ii) If the taxpayer died after the taxpayer's RBD, then the beneficiary's RMD is based on the Single Life Table that takes into account the deceased taxpayer's life expectancy immediately before death ("the ghost life expectancy").

h. The beneficiary may withdraw more than the RMD in a given year, but the beneficiary must withdraw at least the RMD each year to avoid IRS imposition of a penalty.

(i) Although payouts other than lump sum distributions in IRAs are common, not all IRAs offer this option.

(ii) Many qualified plans typically require a lump sum distribution upon death.

(iii)) However, the Pension Protection Act of 2006 added Code § 402(c)(11), which now allows a non-spouse Designated Beneficiary to rollover a qualified plan account into an IRA by a trustee to trustee transfer.

4. <u>Leaving Retirement Assets To Trusts</u>

a. Situations In Which Trusts Are Crucial

(i) In some situations a trust must be named as beneficiary, such as when (i) the beneficiary is a special needs child that relies on government benefits, (ii) the beneficiary is a second spouse whom you want to have limited access to the trust principal, (iii) the beneficiary is a minor, and (iv) the beneficiary is a spendthrift, has substance abuse problems.

(ii) In these situations, the client may decide the reasons for naming a trust as beneficiary of the IRA outweigh the potential of lost income tax deferral, or may decide a look-through trust is appropriate.

5. <u>What Are Look-Through Trusts, or See-Through Trusts?</u>

a. A trust that qualifies as a Designated Beneficiary is often referred to as a "look-through trust" or "see-through trust". This has not changed under the SECURE Act. The proposed regulations officially adopt certain terminology that we have used in some fashion for some time. A "see-through trust" is a trust that is treated as a DB for required minimum distribution purposes. A "conduit trust" (discussed below) is one kind of a see-through trust. An "Accumulation trust" is any qualified see-through trust that is not a conduit trust.

(i) If a taxpayer names a see-through trust as the beneficiary, then the trust will qualify as Designated Beneficiary (same as the old law), and may qualify as an Eligible Designated Beneficiary.

(ii) In essence, for these purposes, the trust is ignored and the beneficiaries of the trust are treated as the beneficiaries of the retirement account. This analysis remains important under the SECURE Act.

b. An Accumulation trust must satisfy five tests to qualify as a Designated Beneficiary. <u>These rules were not changed by the SECURE Act</u>.

(i) The first four tests are as follows: (i) the trust must be valid under state law, (ii) the trust must be irrevocable or become irrevocable at the taxpayer's death, (iii) the trust beneficiaries must be identifiable, and (iv) certain documentation must be provided to the plan administrator or IRA custodian by October 31 of the year after the taxpayer's death.

(ii) If these four tests are met, then the trust is a Designated Beneficiary.

(iii) There is, in essence, a fifth test for the trust to be a Designated Beneficiary, as all of the beneficiaries of the trust must be individuals the oldest of whom can be identified. Herein lies our time-honored dilemma in drafting see-through trusts.

(iv) What Trust Beneficiaries Can Be Ignored?

(a) It has historically been a challenge to draft a trust that only has individual beneficiaries and where it is possible to ascertain the oldest beneficiary (especially when the IRS has not told us which contingent beneficiaries can be ignored!).

(b) The current official regulations provide that if the first four tests above are met, then the beneficiaries of the trust are considered beneficiaries of the retirement account. The question is, which beneficiaries must be considered?

(c) The current official regulations provide two rules in this regard.

[1] The general rule is that with respect to determining if there is a beneficiary of the trust that is not an individual (which would disqualify the trust as a Designated Beneficiary), and determining who is the oldest beneficiary, a "contingent beneficiary" must be taken into account.

[2] The second rule provides that, a person will not be considered a beneficiary for purposes of determining who is the beneficiary with the shortest life expectancy, or whether a person who is not an individual is a beneficiary, merely because the person could become the successor to the interest of one of the employee's beneficiaries after that beneficiary's death. However, the preceding sentence does not apply to a person who has any right (including a contingent right) to an employee's benefit beyond being a mere potential successor to the interest of one of the employee's beneficiaries upon that beneficiary's death.

[3] This rather unhelpful regulation tells us that a "contingent beneficiary" must be taken into account, but a "mere potential successor" beneficiary can be ignored. However, it does not bother to define these terms!

(v) Recent private IRS letter rulings have not been terribly helpful in providing additional guidance as to which contingent remainder beneficiaries can be ignored.

(a) Under the IRS's analysis in these rulings, if a trust is to distribute the assets outright to a beneficiary upon a life income beneficiary's death, then the only remainder beneficiaries that must be counted are the individuals that would receive those assets, provided those individuals are alive on the taxpayer's death and they have already attained the required age to receive the assets outright.

(b) This ruling is not helpful to dynasty trusts or lifetime trusts with periodic principal distributions or withdrawal rights, as the beneficiary may never be required to take outright ownership of the trust assets.

(vi) PLR 201633025, published in mid-August of 2016, shed very important light on the IRS' then current thinking on this issue.

(a) In this ruling, a trust was named as beneficiary of an IRA. Under the terms of the trust, the Trustee is to distribute all of the net income of the trust to the decedent's child, and the trustee also has discretion to make principal distributions to the child or the child's issue for health, education, support or maintenance. When the child attains age fifty (50), the trust will terminate and all remaining income and principal will be distributed to the child.

(b) If the child dies prior to attaining age fifty (50), the trust provided that the trust will terminate and will be distributed to the children of the child. If the child and all of the child's issue are deceased prior to the final distribution of the trust assets, the trustee shall distribute the remaining trust assets to the decedent's siblings. If the child, all the child's issue, and the decedent's siblings are all then deceased, then the rest of the trust shall be distributed to various charitable organizations.

(c) The IRS ruled that the only beneficiaries which must be taken into account are the child and the child's children for purposes of determining whether the trust qualifies as a "Designated Beneficiary" for RMD purposes. Therefore, the trust qualified as a "see-through" trust and the trust may receive minimum distributions after the owner's death based on the child's life expectancy. All other potential recipients of the trust were deemed to be mere potential successors! Of course, under the new SECURE Act, this ruling only allows the usage of a ten year period instead of a five year distribution period in a similar fact pattern.

(vii) PLR 201840007 is a great recent example of post-mortem maneuvering in order to achieve "see-through" trust treatment and resulting stretching of an IRA payable to decedent's revocable trust.

(a) Decedent's trust was named as the primary beneficiary of decedent's 401(k).

(b) Upon decedent's death, the trust splits into three (3) separate describing trusts for each of decedent's three (3) oldest children.

(c) After decedent's death, the Trustee of the trust engineered a severance agreement which split each of the three children's trusts into a Trust A and Trust B. Each Trust A and Trust B has different sets of descendants as default remainder beneficiaries.

(d) Each discretionary trust has that child as primary beneficiary. Upon the death of such child, if he or she has attained age thirty (30), such child has a broad special power of appointment, with the potential appointees including any person or charity, other than the child's estate, the creditors of the child, or the creditors of the child's estate.

(e) On September 30 of the year following the decedent's death, as to the Trust share receiving the IRA, each of the three children executed a Partial Release of Power of Appointment, whereby each released his or her right to appoint to any charity or any individual other than an individual younger than the oldest child.

(f) The IRS ruled that each of the subtrusts qualified as see-through trusts, and RMD's may be stretched over the life expectancy of the oldest child. Under the SECURE Act, this successful see-through ruling under these facts would only buy a ten-year stretch.

(viii) The proposed regulations under Section 401(a)(9) provide some additional guidelines in determining "countable" beneficiaries.

(a) First, certain "specified beneficiaries", or any beneficiaries who could receive amounts in the trust representing the participant's interest in the plan or IRA that are neither contingent upon, nor delayed until, the death of another trust beneficiary, are always "countable".

(b) Second, certain "secondary beneficiaries", or a beneficiary who could receive amounts in the trust representing the participant's interest in the plan or IRA that were not distributed to the "specified beneficiaries," are NOT countable in the case of conduit trusts, but almost always countable in the case of see-through trusts.

(c) Third, a third category of beneficiaries are those who could receive amounts from the trust that represent the participant's interest in the plan or IRA solely because of the death of a

secondary beneficiary. This third category of beneficiaries are NOT countable. However, if a beneficiary qualifies as both a secondary beneficiary and in the third category of beneficiary, he is characterized as a secondary beneficiary.

(ix) The proposed regulations still leave uncertainty in this area, as the example in the proposed regulations is very simplistic, leaving open the consequences of dynastic trusts and "spray" trusts. Again, ACTEC has suggested additional examples that provide more clarity in result for these trusts.

6. <u>"Conduit Trusts"</u>

a. Fortunately, the 401(a)(9) regulations do provide a type of safe harbor trust, a "conduit trust", where a beneficiary will be treated as a Designated Beneficiary. And now, the proposed regulations officially bless the label, "conduit trust"!

(i) A conduit trust requires the trustee to distribute all of the retirement account withdrawals to the beneficiary.

(ii) The trustee may use conduit trust assets to pay expenses attributable to such assets.

(iii) As the trust may not accumulate any assets withdrawn from the retirement account, the IRS allows the trust beneficiary to be treated as the Designated Beneficiary of the retirement account.

b. Although conduit trusts have the advantage of certainty as they are specifically described in the treasury regulations, they also have a major disadvantage.

