Dennis I. Belcher

The 52nd Annual Heckerling Institute on Estate Planning is dedicated to the memory of Dennis Belcher, who passed away last spring. Dennis was one of the Institute's most beloved and popular speakers, and a long-time member of the Institute's Advisory Committee. He was a valuable advisor, a talented speaker, and a trusted friend.

Dennis was invited to deliver his first podium lecture at the Institute in 1988, and, judging by the audience ratings, it was quite a success. Dennis's topic that January involved planning for the closely-held business, a topic he spoke on frequently over the years both at the Institute and elsewhere. By the time he delivered that first Institute lecture, Dennis was already a well-known and popular speaker at other programs around the country. It was clear that he had what it took to become a favorite with the Institute's attendees. He obviously had the depth of knowledge and command of the subject matter they would expect but, perhaps more importantly, he also delivered his message with an unassuming, easy going, and often humorous style. As a result of that first lecture, Dennis was invited to return to the Institute for a follow-up appearance on the podium in January of 1996. That lecture also received top ratings from the audience, and resulted in regular podium lecture and panel appearances by Dennis at the Institute from that time on.

While all of his lecture presentations at the Institute were top rated by the audience, Dennis really found his Institute niche in 2002, when he first served as the chair and moderator of the annual opening Recent Developments panel. Initially Dennis served in that capacity every other year, often delivering a podium lecture or serving on an afternoon panel in alternate years. Based upon the overwhelming positive reviews of his performance as moderator, however, it soon became clear that he was simply the best person available anywhere to fill that role. As a result, Dennis assumed the annual responsibility of chairing and moderating the Recent Developments panel. He was instrumental not only in shaping the content of the recent developments presentations, but also in seeking out the best of the best to join him on the panel. All of those who attended the Institute benefited from and appreciated his substantive expertise, and his practical, down-to-earth take on what the year's developments meant to their clients and their practices. The audience valued his opinion and counted on him to present all sides of any controversial issue. Dennis's openness, warmth and humor made people feel as if they got to know him personally as they relied on him year after year to provide solid, practical guidance on the most important planning issues of the day.

Dennis was also a long-time member of the Institute's Advisory Committee. The Advisory Committee is responsible for identifying topics and speakers for the program, and for providing input on trends and significant developments in the practice area. Dennis never missed one of the committee's annual meetings, even though they were regularly scheduled on the Monday of Institute week, just before he was scheduled to chair the three-hour Recent Developments panel. Dennis could always be counted on for honest and helpful advice on matters ranging from topics, to speakers, to the Institute's role within the estate planning community. Over the years, his sound advice and creative thinking were the spark that led to many successful programs and contributed in a significant way to the success of the Institute.

Dennis was a leader within the Institute, both as a speaker and as a trusted advisor. His leadership on the Advisory Committee and as the Chair of the Recent Developments panel contributed to the content, tone, and successful development of the Institute over the years in innumerable ways. We will all miss his advice, his friendship, his candor, and his good natured sense of humor.

Recent Developments – 2017

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Recent Developments – 2017

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Recent Developments – 2017

Steve R. Akers; Samuel A. Donaldson; Charles D. "Skip" Fox IV; Jeffrey N. Pennell; Howard M. Zaritsky; Ronald D. Aucutt, editor

The recent developments presentation at the 52nd Annual Heckerling Institute on Estate Planning will be made without the infectious winsomeness and penetrating legal instincts of Dennis Belcher, who has occupied the moderator's chair for many years. Dennis was a partner in the Richmond, Virginia, office of McGuireWoods LLP, where he had practiced law for his entire career since 1976. He passed away on April 27, 2017, at the age of 65, and is sorely missed by all who knew him. The contributors dedicate this compilation of 2017 recent developments to Dennis's memory.

I. Federal Legislation: "Tax Cuts and Jobs Act" (H.R. 1)

[This Part is updated through December 2, 2017.]

A. Introduction and Initial Consideration

The "Tax Cuts and Jobs Act" was introduced as H.R. 1 on November 2, 2017, by Ways and Means Committee Chairman Kevin Brady, who followed with various amendments and technical corrections. The Ways and Means Committee finished reviewing and amending H.R. 1 on November 9. The House approved H.R. 1 on November 16 by a vote of 227-205. The vote was very partisan: thirteen Republicans voted against it, but no Democrat voted for it.

On November 9, Senate Finance Committee Chairman Orrin Hatch offered a substitute for H.R. 1. Statutory language, reflecting the Finance Committee's approval, was released on November 21. Early on December 2, the Senate approved the substitute, with amendments, by a vote of 51-49. Again the vote was very partisan: Senator Corker of Tennessee was the only Republican to vote against it, and no Democrat voted for it. **The changes made by the Senate version would generally sunset in 2026.**

B. Income Tax Provisions

The House version of H.R. 1 would (i) reduce the corporate income tax rate to a single rate of 20%, (ii) repeal the corporate alternative minimum tax, and (iii) provide for a 25% net rate on the business income of individuals (either in a sole proprietorship or in a passthrough entity), all effective January 1, 2018.

The Senate version would (i) also lower the corporate income tax rate to 20%, **but not until 2019**, (ii) retain the corporate alternative minimum tax, (iii) recast the individual business provision as a deduction generally of "the lesser of (A) 23 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or

(B) 50 percent of the W-2 wages with respect to the qualified trade or business," and (iv) exempt such "qualified business income" from the alternative minimum tax.

The House version would reduce the current seven individual income tax brackets to four. The Senate version would retain seven brackets. Here, for example, is a comparison of the House and Senate versions with current law for married individuals filing joint returns and surviving spouses:

Married Couples Filing Jointly and Surviving Spouse (as of December 2, 2017)					
Current Law (in 2018)		House Version (2018)		Senate Version (2018)	
Rate	Starting at (taxable income)	Rate	Starting at (taxable income)	Rate	Starting at (taxable income)
10%	$0	12%	$0	10%	$0
15%	$19,050			12%	$19,050
25%	$77,400	25%	$90,000	22%	$77,400
28%	$156,150			24%	$140,000
33%	$237,950	35%	$260,000	32%	$320,000
35%	$424,950			35%	$400,000
39.6%	$480,050	39.6%	$1,000,000	38.5%	$1,000,000

And for estates and trusts:

Estates and Trusts (as of December 2, 2017)					
Current Law (in 2018)		House Version (2018)		Senate Version (2018)	
Rate	Starting at (taxable income)	Rate	Starting at (taxable income)	Rate	Starting at (taxable income)
15%	$0	12%	$0	10%	$0
25%	$2,600	25%	$2,550	24%	$2,550
28%	$6,100	35%	$9,150	35%	$9,150
33%	$9,300				
39.6%	$12,700	39.6%	$12,500	38.5%	$12,500

The 2018 brackets in the Senate version are the current 2017 brackets.

In both versions, bracket amounts would be indexed after 2018, but by reference not to the customary Consumer Price Index (CPI), but to a "Chained CPI." A Chained CPI would take into account anticipated consumer shifts from products whose prices increase to products whose prices do not increase or increase at a lower rate. The result would generally be slower inflation adjustments and higher tax levels over the long term.

The House version would repeal the individual alternative minimum tax. The Senate version would increase the individual AMT exemption by about 27%.

Neither version would make fundamental changes to the income tax treatment of retirement benefits.

C. Transfer Tax Provisions

Effective January 1, 2018, both the House and Senate versions of H.R. 1 would double the estate tax, gift tax, and GST tax exclusion amounts/exemptions. Thus, those amounts for 2018 would be approximately $11,200,000 (2 times $5,600,000), or $11,210,000 after application of the rounding rules. The exemptions would continue to be indexed for inflation going forward, also by using a "Chained CPI" approach. Portability for estate and gift tax purposes would be preserved. The tax rate would remain 40%.

Effective January 1, **2025**, the House version of H.R. 1, **but not the Senate version**, would **repeal the estate and GST taxes –** technically, would provide that those taxes "shall not apply." The gift tax would be retained, at a rate of 35% (its lowest point in recent history, in 2010). The doubled exclusion amount, indexed, would continue. Current basis rules would not be changed. Indeed, amendments to Section 1014 would explicitly preserve the basis rules for assets transferred at death, including a stepped-up basis for appreciated assets. Distributions from (but not terminations of) qualified domestic trusts (QDOTs) for surviving spouses of decedents dying before January 1, 2025, would continue to be taxed as under current law through 2034.

II. Treasury-IRS Priority Guidance Plan

The Treasury-IRS Priority Guidance Plan for the 12 months beginning July 1, 2017, was released on October 20, 2017. Reflecting additional review mandated this year by President Trump, its organization differs from previous Plans. The introduction provides the following explanation:

> Part 1 of the plan focuses on the eight regulations from 2016 that were identified pursuant to Executive Order 13789 and our intended actions with respect to those regulations. Part 2 of the plan describes certain projects that we have identified as burden reducing and that we believe can be completed in the 8½ months remaining in the plan year. As in the past, we intend to update the plan on a quarterly basis, and additional burden reduction projects may be added. Part 3 of the plan describes the various projects that comprise our implementation of the new statutory partnership audit regime, which has been a topic of significant concern and focus as the statutory rules go into effect on January 1, 2018. Part 4 of the plan, in line with past years' plans and our long-standing commitment to transparency in the process, describes specific projects by subject area that will be the focus of the balance of our efforts this plan year.

A. Part 1: Identifying and Reducing Regulatory Burdens – Withdrawal of the Proposed Section 2704 Regulations: Executive Order 13789, Notice 2017-38

Treasury withdraws proposed Section 2704 regulations. Executive Order 13789, 82 Fed. Reg. 19317 (April 26, 2017); Notice 2017-38, 2017-30 I.R.B. 147 (July 24, 2017); Dept. of Treas., "Second Report to the President on Identifying and Reducing Tax Regulatory Burdens," pp. 2-3 (Oct 2, 2017); 82 Fed. Reg. 48013 (Oct. 16, 2017); 82 Fed. Reg. 48779-80 (Oct. 20, 2017).

Part 1 of the Plan contains eight items, the first of which is expressed as "Withdrawal of proposed regulations under §2704 regarding restrictions on liquidation of an interest for estate, gift, and generation-skipping transfer taxes. Proposed regulations were published on August 4, 2016."

On April 21, 2017, President Trump issued Executive Order 13789, 82 Fed. Reg. 19317

(April 26, 2017), requiring the Treasury Department to review all significant tax regulations issued in 2016 and to date in 2017, to identify those that (1) impose an undue financial burden on United States taxpayers, (2) add undue complexity to the Federal tax laws, or (3) exceed the statutory authority of the IRS.

On July 8, 2017, the IRS issued Notice 2017-38, explaining that, of the 105 temporary, proposed, and final regulations promulgated after January 1, 2016, eight met at least one of the first two criteria described in Executive Order 13789. (The IRS did not identify any regulations that exceeded statutory authority.) These eight included the proposed regulations under Section 2704, about which the Notice state:

> Commenters expressed concern that the proposed regulations would eliminate or restrict common discounts, such as minority discounts and discounts for lack of marketability, which would result in increased valuations and transfer tax liability that would increase financial burdens. Commenters were also concerned that the proposed regulations would make valuations more difficult and that the proposed narrowing of existing regulatory exceptions was arbitrary and capricious.

The Notice requested comments on whether those regulations "should be rescinded or modified, and in the latter case, how the regulations should be modified in order to reduce burdens and complexity."

On October 2, 2017, the Treasury Department issued its Second Report in response to Executive Order 13789, announcing:

> After reviewing these comments, Treasury and the IRS now believe that the proposed regulations' approach to the problem of artificial valuation discounts is unworkable. In particular, Treasury and the IRS currently agree with commenters that taxpayers, their advisors, the IRS, and the courts would not, as a practical matter, be able to determine the value of an entity interest based on the fanciful assumption of a world where no legal authority exists. Given that uncertainty, it is unclear whether the valuation rules of the proposed regulations would have even succeeded in curtailing artificial valuation discounts. Moreover, merely to reach the conclusion that an entity interest should be valued as if restrictions did not exist, the proposed regulations would have compelled taxpayers to master lengthy and difficult rules on family control and the rights of interest holders. The burden of compliance with the proposed regulations would have been excessive, given the uncertainty of any policy gains. Finally, the proposed regulations could have affected valuation discounts even where discount factors, such as lack of control or lack of a market, were not created artificially as a value-depressing device.

The proposed regulations were withdrawn in 82 Fed. Reg. 48779-80 (Oct. 20, 2017).

B. Part 2. Near-Term Burden Reduction

In addition to announcing the intended withdrawal of the Section 2704 proposed regulations, Treasury's October 2, 2017, Second Report in response to Executive Order

13789 stated that “Treasury continues to analyze all recently issued significant regulations and is considering possible reforms of several recent regulations not identified in the June 22 Report [Notice 2017-38].” In that vein, as noted above, Treasury and the IRS stated in the current Priority Guidance Plan that “Part 2 of the plan describes certain projects that we have identified as burden reducing and that we believe can be completed in the 8½ months remaining in the plan year” – that is, by June 30, 2018.

The first of the 19 items in Part 2 perpetuates the initiative of “Guidance removing or updating regulations that are unnecessary, create undue complexity, impose excessive burdens, or fail to provide clarity and useful guidance.” The other 18 items in Part 2 refer more conventionally to particular topics and projects. The fourth and eighth are taken from the section of previous Plans entitled “Gifts and Estates and Trusts.”

1. Consistent Basis Rules

The fourth item in Part 2 of the Plan is described as “Regulations under §§1014(f) and 6035 regarding basis consistency between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016.” The proposed regulations and their statutory background were extensively reported in ¶101 of last year’s Recent Developments. Among other things, that discussion points out what seem to be unnecessarily harsh requirements in the proposed regulations, including

- a requirement to provide estate tax values to beneficiaries 30 days after the estate tax return is filed, possibly long before the executor can know which beneficiaries will receive which assets, necessitating a wasteful, confusing, and divisive report of all assets the beneficiary might ever receive (¶101.9[I];
- a requirement that successive transferors furnish those estate tax values to recipients of gifts and other transferees in carryover basis transactions, apparently in perpetuity (¶101.9[L]); and
- a “zero basis” for the recipients of certain after-discovered or otherwise omitted property (¶101.9[E]).

The regulations should have been finalized by January 31, 2017 – that is, within 18 months of enactment of the statute, to permit them to be retroactive to the effective date of the statute under Section 7805(b)(2). **They were not.** Now, despite the burdens those proposed regulations would impose, such as the three controversial requirements listed above, finalizing those regulations has been identified as “burden reducing.” One can only infer – or hope – that Treasury and the IRS have found, or are determined to find, workarounds to those burdens.

2. Section 2642(g) Regulations

The eighth item in Part 2 of the Plan is described as “Final regulations under §2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption.” This project first appeared in the 2007-2008 Plan. The background of this project is section 564(a) of the 2001 Tax Act, which added subsection (g)(1) to Section 2642, directing Treasury to publish regulations providing for extensions of time to allocate GST exemption or to elect out of statutory allocations of

GST exemption (when those actions are missed on the applicable return or a return is not filed).

Before the 2001 Tax Act, similar extensions of time under Reg. §301.9100-3 (so-called "9100 relief") were not available, because the deadlines for taking such actions were prescribed by the Code, not by the regulations. Section 2642(g)(1)(B) states that for purposes of the expanded relief the statute contemplates:

> In determining whether to grant relief under this paragraph, the Secretary shall take into account all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Secretary deems relevant. For purposes of determining whether to grant relief under this paragraph, the time for making the allocation (or election) shall be treated as if not expressly prescribed by statute.

Shortly after the enactment of the 2001 Tax Act, Notice 2001-50, 2001-2 C.B. 189, acknowledged Section 2642(g)(1) and stated that taxpayers may seek extensions of time to take those actions under Reg. §301.9100-3. The IRS has received and granted many requests for such relief over the years since the publication of Notice 2001-50.

Proposed Reg. §26.2642-7 (REG-147775-06) was released on April 16, 2008. When finalized, the new regulations will oust Reg. §301.9100-3 in GST exemption cases and become the exclusive basis for seeking the extensions of time Congress mandated in Section 2642(g)(1) (except for a simplified procedure for dealing with pre-2001 annual exclusion gifts under Rev. Proc. 2004-46, 2004-2 C.B. 142).

The proposed regulations resemble Reg. §301.9100-3, but with some important differences. Under Proposed Reg. §26.2642-7(d)(1), the general standard is still (as in Reg. §301.9100-3) "that the transferor or the executor of the transferor's estate acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the Government." But Proposed Reg. §26.2642-7(d)(2) sets forth a "nonexclusive list of factors" to determine whether the transferor or the executor of the transferor's estate acted reasonably and in good faith, including (i) the intent of the transferor to make a timely allocation or election, (ii) intervening events beyond the control of the transferor or the executor, (iii) lack of awareness of the need to allocate GST exemption to the transfer, despite the exercise of reasonable diligence, (iv) consistency by the transferor, and (v) reasonable reliance on the advice of a qualified tax professional. Proposed Reg. §26.2642-7(d)(3) sets forth a "nonexclusive list of factors" to determine whether the interests of the Government are prejudiced, including (i) the extent to which the request for relief is an effort to benefit from hindsight, (ii) the timing of the request for relief, and (iii) any intervening taxable termination or taxable distribution. Noticeably, the proposed regulations seem to invite more deliberate weighing of all these factors than the identification of one or two dispositive factors as under Reg. §301.9100-3.

In addition, Proposed Reg. §26.2642-7(h)(3)(i)(D) requires a request for relief to be accompanied by "detailed affidavits" from "[e]ach tax professional who advised or was consulted by the transferor or the executor of the transferor's estate with regard to any aspect of the transfer, the trust, the allocation of GST exemption, and/or the election under section 2632(b)(3) or (c)(5)." The references to "any aspect of the transfer" and "the trust" appear to go beyond the procedural requirement of Reg. §301.9100-3(e)(3) for "detailed affidavits from the individuals having knowledge or information about the events that led to the failure to make a valid regulatory election and to the discovery of the failure."

In short, the prospect of seeking relief under the proposed Section 2642(g) regulations has appeared, to many observers since they were published in 2008, to be more onerous than the familiar "9100 relief." The Section 2642(g) regulation project was even dropped from the 2016-2017 Priority Guidance Plan. Now, it also reappears with the label of "burden reducing."

C. Part 3: Partnership Audits

Part 3 of the Plan deals with partnership audit regulations implementing 2015 legislation. that takes effect on January 1, 2018. There is nothing in Part 3 uniquely of interest to estate planners.

D. Part 4: General Guidance

Part 4 of the Plan, entitled "General Guidance," like previous Plans and as noted above, "describes specific projects by subject area that will be the focus of the balance of [Treasury's and the Service's] efforts this plan year." It lists 166 items (down from 281 last year), including the following three items (down from 12 last year) under the heading of "Gifts and Estates and Trusts" that should be near completion.

1. Basis of Grantor Trust Assets at Death

This project was new in 2015.

Rev. Proc. 2015-37, 2015-26 I.R.B. 1196 (June 29, 2015), added "[w]hether the assets in a grantor trust receive a section 1014 basis adjustment at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate of that owner under chapter 11 of subtitle B of the Internal Revenue Code" to the list of "areas under study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, a revenue procedure, regulations, or otherwise." That designation was continued in section 5.01(12) of Rev. Proc. 2016-3, 2016-1 I.R.B. 126, and in section 5.01(10) of Rev. Proc. 2017-3, 2017-1 I.R.B. 130.