(i) A conduit trust cannot withdraw retirement account proceeds and accumulate them inside of the trust.

(ii) This is often contrary to the intent of the client, who may be using a trust to prevent the retirement account assets from being distributed to the beneficiary for one reason or another.

c. In PLR 201902023, the IRS ruled that, when a revocable trust named as IRA beneficiary establishes a subtrust with conduit trust provisions to hold any retirement plan benefits payable to the revocable trust, such structure achieves the status of a conduit trust and a Designated Beneficiary.

d. Under the SECURE Act, depending directly on how an existing conduit trust is drafted, it may very well tie the hands of the individual beneficiary by either forcing the entire IRA to be paid out in the tenth year, or forcing the IRA to be paid out in ten annual installments. To the contrary, an accumulation trust which qualifies as a Designated Beneficiary allows the Trust to take out the distributions at any time within the ten-year period. Accordingly, the usage and drafting of a conduit trust must be carefully evaluated going forward.

e. Nonetheless, a conduit trust will be very important for preserving Eligible Designated Beneficiary status for a trust for certain beneficiaries.

(i) A conduit trust for a spouse, unlike an accumulation trust, results in the spouse being considered the sole beneficiary of the IRA, the trust not having to begin minimum distributions until the end of the year in which the decedent would have attained age 73, the spouse's life expectancy, recalculated annually, being the applicable distribution period, and ten year rule will not apply while the spouse is alive. Beginning in 2024, under SECURE 2.0, a spousal conduit trust can elect to use the Uniform Life Table, AND we believe continue to recalculate annually, which allows for even more deferral with spousal conduit trusts.

(ii) A conduit trust for a minor child will allow a modified stretch, until the child reaches the age of majority, followed by a ten year distribution period.

f. Proposed Regulation Section 1.401(a)(9)-4(f)(1)(ii)(A) removes any uncertainty that a conduit trust is permitted to have multiple current beneficiaries.

7. Other Issues Applicable to Accumulation Trusts

a. The compressed income tax brackets of a trust lead to a significant tax cost to the usage of an Accumulation trust.

(i) A trust pays the highest rate of tax after the first $14,450 in income.

(ii) If significant amounts will likely be accumulated, the income tax cost is a significant detriment to consider before utilizing this type of trust.

b. Naming an Accumulation trust for an Eligible Designated Beneficiary as IRA beneficiary can be problematic.

(i) Despite the fact that the primary beneficiary of an Accumulation trust is an Eligible Designated Beneficiary, other countable beneficiaries of the trust are not Eligible Designated Beneficiaries, and thus the general rule is that the trust will not qualify as an Eligible Designated Beneficiary. An Accumulation trust for either a spouse or a minor child may NOT qualify as an Eligible Designated Beneficiary.

(ii) An exception under the SECURE Act allows an accumulation trust for a chronically ill or disabled beneficiary to qualify as an Eligible Designated Beneficiary, despite the existence of future other trust beneficiaries. The trust will be considered an "applicable multi-beneficiary trust" ("AMBT") if such trust has more than one beneficiary, each of which qualify as Designated Beneficiaries, and at least one of such beneficiaries is either a disabled or chronically ill beneficiary. If the applicable multi-beneficiary trust is required by the terms of the instrument to be divided immediately upon the death of the participant into separate trusts for each beneficiary, and all post-death distributions, gains and losses shall be shared ratably between the separate trusts, the revocable trust will qualify as a "Type I AMBT". As long as there is no beneficiary other than a chronically ill or disabled beneficiary who has any right to the IRA until the death of all chronically ill or disabled beneficiaries, then this specific trust share will qualify as a "Type II AMBT" and a stretch over the life of the chronically ill or disabled. The proposed regulations provide a roadmap for qualification of an Type I AMBT and a Type II AMBT.

(iii) The proposed regulations bring additional relief, a safe harbor, in drafting for minor beneficiaries. If the trust requires complete distribution of the plan or IRA to an individual on or before the end of the tenth calendar year following the calendar year in which the minor attains the age of majority, or the end of the calendar year after the year of the minor's death if earlier, any beneficiary who receives nothing UNLESS a the minor dies before that point is not a countable beneficiary. This creates a safe harbor trust (now popularly referred to a an "Age 31 Trust") possibility for a participant's minor children, which will qualify as an EDB, EVEN IF a non-DB is a remainder beneficiary of such trust.

(iv) This safe harbor structure in fact is not limited to minor children. Any accumulation trust for any individual who is younger than 31 which provides for complete distribution of the plan or IRA to the individual beneficiary no later than his or her 31st birthday, can have its remainder beneficiaries not counted as beneficiaries for RMD purposes. For example, if the accumulation trust meets the above test, then the remainder beneficiaries who would take if the individual dies before attaining age 31 can include charities, and the trust will STILL be characterized as a DB (or an EDB).

c. Post-Death Changes to Trusts Which Are Beneficiaries of QRPs or IRAs.

(i) Powers of appointment. What if the trust which is named as a beneficiary of a QRP or IRA provides that, upon the life income beneficiary's death, the life income beneficiary has a power of appointment over the remaining trust property. The proposed regulations provide that the existence of such a power of appointment will not cause the trust to fail the requirement that the individual beneficiaries be "identifiable".

(a) However, the remainder of the proposed regulation in this regard illustrates a fundamental misunderstanding of powers of appointment (i.e., what constitutes an "exercise" of a power of appointment, the function of "takers in default", etc.). If the power of appointment is exercised by the power holder on or before the Beneficiary Determination Date ("BDD") of September 30 of the year following the year of the participant's death, then those individuals named in such exercise are treated as the remainder beneficiaries designated under the plan. Additionally, if in lieu of an exercise of the power of appointment, before the BDD, the power-holder has "restricted" it so that the power can be exercised at a later time in favor of only two or more identifiable beneficiaries, the those individuals are treated as the "countable" remainder beneficiaries designated under the plan. If by the BDD, the power of appointment is not exercised or restricted, then the takers in default under the trust instrument are treated as the beneficiaries designated under the plan.

(b) We know that a testamentary power of appointment is not exercised until the power holder's death. It seems that Treasury is considering the execution of a purported exercise by the power holder as an exercise for purposes of these regulations. We also know that a "restriction" is typically not itself an "exercise", and therefore it is legally incorrect to ignore takers in default when there is a restriction but no exercise. ACTEC decided to NOT attempt to correct this misunderstanding, in favor of having some bright line rules to live by.

(c) Under the proposed regulations, if the power holder exercises such power of appointment AFTER the BDD, then a prospective change to the minimum distribution schedule may need to be made.

(d) This section of the proposed regulations, while helpful in some respects, need more work! ACTEC has recommended a couple of additions, along with illustrative examples; first, inserting a certification requirement by the IRA provider as of the Beneficiary Determination Date, and a requirement of an updated certification upon any changes to the "exercise" of the power of appointment.

(ii) Post-death modification of the trust. First of all, the proposed regulations make clear that the mere possibility of post-death modification does not prevent the trust from being a DB. If a post-death reformation or decanting of a trust occurs, the turns will need to be RE-evaluated for RMD purposes, and if the distribution period is accelerated, or the trust no longer qualifies as a DB, then the RMD is prospectively recomputed, so in any event, a complete re-computed distribution is not required until the next calendar year.

8. Marital Trusts

a. We are all aware that one of the major requirements for a marital trust (either a general power of appointment trust or a QTIP trust) is that the surviving spouse be entitled all income of the Trust, at least annually.

b Rev. Rul. 2006-26, considered whether the "all income" requirement of I.R.C. §2056 and Treas. Reg. §§20.2056(b)-5(f)(1) and 20.2056(b)-7(d)(2) was satisfied in three fact situations. In each, a marital deduction trust held an IRA or a defined contribution plan.

(i) Assuming that a QTIP marital trust was governed by the law of a state that had adopted the 1997 version of the Uniform Principal & Income Act ("UPIA"), the ruling concluded that the trust may not meet the "all income" requirement if: (1) the trust language did not require the trustee to distribute to the spouse the greater of all the income of the IRA (considered as if the IRA were a separate trust) or the annual required minimum distribution under I.R.C. §408(a)(6), and (2) the governing law included §§409(c) and (d) of the 1997 version of the UPIA.

(a) This was because UPIA §409(c) provided that a required minimum distribution from the IRA was allocated 10 percent to income and 90 percent to principal of the recipient trust, whereas the view of the IRS was that such an apportionment between principal and income was not based on the total return of the IRA and did not reflect a reasonable apportionment of the total return between income and remainder beneficiaries.

(b) If the trust language did not require the distribution of at least the income of the IRA when the spouse exercised the spouse's right to direct a withdrawal and UPIA §409(c) applied, the "all income" requirement may not be satisfied, according to the ruling.

(c) Although §409(d) of UPIA 1997 states that a trustee must allocate a larger portion of any distribution to income to the extent that doing so is necessary to qualify for the marital deduction, the Service in Rev. Rul. 2006-26 stated that this provision was ineffective to reform an instrument for tax purposes, analogizing the statute to a savings clause in a document that would be ineffective to reform the document for federal tax purposes.

(ii) This ruling set forth a "safe harbor" that would apply if a QTIP election were made over both the trust and the IRA or retirement plan and the spouse had the power exercisable annually to compel the trustee to withdraw the income earned on the IRA or retirement plan and to distribute that income and all income earned on the other trust assets to the spouse.

(iii) The ruling concluded that marital trusts governed by §§409(c) and (d) of UPIA 1997 could not qualify for the safe harbor.

c. The Uniform Law Commission considered Rev. Rul. 2006-26 and made the changes discussed below to permit trusts governed by the 2008 version of the UPIA to qualify for the above-described safe harbor.

(i) The 2008 UPIA §409 retains a 90/10 allocation for trusts other than QTIP and general power of appointment marital trusts.

(ii) However, for trusts intended to qualify for the estate tax marital deduction, the trustee is required to separately determine the income of each "separate fund" in such a trust for each accounting period. Separate funds include annuities, IRAs, pensions, profit sharing and bonus sock funds and stock ownership plans.

(a) All distributions received by a trust from such a separate fund are considered income until the income determined in this manner is reached. Distributions in excess of that amount are considered principal.

(b) If the distributions are less than this amount, the 2008 UPIA §409 states that the spouse may require that the trustee allocate principal from a source other than the separate fund to income, to make up the difference.

(c) Subsection (f) of the 2008 UPIA §409 requires that a trustee demand that the person administering the fund distribute the internal income to the trust upon the request of the surviving spouse.

(d) Under UPIA 2008, if a trustee cannot determine the income of a separate fund, the trustee is to apply a percentage between 3 and 5 percent, depending on the adopting state's choice, to the fund's value to determine the income.

(e) Further, if the value of the separate fund cannot be determined, the trustee is to compute an income equivalent by multiplying the I.R.C. §7520 rate by the present value of the payments, based on the §7520 rate.

d. The Service has published no new guidance on this issue since the 2008 revisions to the UPIA.

(i) A new revenue ruling replacing Rev. Rul. 2006-26 and concluding that the "all income" requirement is satisfied by marital trusts governed by the laws of a state adopting §409 of UPIA 2008 is needed.

(ii) ACTEC has formally requested that the Service to issue a revenue ruling concluding that marital trusts governed by UPIA 2008 that hold IRAs or defined contribution plan benefits satisfy the "all income" requirement. (The UPIA was further amended in the summer of 2018 by the Uniform Law Commission, specifically in Sections 102(19(C), 203(e)(1) and 309(b), placing limits on a Trustee's power to adjust between income and principal, so as to avoid marital deduction qualification issues.)

9. <u>Outright to Spouse Versus a Marital Trust</u>

a. Due to the powerful benefits of the spousal rollover, leaving qualified retirement assets outright to the surviving spouse is usually the best tax strategy, as long as it fits within the client's objectives.

b. On many occasions, a client is extremely reticent to leaving retirement assets outright to a spouse, for a variety of reasons, including the existence of a second marriage, asset protection concerns, spendthrift concerns, or disability concerns. For non-retirement assets, our time-honored answer has been the use of a QTIP Trust.

(i) A "QTIP" Trust as a beneficiary of an IRA has the following consequences:

(a) The surviving spouse cannot rollover the IRA, and therefore distributions from the IRA must begin in the calendar year after the first spouse's death, instead of being deferred until the surviving spouse attains the age 73. Therefore, if the surviving spouse is younger than 73 years old, a tremendous tax deferral opportunity will be lost.

(b) If the intention is for the QTIP Trust to qualify for the estate tax marital deduction, then the trust must receive the greater of the minimum distribution amount, or the amount of income earned by the IRA. If the income earned by the IRA exceeds the minimum distribution amount, then greater amounts must be distributed from the IRA and less deferral is achieved.

(ii) As an alternative to the QTIP Trust technique in second marriage situations, we have been successful in persuading clients to instead leave a fractional amount to the surviving spouse and fractional amounts to the children of the first marriage.

(iii) Another alternative is to leave the total retirement asset amounts to the surviving spouse, and "compensate" the children of the first marriage with non-retirement assets. However, this technique requires constant monitoring of the relative levels of these assets, in order to ensure that the estate plan does not become out of the client's intended balance.

(iv) If asset protection, spendthrift protection, or some other disability protection is the objective motivating the client to consider a trust for the spouse, we must make sure that the client understands the real cost in naming a trust versus naming the spouse outright.

10. <u>Estate Planning In Light Of The Secure Act</u>

a. <u>Initial steps for the Estate Planner</u>

(i) Sending a client alert to everyone…..a quick concise notice aimed at getting their attention and inspiring them to contact us for possible new planning.

(ii) A more targeted outreach to those high net worth clients with large IRAs or QRPs.

(iii) Have your assistant globally search your client data base for certain key words, like "conduit trust"…. "special needs trust"

b. Immediate Issues to Address

(i) Existing conduit trust planning in place

(ii) Taking steps to preserve "Eligible Designated Beneficiary" status.

(a) Review plans where a spousal trust is the named beneficiary of an IRA.

(b) Trusts for Minor children as IRA beneficiaries must be re-evaluated.

(c) The designation of a special needs trust as IRA beneficiary should be reviewed and tweaked in light of the SECURE Act.

(iii) The immediate concerns to convey to our clients…..

(a) The real post-death value of our clients' IRA and QRP interests have been potentially diminished significantly.

(b) How will this income tax increase be paid?

(c) A new reason for the ILIT wealth replacement concept?

(d) More customized beneficiary designations!

11. Charitable Planning

a. Such a change will provide even more incentive for benefitting charity with IRAs upon death.

b. Funding a CRT with an IRA will achieve some of the deferral lost with the limited availability of the IRA stretch technique.

(i) This should only be considered by the charitably inclined.

(ii) Computations specific to your fact pattern must be made in order to ascertain the real stretching benefit of this approach.

c. This law change will add more fuel to the fire in Roth IRA conversion planning.

d. If generation skipping planning is a major objective of a client, utilizing IRAs to push taxable inheritance down to lower bracket beneficiaries should be strongly considered.

e. The planner should anticipate to the extent feasible the possible use of disclaimers by designated beneficiaries of the IRA, in the structuring of the IRA owner's beneficiary designation, as such beneficiaries attempt to do their own post-death income tax planning.

f. Consider adding new boilerplate to your revocable trust forms.

(i) Consider a springing separate share for a trust beneficiary who turns out to be disabled or chronically ill at the decedent's death

(ii) Consider a savings clause which precludes any non-disabled beneficiaries and any non-chronically ill beneficiaries from being eligible to receive any trust benefits during the life of the disabled or chronically ill beneficiary of an accumulation trust, to preserve Eligible Designated Beneficiary treatment.

(iii) Limit the class of potential appointees under a power of appointment to the extent necessary to preserve Eligible Designated Beneficiary treatment of an accumulation trust for disabled or chronically ill beneficiaries.

(iv) Consider inserting an elective process, by a trustee or trust protector, whereby either a conduit trust or accumulation trust becomes effective on or before the Beneficiary Determination Date for a separate Trust share.

12. Creditor Access To Inherited IRAs

a. It is always big news when an "estate planning" topic is addressed by the U.S. Supreme Court, and it happened most recently in the summer of 2014 in Clark v. Rameker, 573 U.S. ____, 134 S.Ct. 2242 (June 12, 2014).

(i) In Clark, the United States Supreme Court granted certiorari to resolve a conflict between the Circuits on the issue of whether a beneficiary of an inherited IRA can claim a federal bankruptcy exemption from creditors for such inherited IRA.

(ii) The federal bankruptcy law provides an exemption for "[r]etirement funds to the extent that those funds are in a fund or account that is exempt from taxation under §§ 401, 403, 408, 408A, 414, 457 or 501(a) of the Internal Revenue Code of 1986." 11 U.S.C. §§ 522(b)(3)(c), 522(d)(12) (It is noteworthy that an "inherited IRA" is an IRA classification specifically recognized by section 408(d).)

(iii) In a unanimous decision, the Court first defined "retirement funds" as funds set aside for the day when an individual is no longer working, and then cited three (3) characteristics which, in the view of the Court, prevents inherited IRAs from being considered "retirement funds."

(a) First, the holder of an inherited IRA may never make contributions thereto, as opposed to traditional IRAs and Roth IRAs which receive tax incentives for the accumulation of additional funds for retirement.

(b) Second, a holder of an inherited IRA is required to withdraw money from such account, without regard to how far away that person is from retirement.

(c) Third, the holder of an inherited IRA may withdraw all of the funds at any time without penalty, and use them for any purpose, while the owner of a traditional IRA or a Roth IRA must wait until attaining age 59½ in order to withdraw funds from such accounts without penalty.

(iv) In a crowning blow, the Court stated that nothing about an inherited IRA's legal characteristics prevents or discourages an individual from using the entire balance immediately after bankruptcy for purposes of current consumption.

b. The history behind Clark.

(i) Remember that IRAs belonging to the original account owner are generally exempt from the account owner's creditors in federal bankruptcy and otherwise.

(ii) One major source of confusion in this area is, although bankruptcy law is federal law decided in federal bankruptcy courts, many states opt out of the federal bankruptcy scheme, thus activating the application of state exemption statutes in federal bankruptcy cases (some states, like Texas, allow a debtor to select state or federal exemptions). The majority of states opt out, and thus the bankruptcy exemptions are decided under state exemption laws.

(iii) Prior to Clark, there were twelve (12) reported cases dealing with beneficiaries of inherited IRAs within the federal bankruptcy context.