Meanwhile, Letter Ruling 201544002 (issued June 30, 2015; released Oct. 30, 2015), held that assets in a revocable trust created by *foreign* grantors for their U.S. citizen children would receive a stepped-up basis under Section 1014(b)(2) at the grantors' deaths. The ruling acknowledged the no-rule policy of Rev. Proc. 2015-37, but avoided it on the ground that the ruling request had been submitted before the no-rule policy was announced.

Because the letter ruling was released just one day after the publication of the no-rule policy it sought to distinguish, it has been widely assumed that the two were related, possibly that the no-rule policy was even prompted by the receipt of the ruling request. In that case, the regulation project announced about a month later in the 2015-2016 Plan might be aimed, like the letter ruling, at foreign trust, and therefore might not be as interesting. It is also possible that, even if the project originally had such a narrow focus, it has since been expanded in the Trump Administration.

2. Restrictions on Estate Assets During the First Six Months

This regulation project, which first appeared in the 2007-08 Plan, is described as "Final regulations under §2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011."

The first set of proposed regulations related to this project, Proposed Reg. §20.2032-1(f) (REG-112196-07), was published on April 25, 2008. The preamble appeared to view these regulations as the resolution of "[t]wo judicial decisions [that] have interpreted the language of section 2032 and its legislative history differently in determining whether post-death events other than market conditions may be taken into account under the alternate valuation method."

In the first of these cases, *Flanders v. United States*, 347 F. Supp. 95 (N.D. Calif. 1972), after a decedent's death in 1968, but before the alternate valuation date, the trustee of the decedent's (formerly) revocable trust, which held a one-half interest in a California ranch, entered into a land conservation agreement pursuant to California law. The conservation agreement reduced the value of the ranch by 88%. Since that reduced value was the value of the ranch at the alternate valuation date (which until 1971 was one year after death), the executor elected alternate valuation and reported the ranch at that value. Citing the Depression-era legislative history to the effect that alternate valuation was intended to protect decedents' estates against "many of the hardships which were experienced after 1929 when market values decreased very materially between the period from the date of death and the date of distribution to the beneficiaries," the court held that "the value reducing result of the post mortem act of the surviving trustee" may not be considered in applying alternate valuation.

The second of these cases was *Kohler v. Commissioner*, T.C. Memo. 2006-152, *nonacq.*, 2008-9 I.R.B. 481, involving the estate of a shareholder of the well-known family-owned plumbing fixture manufacturer. The executor had received stock in a tax-free corporate reorganization that had been under consideration for about two years before the decedent's death but was not completed until about two months after the decedent's death. The court rejected the Service's attempt to base the estate tax on the value of the stock *surrendered* in the reorganization (which had been subject to fewer restrictions on transferability), on the ground that Reg. §20.2032-1(c)(1) prevents that result by specifically refusing to treat stock surrendered in a tax-free reorganization as "otherwise disposed of" for purposes of Section 2032(a)(1). The court also noted that the exchange of stock must have been for equal value or the reorganization would not have been tax-free as the parties had stipulated (although, ironically, the executor's own appraiser had determined a value of the pre-reorganization shares of $50.115 million and a value of the post-reorganization shares of $47.010 million – a difference of about 6.2%). The court distinguished *Flanders*, where the post-death transaction itself reduced the value by 88%. It viewed the 1935 legislative history relied on in *Flanders* as irrelevant, because Reg. §20.2032-1(c)(1) (promulgated in 1958) was clear and unambiguous and because "the legislative history describes the general purpose of the statute, not the specific meaning of 'otherwise disposed of' in the context of tax-free reorganizations."

The 2008 proposed regulations would have made no change to Reg. §20.2032-1(c)(1), on which the *Kohler* court relied. But they invoked "the general purpose of the statute" that was articulated in 1935, relied on in *Flanders*, and bypassed in *Kohler* to beef up Reg. §20.2032-1(f), to clarify and emphasize, with both text and examples, that the benefits of alternate valuation are limited to changes in value due to "market conditions." The 2008 proposed regulations would specifically add "post-death events other than market conditions" to changes in value resulting from the "mere lapse of time," which are ignored in applying alternate valuation under Section 2032(a)(3).

New proposed regulations (REG-112196-07) were published on November 18, 2011. In contrast to the 2008 approach of ignoring certain intervening events – and thereby potentially valuing assets six months after death on a hypothetical basis – the new approach is to expand the description of intervening events that are regarding as dispositions, triggering alternate valuation as of that date. The expanded list, in Proposed Reg. §20.2032-1(c)(1)(i), includes distributions, exchanges (whether taxable or not), and contributions to capital or other changes to the capital structure or ownership of an entity, including "[t]he dilution of the decedent's ownership interest in the entity due to the issuance of additional ownership interests in the entity." Proposed Reg. §20.2032-1(c)(1)(i)(I)(*1*).

While the 2008 proposed regulations were referred to as the "anti-*Kohler* regulations," the most significant impact of these proposed regulations may be felt by efforts to bootstrap an estate into a valuation discount by distributing or otherwise disposing of a minority or other noncontrolling interest within the six-month period after death (valuing it as a minority interest under Section 2032(a)(1)) and leaving another minority or noncontrolling interest to be valued six months after death (also valued as a minority interest under Section 2032(a)(2)). Examples 7 and 8 of Proposed Reg. §20.2032-1(c)(5) specifically address the discount-bootstrap technique – Example 8 in the context of a limited liability company and Example 7 in the context of real estate – and leave no doubt that changes in value due to "market conditions" do not include the valuation discounts that might appear to be created by partial distributions. And Example 1 reaches the same result with respect to the post-death formation of a limited partnership.

The 2008 proposed regulations were to be effective April 25, 2008, the date the proposed regulations were published. The new proposed regulations, more traditionally, state that they will be effective when published as final regulations.

3. Personal Guarantees and Present Value Concepts for Estate Administration Expenses

This project, which first appeared in the 2008-09 Plan, is described as "Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate." It is an outgrowth of the project that led to the final amendments of the Section 2053 regulations in October 2009.

The part of this project relating to "present value concepts" is evidently aimed at the leveraged benefit obtained when a claim or expense is paid long after the due date of the estate tax, but the additional estate tax reduction is credited as of, and earns interest from, that due date. Graegin loans (see *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477) are an obvious target.

E. Net Investment Income Tax Regulations

Item 20 under the heading "General Tax Issues" in the Plan is described as "Final regulations under §1411 regarding issues related to the net investment income tax. Proposed regulations were published on December 2, 2013." That is the 3.8% tax (sometimes called the "Medicare Tax" or "Medicare Surtax") that has proved so difficult to apply to trusts.

F. Deletions in 2017 from the 2016-2017 Plan

1. Spousal Support Trusts

This project, new in 2016, was described as "Guidance on definition of income for spousal support trusts under §682."

2. Valuing Promissory Notes

This project, new in 2015, was described as "Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872."

It is well known that the Tax Court has held that Section 7872 is the applicable provision for valuing an intra-family promissory note – specifically for determining that a note carrying the Section 7872 rate may be valued at its face amount. *See Frazee v. Commissioner*, 98 T.C. 554 (1992). *See also Estate of True v. Commissioner*, T.C. Memo. 2001-167, *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004). But Judge Hamblen concluded his opinion in *Frazee* by stating: "We find it anomalous that respondent urges as her primary position the application of section 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept." 98 T.C. at 590. Perhaps this project was intended to resolve that anomaly, probably by regulations.

Section 7872(i)(2) states:

> Under regulations prescribed by the Secretary [of the Treasury], any loan which is made with donative intent and which is a term loan shall be taken into account for purposes of chapter 11 [the estate tax chapter] in a manner consistent with the provisions of subsection (b) [providing for the income and gift tax treatment of below-market loans].

Proposed Reg. §20.7872-1 (proposed in 1985) provides that a "gift term loan" shall be valued for estate tax purposes at no less than (a) its unpaid stated principal plus accrued interest or (b) the present value of all the future payments under the note using the applicable federal rate in effect at the time of death.

> **Note:** The estate planner's answers to the proposed regulation would include the arguments that (1) the proposed regulation is not effective unless and until it is finalized, (2) the loan represented by the installment note is not a "gift term loan" because it uses an interest rate calculated to avoid below-market treatment under

> Section 7872(e), and (3) with respect to Section 7872(i)(2) itself, the loan is not made "with donative intent" because the transaction is a sale.

Under Section 7805, the proposed regulations could probably be expanded even beyond the strict mandate of Section 7872(i)(2), and under Section 7805(b)(1)(B) such expanded final regulations might even be made effective retroactively to the publication date of the proposed regulations in 1985 (although that would be an aggressive choice that undoubtedly would be roundly criticized). But, unless and until that happens, most estate planners have seen no reason why the estate tax value should not be fair market value, which, after all, is the general rule, subject to Reg. §20.2031-4, which states:

> The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus interest accrued to the date of death, unless the executor establishes that the value is lower or that the notes are worthless. However, items of interest shall be separately stated on the estate tax return. If not returned at face value, plus accrued interest, satisfactory evidence must be submitted that the note is worth less than the unpaid amount (because of the interest rate, date of maturity, or other cause), or that the note is uncollectible, either in whole or in part (by reason of the insolvency of the party or parties liable, or for other cause), and that any property pledged or mortgaged as security is insufficient to satisfy the obligation.

It is not clear that this guidance project was related to these developments, and in any event it did not cite Proposed Reg. §20.7872-1. It *is* clear that the IRS has long been interested in the valuation of promissory notes, and at times has seemed to embrace a market interest rate standard. *See* Letter Ruling 200147028 (issued Aug. 9, 2001; released Nov. 23, 2001). The interest of the IRS was especially apparent after the docketing of *Estate of Davidson v. Commissioner*, T.C. Docket No. 13748-13, in which the IRS asserted $2.8 billion in estate, gift, and generation-skipping taxes owed. On July 6, 2015, the case was settled for just over $550 million. Addressing Mr. Davidson's sales both in Chief Counsel Advice 201330033 (issued Feb. 24, 2012; released July 26, 2013) and in its answer in the Tax Court, the IRS argued that the notes should be valued, not under Section 7520, but under a willing buyer-willing seller standard that took account of Mr. Davidson's health. *See also Estate of Kite v. Commissioner*, T.C. Memo. 2013-43.

3. Defined Value Formula Clauses

This project, new in 2015, was described as "Guidance on the gift tax effect of defined value formula clauses under §§2512 and 2511."

Defined value clauses have an interesting history. See, for example, Technical Advice Memorandum 8611004 (Nov. 15, 1985) (approving a transfer of "such interest in X Partnership … as has a fair market value of $13,000"); *Knight v. Commissioner*, 115 T.C. 506 (2000) (disregarding the use of such a technique to transfer "that number of limited partnership units in [the partnership] which is equal in value, on the effective date of this transfer, to $600,000"); *Succession of McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), *rev'g* 120 T.C. 358 (2003) (approving a defined value clause, with the excess going to charity); *Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008) (reviewed by the Court), *aff'd*, 586 F.3d 1061 (8th Cir. 2009) (approving a formula disclaimer in favor of charity); *Estate of Petter v. Commissioner*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011) (approving a defined value clause, with the excess going to charity); *Hendrix v. Commissioner*, T.C. Memo. 2011-133 (approving a defined value clause, with the excess going to charity); *Wandry v. Commissioner*, T.C. Memo. 2012-88, *nonacq*., AOD 2012-004, 2012-46 I.R.B. (approving a type of defined value clause, with the excess remaining with the transferor); *Estate of Donald Woelbing v. Commissioner* (Tax Court Docket No. 30261-13, stipulated decision entered March 25, 2016) and *Estate of Marion Woelbing v. Commissioner* (Tax Court Docket No. 30260-13, stipulated decision entered March 28, 2016).

In affirming the Tax Court in *Petter*, albeit in the context of a rather narrow subpoint of a condition precedent within the meaning of Reg. §25.2522(c)-3(b)(1), the Court of Appeals for the Ninth Circuit concluded its opinion by quoting:

> [W]e expressly invite[ ] the Treasury Department to "amend its regulations" if troubled by the consequences of our resolution of th[is] case." *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704, 713 (2011) (quoting *United Dominion Indus., Inc. v. United States*, 532 U.S. 822, 838 (2001)).

Maybe, in this guidance project, Treasury was proposing to accept that invitation.

4. Split-Interest Charitable Trusts

This project, new in 2016," was described as "Guidance under §§2522 and 2055 regarding the tax impact of certain irregularities in the administration of split-interest charitable trusts."

5. Gifts or Bequests from Certain Expatriates

This project was described as "Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates."

The Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART" Act) enacted a new income tax "mark to market" rule when someone expatriates on or after June 17, 2008, and a new succession tax on the receipt of certain gifts or bequests from someone who expatriated on or after June 17, 2008. The new succession tax is provided for in Section 2801, comprising all of new chapter 15.

Referring to the guidance contemplated by this project, Announcement 2009-57, 2009-29 I.R.B. 158 (released July 16, 2009), stated:

> The Internal Revenue Service intends to issue guidance under section 2801, as well as a new Form 708 on which to report the receipt of gifts and bequests subject to section 2801. The due date for reporting, and for paying any tax imposed on, the receipt of such gifts or bequests has not yet been determined. The due date will be contained in the guidance, and the guidance will provide a reasonable period of time between the date of issuance of the guidance and the date prescribed for the filing of the return and the payment of the tax.

This project first appeared on the 2009-2010 Plan. Originally it was referred to by Treasury and IRS personnel as a top priority, but now it has been dropped from the Priority Guidance Plan, even though proposed regulations were published on September 10, 2015. Evidently the implementation of what amounts to a succession tax on transferees, not transferors or their estates, is complicated and challenging.

III. Federal Transfer Tax Developments

A. Inclusion in the Gross Estate

1. Transfers Incident to Divorce: PLRs 201707007 & 201707008

IRS reviews the tax consequences of a property settlement trust incident to a couple's divorce. Letter Rulings 201707007 and 201707008 (issued Oct. 31, 2016; released Feb. 17, 2017).

As part of the settlement agreement negotiated by H and W incident to their divorce, H proposes to transfer Company shares to an irrevocable trust for the benefit of W, in exchange for which W relinquishes all marital rights and property claims that she might have acquired while married to H. Under the trust terms, W will receive all net income during life and may, at the trustee's discretion, receive distributions of principal. The trustee may not, however, distribute Company shares to W or sell such shares to make cash distributions to W. At W's death, any remaining trust principal will be distributed to H, or, if he predeceased W, his estate. W also can withdraw the greater of a stated dollar amount or a stated percentage of the principal of the trust each year.

The IRS ruled that

(a) if the transfer of the shares of stock in the Company occurred within six months after the entry of the final judgment of divorce, neither spouse will recognize a gain or loss on the creation of the trust, under Section 1041, which provides that, in the case of any transfer of property incident to a divorce is treated as acquired by the transferee by gift, and the basis of the transferee in the property shall be the adjusted basis of the transferor;

(b) Sections 2501 and 2702(c) will not cause either spouse to have made a taxable gift of an interest in the trust, because H is transferring property to the trust in exchange for W's relinquishment of her marital support and property rights, which constitutes a transfer for full and adequate consideration under Section 2516, and no member of H's family acquires an interest in the trust under Reg. §25.2702-4(d), Ex. 5;

(c) except to the extent of any unexercised withdrawal right held by W at her death, none of the assets of the trust will be included in W gross estate for federal estate tax purposes; and

(d) the fair market value of the trust property on H's death (or the alternate valuation date, if elected), less the fair market value of W's outstanding income interest, will be included in H's gross estate under Sections 2036(a)(1) and 2036(a)(2), because H retained a right to the property if he survives W.

2. Adequate and Full Consideration Exception: CCA 201745012

Deathbed purchase of GRAT remainder interest does not avoid application of Section 2036 or create estate tax deduction. Chief Counsel Advice 201745012 (issued Aug. 4, 2017; released Nov. 9, 2017).

On Date 1, Donor created Trust 1, an irrevocable discretionary trust for the benefit of Donor's first spouse and issue. Trust 1 terminates on the later of the death of Donor or his first spouse, at which time the principal and any accumulated income are distributed outright to Donor's issue per stirpes. Donor's first spouse predeceased him; Donor then married Spouse. On Date 2, Donor formed Trust 2, a grantor retained annuity trust for the benefit of Donor and his issue. Under the terms of Trust 2, an annuity is payable to Donor for the term of the trust, and the remainder is payable under the terms of Trust 1. On Date 3, Donor formed Trust 3, a grantor retained annuity trust for the benefit of Donor and his issue. Under the terms of Trust 3, an annuity is payable to Donor for the term of the trust, and the remainder is payable under the terms of Trust 1. On Date 4, before the expiration of the annuity terms of Trusts 2 and 3, Donor bought the remainder interests in Trusts 2 and 3 from the trustees of Trust 1. Donor paid the purchase price with two unsecured promissory notes. Donor died the following day, before the annuity terms of Trusts 2 and 3 expired.

Donor's executor filed a gift tax return and reported the purchases of the remainder interests as non-gift transfers, claiming that Donor received adequate and full consideration in money or money's worth in the form of the remainder interests in Trusts 2 and 3. Spouse elected to split gifts with Donor. Donor's executor also filed an estate tax return, including the corpus of Trusts 2 and 3 in the gross estate. Section 2036(a)(1); Reg. §20.2036-1(c)(2). Donor's executor deducted the value of the outstanding promissory notes payable to the trustees of Trust 1 as claims against the estate.

Adequate Consideration. The IRS Chief Counsel's Office stated that, where a purchase of the remainder occurs on the donor's deathbed during the annuity term of a GRAT, the remainder does not replenish the donor's taxable estate, and therefore, does not constitute adequate and full consideration in money or money's worth for gift tax purposes. The Chief Counsel's Office explained that, as to any property, or part of or interest in any property, of which 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 for the benefit of another, the gift is complete. Reg. §25.2511-2(b). The Chief Counsel's Office relied on *Commissioner v. Wemyss*, 324 U.S. 303 (1945) and *Merrill v. Fahs*, 324 U.S. 308 (1945), in which the Supreme Court held that "adequate and full consideration in money or money's worth" has a different meaning for contracts law purposes then it does for gift tax purposes. The gift tax law requires consideration that is reducible to a money value and thereby replenishes the recipient's estate for the value of the property for which it was transferred. The right to decide how property shall be disposed of may have value for contract law purposes, but it does not replenish the transferor's estate and thus does not constitute adequate and full consideration for gift tax purposes.

In the facts before the Chief Counsel's Office, Donor's liability on the promissory notes depleted his taxable estate, because the donor had retained a Section 2036 interest or power, which already caused the value of the remainder to be part of his estate. The receipt of the actual remainder interests did not increase the value of the donor's taxable estate, so receipt of the remainder interests could not constitute adequate and full consideration for gift tax purposes. Rev. Rul. 98-8, 1998-1 C.B. 541 (reaching a similar conclusion for gift tax purposes in the context of Sections 2519 and 2044).

Deductibility of the Notes. The Chief Counsel's Office also concluded that the notes were not deductible as a claim against Donor's estate under Section 2053(c)(1)(A), which provides, in part, that the deduction allowed in the case of claims against the estate, unpaid mortgages, or any indebtedness shall, when founded on a promise or agreement, be limited to the extent that they were contracted bona fide and for an adequate and full consideration in money or money's worth. *See also* Reg. §20.2053-1(b)(2)(i). No deduction is permissible to the extent it is founded on a transfer that is essentially donative in character (a mere cloak for a gift or bequest). The regulations (Reg. §20.2053-1(b)(2)(ii)) also state that factors indicative (but not necessarily determinative) of the bona fide nature of a claim or expense involving a family member of a decedent, or a beneficiary of a decedent's estate or revocable trust, may include, but are not limited to: (A) the transaction underlying the claim or expense occurs in the ordinary course of business, is negotiated at arm's length, and is free from donative intent; (B) the claim or expense is not related to an expectation or claim of inheritance; (C) the claim or expense originates pursuant to an agreement between the decedent and the family member or beneficiary, and the agreement is substantiated with contemporaneous evidence; (D) performance by the claimant is pursuant to the terms of an agreement between the decedent and the family member or beneficiary and the performance and the agreement can be substantiated; (E) all amounts paid in satisfaction or settlement of a claim or expense are reported by each party for Federal income and employment tax purposes, to the extent appropriate, in a manner that is consistent with the reported nature of the claim or expense. In *Merrill v. Fahs*, the Supreme Court held that adequate and full consideration should be deemed to have the same meaning in both the estate tax and the gift tax. 324 U.S. at 313 (1945). Consideration, therefore, is limited to something that replenishes the donor's taxable estate for transfer tax purposes.