(a) Eight of these courts (all of which are in "opt-out" states, except for Texas) found that the inherited IRAs were not exempt from the bankrupt estate in federal bankruptcy, including: In re Sims, 241 B.R. 467 (Bankr. N.D. Okla. 1999); In re Greenfield, 289 B.R. 146 (Bankr. S.D. Cal. 2003); In re Navarre, 332 B.R. 24 (Bankr. M.D. Ala. 2004); In re Taylor, Bank. No. 05-93559, 2006 WL 1275400 (Bankr. C.D. Ill. May 9, 2006); In re Kirchen, 344 B.R. 908 (Bankr. E.D. Wis 2006); In re Jarboe, 365 B.R. 717 (Bankr. S.D. Tex. 2007); Robertson v. Deeb, 16 So. 3d 936 (Fla. 2d DCA 2009); and In re Chilton, 2010 WL 817331 (Bankr. E.D. Tex. March 5, 2010).

(b) Four of the courts found that the inherited IRA was exempt in federal bankruptcy, those being: In re McClelland, Bank No. 07-40300, 2008 WL 89901 (Bankr. D. Idaho Jan. 7, 2008); In re Nessa, 2010 Bankr. Lexis 931 (B.A.P. 8th Cir. Apr. 9, 2010); In re Tabor, 2010 105 AFTR 2d (Bankr. M.D. Pennsylvania June 18, 2010); and In re Hamlin, 465 B.R. 863 (BAP 9th Cir. 2012).

(c) The Nessa decision (in a non-opt-out state) led many district courts, in unreported decisions, to allow the inherited IRA to be an exempt asset, until Clark came along.

c. Clark is NOT the Last Word!

(i) In some opt-out states, the interpretation of existing statutes with broad exemption language may allow the exemption of inherited IRAs for state exemption purposes, and state exemptions are recognized under U.S. Bankruptcy Code § 522(b)(3)(A).

(a) The state of Kansas has such a broad statute which could arguably be construed to exempt inherited IRAs.

(b) However, in Mosby v. Clark (In Re Mosby), 15-5193-JWL (D Kan. Oct. 30, 2015), the Kansas District Court held that an inherited IRA is not exempt under the Kansas exemption statute. The very recent case of In Re: Todd, Case No. 15-11083 (U.S. Bankr., NDNY 2018), held that the applicable New York exemption statute was not intended to include inherited IRAs within the exemption from bankruptcy.

(ii) In my home state of Missouri, along with Alaska, Arizona, Delaware, Florida, Nevada, North Carolina, Ohio, South Carolina, Texas, West Virginia and Wyoming, the Clark holding is completely irrelevant, as these states have statutes which specifically exempt inherited IRAs for state exemption purposes and have opted to use the state exemptions for federal bankruptcy law purposes. Idaho has case law to this effect.

(iii) In a post-Clark decision, the federal Bankruptcy Court in New Jersey held that a debtor's inherited IRA was not property of the bankruptcy estate under New Jersey law. In re Andolino, 525 B.R. 588 (Bankr. D.N.J. 2015). The Bankruptcy Court stated that the question of inclusion in the estate must be reached first, before the Clark analysis of the application of an exemption can be made. (The Todd decision in New York also rejected an Andolino argument regarding inclusion of the inherited IRA.)

(iv) In another post-Clark decision, the federal Bankruptcy Court in Tennessee held that an IRA account was protected from creditors, even though the IRA owner had used part of the funds during the 60 day rollover period to purchase a home, as the owner ultimately deposited the exact amount eligible for rollover into the IRA. The In Re: Chaundry court rejected the bankruptcy trustee's contention that the rollover was not qualified unless the IRA owner deposited the exact same funds received from the predecessor plan.

(v) In October of 2019, the appellate court affirmed the Bankruptcy Court in Minnesota's ruling that a divorced former spouse who had received one-half of his ex-spouse's 401(k) and IRA upon the divorce could not claim an exemption in bankruptcy for such retirement assets. In Re: Lebakken, (No. 18-6018, 8th Circuit Court of Appeals). The courts relied on Clark in reaching this decision.

d. <u>Use of spendthrift trusts as an alternative asset protection device.</u>

(i) If you are in a state where the applicable exemption is either indefinite or not existent, you should consider naming a spendthrift trust for the benefit of any beneficiary with creditor issues as the beneficiary of the IRA.

(ii) However, if the RMD amount received by the trust must be distributed from the trust (i.e. in a conduit trust), the Uniform Trust Code reverses the common law spendthrift protection for this type of a distribution interest and allows any creditor to attach the RMD amount from a spendthrift trust.

(iii) As an alternative, consider a "Trusteed IRA." If the provider offers a Trusteed IRA, and the Trusteed IRA agreement contains a spendthrift clause, then creditor protection should be accomplished.

13. <u>Naming Charity(S) As Beneficiary Of The IRA</u>

a. If a client indicates a desire to leave funds to charity(s) upon his or her death, the first words out of our mouths should be to consider making such at-death gifts from qualified retirement plans or traditional IRAs.

(i) If the client's estate plan contemplates benefits both to charity and to children or other individual beneficiaries, the most efficient income tax planning is accomplished by satisfying the charitable gifts with retirement plan assets, and using other assets to leave to the individual beneficiaries. While the charity will not pay income tax on any inheritance it receives, including retirement plan benefits, individual beneficiaries will pay income tax on the distribution of a retirement plan interest, and will not pay income tax on almost all other forms of inheritance.

(ii) In addition to satisfying the client's charitable desires, a variety of charitable giving techniques involving retirement benefits will help realize additional estate planning objectives as well.

(iii) With this planning, charitable intent should be more important than tax savings!

(iv) In contrast, since Roth IRAs pass to the designated beneficiary without any income tax liability, naming charity as beneficiary of the Roth IRA is not tax efficient.

b. There are various techniques for leaving retirement benefits to charity(s) upon a taxpayer's death.

(i) The easiest way to leave retirement plan benefits to charity(s) is to name the charity(s) as a direct beneficiary of one hundred percent (100%) of the benefits payable upon the taxpayer's death.

(a) A properly completed beneficiary designation form in this regard is easy to accomplish.

(b) Although all of the income associated with retirement benefits will be included in the income of the charitable organization named as beneficiary, such charity's income tax exemption will make the retirement plan benefit distribution not taxable.

(c) In addition, the deceased taxpayer's estate will receive a dollar for dollar estate tax charitable deduction for the estate tax value of the retirement plan interest.

(ii) In many instances, the client will want to leave a specific dollar amount to one or more charities, with the balance of the retirement plan interest passing to other individual beneficiaries (i.e., his or her lineal descendants, per stirpes).

(a) This usually requires an attachment to the beneficiary designation form setting forth the specific amount gift, and a description of the residual beneficiaries.

(b) In my experience, you should be sure at the planning stage that the retirement plan administrator will accept and honor this attachment!

(c) In order for the individual beneficiaries to be able to use separate accounts and a deferred payout, it will be necessary to be sure that the charity(s) are "cashed out" (i.e., fully paid from the retirement plan) before September 30 of the year following the year of the taxpayer's death.

(d) Be careful doing this through a trust vehicle!

[1] In PLR 201438014, decedent's Trust was named as beneficiary of his IRA, and the Trust provided for payment of pecuniary bequests to two charities and the residue to be distributed to individuals.

[2] A state court ordered a reformation of the Trust, providing that either the Trust's transfers to the charities were to be treated as direct bequests of the IRA amounts to the charities, or such transfers were to be considered to be made out of the trust's gross income pursuant to the terms of the governing instrument.

[3] The IRS ruled that the Trust must treat the payments to the charities as sales or exchanges (since the IRA is being used to satisfy a pecuniary legacy), and the Trust must include in its gross income the amount of the IRA used to satisfy the charitable legacies. Further, the Trust is not entitled to a charitable income tax deduction for these distributions. The bottom line was, because the purpose of the reformation was not to resolve a conflict but merely to obtain tax benefits, then the IRS will not respect the reformation and treat it as part of the governing instrument. PLR 201438014.

(e) Careful drafting will be necessary when an IRA is designated to be distributed to a Trust, which contains residuary charitable bequests.

[1] Chief Counsel Memorandum 200848020 (July 28, 2008), provides that a Trust is denied a charitable income tax deduction after it receives taxable IRA distributions and then distributes some of those amounts to charities.

(i) CCM 200848020 involved a decedent who left his IRA payable to his Trust upon his death, which benefited his six children and several charities. The Trust received distributions from the IRA, and the Trustee immediately paid those amounts to the charities, leaving the six children as the only remaining beneficiaries of the Trust. The Chief Counsel's Office concluded that the Trust had taxable income from the IRA distribution, but was not entitled to claim an offsetting charitable deduction (remember only an estate may claim an income tax charitable "set aside" deduction").

(ii) In order for the distribution of IRA proceeds to charity to be deductible by the Trust, the Trust must meet the legal requirement for a trust to claim a charitable income deduction. In order to claim a charitable income tax deduction, the charitable payment must be traced to income and must generally be made pursuant to the terms of the governing instrument specifically requiring income to be paid to a charity. IRC § 642(c).

(iii) In the Trust involved in CCM 200848020, there was no specific instruction to distribute income to a charity, just a general provision for a percentage of the residuary to be paid to several charities. Therefore, the Trust could not claim the charitable income tax reduction.

[2] Ostensibly, one solution would be to include a clause in the Trust document that instructs all residuary charitable gifts to be made, to the extent possible, from property that constitutes "income in respect of the decedent" as that term is defined under the U.S. income tax laws.

(i) However, Treas. Reg. § 1.642(c)-3(b)(2) provides that instructions in a trust instrument to distribute specific types of income to a charity will not be respected for federal income tax purposes unless the instruction has an "economic effect independent of income tax consequences".

(ii) The examples in this Regulation provide that, unless the amount to be paid to charity is dependent upon the type of income from which it is to be paid, the above-described ordering provision is considered to not have economic effect independent of income tax consequences.

[3] Interestingly, in PLR 201444024, where the Trust was named as the beneficiary of decedent's IRA and the Trust provided that, after two pecuniary bequests to individuals, the residue shall be immediately distributed to charity, the IRS held that the Trust may re-title the name of the IRA to reflect the name of the charity in a non-taxable transfer, and the charity, not the trust, will include the taxable amount of the IRA distributions in charity's income for tax purposes, as if the charity were the direct beneficiary.

[4] The alternative answer at the planning stage is to draft the beneficiary designation of the IRA so as to mirror the dispositive provisions of the Trust (i.e., list the children and the charities and their respective percentages on the IRA designation itself, rather than sending the IRA to the decedent's Trust).

[5] In addition, the will and/or revocable trust of the decedent must provide that no estate taxes are to be charged against or paid out of the charity's share of trust assets.

(f) Charitable Remainder Trusts. This technique involves a charitable remainder trust ("CRT") as that term is defined in IRC § 664.

[1] Income tax consequences

(i) Since a charitable remainder trust is exempt from income tax, the distribution of all the retirement benefits to a charitable remainder trust results in no current income tax liability.

(ii) The individual beneficiaries of the charitable remainder trust will receive their lifetime interest earned from the entire amount, as opposed to an after-tax amount, of the distributed retirement benefit interest.

(iii) However, the tax-deferred income received by the CRT must be "booked" from day one by the CRT, and will gradually "leak out" to the individual beneficiaries with the distribution of each lifetime payment. Under the "tiered" approach to income taxation of CRT distributions, the distribution to the individual lifetime beneficiary is deemed first to be derived from ordinary income earned in all prior years and the current year, to the extent such amount has not already been allocated to a prior distribution.

(iv) Although an individual IRA beneficiary is entitled to a Section 691(c) income tax deduction for the portion of federal estate taxes attributable to retirement plan benefits, this deduction is rarely if ever available to an individual beneficiary of a CRT, as all of the tiers of ordinary income, capital gain income and tax-exempt income would need to be exhausted before any CRT distribution would carry out the use of the IRD deduction.

[2] Estate tax consequences

(i) The decedent's estate is entitled to a federal estate tax charitable deduction for the actuarial value of the charitable remainder interest at the time of the decedent's death.

(ii) The actuarial value of the charitable remainder interest must be at least ten percent (10%) of the date of death value of the trust in order for the CRT to be qualified.

(iii) Because the non-charitable actuarial interest in the CRT is taxable in the decedent's estate, the decedent's tax clause in his or her will or revocable trust will need to provide for payment of any estate tax attributable to the non-charitable CRT interest from other sources of the decedent's estate.

[3] Leaving a retirement plan interest to a CRT is not a good idea in all situations.

(i) If the individual beneficiary or beneficiaries are young enough, the actuarial value of the charitable interest may not exceed ten percent (10%) of the total value of the trust, and the trust will not qualify as a CRT. However, a term of years could be used to make the CRT work in this situation.

(ii) If the CRT will receive a large amount of retirement benefits, it is possible that there will not be enough non-retirement assets to pay any estate tax due because of the actuarial value of the non-charitable interest in the CRT.

[4] With the severe limitation of the "stretch IRA" technique as a result of SECURE, a designation of a charitable remainder trust will allow some "stretching" to still occur.

14. Charitable Lead Trusts

a. Since a charitable lead trust ("CLT") is the theoretical opposite of a charitable remainder trust (i.e., the initial stream of payments is paid to a charity for a term of years, with the remainder passing to one or more individuals at the end of the term), this seems on its face to be a viable technique.

b. However, the charitable lead trust has one important characteristic which is different from a CRT; the CLT is not exempt from income tax. Therefore, when all of the retirement benefits are distributed to the CLT, the trust must pay income tax on the entire amount of benefits distributed.

c. Because of the drastic income tax consequences, one should not advise leaving retirement benefits to a CLT.

15. Lifetime Gifts Of Qualified Retirement Benefits To Charity

a. Lifetime Gifts From Retirement Plan Distributions

(i) For some of our clients, the most readily available funds with which to make lifetime charitable gifts are their retirement plan funds.

(ii) Except for the charitable IRA rollover discussed below, the only way for this client to make such a gift is to withdraw funds from the qualified plan or IRA and then gift such funds to the charity.

(a) This of course results in the immediate taxation of the distributed assets from the plan on the donor's income tax return.

(a) One would hope that the income tax charitable deduction will result in a "wash" of this income for income tax purposes. However, there are some circumstances which will prevent a complete wash of the income.

[1] If the charitable donations exceed the applicable percentage of AGI limits, then a complete wash will not result.

[2] For high income taxpayers, there is an automatic reduction of itemized deductions under Code § 68 which could also prevent a complete wash of the income.

[3] Of course, if the taxpayer is under age 59½ at the time of the withdrawal, he or she will suffer a ten percent (10%) penalty on the distribution. The charitable deduction will not in any way reduce this penalty.

[4] If the taxpayer resides in a state that does not allow a charitable deduction in computing its state income tax, then a complete wash will not be possible.

[5] Of course, any individual who does not itemize deductions would not achieve a wash of the income since he or she would not be itemizing the charitable deduction. There will be many more non-itemizers under the new tax law, with the increase of the amount of the standard deduction!

b. Gifts of RMD Amounts to Charity(s)

(i) A taxpayer who is already receiving RMDs from his or her IRA or qualified plan may use the distributed amounts for charitable giving.

(ii) Although the above-described obstacles may prevent a complete wash of the income, since the taxpayer is required to receive the RMD in any event, he or she may as well attempt to receive some income tax relief through charitable giving.

c. There are Potential Charitable Gifts of Unique Retirement Plan Benefits That Can Be Beneficial During Life

(i) An individual under age 59½ may avoid the ten percent (10%) premature withdrawal penalty through implementing a "series of substantially equal periodic payments" from a retirement plan, and such taxpayer could use those payments to make offsetting charitable gifts.

(ii) In certain limited circumstances, wherein a distribution is made from a qualified plan of employer stock which includes "net unrealized appreciation", the taxpayer is not immediately taxed on such net unrealized appreciation at the time of the plan distribution. Instead, taxation of this unrealized appreciation is deferred, and may be completely avoided through certain future charitable gifts.

(iii) A lump sum distribution from a qualified plan to a participant who is born before January 2, 1936 (or to the beneficiaries of such a participant) may exclude the distribution from the recipient's gross income and is taxed under a different rate schedule. In some circumstances, the distributee may give the distributed amount to charity, and effectively deduct the gift from his or her other income, since the lump sum distribution is taxed at a much lower rate.

(iv) "Qualified replacement property" received by a business owner who has sold his or her stock to an ESOP, wherein the owner did not have to pay income tax on the sale, may be gifted to charity to avoid permanently some or all of the tax on such sale.

16. IRA Charitable Rollover

a. Congress has had an on-again/off-again love affair with the IRA Charitable Rollover.

(i) The 2006 Pension Protection Act first established the "IRA Charitable Rollover" concept. After being allowed to expire in 2008, this provision was renewed temporarily two more times, and expired again on January 1, 2014.

(ii) The "Public Good IRA Rollover Act" was introduced in the Senate on November 21, 2013, which sought to renew and make permanent the IRA Charitable Rollover. Comparable legislation was introduced in the House in early 2014, and passed on July 17, 2014. Finally, on December 16, 2014, the Senate signed off on several "extenders," including this provision, which was signed into law by the President on December 19, 2014. Unfortunately, the IRA Charitable Rollover provision expired again as of January 1, 2015!

(iii) After months of watching two separate bills which proposed to enact the IRA Charitable Rollover on a permanent basis sit idle in the House of Representatives, action finally came in December, 2015. President Obama signed the "Protecting Americans from Tax Hikes Act" into law on December 18, 2015. Among other things, this Act finally makes the IRA Charitable Rollover permanent.

b. What constitutes an "IRA Charitable Rollover"?

(i) A "Qualified Charitable Distribution" is an otherwise taxable distribution from an IRA (not including an ongoing SEP or SIMPLE IRA) owned by an individual who is at least age 70½ (yes, this age limitation was NOT changed by the SECURE ACT), and that is paid directly from the IRA to "eligible charitable organizations."

(ii) A taxpayer can exclude from gross income up to One Hundred Thousand Dollars ($100,000) of a Qualified Charitable Distribution made for a given year.

(a) The Qualified Charitable Distribution can be used to satisfy any required minimum distributions from the IRA for that year.

(b) Likewise, the amount of the Qualified Charitable Distribution excluded from gross income is not shown as an itemized deduction for a charitable contribution.

(iii) An eligible charitable organization for these purposes includes a public charity, other than a donor advised fund or supporting organizations. Individuals can make a Qualified Charitable Distribution to a private operating foundation or to a private foundation that elects to meet certain conduit rules in the year of the distribution.