The Chief Counsel's Office concluded that, where the purchase of the remainder occurs on the donor's deathbed while he is holding a Section 2036 "string" to the transferred property, the remainder does not increase the value of the donor's taxable estate, because the entire value of the transferred property, including that of the remainder, will be includible in the donor's gross estate pursuant to Section 2036(a)(1). *See also Estate of Goetchius v. Commissioner*, 17 T.C. 495, 503 (1951). The Chief Counsel's Office viewed the promissory notes in this situation as "a mere cloak for a gift." Reg. §20.2053-1(b)(2)(i); *Estate of Tiffany v. Commissioner*, 47 T.C. 491 (1967); *Estate of Davis v. Commissioner*, 57 T.C. 833 (1972). Accordingly, no deduction is allowable for Donor's liability on the outstanding promissory notes.

> **Note:** The same analysis would apply to the purchase of a remainder interest in a QPRT or, as discussed in Rev. Rul. 98-8, mentioned above, a QTIP. Moreover, it could be extended to the sale of a life insurance policy on the seller's life made

within three years of the seller's death. Section 2035(a) states that a transfer of a life insurance policy by the insured within three years of death does not remove the proceeds from the insured's gross estate, but Section 2035(d) contains an exception for a bona fide sale for full and adequate consideration. The analysis in CCM 201745012 would suggest that the payment of the current fair market value of the policy might be inadequate to remove the proceeds from the gross estate, because it would not replace the value of the asset in the gross estate. Arguably, this is incorrect, because it does replace the estate tax value of the asset on the date of the sale, but the IRS could well seek to extend the analysis applied in CCM 201745012 in this context.

B. Valuation

1. Controlling Interest in an LLC Holding Liquid Assets: *Koons*

The Tax Court and the Court of Appeals for the Eleventh Circuit Both Reject the Estate's Valuation of Controlling Interest in an LLC Holding Liquid Assets. *Estate of Koons v. Commissioner*, 686 Fed. Appx. 779 (11th Cir. April 27, 2017), *aff'g* T.C. Memo. 2013-94.

The decedent, John F. Koons, III, created Central Investments Corp., which established and ran a soft drink vending machine business. He made a large series of gifts of stock of Central to various family members, including his four children, his many grandchildren, and his three ex-wives. Less than three months before his death, the decedent sold the operations to Pepsi for $400 million, to settle a dispute with the soft-drink company. Central Investments then created Central Investments, LLC ("the LLC"), to hold and invest the sales proceeds. The shareholders of Central Investments entered into a Stock Purchase Agreement that required the company to distribute the LLC membership interests to the shareholders, required the redemption of the interests of several of the donees after the decedent's death, and limited discretionary distributions to 30% of "the excess of 'distributable cash,'" but permitted removal of the 30% limitation by a majority vote. The redemptions left the decedent's estate with a 70.42% voting interest in the LLC, which then held approximately $351 million of assets, of which $322 million was in cash, and had a net asset value, after liabilities, of approximately $318 million. The estate valued its interests in the LLC with a 31.7% discount – a cumulative 26.6% discount for lack of marketability, 4% discount for post-sale contingent liabilities, and 3% discount for the 75% vote required to transfer interests outside of the family.

The Tax Court (Judge Morrison) held for the IRS, finding that the appropriate discount was 7.5%, rather than 31.7%, and that the loan interest was not deductible. The court strongly favored and adopted the views of the IRS's expert, Prof. Mukesh Bajaj, ignoring the 30% discretionary distribution limitation because a simple majority vote could remove it. He also noted that the LLC's underlying assets were overwhelmingly liquid, so a 70.42% owner could distribute most of these assets without liquidating the entity. These facts made the typical restricted stock transaction studies inapplicable, the IRS expert contended, leaving an appropriate discount of 7.5%.

The court noted that the estate's expert failed to consider that the discretionary distribution limitations could be overcome with a simple majority vote allowing the

70.42% owner to distribute much of the underlying liquid assets. The court stated that the IRS's expert's views were based on "experience and common sense," and that he arrived at the more accurate valuation, in part because (a) the estate's expert used a regression equation derived from an evaluation of 88 businesses engaged in mainly active businesses as opposed to holding cash assets; (b) the estate's expert explained only one-third of the variation in the discounts in the ownership interests in the 88 companies; (c) the estate's calculation involved ownership of minority interests; and (d) the estate's expert overestimated the relationship between block size and the valuation discount.

The Court of Appeals for the Eleventh Circuit (District Judge Reeves) affirmed both holdings. With respect to the valuation of the membership interests, the court held that the Tax Court had properly concluded that the redemptions would occur. The estate noted that, at Mr. Koons' death, the Revocable Trust's interest was not controlling, but the court noted that each of the children had signed an offer to redeem his or her interest and that, after these redemptions, the Revocable Trust would have over 70% of the voting interests. The court agreed that it was reasonable to assume that these redemptions would be carried out, because the testimony at trial suggested that the children were not interested in an ownership stake in the LLC, but instead wanted cash, and that the managers of the LLC did not want the children to remain. The children had raised objections to some of the terms of the redemptions, but then they had signed the agreement, effectively waiving those objections.

The Eleventh Circuit also stated that the Tax Court had properly evaluated the fiduciary obligations under state law, in concluding that a hypothetical buyer of the Revocable Trust's interest in the LLC would be permitted to force a distribution of most of the LLC's assets. The estate argued that majority interest holders owe those holding a minority interest a heightened fiduciary duty under Ohio law, which would prevent them from frustrating the purposes for which the LLC was created. The appeals court held that, while Ohio imposes a heightened fiduciary duty on majority shareholders to prevent them from abusing their power at the expense of minority shareholders (*see Edelman v. JELBS*, 57 N.E.3d 246, 255 (Ohio Ct. App. 2015), it does not require that majority shareholders' actions have a legitimate business purpose; it only obliges them to demonstrate that their action had a legitimate business purpose if the action breached a fiduciary duty. *See Crosby v. Beam*, 548 N.E.2d 217, 221 (Ohio 1989). Actions by a majority shareholder that benefit all shareholders equally cannot violate a fiduciary obligation, even if there is no business purpose.

The Eleventh Circuit also held that the Tax Court properly gave controlling weight to the Commissioner's expert regarding his methodology and valuation determination. The court stated that the Tax Court had, essentially, viewed the LLC as a holding company only 4% of the assets of which were an operating business. Therefore, the LLC's value was properly determined by the value of its underlying assets.

> **Note:** The issue of the deductibility of interest on a "Graegin loan" in this case is discussed in Part III.D.

2. Self-Cancelling Installment Notes: *Johnson*

The IRS has again questioned the valuation of a self-canceling installment note.

***Estate of Johnson v. Commissioner*, T.C. Docket No. 11708-16 (filed May 16, 2016).**

In 2005, Ms. Johnson sold shares of a closely-held company in exchange for a SCIN. The SCIN provided for current interest payments, but a balloon principal payment on April 28, 2013. Ms. Johnson died in January 2012, about one year before the maturity date, and the principal payments were cancelled pursuant to the terms of the SCIN. The face amount of the SCIN was $5,532,589, of which $2,941,356 represented a principal premium to compensate for the actuarial risk of Ms. Johnson's premature death and the cancellation of the note. The risk premium "was determined by actuarial computations based on the life expectancy factors of Reg. §1.72-9 (Table V)." In addition, the interest rate on the note was 4.28% per annum, which was greater than the AFR of 4.09%. According to the petition filed with the Tax Court, the IRS refused to treat the SCIN "as bona fide consideration equal in value to (i) the fair market value of such units, plus (ii) the fair market value of the risk associated with the possibility of cancellation in the event that Decedent did not survive the term of the SCIN."

An additional issue is that the estate reported the gain on the cancellation of the note as gain on the decedent's final income tax return rather than on the estate's first fiduciary income tax return. (Reporting the gain on the decedent's final income tax return resulted in a substantial debt deduction for estate tax purposes.) The IRS's position is that gain should be reported on the fiduciary income tax return, based on the Eighth Circuit Court of Appeals opinion in *Estate of Frane v. Commissioner* (998 F.2d 567), and the IRS's published position in Revenue Ruling 86-72. The taxpayer's position is that the Tax Court decision in *Estate of Frane* (98 T.C. 341) remains the controlling law in the Tenth Circuit, despite its reversal by the Eighth Circuit.

The case also involved $10 million and $5 million life insurance policies financed by a third-party lender and a private split-dollar arrangement.

That case has now been settled, largely in the taxpayer's favor. The IRS settled for a $969,761 deficiency in a stipulated decision entered in the Tax Court on August 30, 2017. *See* Erin McManus, *former Bookkeeper's Estate Mostly Wins on Complex Plan,* BNA Daily Tax Report (Sept. 1, 2017).

> **Note:** *Johnson* appears in a succession of cases in which the IRS has expressed its concerns about SCINs. *See Estate of Kite v. Commissioner*, T.C. Memo. 2013-43; *Estate of Davidson v. Commissioner*, T.C. Docket No. 13748-13 (filed June 14, 2013; settled July 6, 2015).

3. Artwork: *Kollsman*

Old Masters Artwork substantially undervalued; informal appraisal by auction house appraiser rejected. *Estate of Kollsman v. Commissioner*, T.C. Memo. 2017-40 (Feb. 22, 2017).

Eva Franzen Kollsman died owning two 17th-Century Old Master paintings – "Village Kermesse, Dance Around the Maypole" (Maypole) by Pieter Brueghel the Younger, and "Orpheus Charming the Animals" (Orpheus) by Jan Brueghel the Elder or Jan Brueghel the Younger or a Brueghel studio. A vice president of Sotheby's (and cochairman of Sotheby's Old Master Paintings Worldwide), saw the paintings during a visit to decedent's residence, and near the date of death, outline proposed terms by which Sotheby's would auction the two paintings. The Sotheby's expert provided a pre-sale estimate of $500,000 for Maypole and $100,000 for Orpheus, "based on firsthand inspection of the property." The executor had the paintings cleaned and put in new frames by a leading art restorer, who stated that Orpheus had a slight bow along the bottom and possibly the top as well, that both paintings had heavy dirt, that one painting had discolored varnish, but that cleaning should be "relatively safe." Sotheby's sold Maypole for a hammer price of $2.1 million (total price of $2,434,500), against a presale estimate of $1,500,000 to $2 million. On the estate tax return, the estate valued Maypole at $500,000 and Orpheus at $100,000. The IRS asserted that the fair market values of Maypole and Orpheus were $2,100,000 and $500,000, respectively.

The Tax Court (Judge Gale) rejected the use of the informal appraisal by the Sotheby's expert as a basis for estate tax valuation, but did allow discounts from the IRS appraised value for the risks involved in cleaning both paintings and the disputed maker of Orpheus. The court valued the paintings under Reg. §20.2031-1(b), at the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. *United States v. Cartwright*, 411 U.S. 546, 551 (1973). The court rejected the report of the Sotheby's expert, and relied instead on that of the IRS expert, a Ph.D. and art historian with extensive art appraisal experience. The Sotheby's appraisal cited no comparable sales and acknowledged that the dirtiness of the paintings made it difficult to know "for certain [the] inherent value." It attributed the substantial difference between the actual sales price of Maypole and the appraised value to the improved condition produced by the cleaning and an increased market demand from a large influx of Russian buyers of Old Masters, and it identified three problems with Orpheus, including the uncertain attribution, weaknesses in the "composition, such that some of the animal figures are barely visible and others appear disjointed from their surroundings," and the dirtiness of that painting. The court rejected the Sotheby's valuation, because (a) Sotheby's wanted to sell the paintings and might, therefore, be inclined to provide a tax-favorable low appraisal; (b) Sotheby's overstated the dirtiness of the paintings and the risks involved in cleaning them, in light of the testimony of the art conservator that the cleaning was reasonably safe, and the fact that the cleaning was actually done using only the mildest detergents used for cleaning paintings; and (d) Sotheby's included no comparables. The court stated that the price for which Maypole was actually sold was relevant, even though the sale occurred after the date of death. *Ithaca Tr. Co. v. United States*, 279 U.S. 151 (1929); *First Nat'l Bank of Kenosha v. United States*, 763 F.2d 891, 894 (7th Cir. 1985); *Estate of Jung v. Commissioner*, 101 T.C. 412, 431-432 (1993); *Estate of Newberger v. Commissioner*, T.C. Memo. 2015-246, at *6. The government's appraiser, on the other hand, valued Maypole at $2.1 million and Orpheus at $500,000, using comparative market data and denying discounts for the risks of cleaning. The court generally agreed with those values, but it allowed a 5% discount against each painting for the risk of cleaning, a 10% discount for Orpheus for the fact that it was bowed, and a 25% discount for Orpheus for the questions about its attribution.

> **Note:** The estate also noted the property casualty policy providing coverage for decedent's residence and its contents, including Maypole and Orpheus

specifically, at insured values of $600,000 and $80,000, respectively. The IRS noted that the estate required that the art restorer maintain $1 million of insurance for Maypole and $500,000 for Orpheus.

4. Alternate Valuation: PLR 201719014

The IRS permits a late alternate valuation date election. Letter Ruling 201719014 (issued Jan. 23, 2017; released May 12, 2017).

D's executors hired Attorney to prepare the estate tax return, and Attorney failed to advise them to elect the alternate valuation date under Section 2032. The return was filed without the election. Later, Accounting Firm advised the executors that they should file the alternate valuation date election, and they filed a supplemental estate tax return with the election.

The IRS allowed the late election, noting that the alternate valuation date may be elected on a supplemental or late return, as long as the return is filed within one year after the prescribed filing date. Reg. §20.2032-1(b)(3). A discretionary extension of the time to make this election will be allowed under Reg. §301.9100-3 if the taxpayer provides the evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election. In this case, the IRS ruled that those conditions were met, and the extension was granted.

C. Family Limited Partnerships: *Powell*

FLP assets includable in the gross estate under Section 2036(a)(2). *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017) (reviewed by the Court) (Senior Judge Halpern, joined by Judges Vasquez, Thornton, Holmes, Gustafason, Morrison, Buch, and Ashford, with Judges Foley and Paris concurring in the result only; concurring opinion by Judge Lauber, joined by Judges Marvel, Gale, Kerrigan, Nega, and Pugh).

[The following analysis is contributed by Steve Akers.]

Powell is a "reviewed" Tax Court decision that may be the most important Tax Court case addressing FLPs and LLCs since the *Bongard* case (124 T.C. 95 (2005)) 12 years ago. The Tax Court breaks new ground (1) in extending the application of Section 2036(a)(2) to decedents owning only limited partnership interests, and (2) in raising the risk of double inclusion of assets under Section 2036 *and* a partnership interest under Section 2033, which may (in the court's own words) result in "duplicative transfer tax." (The case was decided on cross motions for summary judgement, and is not an opinion following a trial.)

The facts involve "aggressive deathbed tax planning," and the fact that the taxpayer lost the case is no surprise. But the court's extension of the application of Section 2036(a)(2) and the extensive discussion of possible double inclusion for assets contributed to an FLP or LLC are quite surprising (but whether a majority of the judges would apply the double inclusion analysis is not clear).

The decedent's son, acting in the decedent's behalf under a power of attorney, contributed about $10 million of cash and marketable securities to a limited partnership (FLP) in return for a 99% limited partnership (LP) interest. The decedent's two sons contributed unsecured notes in return for the 1% general partner (GP) interest. The partnership agreement allowed for the partnership's dissolution with the written consent of all partners. The same day, the son who was the agent under the power of attorney (acting under the power of attorney) transferred the decedent's 99% LP interest to a charitable lead annuity trust (CLAT) paying an annuity to charity for the decedent's life with the remainder passing to the decedent's two sons (the remainder was valued by assuming a 25% discount for lack of control and marketability of the 99% LP interest). (A problem with the transfer to the CLAT is that the power of attorney only authorized gifts to the principal's issue up to the federal gift tax annual exclusion amount. (The taxpayer argued that gifts were authorized under the power of attorney under general state case law where the gifts were consistent with the estate plan.)

The decedent died seven days later. The IRS claimed that the $10 million of assets contributed to the FLP were includible in the decedent's estate (without a discount) under Section 2036(a)(1) (retained enjoyment or income), 2036(a)(2) (retained right in conjunction with any person to designate who could enjoy the property or its income), or 2038 (power to alter, amend, revoke, or terminate the transfer at the decedent's death), or under Section 2035(a) (transfer of property within three years of death that otherwise would have been included in the estate under Sections 2036-2038 or 2042) if the transfer to the CLAT was valid. The opinion indicates that the taxpayer did not contest the application of Section 2036(a)(2) [counsel has reportedly stated that he did *not* concede that issue], or contest that the bona fide sale for full consideration exception to Section 2036 was not applicable. The taxpayer merely argued that Sections 2036 and 2038 could not apply because the decedent no longer owned the LP interest at her death (despite the fact that the interest had been transferred within 3 years of her death and Section 2035(a) would then apply).

Section 2036(a)(2) Issue

The majority and concurring opinions both agreed that Section 2036(a)(2) applied (though the concurring opinion did not address the reasoning for applying Section 2036(a)(2)). The majority opinion reasoned (1) that the decedent, in conjunction with all the other partners, could dissolve the partnership, and (2) that the decedent, through her son as the GP and as her agent, could control the amount and timing of distributions. The opinion adopted the analysis in *Strangi* as to why the "fiduciary duty" analysis in the Supreme Court *Byrum* case does not apply to avoid inclusion under Section 2036(a)(2) under the facts of this case because any such fiduciary duty is "illusory."

The Section 2036(a)(2) issue is infrequently addressed by the courts; it has only been applied with any significant analysis in four prior cases (*Kimbell* and *Mirowski* [holding that Section 2036(a)(2) did not apply], and *Strangi* and *Turner* [holding that Section 2036(a)(2) did apply]). In both *Strangi* and *Turner*, the decedent was a general partner (or owned a 50% interest in the corporate general partner). *Powell* is **the first case to apply Section 2036(a)(2) when the decedent owned merely a limited partnership interest**.

In this case the decedent owned a 99% LP interest, but the court's analysis drew no distinction between owning a 99% or 1% LP interest; the court reasoned that the LP "in conjunction with" all of the other partners could dissolve the partnership at any time. (Whether the court would have applied Section 2036(a)(2) had the decedent owned only a small LP interest is not known, but the court's reasoning does not draw any distinction based on the amount of LP interest owned by the decedent.)

Because Section 2036(a)(2) applied, the court did not address Section 2036(a)(1) or Section 2038.