(iv) The donor must instruct their IRA administrator to make the contribution directly to the eligible charity.

c. Trap Created By The Secure Act

(i) A working individual who is 70 ½ or older can make tax-deductible contributions to a traditional IRA (in 2021, the maximum deductible contribution for anyone 50 years of age or older is $7,000)

(ii) Under the SECURE Act, if such an individual ever makes a tax-deductible contribution to a traditional IRA after attaining age 70 1/2 , then the amount of a qualified charitable distribution from an IRA that can be excluded from taxable income is reduced by that amount.

(iii) If your client wants to make charitable gifts from his or her IRA, they should never make a tax-deductible contribution to their IRA after attaining age 70 ½.

d. SECURE 2.0 now allows a one-time charitable rollover of up to $50,000 to a charitable remainder trust or a charitable gift annuity. It also provides that the general $100,000 threshold will now be adjusted annually by inflation.

e. Who really benefits from this continued IRA Charitable Rollover technique?

(i) A high income donor who itemizes deductions and whose charitable contribution deductions are reduced by the percentage of income limitation (otherwise, such individuals who receive a distribution from their IRA and make a corresponding charitable contribution, must count the entire distribution as income and receive a charitable deduction for a lesser amount).

(ii) Individuals who do not itemize their deductions.

(iii) Individuals in certain states where the operation of the state income tax law would offer greater benefits as a result of a charitable rollover.

(iv) Those rare individuals who already exceed their percentage of income limitation in terms of charitable contribution limits (i.e., more than 50% of their adjusted gross income for gifts of cash to public charities).

17. Decision Tree For Planning For A Large IRA

a. Pre-Death Planning

(i) Consider taking greater then RMD distributions during life and pay the extra income tax (analyze relative income tax rates of clients and clients' descendants).

(ii) Consider utilizing part of the above-described accelerated distributions to make gifts to descendants

(iii) Consider strategic usage of Roth Conversions to soak up excess itemized deductions and utilize lower tax rates during life

(iv) Charitable IRA rollover

b. At-Death Planning

(i) The Spouse as the outright Primary Beneficiary

(a) Second Marriage Dilemma- Spouse v. Family of First Marriage

(b) Analyze Conduit trust for spouse

(c) Analyze Accumulation trust for spouse

(d) Split the IRA between spouse and children

(e) Leave the IRA to spouse, and non-IRA assets to children

(ii) Consider Charity in Whole or in Part as Contingent Beneficiary?

(iii) Descendants in Whole or in Part as Contingent Beneficiary?

(a) Minor child is one who has not reached age 21

(b) If one makes a minor child the outright beneficiary, you may end up with a probate guardianship or conservatorship

(c) Consider designating a Uniform Gift to Minor's Account?

(d) Designation of a Conduit Trust for Minor Child?

(e) Designation of an Accumulation Trust for Minor Child?

(f) New "Age 31 Trust"?

(g) Push some of the IRA benefits down to lower generation?

(h) Build into the designation specific default beneficiaries if an adult child wants to disclaim in whole or in part (possible combination of a donor advised fund and/or child's descendants)

(iv) Planning Options for DB Who Is Not an EDB

(a) Name Designated Beneficiaries as outright beneficiaries

(b) Recommend qualifying for separate account treatment by dividing the interest in the beneficiary designation form

(c) Consider use of a Conduit Trust

(v) Special needs trusts for disabled or chronically ill beneficiaries

(vi) Consider the economics of the purchase of life insurance payable to beneficiary to replace accelerated income tax on distributions

(vi) OUR ULTIMATE GOAL IN PLANNING IS TO NOT PRECLUDE THE POSSIBILITY OF EDB STATUS THAT DOES NOT EXIST AT THE TIME OF THE PLANNING!

H. Trust Modifications, Sales, Decantings, Terminations

1. Uniform Basis Rules

a. When property is acquired by gift or from a decedent, the property has a basis determined either sections 1015 or 1014 of the Code, as the case may be. That basis can be shared among different owners of the property if, for example, the property is jointly owned by the recipients. The same holds true if the property is held in trust for the benefit of multiple beneficiaries, with varying interests in the trust property. The Treasury Regulations explain, "The principle of uniform basis means that the basis of the property (to which proper adjustments must, of course, be made) will be the same, or uniform, whether the property is possessed or enjoyed by the executor or administrator, the heir, the legatee or devisee, or the trustee or beneficiary of a trust created by a will or an inter vivos trust." Treas. Reg. § 1.1014-4(a)(1). *See also* Treas. Reg. § 1.1015-1(b). In one sense, the uniform basis rule is the historical amount of basis that is transferred from the donor or the decedent to the recipient (but adjusted for certain deductions in the future and reinvestments of the property). *See* Treas. Reg. § 1.1015-5(a)(1) (The uniform basis is the unadjusted basis of the entire property determined immediately after the decedent's death under the applicable sections of Part II of Subchapter O of Chapter 1 of the Code). Indeed, from the moment of the transfer, the recipient becomes the owner of the property and is responsible for all tax items associated with the property. In the context of a trust, a beneficiary will generally not receive all of the interests in the trust, and the beneficiary's partial interest in the trust property is reflected in the beneficiary's partial interest in the uniform basis. As such, when an interest in a trust (e.g., income, remainder, life, or term) is commuted, sold, or otherwise disposed of for consideration, the uniform basis rules determine the gain or loss on such disposition. Treas. Reg. §§ 1.1014-5(a)(1) and 1015-1(b).

b. Initially, uniform basis starts with the basis of the property transferred in trust either under sections 1015 (gift) or 1014 (testamentary transfer) of the Code. The uniform basis is adjusted from the initial basis for capital expenditures and cost recovery deductions. See Treas. Reg. § 1.1014-4(a)(1). It is also adjusted to reflect subsequent sales and reinvestments of the underlying property, although not explicitly stated in the Treasury Regulations. In fact, no examples of reinvestments of trust assets are contained in the Treasury Regulations, but this must be true. *See* IRS Notice 2008-99, 2008-47 I.R.B. 1194, which led to issuance of section 1.1014-5(c) of the Treasury Regulations (reducing the amount of uniform basis allocated to a term interest in a tax-exempt trust like a charitable remainder trust). *See also* Treas. Reg. § 1.1014- 4(a)(1) regarding reinvestments by fiduciary, but seemingly only applies to the initial uniform basis if reinvestment is required by the terms of the gift. Uniform basis, as properly adjusted for basis adjustments, is used for computing depreciation, depletion, and amortization deductions. Treas. Reg. § 1.1014-4(a)(1)·· The sale, exchange, or other disposition by a life tenant or remainderman of the life interest or remainder has no effect on the property's uniform basis in the hands of those who acquired it from the decedent or donor. As a result, gain or loss on a sale of trust assets by the trustee is determined without regard to any prior sale of any

interest in the property, and adjustments for cost recovery deductions at the trust level are likewise unaffected by such prior sale. Depreciation, depletion, and amortization deductions allowed or allowable to a trustee and to the trust beneficiaries constitute adjustments to the basis of the property not only in the hands of the trustee, but also in the hands of the trust beneficiaries and every other person to whom the uniform basis applies. Similarly, adjustments for capital expenditures or losses, tax-free distributions, or other distributions that reduce basis, and other items for which the basis must be adjusted are made without regard to which one of the persons to whom the same uniform basis applies makes the capital expenditures or sustains the capital losses, or to whom the tax-free or other distributions are made, or to whom the deductions are allowed or allowable. Thus, if a some trust property is distributed to a beneficiary, carrying with it some of the basis, the uniform basis will be reduced. Furthermore, the uniform basis rules do not apply when a trust or estate sells property to a beneficiary. The beneficiary's basis is determined under the usual basis rules applicable between unrelated persons.

c. The Treasury Regulations provide that the actuarial factors contained in section 20.2031-7(d)(7) will determine the amount of total basis allocated to a life interest, term interest, or remainder interest in property on the date such interest is sold, and those actuarial factors are contained in the Treasury Regulations under section 7520 of the Code. Thus, the "uniform basis" is the total basis of all interest in the property, and the sum of the parts equals the basis of the underlying assets (i.e., in trust). However, the allocation of that uniform basis among the interests will be based upon the relative values attributed to such interests. As a result, as a life tenant grows older and the remaining time left on a term of years gets shorter, the value of those interests decreases and its share of the uniform basis gets smaller. The decrease is offset by increases in the value (and share of basis attributable to) the remainder interest. The relative values between life, term, or remainder interests will also change with the section 7520 rate each month. Higher section 7520 rates generally increase the value of life and term interests (decrease to the remainder interest), and lower interest rates will increase the value of the remainder interest. Finally, when life expectancy factors under section 7520 are updated, the relative values of the interests will also change. On August 7, 2020, the National Center for Health Statistics at the Centers for Disease Control and Prevention issued the decennial life table for 2009-2011. This is the source for the actuarial tables under section 7520.

d. Section 1001(e) of the Code provides, "In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded."[1009] Thus, if there is a sale or other taxable disposition of a "term interest," any basis that would have been attributed to such "term interest" shall be ignored. A "term interest" in property means a "life interest in property," an interest in property for a term of years," or an "income interest in a trust." The foregoing "zero basis" rule "shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons."

e. Example 1 (FMV Equals Basis): Decedent funds a testamentary trust with $1 million of property, the basis of which is determined under section 1014 of the Code. The trust provides for a life estate for the decedent's spouse who is 55 years of age and remainder to their child. At the time of the decedent's death the section 7520 rate is 2.0%.

(i) On the date of death, the spouse's life estate is worth $383,650 or 38.365% of the fair market value of the trust property, and the child's remainder interest is worth $616,350 (61.635% of the value).

(ii) Spouse's share of the $1 million of uniform basis is $383,650, and child's share of the uniform basis is $616,350.

f. Example 2 (FMV Increases, Time Passes, and 7520 Rate Changes): Same facts as above, except 5 years have passed, and the spouse is 60 years of age. The property in the trust has appreciated to $1.4 million, and the section 7520 rate is 4.0%.

(i) Spouse's life estate is worth $751,660 or 53.690% of the fair market value of the trust property, and the child's remainder interest is worth $648,340 (46.310% of the value).

(ii) Spouse's share of the $1 million of uniform basis is $536,900, and child's share of the uniform basis is $463,100.

Notice, despite the fact that spouse is 5 years older, the combination of a higher section 7520 rate and an increase in value causes spouse's share of the uniform basis, which does not change, to significantly increase. It's also important to note that the property in the trust may have a basis that is higher than $1 million.

2. Sales of Partial Interests

a. Sale of Term Interest or Other Transfer

(i) Section 1001(e)(1) of the Code provides, "In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded." *See also* Treas. Reg. § 1.1001-1(f) Thus, if there is a sale or other taxable disposition of a "term interest," any basis that would have been attributed to such "term interest" shall be ignored. Per section 1001(e)(2), a "term interest" in property means a "life interest in property," an interest in property for a term of years," or an "income interest in a trust." This effectively provides that a term interest will effectively have zero basis in a sale or taxable exchange of just a term interest.

(ii) For comparison's sake, note that transferring a term interest to a controlled corporation in a tax-free exchange under section 351 of the Code, followed by a sale of the corporation's stock, will not provide the term holder with basis. Even worse, the corporation will not have any basis in the term interest. *See* Treas. Reg. §§ 1.1014-5, Ex. 6, and 1.1001-1(f)(2) Assuming the corporation is a C corporation, this would eventually mean double taxation of the property. When the shareholder sells the stock of the corporation, gain will be recognized. When the corporation sells the term interest, the corporation will recognize gain at the entity level with no benefit of basis.

b. Sale of Remainder Interest or Other Transfer

(i) There is no corresponding rule for remainder interests. Thus, the basis used in computing gain or loss realized from a sale or other disposition of a remainder interest in property acquired through a decedent or from a donor equals the portion of the adjusted uniform basis assignable to the remainder interest. Treas. Reg. §§ 1.1014-5(a)(1) and 1015-1(b). Thus, a remainder interest can be sold, and the seller of the remainder interest will be entitled to use its portion of the adjusted uniform basis to calculate gain or loss in the transaction.

(ii) If the holder of a remainder interest predeceases the life tenant, the interest's uniform basis is not adjusted because of the death of the remainder owner. Treas. Reg. § 1.1014-8(a)(1). However, the basis of the remainder in the hands of the successor to the remainder owner equals the portion of the uniform basis assigned to the remainder: (i) increased by any excess of the value of the remainder interest included in the remainder owner's gross estate over the basis in the remainder interest immediately before the remainder owner's death, or (ii) decreased by any excess of the basis in the remainder interest immediately before the remainder owner's death over the value of the remainder interest included in the remainder owner's gross estate. The Treasury Regulations include the following helpful example (Treas. Reg. § 1.1014-8(b), Ex. 1):

Example (1)

> Assume that, under the will of a decedent, property consisting of common stock with a value of $1,000 at the time of the decedent's death is transferred in trust, to pay the income to A for life, remainder to B or to B's estate. B predeceases A and bequeaths the remainder interest to C. Assume that B dies on January 1, 1956, and that the value of the stock originally transferred is $1,600 at B's death. A's age at that time is 37. The value of the remainder interest included in B's estate is $547 (0.34185, remainder factor age 37, x $1,600), and hence $547 is C's basis for the remainder interest immediately after B's death. Assume that C sells the remainder interest on January 1, 1961, when A's age is 42. C's basis for the remainder interest at the time of such sale is $596, computed as follows:

Basis of remainder interest computed with respect to uniform basis of entire property (0.39131, remainder factor age 42, x $1,000, uniform

basis of entire property)	$391 plus	
Value of remainder interest included in B's estate		$547
less		
Basis of remainder interest immediately prior to B's death (0.34185, remainder factor age 37, x $1,000)	342	205
	-----	-----
Basis of C's remainder interest at the time of sale		$596

(iii) The basis of any property distributed to the heir, legatee, or devisee upon termination of a trust or legal life estate, or at any other time, equals the distributed property's adjusted uniform basis: (i) increased by any excess of the value of the remainder interest included in the remainder owner's gross estate over the basis in the remainder interest immediately before the remainder owner's death, or (ii) decreased by any excess of the basis in the remainder interest immediately before the remainder owner's death over the value of the remainder interest included in the remainder owner's gross estate. The Treasury Regulations include the following additional example:

Example (2)

Assume the same facts as in example (1), except that C does not sell the remainder interest. Upon A's death terminating the trust, C's basis for the stock distributed to him is computed as follows:

Uniform basis of the property, adjusted to date of termination of the trust		$1,000
plus		
Value of remainder interests in the property at the time of B's death	$547	
less		
B's share of uniform basis of the property at the time of his death	342	205
	-----	-----

C's basis for the stock distributed to him upon the termination of the trust $1,205

c. Sale of Entire Interest

(i) Section 1001(e)(2) of the Code provides that the foregoing "zero basis" rule with respect to term interests "shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons." As a result, if both the term and remainder interests in the trust are sold in the same transaction, the seller of the term interest will be entitled to use its portion of the adjusted uniform basis to calculate gain or loss in the transaction.

(ii) The Treasury Regulations provide an example pursuant to which the life tenant and the remainder owner jointly sold their respective interests to an unrelated purchaser. Treas. Reg. § 1.1014-5, Ex. 5. Both the life tenant and the remainder were able to use their respective portions of the adjusted uniform basis. In the example, the life tenant recognized a loss, and the remainder holder recognized gain.

3. Commutations or Early Terminations

a. The IRS has held in PLRs 200210018, 200231011, 200648016, and 200648017 and as recently as 2019 in a series of related private letter rulings, PLRs 201932001 through 201932010, that the commutation or early termination of a trust pursuant to which the term interest holder and the remainder holder receive their respective actuarial shares of the underlying trust assets is a taxable exchange between the term and remainder holders. It is, according to the IRS, a transaction in which the term holder sells the term interest to the remainder holder. As such, because it is not a sale of the entire interest in the trust to a third party purchaser, the "zero basis" rule of section 1001(e) of the Code applies, resulting in the term holder recognizing gain with the no benefit of basis.

b. The 2019 private letter rulings involved the early termination of generation- skipping trusts. The settlor created an irrevocable trust for the benefit of his son for his lifetime, providing for distributions of all net income, but no distributions of corpus were authorized. The trust provided upon son's death, the remainder would be distributed to his then living issue, per stirpes. Pursuant to a non-judicial agreement among the trust beneficiaries, the trust would terminate, and the assets of the trust would be distributed to the various beneficiaries based on the actuarial values of their respective interests, on a pro-rata or in-kind basis. The early termination and distribution were contingent upon local court approval. The court approved finding the trust was ""is no longer necessary to achieve any clear material purpose of such trust because [Son]'s net worth has grown significantly, such that he does not need income from [Trust] for his support."

c. The IRS ruled, "Although the proposed transaction takes the form of a distribution of the present values of the respective interests of Son, the Current Remaindermen, and the Successor Remaindermen, in substance it is a sale of Son's and the Successor Remaindermen's interests to the Current Remaindermen." PLR 201932001. The current remaindermen are son's children, and the successor remaindermen are the issue of the son's children. In support of the foregoing, the IRS cited Revenue Ruling 69-486, which involved a trustee's non-pro rata distribution of two different assets to two beneficiaries (one of which was a charitable organization). The trust did not authorize the trustee to make non-pro rata distributions of property. As such, the IRS treated the foregoing as a pro rata distribution of the two assets to each of the beneficiaries, following by a taxable exchange of half of the assets received by each of them.

d. The IRS ruled the sale of son's lifetime interest in the trust was the sale of a capital asset, citing Revenue Ruling 72-243. However, son's term interest is "not part of a transaction in which the entire interest in Trust is transferred to a third party," and as such, son's portion of the adjusted uniform basis is disregarded under section 1001(e)(1) of the Code and the entire amount realized by the son will be considered long-term capital gain.

e. In addition, the IRS held, the amounts received by the successor remainder holders (the issue of the son's children) as a result of the termination are amounts received from the sale or exchange of a capital

asset. Because this would be a sale of a remainder interest, each remainder holder would be entitled to get the benefit of their respective share of the adjusted uniform basis in determining the net long-term capital gain recognized. Interestingly, the ruling does not take the position that the current remainderman (the children) sold their interest in the trust. Rather, the IRS ruled, "to the extent that a Current Remainderman exchanges property, including property deemed received from Trust, for the interests of Son and the Successor Remaindermen, the Current Remainderman will recognize gain or loss on the property exchanged." In other words, trust property that had been distributed tax free to the children would be considered part of a subsequent taxable exchange to the extent used to purchase the trust interests held by the son and successor remaindermen. In essence, the IRS concluded that the children (current remaindermen) purchased the son's lifetime term interest and the contingent remainder interest.

f. While the position taken by the IRS may seem harsh, consider that, after the termination of the trusts, each of the beneficiaries have materially different property rights and assets. *See* F. Ladson Boyle, Howard M. Zaritsky, and D. Ryan Wallace, *The Uniform Basis Rule and Terminating Interests in Trusts Early*, Real Prop., Tr. & Est. L.J. 1 (Spring 2020) and Douglas A. Kahn, *Gain from the Sale of an Income Interest in a Trust*, 30 Va. Tax Rev. 445 (2010), for excellent discussions on the tax implications of sales of income interests and commutations. Prior to the termination, son had an income interest for life, his children had a remainder interest in the trust property if they survived the death of son, and the issue of the children had an even more remote interest in the trust. After the termination, son, children, and the issue of the children directly owned their respective actuarial portions of the trust assets, without any contingencies and without any limitations to control or benefit from such assets. As discussed above, the principle set out in *Cottage Savings* led to the Treasury Regulations which says, "the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained." Treas. Reg. § 1.1001-1(a). Quite obviously, amending the trust to allow distributions of income and principal to these various beneficiaries might have been a better course to follow.