"Double Inclusion" Issue

The majority raised, on its own with no argument or briefing from any party, how Section 2036 or Section 2038 operate in conjunction with Section 2043 ostensibly to avoid double inclusion. The consideration received in return for the contribution to the FLP (*i.e.* the 99% LP interest) is subtracted under Section 2043 from the amount included in the gross estate under Section 2036. In effect, the value of the discount is included under Section 2036/2043 (*i.e.*, the value of the assets contributed to the FLP minus the value of the 99% LP interest considering lack of control and marketability discounts). The opinion refers to this amount as the "doughnut hole." In addition, the 99% LP interest itself is included in the gross estate (if the gift is not authorized under the power of attorney) or is included in the gift amount if the gift is recognized, and the court referred to this as the "doughnut." That analysis avoids double inclusion IF the assets have not appreciated (and because the decedent died only 7 days later, the parties stipulated that the contribution values were also the date of death values). But if the assets have appreciated, footnote 7 of the "majority" opinion acknowledges that "duplicative transfer tax" would apply because the date of death asset value is included in the gross estate under Section 2036 offset only by the *date of contribution* discounted value of the partnership interest. The date of death value of the LP interest would also be included under Section 2033, so all of the post-contribution appreciation of the assets would be included under Section 2036 AND the discounted post-contribution appreciation would also be included under Section 2033. More value would be included in the gross estate than if the decedent had never contributed assets to the FLP. (Similarly, footnote 17 acknowledges that a "duplicative reduction" would result if the assets depreciated after being contributed to the FLP.) Whether a court would actually tax the same appreciation multiple times (or whether the IRS would even make that argument), in a case in which the majority's analysis is applied is (hopefully) doubtful, but the majority opinion did not even hint that the court would refuse to tax the same appreciation twice in that situation.

The concurring opinion (joined by seven judges) reasoned that the inclusion of the partnership assets in the gross estate under Section 2036 meant that the partnership interest itself was merely an alter ego of those same assets and should not also be included in the gross estate. That approach has been followed by the prior FLP cases in which Section 2036 was applied, and indeed even in this case the IRS did not argue that the asset value/partnership value should be included under both Section 2036 and Section 2033, offset by the partnership value at the date of the contribution. (That argument would have been meaningless in this case [because the date of contribution values and date of death values were the same], but the IRS has not made that argument in *any* other

FLP cases even though substantial additional estate tax liability would have resulted in situations involving significant appreciation of partnership assets.)

The opinion leaves uncertainty, particularly as to the double inclusion issue, because the "majority" opinion (that espoused the double inclusion analysis) was joined by only eight judges (one of whom was Judge Halpern, who is a Senior Judge and not one of the 16 current "regular" Tax Court judges), a concurring opinion (that rejected the double inclusion analysis) was joined by seven judges, and two judges concurred in the majority opinion in result only.

The fact that eight judges adopted the double inclusion analysis may embolden the IRS to take that position in future cases, even though we do not yet know how a majority of the Tax Court judges would rule as to that issue. This raises a risk that contributing assets to an FLP (or for that matter, any entity) may leave a taxpayer in a significantly worse tax position than if the taxpayer had merely retained the assets.

Rejection of Gift to CLAT

The court concluded that the gift to the CLAT was not valid, and therefore denied the IRS's additional gift tax deficiency and also the addition to the gross estate of additional gift tax on the gift made within three years of death.

Increased Significance of Bona Fide Sale for Full Consideration Exception

The combination of applying Section 2036(a)(2) even to retained *limited partnership* interests and the risk of "duplicative transfer tax" as to future appreciation in a partnership makes qualification for the bona fide sale for full consideration exception to Sections 2036 and 2038 especially important. In one respect, this means that *Powell* does not reflect a significant practical change for planners, because the Section 2036 exception has been the primary defense for any Section 2036 claim involving an FLP or LLC.

This case is appealable to the Court of Appeals for the Ninth Circuit.

For excellent discussions of *Powell*, see Todd Angkatavanich, James Dougherty & Eric Fisher, Estate of Powell*: Stranger Than* Strangi *and Partially Fiction*, Tr. & Ests. 30 (Sept. 2017) and Mitchell M. Gans & Jonathan G. Blattmachr, *Family Limited Partnerships and Section 2036: Not Such a Good Fit*, 42 ACTEC L.J. 253 (Winter 2017).

Basic Facts

1. The decedent's son, as her attorney-in-fact under a power of attorney, contributed about $10 million of cash and marketable securities (managed by the son's wealth management firm) to an FLP on August 8, 2008 in return for a 99% LP interest. Two sons contributed unsecured promissory notes in return for a 1% GP interest.

2. The partnership agreement gives the GP the sole discretion to determine the amount and timing of distributions. In addition, the agreement permits the dissolution of the partnership with the consent of all partners (but even without that specific provision in the partnership agreement, all of the partners could get together at any time to dissolve the partnership or amend the agreement).

3. Also on August 8, 2008, the son as agent under a power of attorney transferred all of the decedent's 99% LP interest to a CLAT that would pay an annuity to charity

for the decedent's life and pay the remainder to her two sons. However, the power of attorney only authorized gifts to the decedent's issue "to the full extent of the federal annual gift tax exclusion." In determining value of the remainder interest gift that resulted from the creation of the CLAT, a 25% discount for lack of control and lack of marketability was used to value the 99% LP interest. The estate took the position on its gift tax return that the 99% limited partnership interest (valued at a 25% discount pursuant to a Duff & Phelps, LLC appraisal) was $7,516,773, and that the gift tax value of the remainder interest of the CLAT was equal to $1,661,422, thus reflecting that the actuarial value of the remainder interest was 22.1% of the value contributed to the CLAT.

4. The decedent died on August 15, 2008. [Counsel has reportedly indicated that the decedent was recovering nicely from a broken hip, and the CLAT was planned (and a medical opinion was received reflecting a greater than 50% likelihood of surviving a year) during that recovery, but the decedent contracted an infection after she had been cleared for a hospital discharge and died shortly thereafter from ensuing sepsis.]

5. The decedent and the son, who was the executor of the estate, resided in San Francisco when the petitions were filed (meaning that the case would be appealable to the Ninth Circuit Court of Appeals).

6. The IRS issued an estate tax notice of deficiency for about $5.88 million, resulting from an increase in the gross estate of $12.98 million ($10.02 million from the assets included under Section 2036 or Section 2038 and $2.96 million from additional gift tax resulting from the gift to the CLAT that would be includable under Section 2035(b) – but for some reason without allowing an additional deduction under Section 2053(a)(3) for the additional gift tax [see footnote 12]).

   The IRS also issued a gift tax notice of deficiency for $2.96 million as a result of the creation of the CLAT (determining the gift amount using a 15% discount rather than a 25% discount in valuing the 99% LP interest) and treating the decedent as being terminally ill when the gift was made. The IRS valued the 99% limited partnership interest at $8,518,993 (applying a 15% discount) and valued the remainder interest in the CLAT at $8,363,095, thus reflecting that the actuarial value of the charitable interest (assuming the decedent was terminally ill) was only 1.56% of the value contributed to the CLAT.

7. Counsel has reportedly stated that the estate attempted to settle the case, agreeing with Section 2036 inclusion, but the IRS examiner's calculations refused to reduce the amount of adjusted taxable gifts by the amount of the gifts included in the estate under Section 2036 in calculating the estate tax, as required by the last sentence of Section 2001(b).

8. The estate sought summary judgment that no estate or gift tax deficiency existed. The IRS moved for partial summary judgment that the value of assets contributed to the FLP is includable under Section 2036(a)(1), 2036(a)(2), or 2038(a), or because the gift of the 99% LP interest to the CLAT was not authorized.

9. The case indicates that the taxpayer did not contest the application of Section

2036(a)(2) [counsel has reportedly stated that he did *not* concede that issue] or contest that the bona fide sale for full consideration exception to Section 2036 was not applicable.

Analysis – Majority Opinion

1. **Failure to Contest That Section 2036(a)(2) "Right to Designate" Elements Apply and That the Bona Fide for Full Consideration Exception Does Not Apply**. The estate did not refute the IRS argument that the "right to designate" requirements in Section 2036(a)(2) are satisfied or that the bona fide sale for full consideration exception to Section 2036 does not apply. The estate merely argued that Sections 2036 and 2038 could not apply because the decedent no longer owned the LP interest at her death (despite the fact that the interest had been transferred within 3 years of her death and Section 2035(a) would then apply).

2. **Section 2035**. In light of the estate's argument that the decedent no longer owned any interest in the FLP at her death, the opinion analyzes whether estate inclusion results even if the gift to the CLAT was valid (despite that the gift exceeded the agent's authority under the power of attorney). Section 2035(a) provides that if a decedent makes a transfer or relinquishes a power over property within three years of death and if the property would have been included in the decedent's gross estate under Sections 2036-2038 or Section 2042 at her death if the transfer had not been made, the value of any property that would have been so included is included in the gross estate under Section 2035. Therefore, if Section 2036(a)(2) would apply if the decedent had still owned the LP interests at her death, the property contributed to the partnership would be included in the decedent's estate under Section 2035 if the gift is valid because the gift was made within three years of her death.

3. **Section 2036(a)(2) Applies**. Section 2036(a)(2) provides that if the decedent has made a transfer of property (other than a bona fide sale for adequate and full consideration), the property is included in the decedent's gross estate if the decedent controlled "the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the property or the income therefrom." The IRS argues that the decedent transferred property to the FLP and that the decedent still had the ability to designate who could possess or enjoy the property or its income.

   The court in *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145, *aff'd*, 417 F.3d 468 (5th Cir. 2005) held that Section 2036(a)(2) (as well as Section 2036(a)(1)) applied to a situation in which the taxpayer's son funded an FLP on behalf of the taxpayer, with the taxpayer owning a 99% limited partnership interest and owning 47% of an S corporation that was the 1% general partner. The *Powell* majority opinion adopted the analysis from *Strangi*, both in reasoning why Section 2036(a)(2) applies and why the *Byrum* Supreme Court holding (discussed in Paragraph 4 below) should be distinguished. (While the Fifth Circuit affirmed the *Strangi* case, it did not address the Section 2036(a)(2) issue, finding that inclusion under Section 2036(a)(1) was sufficient to dispose of the case.)

   Powell concluded that if the decedent owned the LP interest at her death, Section

2036(a)(2) would apply for two different reasons. First, the decedent, in conjunction with the other partners, could all agree together to dissolve the partnership at any time. That would revest the property in decedent and she could then designate who could enjoy the property or its income. That alone is "sufficient to invoke section 2036(a)(2)," but the court also applied a second reason (also used in *Strangi).* Second, the decedent had the right, through her son who was a general partner and her agent under the power of attorney, to determine the amount and timing of distributions. The court pointed out similarities with the *Strangi* facts and reasoning [but the opinion failed to mention that part of the analysis in *Strangi* was that the decedent in the *Strangi* case also owned 47% of the corporate general partner and that the *Strangi* court made reference to the powers of the general partner].

4. "**Fiduciary Duty" Limitation on Applicability of Section 2036(a)(2) Under *Byrum* Is Distinguished.** The U.S. Supreme Court held in *United States v. Byrum*, 408 U.S. 125 (1972) that retaining the right to vote shares of stock in corporations that a decedent had transferred to a trust did not require that the shares be included in his estate under Section 2036(a)(2). In *Strangi,* the estate argued that if the mere fact that a decedent "could band together with all of the other shareholders of a corporation" is sufficient to cause inclusion under Section 2036(a)(2), the Supreme Court could not have reached its decision in *Byrum*. The estate in *Strangi* argued that the decedent's authority over the partnership, through her son-in-law, was subject to state law fiduciary duties and therefore insufficient under *Byrum* to invoke Section 2036(a)(2). The *Strangi* court responded with an analysis of the additional constraints in *Byrum* that were not present under the *Strangi* facts. The *Powell* majority opinion adopted reasoning from *Strangi* to distinguish why the "fiduciary duty" analysis in *Byrum* does not apply under the facts of this case because any such fiduciary duty is "illusory."

    - The son, in carrying out duties to the partnership as general partner, also owed duties to the decedent as her attorney-in-fact under the power of attorney and could not act in ways "that would have prejudiced decedent's interests." (In *Byrum*, dividend distributions would have been made to the trust, and distribution decisions from the trust were made by an independent trustee.)
    - The decedent owned the 99% LP interest, so any fiduciary duties that limited the son's discretion as general partner in making partnership distributions "were duties that he owed almost exclusively to decedent herself." (*Strangi* had observed a distinction for "intrafamily fiduciary duties.")
    - The FLP did not conduct meaningful business operations and was merely an investment vehicle for decedent and her sons. (*Strangi* concluded "Intrafamily fiduciary duties within an investment vehicle simply are not the equivalent in nature to the obligations created by the <u>United States v. Byrum</u> … scenario.")

5. **Limit Imposed by Section 2043 on Amount Includible Under Section 2036; "Double Inclusion" Issue.** The majority opinion, on its own without argument by

any of the parties or any briefing, analyzed how Section 2036 is applied, in conjunction with Section 2043, in the context of assets contributed to an FLP (or LLC). The analysis is not central to the conclusion that Section 2036(a)(2) applies, and in that respect may be treated as dictum.

If Section 2036 applies, the assets contributed to an FLP are included in the estate, but if the decedent continues to own the LP interest, that interest is also included under Section 2033 (according to the majority opinion), and the majority opinion has an extended analysis to explain why this does not result in "double inclusion." The majority opinion observes that prior cases have not articulated "the precise legal grounds that prevent such illogical 'double taxation'" from inclusion of "both the assets transferred to a family limited partnership and the partnership interest received in return." The majority opinion views this case as "the opportunity to fill that lacuna and explain why a double inclusion in a decedent's estate is not only illogical, it is not allowed." [For those, who like me, have no idea what a "lacuna" is, it is "an unfilled space or interval, a gap."]

Section 2043 provides:

> If any of the transfers, trusts, interests, rights, or powers enumerated and described in sections 2035 to 2038, inclusive, and section 2041 is made, created, exercised, or relinquished for a consideration in money or money's worth, but is not a bona fide sale for an adequate and full consideration in money or money's worth, there shall be included in the gross estate only the excess of the fair market value at the time of death of the property otherwise to be included on account of such transaction, over the value of the consideration received therefor by the decedent.

Broken down in the context of assets contributed to an FLP that are included in a decedent's gross estate under Section 2036:

- If any transfer, interest, or power that would cause inclusion in the gross estate under Section 2036 is relinquished
- for consideration,
- but the consideration is not a bona fide sale for an adequate and full consideration (meaning that the "bona fide sale for full consideration" exception under Section 2036 does not apply to pre-empt the application of Section 2036),
- then the amount included under Section 2036 is reduced such that the amount included is
    - the fair market value, at the time of death, of the property that would otherwise be included, minus
    - the value of the consideration received for such relinquishment by the decedent.

The purpose of Section 2043(a) is to complement the bona fide sale exception in each of Sections 2035-2038. The bona fide sale exception limits the application of Sections 2035-2038 to transactions that deplete a decedent's estate. If some consideration is received, but not enough to prevent depletion of the estate, Section 2043(a) "limits the inclusionary rules so that they apply only to the extent necessary to prevent depletion of the transferor's estate." Section 2043(a) attempts "to provide a measure of relief from double taxation of the same economic interest" [quoting *Estate of Frothingham v. Commissioner*, 60 T.C. 211, 216 (1973)] and "limits the required inclusion to the amount by which the transfer depletes the decedent's estate."

In the context of applying Section 2036 to the transfer of the $10 million to the FLP by the decedent, the amount included under Section 2036 is "only the excess of the fair market value at the time of her death of the cash and securities transferred to [the FLP] over the value of the 99% limited partner interest in [the FLP] issued in exchange for those assets" (but footnote 7 observes that the reduction is just the value of the 99% LP interest "on the date of the transfer" of assets to the FLP). The bona fide sale exception under Sections 2036 and 2038 with respect to transfers to an FLP has two requirements – (i) a bona fide sale (meaning "the existence of a legitimate and significant nontax reason for creating the family limited partnership") and (ii) adequate and full consideration (meaning "the transferors received partnership interests proportionate to the value of the property transferred") [footnote 6 quoting *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005)]. Under *Bongard*'s proportionality test for what satisfies the second "adequate and full consideration" prong, a transfer of assets to an FLP can be treated as being made for full consideration even if discounts for lack of control or marketability "cause the value of the partnership interest received by a decedent to be less than the value of the assets he transferred to the partnership." [Footnote 6] Therefore, transfers to an FLP can result in some depletion of the estate but only if the partnership was created for a legitimate and significant nontax reason, thus causing the exception under Section 2036 to prevent Section 2036 from applying. If the bona fide sale test is not met (*i.e.*, if there is no legitimate and significant nontax reason for creating the partnership), the net effect is that Section 2036 as limited by Section 2043(a) "includes in the value of decedent's gross estate the amount of any discounts applicable in valuing the 99% limited partner's interest in [the FLP] issued in exchange for the cash and securities [assuming the assets have not appreciated] (an amount that could colloquially be characterized as the 'hole' in the doughnut)." The date of death value of the 99% LP interest itself, if still owned by the decedent, would be included in the gross estate under Section 2033 (or under the facts of *Powell*, if the transfer to the CLAT were either void or revocable, would be included under Section 2038).

Only one previous FLP Tax Court case (*Estate of Harper v. Commissioner*, T.C. Memo. 2002-121) that applied Section 2036 has addressed the impact of Section 2043(a), and the *Powell* majority opinion said it concluded that a partnership interest did not qualify as "consideration," for purposes of either Section 2036(a) or Section 2043(a), if the formation of the partnership did not involve a genuine pooling of assets, but is nothing other than circuitous "recycling of value" that does not "rise to the level of a payment of consideration."

The entire reference to Section 2043 in *Harper* is as follows:

> Furthermore, although section 2043 can entitle taxpayers to an offset for partial consideration in cases where a transfer is otherwise subject to section 2036, this section, too, is inapplicable where, as here, there has been only a recycling of value and not a transfer for consideration.

The majority opinion has an extended 8-page discussion to rebut the assertion that Section 2043(a) does not apply to FLP-Section 2036 transfers because of that one sentence statement in *Harper*. It concludes that the "pooling of assets" and "recycling of value" discussion in *Harper* "is more germane to the first prong (the bona fides of the transaction) than to the second (adequacy of consideration)" of the bona fide sale for full consideration exception in Section 2036. Similarly, a comment in *Estate of Thompson v. Commissioner*, T.C. Memo. 2002-246, *aff'd*, 382 F.3d 367 (3d Cir. 2004) that "the decedent's receipt of a partnership interest in exchange for his testamentary assets is not full and adequate consideration within the meaning of section 2036," was likely related to the bona fide sale prong of the Section 2036 exception, and the Third Circuit's affirmance "referred only to the absence of 'any valid, functioning business enterprise' rather than on the proportion of partnership assets contributed by the decedent."

> **Note:** Despite the lengthy explanation and attempt to distinguish the statement in *Harper* that Section 2043(a) is inapplicable "where, as here, there has been only a recycling of value and not a transfer for consideration," the majority opinion's rationale that the "pooling" and "recycling of value" comments in *Harper* relate to the first leg of the bona fide sale for full consideration exception in Section 2036 does not explain why Section 2043(a) would not apply because Section 2043(a) makes no reference to the bona fides of the transaction.

6. **Double Inclusion Issue; "Duplicative Transfer Tax" *Does* Exist to the Extent of Post-Contribution Appreciation.** The purpose of the court's lengthy discussion of the manner in which Section 2043 limits double taxation if Section 2036 includes assets contributed to a partnership AND the partnership interest itself is also included in the estate is to demonstrate that double inclusion does not really result. (The majority opinion fills the "lacuna and explain[s] why a double inclusion in a decedent's estate is not only illogical, it is not allowed.") The majority opinion itself, however, acknowledges that "duplicative transfer tax" can result to the extent of post-contribution appreciation of assets in the FLP/LLC:

> Changes in the value of the transferred assets would affect the required inclusion because sec. 2036(a) includes in the value of decedent's gross estate the date-of-death value of those assets while sec. 2043(a) reduces the required inclusion by the **value of the partnership interest on the date of the transfer**. To the extent that any post-transfer increase in the value of the transferred assets is

> reflected in the value of the partnership interest the decedent received in return, the appreciation in the assets would generally be subject to a duplicative transfer tax. (Conversely, a post-transfer decrease in value would generally result in a duplicative reduction in transfer tax.) Footnote 7 (emphasis added).