4. Tax Implications of Decanting and Trust Modifications

a. Changes in circumstances that arise subsequent to the time that a trust becomes irrevocable may give rise to a modification of an otherwise irrevocable trust, either by the agreement of the parties (where permitted by local law) or through an action for a judicial modification. Under the traditional equitable deviation doctrine, if circumstances unanticipated by the settlor occur, a court may modify the administrative terms of a trust, but only to prevent the unanticipated circumstances from defeating or substantially impairing the accomplishment of the purposes of the trust. *See* Restatement of Trusts 2d § 167(1) (1959). State statutes often permit modification of trusts under a broader variety of circumstances, permitting the modification of both administrative and dispositive provisions, if the changes have the effect of furthering the purposes of the trust. *See, e.g.*, Unif. Trust Code §§ 410-417 (2004). Modifications may also be effected by the action of a trustee who, acting under its authority to make distributions to or for the benefit of one or more beneficiaries, exercises that discretion to place property into a new and different trust, an action that has come to be referred to as "decanting."

b. Decanting involves the distribution of assets by a trustee in an exercise of fiduciary discretion (note: a distribution without fiduciary discretion is the exercise of a power of appointment) of one trust (the old trust) to another trust (the new trust) to be held for the benefit of one or more of the beneficiaries of the original trust but on different terms than the old trust. Depending on how different the terms of the new trust are from the old trust, a decanting may be treated as a taxable exchange of trust interest by and among the beneficiaries. The IRS issued Notice 2011-101, 2011-52 I.R.B. 932, requesting comments on trust decanting, and it has added a number of tax consequences of a decanting to its "areas understudy" no ruling list (Rev. Proc. 2021-3, 2021-1 I.R.B. 140, sections 5.01(8)):

> Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a distribution for which a deduction is allowable under § 661 or which requires an amount to be included in the gross income of any person under § 662.
>
> Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a gift under § 2501.

> Whether the distribution of property by a trustee from an irrevocable generation- skipping transfer tax (GST) exempt trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is the loss of GST exempt status or constitutes a taxable termination or taxable distribution under § 2612 .

c. Notwithstanding the foregoing, in most cases, decanting from one trust to another, trust modifications, and trust combinations should present minimal, if any, unexpected income tax consequences to the trust or the trust beneficiaries. If trust assets are decanted from one trust to another trust, one possibility is that the decanting will be treated as simply a trust modification rather than a termination of the initial trust; consequently, both trusts will be treated as the same trust for income tax purposes. No income tax consequences would be recognized to either trust because of the decanting. Instead, the result would be that the surviving trust will report all income, expenses, and distributions for the entire year. *See* PLRs 200736002, 200723014, 200607015.

d. A second possibility in the case of decanting follows the general rule that any distribution from a trust will carry with it a portion of the DNI. Trust distributions are generally treated as coming first from the trust's current income, with tax-free distributions of "corpus" arising only if distributions exceed DNI, per section 661. If distributions are made to multiple beneficiaries, DNI is allocated to them pro rata. If a trust terminates, current income is carried out, as are any unused capital losses, net operating losses, and expenses incurred in excess of income. Thus, when two trusts combine or "merge," no provision of the Code provides that the combination of trusts is tax-free. Therefore, the treatment may be that the terminating trust will be treated as making a terminating distribution, carrying out its DNI, unused losses, and excess deductions, to the surviving (new) trust. In other words, the result would be that the new trust would receive taxable income to the extent of the old trust's DNI, and the old trust would receive a corresponding distribution deduction.

e. If the old trust does not terminate but instead a partial decanting occurs with the old trust retaining a right to withdraw a portion of the second trust, the first trust may be treated as the owner of the retained portion of the second trust. The new trust is possibly treated as a “grantor trust” of the old trust. *See* PLR 201633021. In that case, section 678 of the Code would treat new trust as a “grantor trust” and the old trust will report DNI as defined in new trust.

f. If the old trust is a grantor trust, it would seem the act of transferring, “merging,” or decanting the assets of a grantor trust to the new grantor trust should have no tax effect, under Revenue Ruling 85-13, even if there is debt in excess of basis. If the old trust is a grantor trust and the new trust is a non-grantor trust, then, like a termination of grantor trust status, the distribution of assets would generally not be a taxable event, unless there is debt in excess of basis. If old trust is a non-grantor trust and the new trust is a grantor trust, then based on the two rulings discussed earlier in the conversion from non-grantor to grantor trust, there would not be any transfer for any income tax purpose.

g. If a proposed decanting or modification results in a significant change in property rights, however, the IRS may argue the decanting or trust modification may be treated as a distribution followed by an exchange of interests among the beneficiaries, resulting in recognized gain for income tax purposes.

In Private Letter Ruling 200231011, the taxpayer asked the IRS to rule on the tax consequences of a proposed trust modification. Under the terms of a testamentary trust, the testator's grandson was to receive a fixed dollar amount each year during his life, with the remainder interest passing to various charities. The trust was later restructured to provide for annual income distributions in accordance with a performance chart. Subsequently, disputes arose regarding the administration of the trust. Under the terms of a settlement, the charities would receive an immediate distribution of corpus in termination of their interest. The remaining amount would continue in trust for the grandson, providing him a 7% unitrust amount plus distributions of principal as needed for his reasonable support. On his death, the remaining corpus would be distributed in accordance with the grandson's general testamentary power of appointment. Citing *Cottage Savings*, the IRS ruled that an exchange of property results in the realization of gain or loss under section 1001 of the Code if the properties exchanged are materially different. The IRS then compared the proposed modification to the modifications in two other cases. The first case, Evans v. Commissioner, 30 TC 798 (1958), involved the exchange of an income interest in a trust for an annuity which the court concluded was a realization event. The second case, Silverstein v. United States, 419 F.2d. 999 (7th Cir. 1969), found that the exchange of an interest in a trust for a right to specified annual payments from the remainder beneficiary did not result in a realization event because

the taxpayer was to receive the same annual payments from the remainderman as she had been receiving from the trust. The IRS determined that the proposed settlement at issue more closely resembled the situation in *Evans* than in *Silverstein* because the grandson was currently entitled to trust income subject to a floor and ceiling, but under the proposed settlement he would receive annual unitrust payments and could receive additional discretionary distributions. The IRS stated, "Even assuming that the projected payments under the proposed order approximate those that would be made under the current terms of the trust, under the proposed order Grandson would lose the protection of the guaranteed minimum annual payments required" under the current terms of the trust. He also would not be limited by the maximum annual payment ceiling, and payments would be determined without regard to trust income. Therefore, the grandson's interest in the modified trust would entail legal entitlements different from those under the current trust agreement, and as a result, the modification would be treated as a realization event for federal income tax purposes.

However, note PLRs 201647001 (because Grantors' status as owners of trust for federal income tax purposes did not change beneficial interests, modification to grant additional trustee powers did not result in transfer); 201528024; 201419001; 200736002 (finding division of trust into three separate trusts on a pro rata basis did not result in gain or loss because new trusts were not materially different, even though trustees would be different in the new trusts); 200615006 (court- approved settlement clarifying ambiguous trust terms to provide that stated distribution amounts were minimums and that trustee should also distribute all trust income to beneficiaries, were not materially different).

In Private Letter Ruling 200743022, the IRS considered whether decanting assets from old trusts to new trusts and the merger of the trusts' assets would cause gain or loss recognition in a situation where both state law and the trust agreement authorized the decanting. Because the decanting was to occur as a result of the discretionary authority of the trustees based on state law and the trust agreement, and not as a result of the beneficiaries' exchange of trust property, the IRS ruled that no gain or loss would be recognized by any of the trusts or the beneficiaries. The exercise of the trustees' discretionary authority and the lack of involvement by the beneficiaries prevented an analysis pursuant to section 1001 of the Code.

h. Under the Treasury Regulations, the severance of a trust occurring on or after August 2, 2007 will not be treated as an exchange of property for other property differing materially either in kind or in extent if (i) an applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust; and (ii) any non-pro rata funding of the separate trusts resulting from the severance, whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.