The majority opinion's Section 2043(a) analysis avoids double taxation of the same value IF the assets have not appreciated (and because the decedent died only 7 days later, the parties stipulated that the contribution values were also the date of death values). But if the assets have appreciated, footnote 7 of the majority opinion acknowledges that "duplicative transfer tax" would apply because the date of death asset value is included in the gross estate under Section 2036 offset only by the *date of contribution* discounted value of the partnership interest. The date of death value of the LP interest would also be included under Section 2033, so all of the post-contribution appreciation of the assets would be included under Section 2036 AND the discounted post-contribution appreciation would also be included under Section 2033. More value may be included in the gross estate than if the decedent had never contributed assets to the FLP. (Similarly, footnote 17 acknowledges that a "duplicative reduction" would result if the assets depreciated after being contributed to the FLP.)

7. **No Consideration of Section 2036(a)(1) or 2038(a)**. Because Section 2036(a)(2) applied, the majority opinion did not consider the arguments for inclusion under Section 2036(a)(1) or 2038(a).

> **Note:** Section 2036(a)(1) may have been be a difficult argument for estate inclusion. All of the decedent's partnership interests were transferred to the CLAT with **no retained interest** for the decedent. If the decedent had retained substantial assets outside the FLP, the IRS may not have had a strong retained implied interest argument. Maybe that is why the court applied Section 2036(a)(2) and not Section 2036(a)(1).]

8. **Transfer to CLAT Void or Voidable; No Gift Deficiency.** The court ruled that the gift to the CLAT was not valid under the express terms of the power of attorney or under state law regarding the powers of agents. Because the gift of limited partnership interests to the CLAT was void or voidable, the government's allegation of a gift tax deficiency was denied. Therefore, the government's allegation that the additional gift tax should be included in the estate under Section 2035(b) was also denied, but the court observed in footnote 12 that including any additional gift tax in the gross estate under Section 2035(b) would have been offset by an equal additional debt deduction for the gift tax debt under Section 2053—which had not been addressed in the IRS Notice of Deficiency or in the IRS's trial position. (The opinion did not observe whether the decedent had made sufficient prior gifts that a gift tax was paid regarding the gift to the CLAT and whether the estate had filed a proper claim for refund of such gift tax within the period for claiming refunds.)

Analysis – Concurring Opinion

1. **Aggressive Deathbed Tax Planning**. The concurring opinion viewed this as a case

of "aggressive deathbed tax planning," and observed that the IRS "had available a number of theories on which to challenge the transactions."

2. **Possible Invalidity of Partnership.** A possible theory to challenge the transaction is that the "partnership was invalid ab initio" because "the other two supposed partners – her sons and heirs – contributed nothing more than unsecure promissory notes." The son, acting under a power of attorney, negotiated with himself, signing the partnership agreement as general partner and for his mother. The majority opinion does not address this "partnership invalidity" theory, perhaps because the IRS did not clearly articulate it and because it could require resolving disputed issues of fact which could preclude a summary judgment resolution of the case.

   Even if the partnership interest is recognized, the concurring opinion expresses skepticism that any lack of marketability discount would have been allowed. ("This theory validates the estate's claimed discount for lack of marketability, which seems highly suspect on the facts presented.")

3. **Section 2036(a)(2) Inclusion**. The concurring opinion also agrees that Section 2036(a)(2) applies. The concurring opinion's full discussion of why Section 2036(a)(2) applies is as follows:

   > The Court correctly concludes that section 2036(a)(2) applies here. [Citations to majority opinion page numbers and the *Strangi* case omitted] The decedent clearly "made a transfer" of the $10 million in cash and securities. And she clearly retained the proverbial "string" that pulls these assets back into her estate.

   This acknowledgement of the application of Section 2036(a)(2), however brief, is important, reflecting that 15 of the 17 judges participating in this decision explicitly recognized that Section 2036(a)(2) applies. (The other two judges concur in the result only of the majority opinion. Because the result is that the assets contributed to the partnership were included in the decedent's estate under Section 2036(a)(2) and on no other grounds, they must also have agreed that Section 2036(a)(2) applied.)

4. **Reject Double Inclusion Analysis.** "This is where I part company with the Court, because I do not see any 'double inclusion' problem." The concurring opinion disagrees with the court's analysis of including assets under Section 2036 (reduced by the discounted value of the partnership interest) AND also including the partnership interest itself under Section 2033. If the assets contributed to the partnership are included under Section 2036, the partnership interest itself should not also be included in the estate under Section 2033. "Once that $10 million is included in her gross estate under section 2036(a)(2), it seems perfectly reasonable to regard the partnership interest as having no distinct value because it was an alter ego for the $10 million of cash and securities."

   The concurring opinion points out that "[n]either party in this case advanced any argument based on section 2043(a); indeed, that section is not cited in either party's briefs." It observes that merely including assets under Section 2036 without also including the partnership interest in the gross estate under Section 2033 is the approach has been followed by all of the prior FLP/LLC cases that have applied Section 2036:

> The Court's exploration of section 2043(a) seems to me a solution in search of a problem. It is not necessary; the parties did not think it was necessary; and our prior cases show that it is unnecessary.

Furthermore, the concurring opinion questions whether Section 2043(a) would apply in this situation:

> And even if the section 2043 issue were properly presented, I am not sure the Court's application of that provision is correct. It is far from clear to me that the decedent's partnership interest – a consequence of the now-disregarded transfer—can constitute "consideration in money or money's worth" within the meaning of section 2043(a).

In support of the concern that Section 2043 might not apply in this situation, the concurring opinion cites the *Harper* and *Thompson* cases (discussed in the majority opinion) and *Estate of Gregory v. Commissioner*, 39 T.C. 1012, 1020 (1963) (holding that a decedent's retained interest in her own property cannot constitute consideration under Section 2043(a)).

Also, the concurring opinion observes that the possibility of a "duplicative reduction in transfer tax" [to the extent of post-contribution *depreciation* of partnership assets] may invite overly aggressive tax planning."

> **Note:** That seems an overreach; no one would purposefully hold onto assets hoping that they would decline in value.

Finally, the concurring opinion believes the new approach risks creating new problems and prefers following the approach used in all of the prior Section 2036 FLP/LLC cases:

> By adopting an untried new theory without first hearing from the parties, we risk creating problems that we do not yet know about. The more prudent (and conservative) approach in my view would be to adhere to the letter and spirit of our precedent, leaving the law in the relatively stable position that it appears to occupy now.

Observations

1. "**Overly Aggressive Deathbed Tax Planning."** The court's refusal to allow valuation discounts is not surprising. The case involves a number of bad (or at least suspicious) factors:

   - Funding of the entity only by the soon-to-be decedent;
   - With only cash and marketable securities;
   - A mere 7 days before death;
   - By the decedent's son acting under a power of attorney;
   - With a subsequent transfer to a CLAT and a retained charitable annuity for the

life of the apparently soon-to-die donor, resulting in a substantial value shift to the agent and his brother.

That the taxpayer lost the case is not surprising.

2. **Significant Extension of Application of Section 2036(a)(2) to Retained Limited Partnership Interests.** The Section 2036(a)(2) issue is infrequently addressed by the courts; it has only been applied with any significant analysis in four prior cases (*Kimbell* and *Mirowski* [holding that Section 2036(a)(2) did not apply], and *Strangi* and *Turner* [holding that Section 2036(a)(2) did apply]). In both *Strangi* and *Turner,* the decedent was a general partner (or owned a 47% interest in the corporate general partner). *Powell* is the **first case to apply Section 2036(a)(2) when the decedent owned merely a limited partnership interest**. In this case the decedent owned a 99% LP interest, but the court's analysis drew no express distinction between owning a 99% or 1% LP interest (but the distinction from *Byrum*'s limitation on the application of Section 2036(a)(2) because of fiduciary duties would not be as strong if other significant partnership interests existed, particularly if they were unrelated parties, and any fiduciary duties were not "owed to herself"). The court reasoned that the LP "in conjunction with" all of the other partners could dissolve the partnership at any time. (Whether the court would have applied Section 2036(a)(2) had the decedent owned only a small LP interest is not known, but the reasoning allowing the ability to dissolve the entity by acting "in conjunction with" other partners would not change based on the amount of LP interest owned by the decedent.)

   The net effect is that Section 2036 will apply to almost all FLPs/LLCs, whether or not the client retains a general partner or managing member interest, unless the bona fide sale for full consideration exception to Section 2036 applies. Furthermore the same reasoning would seem to apply to practically any enterprise or investment involving other parties. For example, interests in C corporations, S corporations, or undivided interests in real estate would be subject to the same reasoning that the decedent could join with the other shareholders/co-owners and dissolve the entity/co-ownership, with all parties receiving their pro rata share of the assets.

3. **Bad Facts Make Bad Law.** To a degree, this may be a "bad facts make bad law" case. The court may have stretched to find that Section 2036(a)(2) applied to avoid estate tax discounts for this deathbed transaction that lacked any non-tax purposes, even though the decedent received only limited partnership interests, because of the difficulty of applying Section 2036(a)(1) when the decedent did not intend to retain ANY interest in the FLP. A consideration of "sham transaction" or "void partnership" theories may have involved fact issues that would have precluded a summary judgment.

   The IRS's real concern is that the transaction was merely a gimmick to produce discounts and lacked economic substance, but the Tax Court had previously rejected the authority of the IRS to merely disregard transfers to partnerships because of the decedent's "subjective intentions" as long as the partnership was validly formed and changed relationships between the decedent and his heirs and creditors. *Estate of Strangi v. Commissioner*, 115 T.C. 478, 486-87, *rev'd on other* *grounds*, 293 F.3d 279 (5th Cir. 2002).

4. **Increased Significance of Bona Fide Sale for Full Consideration Exception to Section 2036.** The combination of applying Section 2036(a)(2) even to retained *limited partnership* interests and the risk of "duplicative transfer tax" as to future appreciation in a partnership makes qualification for the bona fide sale full consideration exception to Sections 2036 and 2038 especially important. Make sure that a legitimate and significant nontax purpose for creating the FLP/LLC exists to satisfy the bona fide prong of the exception, but also be sure that proper capital accounts are maintained to satisfy the full consideration prong of the exception as interpreted by *Stone*, *Kimbell* and *Bongard*. *See Estate of Beyer v. Commissioner,* T.C. Memo. 2016-183 (full consideration prong of Section 2036 exception did not apply because of the failure to maintain proper capital accounts).

   In one respect, this means that *Powell* does not reflect a significant practical change for planners, because the Section 2036 exception has been the primary defense for any Section 2036 claim involving any FLP or LLC. Almost all of the taxpayer victories against a Section 2036 claim have been based on the bona fide sale for full consideration exception to Section 2036. (Several exceptions are *Estate of Kelly v. Commissioner*, T.C. Memo. 2012-73 and *Estate of Mirowski v. Commissioner*, T.C. Memo. 2008-74, which both refused to apply Section 2036 to gift transactions that did not qualify for the full consideration exception. In addition, *Kimbell v. U.S.*, 371 F.3d 257, 268 (5th Cir. 2004), refused to apply Section 2036 to transfers to an LLC without addressing whether the bona fide sale for full consideration exception applied to those transfers.)

5. **Elimination of Unanimous Partner Approval Requirement for Dissolution**. The partnership agreement in this case "allows for the partnership's dissolution with the written consent of all partners." Would the omission of this explicit requirement of unanimous consent for dissolution in the partnership or LLC agreements provide an argument against applying Section 2036(a)(2) under Powell? That would provide a factual distinction from Powell, but the court's reasoning for applying Section 2036(a)(2) made no reference whatsoever to the unanimous consent requirement for dissolution in the partnership agreement. The court made reference various times to the decedent's "ability to dissolve" the partnership in conjunction with her sons, but never made reference to the fact that the partnership could only be dissolved with her consent.

   If the partnership agreement is silent regarding dissolution, the Revised Uniform Limited Partnership Act provides various events that can cause the dissolution of the limited partnership, one of which is "the affirmative vote or consent of all general partners and of limited partners owning a majority of the rights to receive distributions as limited partners at the time the vote or consent is to be effective." Rev. Unif. Ltd. Ptnship. Act §801(a)(2). If the decedent owns a majority of limited partnership interests, the decedent would have the ability to act with others to dissolve the partnership in any event under the Uniform Act (unless the partnership agreement negated that provision). This same provision is included in the California limited partnership act. Calif Code Corporations §15908.01.

If none of the permitted events that would cause dissolution of the partnership involve action by the limited partner, the argument that the decedent could dissolve the partnership in conjunction with others is more tenuous. For example, under the Revised Uniform Limited Partnership Act, if the partnership agreement does not address limited partnership consent regarding dissolution and if a decedent owned less than a majority of the limited partner interests entitled to distributions, the decedent would have no way to participate in the decision to dissolve the partnership. However, the decedent as a limited partner could always join with all the other partners to amend the partnership agreement and add provisions allowing the dissolution of the partnership. *Id.* at §406(b)(1) (affirmative vote or consent of all partners is required to amend the partnership agreement). If a court were inclined to employ common sense limitations in applying the "in conjunction with" phrase (see paragraph 17 below), the ability to join with other partners in amending the partnership agreement seems more remote than an explicit direct ability to join with others in dissolving the partnership.

Indeed, the court in footnote 4 suggests that the application of Section 2036(a)(2) might have been avoided by a change in drafting of the partnership agreement. (Footnote 4 includes the following clause: "had NHP's limited partnership agreement been drafted in a way that prevented the application of sec. 2036(a)(2).") How that drafting would have been accomplished under the court's reasoning is not clear. If the agreement had been silent regarding dissolution, the general partner and a majority of the limited partners (which would have included the decedent) could have dissolved the partnership under California law. Perhaps the court was suggesting that the partnership agreement could have been provided that the limited partners would have had no input into the decision to dissolve.)

6. **Avoid Having Decedent's Agent as General Partner**. One of the court's reasons for apply Section 2036(a)(2) was that the son could make distribution decisions and also owed duties to the decedent under the power of attorney, thus the decedent had the ability through her agent to determine the amount and timing of distributions. Remove that argument by having someone serve as general partner other than the decedent or an agent for the decedent under a power of attorney

7. **Special Voting Interests to Make Liquidation/Dissolution Decisions**. One planning alternative may be to have a special partnership or member interest that would have the exclusive ability to vote on liquidation or dissolution decisions. The first rationale of the court's reasoning under Section 2036(a)(2) would then no longer apply—the decedent could not participate with anyone in deciding when to dissolve the partnership/LLC. That is not a complete answer to the court's reasoning however; under state law, all of the partners/members presumably could agree to change the underlying formation documents any way they wanted, including the omission of the special voting interest. But having significant factual differences may be important if a court looks for ways to distinguish the Powell holding.

8. **Trust Owners with Independent Trustee.** If all of the partners/members were irrevocable trusts with independent trustees, any dissolution proceeds would pass to

the irrevocable trusts, and the decedent could not join with the trustee in making distribution decisions, so the court's "in conjunction with" analysis would no longer give the decedent the ability to designate who could receive the income or property contributed to the partnership/LLC. The decedent's interest could be held in an "incomplete gift" trust (for example if the trust was for the sole benefit of the decedent and the decedent had a testamentary power of appointment), but most clients would likely not be willing to be subject to that inflexibility.

9. **Transfer All Interests During Life**. Some clients have created FLPs/LLCs with the contemplation that some or most of the limited partner/member interest would be retained until the client died, and valuation discounts would apply to those interests for estate tax purposes. In light of the result in *Powell* suggesting that Section 2036(a)(2) will always apply unless the bona fide sale for full exception is applicable, clients in the future may consider only contributing to entities an amount for which the client would contemplate eventually giving or selling all of the retained interests (and having the foresight to do so at least three years before death). Appropriate discounts should apply in valuing the gifts or in determining sale prices, and Section 2036 would not apply to include the entity's assets in the estate (without a discount) under Section 2036.

10. "**Claim Victory" and Dissolve FLP/LLC with Prior Successful Transfers**. If a client has previously created an FLP/LLC and has made gifts or sales of interests in the entity to trusts that have experienced substantial appreciation, consider dissolving the entity so that the trusts would own the value apart from the FLP/LLC, thus negating any possible Section 2036 taint. Value attributable to interests that have been transferred at least three years earlier should not be subject to Section 2036(a)(1) if no implied agreement of retained enjoyment exists (see the *Jorgenson*, *Kelly*, and *Rosen* cases), but Section 2036(a)(2) might continue to apply to gifts of interests over which the decedent has a continued ability (in conjunction with other) to determine the amount or timing of distributions.

11. **Rationale for Estate Inclusion for Basis Adjustment Purposes**. If a decedent dies without estate tax concerns and the estate would like to include the FLP assets in the estate without a discount for basis adjustment purposes, the *Powell* reasoning provides a rationale for including the assets in the estate (at least as to interests retained by the decedent or transferred within the prior three years) as long as the transfer to the partnership did not qualify for the bona fide sale for full consideration exception to Section 2036.

12. **Impact of Retaining 99% Limited Partnership Interest on Section 2036(a)(2) Analysis**. Is the extension of Section 2036(a)(2) to retained limited partnership interests related to the fact that the decedent held 99% of the LP interests? The majority opinion has two references to the retention of most of the interests in the partnership. First, retaining most of the partnership interests is a reason that the *Byrum* opinion's discussion of fiduciary duties as a limitation of the application of Section 2036(a)(2) is not applicable because "any fiduciary duties … were duties he owed 'essentially to himself.'" The second reference addresses a concern that retaining almost all of the partnership interests could be a potential problem in

applying the Section 2043 analysis and the double inclusion approach. Retaining most of the of partnership interests suggests no "pooling" of assets, which some cases (including in Harper) cited as a reason that the bona fide sale for full consideration exception to Section 2036 does not apply. However, the court reasoned that the "degree of pooling is relevant to the question of the nontax bona fides of the transaction," not the degree to which "a partnership interest received in exchange for transferred assets should be treated as consideration received for those assets in applying section 2036(a) or section 2043(a)." The majority opinion reasoned that the "proportion of partnership assets contributed by the decedent" was not a factor in determining whether the receipt of a partnership interest could be treated as consideration under Section 2043(a).

The majority opinion has no discussion directly commenting on the decedent's retention of a 99% LP interest rather than a smaller interest as the reason that the court applied Section 2036(a)(2) to the retention of mere LP interests, or suggesting that the result would have been different if the decedent had retained a much lower LP interest. (Whatever LP percentage is retained could be used "in conjunction with any person" to dissolve the partnership.) One of the reasons given for rejecting the *Byrum* reasoning refusing to treat certain retained authorities as constituting retained "rights" because of fiduciary limitations was that any fiduciary duties were "illusory" because the duties were merely owed to Ms. Powell herself (as the 99% limited partner.) That is the only aspect of the analysis that suggests that retaining a large limited partnership interest versus a smaller interest would have an impact on the Section 2036(a)(2) analysis.

Contributing assets to an FLP/LLC in return for almost all of the interests may affect the "gut reaction" impact of viewing the transaction as mere paper shuffling by a decedent without any reasons for the contribution other than generating valuation discounts.

13. **Double Inclusion Analysis**. The majority opinion's summary of how Section 2043 applies in the context of Section 2036 FLP cases is similar to what Professor Jeffrey Pennell has been telling planners for the last decade. *See e.g.*, Pennell, *Recent Wealth Transfer Developments*, ABA Real Prop., Prob. & Tr. Law Section 14th Ann. Est. Pl. Symposium, at 21-23 (2003). Up to this point, however, the IRS and all of the prior Section 2036 FLP cases have avoided that technical analysis by merely including assets contributed to an FLP in the estate under Section 2036 and not *also* including the retained partnership interest itself in the estate under Section 2033. (Indeed, even in this case, the IRS did not argue that the assets should be included under Section 2036 and that the 99% interest should also be included under Section 2033 to the extent the transfer under the power of attorney was not valid (because gifts were authorized only up to the annual exclusion amount).

The IRS has previously ruled that life insurance proceeds received by a partnership should be not includible in the gross estate *both* under Section 2042 and under Section 2033 as to the decedent's partnership interest under the reasoning that "unwarranted double taxation" would otherwise result. Rev. Rul. 83-147, 1983-2 C.B. 158. Similarly, the regulations regarding GRATS state that if the GRAT assets are included under Section 2036, the retained annuity interest payments that are payable after the decedent's death are not also included under Section 2033 "because they are properly reflected under this section." Reg. §20.2036-1(c)(1)(i).

Dictum. The analysis is not central to the conclusion that Section 2036(a)(2) applies, and in that respect may be treated as dictum.

Appreciation. The big distinction of applying the Section 2036/2043 and Section 2033 inclusion analysis is that future appreciation of assets contributed to the FLP/LLC will result in double taxation. See Paragraph 6 above of the Analysis of the Majority Opinion. More value may be included in the gross estate than if the decedent had never contributed assets to the FLP. That issue was not raised in this case, because the parties stipulated that the date of contribution value and the date of death value (7 days later) were the same. Whether a court would actually tax the same appreciation multiple times (or whether the IRS would even make that argument), in a case in which the majority's analysis is applied is (hopefully) doubtful. For example, in Rev. Rul. 83-147, 1983-2 C.B. 158, the IRS refused to include life insurance proceeds payable to a partnership both as part of a partner's interest in the partnership and under Section 2042 as a result of incidents of ownership attributed to the decedent as partner of the partnership, because doing so would result in "unwarranted double taxation":

> In *Estate of Knipp v. Commissioner*, 25 T.C. 153 (1955), *acq. in result*, 1959-1 C.B. 4, *aff'd on another issue* 244 F.2d 436 (4th Cir. Cir), *cert denied*, 355 U.S. 827 (1957), a partnership held 10 policies on the decedent's partner's life, at his death…. The court found that the decedent, in his individual capacity, had no incidents of ownership in the policies, and held that the insurance proceeds were not includible in the gross estate under the predecessor to section 2042(2) of the Code. The Service acquiesces in the result of *Estate of Knipp* on the basis that in that case the insurance proceeds were paid to the partnership and inclusion of the proceeds under the predecessor of section 2042 would have resulted in the **unwarranted double taxation** of a substantial portion of the proceeds because the decedent's proportionate share of the proceeds of the policy were included in the value of the decedent's partnership interest. *See also* section 20.2042-1(c)(6) of the regulations (which adopts a similar rule with regard to life insurance proceeds paid to or for the benefit of a corporation). (Emphasis added)

Judge Counting. The *Powell* opinion was a plurality opinion in that the majority opinion was not joined in by a majority of the judges. Seven judges joined Judge Halpern's majority opinion espousing double inclusion with 2 judges concurring in result only. Six judges joined Judge Lauber's concurring opinion rejecting double inclusion. Therefore, the vote was 8-7-2, and Judge Halpern is a Senior Judge who is not one of the 16 "regular" Tax Court judges. Therefore, we do not yet know how a majority of the Tax Court judges would rule regarding the double inclusion issue.

Emboldened IRS? The fact that eight judges adopted the double inclusion analysis may embolden the IRS to take that position in future cases, even though we do not yet know how a majority of the Tax Court judges would rule as to that issue. This raises a risk that contributing assets to an FLP (or for that matter, any entity) may leave a taxpayer in a significantly worse tax position than if the taxpayer merely retains the assets.

14. **Reduced Emphasis on Not Retaining Any Interest as General Partner or Manager.** As a result of concerns raised by the *Strangi* and *Turner* cases applying Section 2036(a)(2) when the decedent held an interest as general partner or manager, planners have discouraged clients from keeping any interest as a general partner or manager of an FLP or LLC. If a client insists on having some participation in management of the FLP/LLC, planners have encouraged the client to minimize the interest as general partner or manager as much as possible. The importance of eliminating or minimizing management participation by the client may be reduced under *Powell*, to the extent it is interpreted as applying Section 2036(a)(2) in any event as long as the client continues to hold any limited partnership or member interest in the FLP/LLC. All seventeen of the judges participating in the *Powell* decision agreed that Section 2036(a)(2) should apply in a situation in which the decedent held NO interest as general partner. One possible approach in light of this result is to emphasize reliance on the bona fide sale for full consideration exception rather than avoiding "strings" that could trigger the application of Section 2036(a)(2). (However, the transferor's retention of substantial control of the FLP/LLC may color the court's perception of whether a legitimate and significant nontax reason existed for creating the FLP/LLC, depending on the nontax reasons for which the entity is created.)

15. **Basis Implications**. To the extent that partnership assets are included in a decedent's estate under Section 2036, the assets should receive a basis adjustment inside the partnership "to reflect the value of the property that was included in … the estate" even without a Section 754 election for the partnership. *Hurford Investments No 2, Ltd. v. Commissioner*, Tax Court Docket No. 23017-11 (Order dated April 17, 2017); Letter Ruling 200626003 (issued Feb. 28, 2006; released June 30, 2006). *See* Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications*, ¶ II.Q.8.e.iii.(b) at 928 n.3635 (June 2017). Under the majority opinion's analysis, some of the partnership asset value will be included under Section 2036 (offset by Section 2043) and some will be included under Section 2033 (what the majority opinion refers to colloquially as the "donut"). Presumably, all of that value will result in a basis adjustment of the partnership's inside basis, but as to the portion represented by inclusion under Section 2033, a Section 754 election may be necessary.

16. **Summary of Practical Planning Implications**. Lou Harrison (Chicago, Illinois) provides an outstanding summary of the practical planning implications of *Powell*:

> The holding in the case is bad, but in many regards restates the Tax Court's antipathy toward sham partnerships. Essentially, the court expands the potential reach of 2036(a)(2) to just about any family

partnership. This conclusion is a result of a limited partner's ability to participate in the liquidation decision of the partnership (and of course this will be based on what the default rule and state law provides).

But do not fret. To get out of 2036, and therefore, to have the discount respected, the partnership can still fall within the "bona fide sale for an adequate and full consideration" exception. To be bona fide, the partnership has to have economic substance apart from the tax savings. In essence, then, the Court is merely restating its prior view and holding towards partnerships.

In months to come, practitioners will slice and dice the meaning of this opinion in their various Planning Vegematics. But realistically, the court could have saved us a lot of agony by just saying what was on their mind, specifically: "A family partnership that is clearly a sham, such as a 99% retained marketable asset partnership, will not be respected for discounting purposes." But then again, if lawyers and courts could talk like most human beings, what would be the value of having law schools?

The good news from this case is that a partnership that has economic substance will likely still enjoy the discounting benefit. Louis S. Harrison, *Stupid Is As Stupid Does: Does the* Powell *Case Spell The Demise of Discount Partnership Planning or Does It Merely Restate What We Already Know?* 20 J. Passthrough Entities (July/Aug. 2017).

D. Estate Administration Expenses: *Koons*

The Court of Appeals for the Eleventh Circuit affirms the adverse decision of the Tax Court on an attempted Graegin loan. *Koons v. Commissioner*, 686 Fed. Appx. 779 (11th Cir. April 27, 2017), *aff'g* T.C. Memo. 2013-94.

At John Koons' death in 2005, his revocable trust had a 46.94% voting interest and a 51.59% non-voting interest in CI LLC. CI LLC held the proceeds from the sale of the Pepsi distributorship business own by Koons and his family. The trust's LLC interests represented 50.5% of CI LLC. The net asset value of CI LLC on the date of Koons' death was $317,909,786. The other owners of CI LLC on the date of Koons' death were family members or trusts for their benefit.

In February, 2006, CI LLC loaned the revocable trust $10.75 million in exchange for a promissory note to assist in the payment of the federal and state estate taxes. The promissory note for the loan bore interest at a 9.5% rate, with repayment deferred for 18 years and then payment in 14 semi-annual installments of $5.9 million between August 31, 2024, and February 28, 2031. The terms of the loan prohibited pre-payment. As a result of these terms, the total interest on the loan for its term would be $71,419,497. The estate claimed this amount as a Section 2053 administration expense deduction on the federal estate tax return.

The Tax Court (Judge Morrison) had determined that the revocable trust did not need to borrow the $10.75 million from CI LLC in order to pay the federal tax liability. It found that there were significant liquid assets in the trust, more than $19 million worth. When the trust borrowed the money in February, 2006, its voting interest had increased to 70.42% because of redemptions of some of the other members' interests, and the LLC had over $200 million dollars in highly liquid assets. The revocable trust had the power to force CI LLC to make a pro rata distribution to its members that it then could have used to pay the taxes. The Tax Court based its decision on the fact that the trust had other ways to access funds to pay the estate tax, making the loan unnecessary. The Court of Appeals for the Eleventh Circuit (District Judge Reeves) affirmed.

The loan that the Koons trust entered into was structured as a Graegin loan. In *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477, the assets of the estate consisted primarily of stock in a closely held corporation. After payment of state inheritance taxes and other expenses, the estate had $20,000 of liquid assets remaining. Rather than sell the stock in the closely-held corporation, the estate borrowed funds from a wholly-owned subsidiary of the closely-held corporation to pay the estate taxes. The term of the promissory note was 15 years and the interest rate was 15% simple interest (equal to the prime rate on the date of the loan). All principal and interest of the loan was to be repaid in a single balloon payment at the end of the term and the loan agreement contained a prohibition against early repayment. The estate deducted the amount of the single-interest payment due upon maturity of the note ($459,491) on the federal estate tax return as a cost of administration.

Because the amount of the interest was readily calculable and would not be a lesser amount (as it could be if prepayment was allowed), the Tax Court in *Graegin* held that the entire amount of the interest on the note was deductible as a cost of administration under Section 2053(a)(2).

The IRS issued a Litigation Guideline Memorandum dated March 14, 1989 in response to the decision in *Graegin*. The Memorandum states the Service's position that interest on indebtedness is deductible as an administration expense if the indebtedness is incurred to enable the estate to pay taxes due without selling non-liquid estate assets at a forced sales price. In order to be deductible, the interest must be certain to be paid, and the amount must be subject to reasonable estimation. The IRS also stated that the transaction must have substance and that unusual financing techniques, such as unsecured loans, high rates of interest, and loans with long terms should receive close scrutiny especially if less expensive lending alternatives are available from third party sources.

> **Note:** *Koons* clearly stretched the limits of commercial acceptable loans with a high interest rate and significant deferral of payment. This almost certainly caused the IRS to closely scrutinize the estate tax return. An executor or trustee should be prepared to justify the need for a loan in order to pay estate taxes, and its reasonableness.
>
> In those cases where there are no alternative sources of funds, such as the LLC that could have made distributions in *Koons*, taxpayers generally have been successful in deducting Graegin loan interest. An example is *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249. The decedent's estate structured a

Graegin loan with a family LLC of which it was member. The LLC had significant liquid funds, but the LLC terms required the consent of all the members to a distribution of the magnitude required by the estate, and one member refused to consent. The court allowed the interest deduction for the loan.

The valuation issues in the case are discussed in Part III.B.1.

A reference to the Treasury-IRS administrative or regulatory guidance project that could reduce or eliminate the effectiveness of Graegin loans is in Part II.D.3.

E. Claims Against the Estate

1. Net Gift: *Sommers*

Tax Court denies estate tax deduction for gift tax owed at death by decedent on gifts to decedent's nieces. *Estate of Sommers v. Commissioner*, 149 T.C. No. 8 (2017).

In an earlier case, *Estate of Sommers v. Commissioner*, T.C. Memo. 2013-8, the Tax Court held that a decedent, who then lived in Indiana, made valid gifts of interests in a limited liability company holding artwork to his three nieces in December 2001 and January 2002. Decedent subsequently moved to New Jersey and died in November 2002. Decedent's wife succeeded to the property she owned jointly with decedent, and decedent's will gave all of his estate remaining after the payment of debts and expenses to his wife. The wife subsequently died and her beneficiaries became the ultimate beneficiaries of the estate's assets. In accordance with the agreements governing their gifts from decedent, the three nieces paid the gift tax due on those gifts. The estate filed three motions for partial summary judgement seeking determinations that:

(1) The gift tax owed at decedent's death on his gifts to nieces was deductible under Section 2053;

(2) The estate was entitled to a Section 2056 marital deduction equal to the value of decedent's non probate property that the wife received or to which she succeeded that, under applicable New Jersey law, was exempt from decedent's debts and the expenses of the estate; and

(3) Any federal estate tax due must be apportioned to the nieces and thus did not reduce the estate's marital deduction.

The three nieces filed their own motion for partial summary judgment that none of the estate tax liability could be apportioned to them.

In 2001, decedent, who was then divorced from his wife, sought legal advice on how to transfer works from his art collection to the three nieces, who were then his closest living relatives. His attorneys offered two proposals to reduce or eliminate gift tax on the gift of the artwork. First the attorneys recommended that decedent transfer the artwork to a newly formed limited liability company and then make gifts of the units representing ownership interests in the entity to the nieces. This recommendation assumed that, as a result of applicable valuation discounts, the appraised value of the units in the limited liability company would be less than the value of the artwork they represented. The attorneys also recommended that the decedent make the intended gifts in two stages, transferring some units to each niece on or before December 31, 2001, and the rest thereafter. Spreading the gifts across two years would increase the portions of the gifts that could be covered by the gift tax annual exclusion. It would also allow the decedent to use the increased applicable exclusion amount of $1 million that was scheduled to take effect in 2002. Decedent wanted to transfer the maximum number of units possible to the nieces without incurring gift tax in 2001 and then complete the gifts of the units in 2002.

In accordance with the plan, decedent transferred the artwork to the LLC and executed two sets of gift and acceptance agreements with his nieces. The first agreement was dated December 27, 2001 and the second was dated January 4, 2002. When decedent and his nieces initially executed the agreements, blanks were left for the number of units for each transfer pending completion of an appraisal of the artwork. The appraisal, completed in March 2002, assigned a value to the artwork that led decedent's attorneys to conclude that dividing the transfers of the units across the end of 2001 would not allow for the complete avoidance of gift tax. The nieces then agreed to pay any gift tax resulting from the 2002 transfers and the gift and acceptance agreements were completed by filling in the blanks for the numbered units covered by each transfer.

In addition, decedent's nieces amended each of the 2002 agreements to add a provision pursuant to which each niece "agreed to pay the gift taxes, if any, relating to the gift of the units, including without limitation any gift taxes, penalties, and interest that may later correctly be assessed." None of the 2002 agreements referred to apportionment of any federal estate tax liability resulting from the gifts. While none of the agreements provided for the assumption by the nieces of any liability other than gift tax, none of the agreements specifically exculpated the nieces from other liabilities.

In April 2002, decedent executed his will that directed his executor (his then ex-wife) to pay all of his just debts including funeral and burial costs and expenses of his last illness and all costs and expenses of administering and settling his estate. The nieces received all of decedent's estate remaining after payment of those debts.

In June 2002, shortly before remarrying his ex-wife, decedent initiated litigation in Indiana against his nieces challenging the validity of the purported gifts and seeking return of the artwork. The litigation in Indiana and similar litigation his ex-wife initiated in New Jersey after decedent's death on November 1, 2002 ultimately upheld the validity of the gifts. On the federal estate tax return, decedent's estate took a marital deduction of $3,330,510.43 and after taking account of all deductions, the taxable estate was $507.34. On examination, the IRS increased the taxable estate from $507.34 to $1,092,106.68. This increase of $1,091,599.34 reflected three adjustments that followed from the IRS's determination that decedent's transfers of units were valid gifts. First, the IRS included the gift tax determined to be due as a result of the 2002 gifts. This amount of $510,648 was included because decedent made the gifts less than three years before his death. Second, the IRS excluded from the gross estate the $1,750,000 value that the estate had assigned to the artwork that decedent had transferred to LLC. Third, the IRS reduced the marital deduction by $2,330,951.34. The decrease in the marital deduction reflected the IRS's determination that the estate tax liability of $542,593.34 resulting from the inclusion of the gift tax paid within three years of death under Section 2035(b) that would have to be paid out of marital assets.

With respect to the first issue, the court noted that long standing precedent established that a claim against an estate is deductible in computing the estate tax liability only to the extent that it exceeds any right to reimbursement to which its payment would give rise. The court noted that the key question to examine when there was a net gift as in this case, in which the nieces had paid the gift tax owed, is whether a decedent's estate served as the ultimate source of the funds used to pay the liability that arose when the decedent parted with the value. In this case, decedent effectively provided the nieces with the wherewithal to pay tax on the taxable gifts because for each niece, a portion of the units transferred in 2002 was ultimately determined to be a taxable gift. Decedent made the transfers to the nieces before he died, withdrawing from his potential estate not only the value of the taxable gifts but also the amount of the tax on the gifts. The court also noted that if decedent's estate paid the gift tax liability after decedent's death, it would have had a claim for reimbursement against the nieces to whom decedent had already provided the wherewithal for paying the tax. The court stated that inclusion of the gift tax in decedent's estate did not justify allowing deductions for gift tax in this case anymore than in a case of a gross gift for which the decedent paid the gift tax before the decedent died. As the court put it, "[o]ur acknowledgment that a net gift made within three years of the donor's death effects a removal of funds from the transfer tax base that must be redressed by the gross-up cannot be read as acquiescence in the permanent exemption from transfer tax that would result if the gross-up were offset by a deduction of the same amount under Section 2053(a)(3)."

The court also denied the estate's motion for partial summary judgment regarding the effect of the payment of debts and claims on the marital deduction because the amount of the allowable deduction turned on the factual question of the extent to which assets otherwise exempt from claims against the estate were used to pay estate debts and expenses. Section 2056(a) allows a deduction for the "value of any interest in property which passes or has passed from the decedent to the surviving spouse". Reg. §20.2056(b)-4(a) provides that value for that purpose means net value. Consequently, when property that would otherwise have been distributed to surviving spouse is used to satisfy debts of the estate, it is not included in the allowable marital deduction. The factual question of the extent to which assets otherwise exempt were used to pay debts and expenses precluded summary judgment since this was an issue of material fact and summary judgment may only be granted when there is no issue of genuine material fact.

The court then found that under the New Jersey's estate tax apportionment statute, no portion of any estate tax could be apportioned to the three nieces. Because the LLC units the three nieces received from their uncle were not included in computing the decedent's federal estate tax liability under the New Jersey apportionment statute, the nieces were not "transferees" against whom any of the estate tax liability could be apportioned for purposes of the New Jersey apportionment statute.

The court next looked at whether the payment of the estate tax would reduce the marital deduction claimed by the estate and held that the existing record did not allow for the determination of the effect of the payment of the estate tax on the allowable marital deduction. To the extent that the executor used the property that otherwise would have been exempt from claims against the estate to pay debts or expenses, the estate may have been a "transferee" subject to the apportionment of estate tax under the New Jersey apportionment rules. If neither the estate nor the nieces were "transferees" subject to the apportionment statute, the federal estate tax liability would be apportioned entirely to the estate. To the extent that any tax apportioned to the estate reduced the residuary distributions ultimately made to the wife's beneficiaries, the tax would be paid out of that marital share of the estate. The court did note that the New Jersey statute requires that total estate tax be apportioned in a manner that preserves for the benefit of decedent's spouse, to the extent possible, the benefit of any marital deduction. That statute provided insufficient grounds to rule that as a matter of law any estate tax due could not affect the allowable marital deduction.

2. Purchase of GRAT Remainder Interests: CCA 201745012

This CCA is discussed in Part III.A.2

F. Marital Deduction

1. QTIP Election: PLR 201714020

Decedent's estate qualifies for an extension of time to make a QTIP election. Letter Ruling 201714020 (issued Dec. 6, 2016; released April 7, 2017).

Upon the decedent's death, a Marital Trust was established for the benefit of the spouse. The Marital Trust contained the necessary requirements for a QTIP trust. The spouse was entitled to the net income of the Marital Trust at least quarterly. The trustee could pay to the spouse discretionary distributions of the principal as necessary to support and maintain the spouse in the standard of living to which the spouse was accustomed during the decedent's lifetime. Upon the spouse's death, the Marital Trust property was to be distributed to the decedent's then living descendants. The spouse had a testamentary limited power of appointment to descendants of the decedent.

The spouse and a child were the co-executors of the decedent's estate. They engaged a CPA to prepare the estate tax return. On Schedule M of the estate tax return, the property passing to the Marital Trust was listed as property other than QTIP property. Consequently, no QTIP election was made.

The estate requested an extension of time under Reg. §§301.9100-1 and 301.9100-3 to make a QTIP election. Requests for relief under Reg. §301.9100-3 will be granted when a taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government.

The IRS also noted that a taxpayer is deemed to have acted reasonably and in good faith when the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

The IRS concluded that the requirements of Reg. §301.9100-3 were satisfied and the estate was granted an extension of time to make the QTIP election with respect to the Marital Trust.

2. Effect of a Net Gift on the Marital Deduction: *Sommers*

The *Sommers* case is discussed in Part III.E.1.

G. Gift Tax

1. Transfers Incident to Divorce: PLRs 201707007 & 201707008

These rulings are discussed in Part III.A.1.

2. Reformation of GRATs: PLR 201652002

The IRS permits reformation of grantor retained annuity trusts to correct a scrivener's error. Letter Ruling 201652002 (issued Sept. 15, 2016; released Dec. 23, 2016).

Grantor retained an attorney to draft several grantor retained annuity trusts (GRATs) over a two year period that began after September 20, 1999. The first page of each grantor retained annuity trust provided that the grantor intended to create a grantor retained annuity trust with a retained annuity that met the requirements of a qualified interest under Section 2702(b)(1). In addition, a later provision of the trust also gave the trustees the power to amend the trust in any manner to ensure that the trust would qualify under Section 2702(b) (1). In drafting each of the grantor retained annuity trusts, the draftsperson failed to include language prohibiting the trustees from issuing a note, other debt instrument, option, or other financial arrangement in satisfaction of an annuity obligation as required by Reg. §25.27023(d)(6).

Grantor was made aware of this failure when the grantor's son retained a new attorney to review the grantor's estate plan. As a result of that review, the trustees filed an action in court seeking reformation of each of the GRATs to correct the scrivener's error. The court issued an order reforming each trust to include the language required by the Treasury Regulations. Grantor requested a ruling from the IRS that as a result of the judicial reformation of the GRATs to correct the scrivener's error, Grantor's retained annuity interest in each GRAT was a qualified interest effective as of the date that each grantor retained annuity trust was established. The IRS, in reviewing the facts and noting that each GRAT provided that the grantor's retained interest was intended to be a qualified interest under Section 2702, and noting the fact that the trust instrument and state law permitted the amendment of each trust, ruled that, as a result of judicial reformation of each GRAT to correct the scrivener's error, the grantor's interest in each trust would be a qualified interest as of the date on which each grantor retained annuity trust was created.

> **Note:** The IRS did not state that the attorney admitted the error or that the state court found that the attorney had made the error – it stated only that the attorney made the error. The IRS is likely to permit a retroactive reformation in cases of a scrivener's error, but it is reluctant to do so in cases of misjudgment or changed circumstances, even if the state court deems the reformation to be retroactive.

3. Reformation of a Power of Appointment: PLRs 201737001 & 201737008

Reformation of power of appointment to make it a limited power of appointment is recognized. Letter Rulings 201737001 and 201737008 (issued June 14, 2017; released Sept. 15, 2017).

Grantor created an irrevocable trust to benefit the grantor's spouse and descendants. The irrevocable trust contained a power of appointment providing that on the death of the spouse, the trustee is to distribute such amounts of principal and income as the spouse directed to such persons or charities as the spouse appointed by her will. The terms of the power of appointment did not specifically limit the exercise of the power to appoint to persons other than the spouse, the estate of the spouse, and the creditors of either. It was represented that the grantor intended for the power of appointment to be a limited power of appointment and not a taxable general power of appointment.

The grantor filed a petition with the local court to reform the trust to provide that the spouse would have a limited power of appointment and for the retroactive application of the reformation. The IRS ruled that because of the representations that the grantor did not intend for the spouse to have a general power of appointment and the representation of the lawyer who drafted the trust that an error had been made, the power of appointment as reformed by the local court would not constitute a general power of appointment, and the reformation of the trust was not the exercise or release of a general power of appointment that would constitute a gift by the spouse for federal gift tax purposes.

The applicable state statute in this case allows a court to reform the terms of a governing instrument, even if unambiguous, to conform the terms to the transferor's intention, if it is proved by clear and convincing evidence that the transferor's intent and the terms of the governing instrument were affected by a mistake of fact or law, whether in expression or inducement. Thus, the state court reformation was consistent with state law and given valid retroactive effect for federal tax purposes.

4. Renunciation of a QTIP Interest: PLR 201721006

The IRS rules on impact of renunciation of surviving spouse's interest in QTIP marital deduction trust. Letter Ruling 201721006 (issued Feb. 13, 2017; released May 26, 2017).

In this ruling the first spouse to die and the surviving spouse created a joint revocable trust. Upon the first spouse's death, the trust was divided into a Marital Trust, a Decedent's Trust, and a Survivor's Trust. The Marital Trust qualified for the estate tax marital deduction as a QTIP marital deduction trust.

The trustee of the Marital Trust proposed to divide the Marital Trust into separate shares, Marital Trust One and Marital Trust Two. Each share was to be administered as a separate trust for the benefit of the surviving spouse upon the same terms as the Marital Trust. The surviving spouse then planned to renounce any right, title, or interest that the surviving spouse had in Marital Trust One with the result that his interest in the income and principal of Marital Trust One would terminate. At that point, Marital Trust One would be divided into separate trusts and distributed to the designated remainder beneficiaries.

The following rulings were requested.

1. When the surviving spouse renounces his interest in Marital Trust One, the surviving spouse will not be deemed to have made a gift of the property in Marital Trust Two under Section 2519.

2. When the surviving spouse renounces his interest in Marital Trust One, the value of surviving spouse's income interest in Marital Trust One would not be valued at zero under Section 2702.

3. After the surviving spouse renounces his interest in Marital Trust One, no part of Marital Trust One being transferred under Section 2519 would be included in the surviving spouse's gross estate under Section 2044.

The IRS first ruled that when the surviving spouse renounces his right to all title and interest in Marital Trust One, the surviving spouse will not be deemed to have made a gift of property in Marital Trust Two under Section 2519. It noted that when the surviving spouse renounces his interest in Marital Trust One, the renunciation will be deemed to be a gift of the surviving spouse's income interest in Marital Trust One under Section 2511 and a gift of all property owned by Marital Trust One other than surviving spouse's qualifying income interest in Marital Trust One, under Section 2519. The surviving spouse's gift tax liability for the transfer of the income interest in Marital Trust One will be determined under Section 2511.

With respect to the second ruling request, when the surviving spouse renounces his rights, title, and interest in Marital Trust One, his interest in Marital Trust Two would not be treated as a retained interest under Section 2702. Consequently, the renunciation of the entire interest in Marital Trust One would not result in the surviving spouse's interest in Marital Trust Two being valued at zero under Section 2702.

With respect to the third ruling request, when the surviving spouse renounces the interest in Marital Trust One, the surviving spouse will be deemed to have made a transfer of all the property of Marital Trust One other than his qualifying income interest. Section 2044(b) provides that 2044(a) does not apply to any property if Section 2519 applies to the disposition of part or all of that property prior to a surviving spouse's death. Consequently, the property owned by Marital Trust One that is deemed transferred pursuant to Section 2519 will not be included in the surviving spouse's gross estate under Section 2044 at the surviving spouse's death.

5. "ING" Trusts: PLRs 201650005, 201653001-201653009, 201718010, 201718012 & 201742006

These rulings are discussed in Part IV.C.

6. Payment: *Beckenfeld*

The IRS can rely on taxpayer's designation in crediting check. *Estate of Beckenfeld v. Commissioner*, T.C. Memo. 2017-25 (Jan 31, 2016).

Lillian Beckenfeld died in 2007 and her husband, Mickey, died in 2012. Each of their estates filed a gift tax return for 2007, showing a $1,324,650 gift tax liability and attaching a check for that amount. No election was made to gift-split. The IRS assessed approximately $950,000 in interest, late filing, and late payment penalties against each estate. The executor paid the interest and penalties for Mickey's estate, but not those for Lillian's estate. The executor later claimed that it had meant to pay the interest and penalties on Lillian's estate, rather than those on Mickey's estate, and that the interest and penalties on Mickey's estate should be abated for reasonable cause.

The Tax Court (Judge Chiechi) held for the IRS that Lillian's estate owed the amount assessed for interest and penalties. The court noted that the check was specifically designated both on the check and the cover letter to relate to Mickey's liability, rather than Lillian's. While a taxpayer may designate a payment as he or she wishes, the IRS has the right to rely on that designation. Citing *Dixon v. Commissioner*, 141 T.C. 173, 185 (2013).

7. Gift Tax Statute of Limitations: LAFA 20172801F

Advice given that the period of limitations on assessing gift tax remains open. Legal Advice Issued by Field Attorneys (LAFA) 20172801F (issued May 10, 2017; released July 14, 2017).

Under Section 6501(a) of the Code, the period of time for assessing tax generally is three years after the gift tax return is filed. Obviously, if no return is filed for a particular year, or if a gift is not reported on a return, the statute of limitations does not begin to run, and the IRS is not foreclosed from auditing the donor and assessing tax on the gifts at any date in the future. In this Field Attorney Advice Memorandum, the IRS confirmed this rule with respect to a donor who had made gifts in each of six years but had not filed gift tax returns for those years.

The IRS field executor also asked about a gift made by the donor in a seventh year, which gift was disclosed on a gift tax return. This is the more fact-specific and interesting question for those who work professionally in this area. The disclosure rules go beyond whether a gift is just listed on the return. The disclosure must be adequate under the regulations.

Section 301.6501(c)-1(f) of the regulations sets forth a lengthy set of requirements for what constitutes adequate disclosure, sufficient to start the statute of limitations. Under Reg. §301.6501(c)-1(f)(2), adequate disclosure is defined as a disclosure that adequately apprises the IRS "of the nature of the gift and the basis for the value so reported." The regulations provide, in the nature of a safe harbor, that disclosure is adequate if it includes:

1. A description of the transferred property and any consideration received for it;
2. The identity of the transferor and transferee and how they are related;
3. If the transferee is a trust, the trust's taxpayer identification number and a brief description of the trust terms (or instead of a description, a copy of the trust instrument);
4. A detailed description of the method used to determine the fair market value of the property; and
5. A statement describing any position that is contrary to IRS regulations or Revenue Rulings.

The key requirement for gifts of closely-held interests for which there is not a readily determinable market value is the description of how fair market value was determined. Section 301.6501(c)-1(f)(2)(iv) states that the return must include a detailed description of the method used to determine the fair market value, including financial data used in making the determination. For example, if the value of an interest in a closely-held corporation or partnership was derived by using the entity's financial statements and projections, those statements and projections should be attached or summarized.

Unfortunately, this particular memorandum does not provide details on what the donor did disclose on the gift tax return. It only says that the donor "did not describe the transferred property, nor did

Donor provide a description of the method used to determine the value of the transferred property." From past cases and rulings, an example of inadequate disclosure would be a listing of a gift of "a 10% limited partnership interest in the Smith Family Limited Partnership … $100,000." *See, e.g.*, Chief Counsel Advice 200221010 (issued Feb. 12, 2002; released May 24, 2002). The disclosure does not state how the value is determined, what the underlying assets of the partnership are if the value was based on net asset value, or what valuation discounts were applied. The failure to include any one of those items could make the disclosure inadequate.

> **Note:** This memorandum is a reminder that the IRS does look for opportunities to take a second look at returns. For gift tax returns, this often occurs as part of the estate tax audit of the donor's estate, and that can be many years later. For this reason, it is usually good practice to err on the side of very complete and thorough disclosure in the gift tax return.

8. Retroactive Relief for Same-Sex Married Couples: Notice 2017-15

Same-sex married couples can retroactively claim marital deductions and recalculate GST exemptions. Notice 2017-15, 2017-6 I.R.B. 783 (Jan. 17, 2017).

Prior to 2013, same-sex marriages were not recognized for federal tax purposes. That meant that individuals in same-sex marriages could not claim the marital deduction for gifts and bequests, and they could not use the family generational assignments for generation-skipping transfer tax purposes (they instead had to use the relative ages of the donor and donee to determine whether someone was a skip person). But *United States v. Windsor*, 111 AFTR 2d 2013-2385, 133 S. Ct. 2675, 186 L.Ed.2d 808 (2013), recognized valid same-sex marriages for federal tax purposes, and regulations finalized in 2016 (T.D. 9785, 81 FED. REG. 60609 (Sept. 2, 2016)) redefined "spouses" to include same-sex couples.

The IRS has taken the next step, announcing that same sex-couples who were validly married under state law at the time of a gift from one spouse to another can claim the marital deduction for gift tax purposes. In addition, the marital deduction can be claimed for transfers to a same-sex spouse at death. Importantly, spouses can claim the deduction even if the statute of limitations has run on the return reporting the relevant transfer. As a result, the applicable exclusion amount of a transferor spouse, as well as the deceased spousal unused exclusion amount available to the surviving spouse, may be recalculated.

To take advantage of the retroactive deduction, taxpayers who made gifts to a same-sex spouse should file a new or amended federal gift tax return using a new worksheet and instructions. Executors may likewise amend or revise any estate tax return for a deceased same-sex spouse. The donor or executor should add "FILED PURSUANT TO NOTICE

2017-15" at the top of the Form 709 or 706. But the new rules do not permit a late election to split gifts under Section 2513. And in order to make a QTIP or QDOT election an executor may have to seek relief under Reg. §301.9100-3 if the statutory review period has already lapsed.

While this announcement is helpful in restoring a lost exclusion amount and allows claims for refund of tax paid if the statute of limitations is still open, couples may not claim a refund of taxes paid if the statute of limitations has expired. But even if the statute of limitations has expired, any gift tax paid will continue to be recognized as gift tax paid or payable in computing the estate tax under Section 2001.

The IRS also announced that any allocation of GST exemption made in the past that ignored the marital status of same-sex spouses may be voided, and the exemption may be recalculated even if the statute of limitations has run. Here too the recalculation is made on a new or amended Form 709, or on the Form 706 in the case of a decedent.

The Notice covers only same-sex couples that were validly married at the time of transfer. Couples in registered domestic partnerships, civil unions, or other non-marital relationships are not eligible for retroactive application of the marital deduction or recalculation of the GST exemption.

H. Generation-Skipping Transfer Tax

1. Allocation of GST Exemption: PLRs 201714008, 201731005, 201731010 & 201724007

The IRS confirms a deemed allocation of GST exemption. Letter Ruling 201714008 (issued Dec. 19, 2016; released April 7, 2017).

After 2001, Donor created and funded Trust for the benefit of Brother, Brother's spouse, and Brother's descendants. Brother has a lifetime and testamentary limited power to appoint trust assets to Brother's spouse or lineal descendants, subject to an ascertainable standard, and a power to appoint trust assets to any charitable organization. Brother has no power to appoint assets in favor of himself, his estate, his creditors, the creditors of his estate, or to discharge any of his legal obligations. Brother also has a withdrawal power in an amount equal to any contribution to Trust and upon his death, the withdrawal power passes to Brother's spouse. The withdrawal power may not exceed the least of (i) the total amount of contributions to Trust during that year, (ii) the amount allowable at the time of the first contribution as an exclusion from gift tax under Section 2503(b)(3) (or twice this amount if the donor is married on the date of the last of all contributions made during that year), and (iii) the greater of $5,000 or five percent of the value of Trust. Any unexercised right of withdrawal lapses at the end of each year or, if earlier, thirty days after the contribution to which it relates. Donor was advised by his lawyer that Trust was a GST trust and that GST exemption would automatically be allocated to the transfers to Trust. Thereafter, Donor was advised by his lawyer that Trust may not be a GST trust, and Donor sought clarification from the IRS.

The IRS recognized that Trust could have a generation-skipping transfer with respect to the transferor, to the extent that distributions were made to Brother's grandchildren. Thus, it determined whether Trust was a GST trust for GST tax purposes. The IRS noted that a GST Trust does not include a trust that could have a generation-skipping transfer with respect to the transferor, if —

(i) the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons (I) before the date that the individual attains age 46, (II) on or before one or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or (III) upon the occurrence of an event that, in accordance with regulations prescribed by the Secretary, may reasonably be expected to occur before the date that such individual attains age 46;

(ii) the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than ten years older than such individuals;

(iii) the trust instrument provides that, if one or more individuals who are non-skip persons die on or before a date or event described in clause (i) or (ii), more than 25% of the trust corpus either must be distributed to the estate or estates of one or more of such individuals or is subject to a general power of appointment exercisable by one or more of such individuals;

(iv) the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer;

(v) the trust is a charitable lead annuity trust or a charitable remainder annuity trust or a charitable remainder unitrust; or

(vi) the trust is a trust with respect to which a gift tax charitable deduction was allowed for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

Section 2632(c)(3)(B). The IRS also noted that Section 2632(c)(3)(B) also provides that the value of transferred property shall not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the amount referred to in Section 2503(b) with respect to any transferor, and it shall be assumed that powers of appointment held by non-skip persons will not be exercised. In this case, Trust provided withdrawal powers to beneficiaries who are non-skip persons, but because the amounts of the annual withdrawal rights in Trust do not exceed the amount referred to in Section 2503(b), the amounts subject to the withdrawal right will not be considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal for purposes of the deemed allocation rules. Also, the withdrawal rights lapse each year in their entirety. Accordingly, none of the exceptions to the definition of a "GST trust" in

Section 2632(c)(3)(B) applied, Trust should be considered a GST trust and Donor's available GST exemption deemed allocated automatically to the transfer.

Taxpayers were found to have complied with the essential requirements necessary to allocate GST exemption to an irrevocable trust. Letter Rulings 201731005 and 201731010 (issued April 3, 2017; released August 4, 2017).

These two letter rulings have the same facts. Husband created an irrevocable trust for the benefit of his descendants. Husband and Wife hired an attorney to prepare the gift tax returns. On each return, Husband and Wife signed their consent to treat the transfers as having been made one half by each spouse under Section 2513. The attorney preparing the gift tax returns for Husband correctly reported the transfer to the trust as an indirect gift. The attorney also prepared the returns for Husband and Wife to each elect out of the automatic allocation of GST exemption and to allocate GST exemption to the transfer on Schedule B, Part 2, line 6 of each return; but the attorney failed to attach Notices of Allocation for this transfer. Thus, Husband and Wife failed to literally comply with the instructions for the gift tax return or with the requirements and the regulations for allocating GST exemption to an indirect skip in accordance with Section 2632(c).

The rulings noted that literal compliance with the procedural instructions to make an election is not always required. Elections may be treated as effective where the taxpayer complied with the essential requirements of the regulations (or the instructions to the applicable form) even though the taxpayer failed to comply with certain procedural directions therein. *Hewlett Packard Company v. Commissioner*, 67 T.C. 736 (1977). As a result, the IRS ruled that the gift tax returns contained sufficient information to constitute substantial compliance with the requirements of Section 2632(c) to allocate GST exemption to an indirect skip and, therefore, Husband and Wife had allocated GST exemption to the transfer to the trust.

The IRS rules on gift splitting in allocation of GST exemption to an irrevocable trust. Letter Ruling 201724007 (issued March 2, 2017; released June 16, 2017).

Wife created a trust for the benefit of her spouse and their descendants. In year one, Wife transferred property to the trust. Also in that year, Husband transferred property outright to three adult children.

During Husband's life, the trustee of the irrevocable trust has the discretion to distribute income and principal to Husband for his comfort, welfare, and best interests. If Wife pre-deceased Husband, the trustee had the discretion to distribute income and principal to Husband and his descendants for their comfort, welfare and best interests. Upon the death of the Husband, the remaining principal was to be divided and held in separate trusts for the benefit of the Settlor's surviving children and the issue of deceased children.

Husband and Wife each timely filed a gift tax return for the year. On each gift tax return Husband and Wife signified their consent to treat all of the gifts in that year as split gifts. On each of Husband and Wife's gift tax returns, the property transferred to the trust was mistakenly reported on Schedule A, Part 1 (gifts subject to only to gift tax). Wife did not report any allocation of GST exemption to the transfer to the trust on Schedule D, Part 2. Additionally, Wife did not attach a statement electing out of the automatic allocation of GST exemption to the Form 709. Husband's form was similar.

Subsequently, Wife and Husband amended their Forms 709 to correctly report the transfers to the trust on Part 3 (indirect skips) of Schedule A and to change Schedule D, Part 2, Line 5 to indicate that their respective GST exemptions were automatically allocated to the transfer to the trust. The amended return was filed pursuant to Rev. Proc. 2000-34, 2000-34 I.R.B. 186.

Husband and Wife each elected split gift treatment for these gifts. The IRS found that under Section 2504(c), the time for determining whether gift splitting treatment is effective with respect to the initial transfer with respect to the first year had expired. Therefore the split gift treatment was irrevocable for purposes of that transfer and it applied to all gifts made during the year by both spouses as reported on the returns.

The IRS also held that the trust was a GST trust for purposes of the automatic allocation rules. Husband and Wife had each timely filed a Form 709 for year one signifying their consent to treat the year one gifts to the trusts as having been made one-half by each spouse. Husband and Wife were bound by their consent. Subsequently Husband and Wife filed the amended Form 709 to report the transfer as an indirect skip and report that their GST exemptions were automatically allocated to the transfer. As a result, each of Husband and Wife would be treated as the transferor of one-half of the value of the entire value of the property transferred to the trust in year one and the automatic allocation rules would apply to allocate Husband and Wife's GST exemptions to one-half of the year one transfer to the trust.

2. Extensions of Time: Numerous Letter Rulings

The IRS will grant relief under Reg. §§301.9100-1 and 301.9100-3 from failures to timely make allocations of GST exemption or related elections, when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that granting the relief would not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the allocation or election. In the following rulings, the IRS found that those requirements had been satisfied and granted the requested relief:

To allocate GST exemption:

Letter Ruling 201711001 (issued Nov. 10, 2016; released March 17, 2017)

Letter Ruling 201718026 (issued Dec. 20, 2016; released May 5, 2017)

Letter Ruling 201724008 (issued March 2, 2017; released June 16, 2017)

Letter Rulings 201724022 & 023 (issued March 6, 2017; released June 16, 2017)

Letter Rulings 201725004-007 (issued Jan. 3, 2017; released June 23, 2017)

To elect out of automatic allocation of GST exemption:

Letter Ruling 201724015 (issued March 9, 2017; released June 16, 2017)

Letter Ruling 201729018 (issued March 27, 2017; released July 21, 2017)

Letter Ruling 201736017 (issued June 1, 2017; released Sept. 8, 2017)

Letter Ruling 201737006 (issued June 12, 2017; released Sept. 15, 2017)

Letter Ruling 201737007 (issued June 1, 2017; released Sept. 15, 2017)

To sever a marital trust and/or make QTIP and reverse QTIP elections:

Letter Ruling 201704005 (issued Oct. 3, 2016; released Jan. 27, 2017)

Letter Ruling 201717001 (issued Jan. 4, 2017; released April 28, 2017)

Letter Ruling 201731006 (issued April 10, 2017; released Aug. 4, 2017)

3. Changes to Trusts: Numerous Letter Rulings

The IRS also ruled, in the following rulings, that changes to trusts exempt from GST tax would not affect that exemption from GST tax:

Merger of trusts:

Letter Ruling 201711002 (issued Nov. 30, 2016; released March 17, 2017)

Transfer to another trust followed by modifications of that trust *(i.e.*, decanting):

Letter Ruling 201718014 (issued Jan. 25, 2017; released March 5, 2017)

Other changes:

Letter Rulings 201702016-018 (issued Sept. 19, 2016; released Jan. 13, 2017)

Letter Ruling 201706002 (issued Oct. 24, 2016; released Feb. 10, 2017)

Letter Rulings 201707003 & 004 (issued Oct. 12, 2016; released Feb. 17, 2017)

Letter Rulings 201712003-005 (issued Nov. 29, 2016; released March 24, 2017)

Letter Ruling 201723002 (issued Jan. 23, 2017; released June 9, 2017)

Letter Ruling 201732029 (issued April 20, 2017; released Aug. 11, 2017)

Letter Ruling 201735009 (issued May 25, 2017; released Sept. 1, 2017)

4. Mistakes in the Administration of a Trust: PLR 201735005

Inadvertent payment by trust beneficiary of federal and state income taxes will not have adverse GST, gift, or estate tax consequences. Letter Ruling 201735005, (issued May 8, 2017; released Sept. 1, 2017)

This letter ruling involved a lifetime grandfathered GST irrevocable trust created prior to September 25, 1985. The trust was for the benefit of daughter and her issue. The trust was funded with shares of stock in an S corporation and was a qualified subchapter S trust.

Subsequent to the creation of the trust, the trustee sold the trust's shares of stock in the S corporation in a transaction that resulted in capital gains to the trust for federal and state tax purposes. Pursuant to state law, the capital gains should have been allocated to trust principal and all income taxes due on the capital gains were required to be paid from trust principal. However, the trustee issued a Schedule K-1 to the daughter which treated the capital gains as a taxable distribution to the daughter for both federal and state tax purposes.

After receiving the Schedule K-1, the daughter reported the entire amount of the capital gains on her individual federal and state income tax returns, which she jointly filed with her spouse. The errors on the Schedule K-1 were in Year 1. The trustee made an additional distribution to daughter in Year 2 as a partial reimbursement for the income taxes erroneously paid by daughter and spouse. The daughter did not waive the right of recovery with respect to the erroneous payment of income taxes in Year 1.

The trustee subsequently prepared a draft of its first accounting. Upon receipt of the draft accounting, the daughter became aware that she was due an additional reimbursement from the trustee for the income taxes that she and her spouse paid in connection with the sale of the S corporation stock. The daughter sought a court order to have the trustee reimburse her spouse and her for the income taxes they paid in error.

The daughter also requested a ruling from the IRS that the inadvertent payment by the daughter of the federal and state income taxes would not constitute a constructive addition to the trust for generation skipping tax purposes and that the subsequent reimbursement to the daughter of the income taxes paid together with interest and attorney's fees would not cause any portion of the trust to be subject to GST tax. Rulings were also requested that the inadvertent payments would have no adverse estate and gift tax consequences.

The IRS ruled that there was no constructive addition to the trust for GST purposes that would cause the trust to lose its exemption. It noted that the daughter did not waive her right to recovery and petitioned the court to reimburse her for unreimbursed income taxes with interest and penalty and the Trustee had agreed to reimburse the daughter. Consequently, no addition to the trust occurred as a result of the daughter's inadvertent payment of the income taxes and the trust's prior reimbursement of income taxes and subsequent reimbursement under the court order for the income taxes together with interest and payment.

Also, since there was no change in the beneficial interests of the beneficiaries and no transfer of property had occurred as a result of the inadvertent payment of the income tax and the reimbursement of income taxes, daughter did not make a gift to the trust for gift tax purposes.

Finally, since daughter did not transfer any property to the trust, Section 2036 would not apply to cause any property in the trust to be included in daughter's estate at her death.

I. Portability

1. Requirement that an Executor File a Return and Elect Portability: *Vose*

The decision of Oklahoma Supreme Court in the *Vose* case is discussed in Part VIII.E.

2. Extensions of Time to File a Return and Elect Portability: Rev. Proc. 2017-34

Relief procedure for extensions of time to file returns to elect portability. Rev. Proc. 2017-34, 2017-26 I.R.B. 1282 (June 9, 2017).

Section 2010(c)(5)(A) requires that the portability election be made on an estate tax return for the decedent whose unused exclusion amount is being made available to the surviving spouse. Rev. Proc. 2014-18, 2014-7 I.R.B. 513, allowed relief for certain estates through December 31, 2014. Now Rev. Proc. 2017-34 provides permanent relief through the second anniversary of the decedent's date of death in certain cases if the estate was not otherwise required to file an estate tax return. This is a very helpful relief measure, which will make it unnecessary to pay a hefty user fee for "9100 relief" under Reg. §301.9100-3 to obtain an extension of the time for filing the return to make the portability election.

> **Note:** The articulation of the relief period the Revenue Procedure provides is "the later of January 2, 2018, or the second anniversary of the decedent's date of death." The now past deadline of January 2, 2018, provided relief in the case of those who died while portability was still rather new and unfamiliar. The period of two years after death is the permanent relief. And because relief is now permanent, it is not likely to be liberalized further.

The Procedure states that a "considerable number of ruling requests for an extension of time to elect portability" have been filed, indicating "a need for continuing relief for the estates of decedents having no filing requirement" (which will also relieve "a significant burden" that the ruling requests have placed on the IRS). The two-year limitation on the relief is designed to prevent prejudice to the government from a lack of available records, and also generally avoids the possibility that the period for filing a claim for refund of gift or estate tax paid by the surviving spouse or the surviving spouse's estate would have expired before the portability election was made under this relief procedure.

Requirements for qualifying for the relief procedure are:

- the decedent (i) was survived by spouse, (ii) died after December 31, 2010, and (iii) was a citizen or resident of the United States;
- the executor was not required to file an estate tax return under Section 6018(a) based on the value of the gross estate and adjusted taxable gifts (without regard to the need to file for portability purposes);
- the executor did not file an estate tax return within the time required under Reg. §20.2010-2(a)(1);
- the election is made on a complete and properly prepared Form 706 that is filed on or before the second annual anniversary of the decedent's data death; and
- the following statement appears at the top of the Form 706 – "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER §2010(c)(5)(A)." (§§3.01 & 4.01.)

If a later determination is made that the executor was required to file an estate tax return (based on the value of the gross estate and adjusted taxable gifts), relief under this procedure is deemed null and void *ab initio*. (§4.03.)

This relief procedure does not extend the period of limitations for filing a claim for refund with respect to an overpayment of tax (for example, if the surviving spouse paid a gift tax or died and paid an estate tax that could have been avoided with the applicable exclusion amount made available under the portability election). (§5.01.) However, a claim for refund filed in anticipation of a Form 706 being filed to elect portability pursuant to this Revenue Procedure will be considered a protective claim for refund (§5.02). (Accordingly, if a decedent died after 2010 but before about 2014, and if the surviving spouse paid a gift tax or estate tax for which the period of limitations on a refund will end before a "complete and properly prepared Form 706" can be filed, the taxpayer should file a protective claim for refund before the end of the limitations period stating that it is in anticipation of a complete return being filed pursuant to this Revenue Procedure.)

If an estate does not qualify for relief under this Revenue Procedure (*i.e.*, it does not file a complete and properly prepared Form 706 by the second anniversary of the decedent's death), it may still file a ruling request to seek "9100 relief" under Reg. §301.9100-3. (§3.03.)

3. Examination of the First Deceased Spouse's Estate Tax Return: *Sower*

IRS can review estate tax return of first spouse to die and reduce the amount of the deceased spousal unused exclusion amount reported on that return *Estate of Sower v. Commissioner*, 149 T.C. No. 11 (Sept. 11, 2017).

When Congress enacted portability between spouses in 2010 (made permanent in 2013), it included Section 2010(c)(5)(B), as follows:

> EXAMINATION OF PRIOR RETURNS AFTER EXPIRATION OF PERIOD OF LIMITATIONS WITH RESPECT TO DECEASED SPOUSAL UNUSED EXCLUSION AMOUNT.—Notwithstanding any period of limitation in section 6501, after the time has expired under section 6501 within which a tax may be assessed under chapter 11 or 12 with respect to a deceased spousal unused exclusion amount, the Secretary may examine a return of the deceased spouse to make determinations with respect to such amount for purposes of carrying out this subsection.

The *Sower* case is a test of that statute.

Husband died in 2012, and his estate reported a deceased spousal unused exclusion (DSUE) amount and elected portability. In 2013, the IRS sent Husband's estate a letter stating that the return had been accepted as filed. Wife died in 2013 and Wife's estate claimed the DSUE amount reported by Husband's estate on Wife's estate tax return. As part of an examination of the estate tax return filed by Wife's estate, the IRS also examined the estate tax return filed by Husband's estate and reduced the amount of the DSUE amount by the amount of taxable gifts made by Husband but did not determine or assess a deficiency against Husband's estate. However, the IRS determined an estate tax deficiency against Wife's estate because of the reduction in Husband's DSUE amount. Wife's estate filed a petition in which it made several arguments regarding why the IRS should be prohibited from examining the estate tax return filed by Husband's estate to determine the proper DSUE amount allowable to Wife's estate.

During their lifetime, Husband and Wife each gave away $997,920 in taxable gifts. All the gifts were given between 2003 and 2005. When Husband died in 2012, his estate filed an estate tax return reporting no estate tax liability and reported taxable gifts of zero, but included $945,420 in taxable gifts on the worksheet provided to calculate the taxable gifts to be reported on the return. Husband's estate reported a DSUE amount of $1,256,033 and elected portability as the decedent allowed the surviving spouse to use it.

On November 1, 2013, the IRS issued an initial Letter 627, estate tax closing letter to Husband's estate. The Letter 627 showed no estate tax liability for Husband's estate. The Letter 627 also stated that the return had been accepted as filed and further stated: "[the Commissioner] will not reopen or examine this return unless *** [notified] of changes to the return or there is: (1) evidence of fraud, malfeasance, collusion, concealment or misrepresentation of material fact; (2) a clearly defined substantial error based upon an established Internal Revenue Service position; or (3) a serious administrative error."

Wife died on August 7, 2013. Her estate filed a timely return claiming the DSUE amount of $1,256,033.00 from Husband's estate. Initially her estate reported and paid an overall estate tax liability of $369,036. Three months later the estate paid an additional $386,424 in tax and interest to correct a mathematical error on the original return. As with Husband's estate, Wife's estate did not include the lifetime taxable gifts on the return, but rather than reporting zero in gifts as on Husband's estate tax return, it left the entry blank on Wife's estate tax return.

In February 2015, the IRS began its examination of the estate tax return filed by Wife's estate. In connection with that examination, the Commissioner also opened an examination of the return filed by Husband's estate to determine the proper DSUE amount available to Wife's estate. On March 25, 2015, the IRS sent a letter and draft revised report showing an adjustment to the amount of Husband's lifetime gifts. On July 20, 2015, the IRS sent a second estate tax closing letter to Husband's estate. Nothing in the second closing letter for Husband's estate suggested that the IRS requested any additional information from or determined any additional liability for Husband's estate.

As a result of the examination of the return filed by Husband's estate, the IRS reduced the DSUE amount available to Wife's estate from $1,256,033 to $282,690. The IRS also adjusted Wife's taxable estate by the amount of her lifetime taxable gifts. These adjustments resulted and increased the estate tax liability for Wife's estate by $788,165. Wife's estate made the following arguments.

First, it argued that the estate tax closing document should be treated as a closing agreement under Section 7121 and that the IRS should be estopped from reopening Husband's estate by the text of the document.

Second, Wife's estate argued that the examination that took place after the IRS had sent the first estate tax closing document was an improper second examination.

Third, the estate argued that the effective date of Section 2010(c)(5)(B) and the text of the regulations precluded the IRS from adjusting the DSUE amount of the predeceased spouse for gifts made before 2010.

Finally, the estate argued that the application of Section 2010(c)(5)(B) by the IRS in this case was contrary to the intent of Congress to permit portability and was "unconstitutional for lack of due process" because it overrode the statute of limitations on assessment established in Section 6501.

The Tax Court (Judge Buch) rejected each of these arguments, finding that the IRS had properly exercised the powers inferred by Sections 2010(c)(5)(B) and 7602(a)(1). It examined the return filed by the estate of the predeceased spouse. It found that the DSUE amount had been overstated. It adjusted the amount of the DSUE amount as authorized by the Code and the regulations but did not determine an estate tax deficiency for Husband's estate. The Court rejected the two arguments made by Wife's estate that the initial estate tax closing document should bar the IRS's examination of Husband's estate tax return to determine the DSUE amount available to Wife's estate. The court found that the document was not a closing agreement under Section 7121 because there was no negotiation between the IRS and Husband's estate. It also held that the doctrine of equitable estoppel could not be asserted in this situation because the four essential elements were lacking. These four elements are:

1. A false representation or wrongful misleading silence;
2. An error in a statement of fact and not an opinion or a statement of law;
3. The person claiming the benefits of estoppel must be ignorant of true facts; and
4. The person must be adversely affected by the acts and statements of the person against whom an estoppel is claimed.

The court also found that this was not in an improper second examination. It noted that the estate had not cited Section 7605(b), which protects taxpayers from an impermissible second examination. Moreover, even if this was an improper second examination, the IRS would not have violated Section 7605(b) as to Wife's estate. Only the examined party is protected from second examinations.

The court then rejected the estate's argument that the IRS could not adjust the DSUE amount on the basis of gifts given before December 31, 2010, because the effective date of portability was January 1, 2011. It also rejected the estate's argument that the actions of the IRS violated Congress's intent with respect to portability and was an unconstitutional violation of due process because it overrode the statute of limitations on assessments established in Section 6501. It stated that Section 2010(c)(5)(B) does not give the IRS the power to assess any tax against the estate of the predeceased spouse outside of the period of limitations. But the IRS "may examine returns of each of the surviving spouse's deceased spouses whose DSUE amount is claimed to be included in the surviving spouse's applicable exclusion amount, regardless of whether the period of limitations on assessment has expired for any such return" (quoting Reg. §20.2010-3(d)). The court concluded that the IRS acted within its legal authority when it examined Husband's estate tax return and adjusted the DSUE amount that may be claimed by Wife's estate. Wife's estate also had to include the lifetime taxable gifts in her estate for the purposes of determining the amount of the estate tax due.

J. Special Rules for 2010: PLR 201735015

IRS permits a late election out of the estate tax for a 2010 nonresident alien decedent. Letter Ruling 201735015 (issued May 9, 2017; released Sept. 1, 2017).

Decedent, a nonresident alien, died in 2010 and the executors of Decedent's estate hired

Attorneys to administer the U.S. estate. Attorneys failed to prepare the Form 8939 to elect out of the estate tax and obtain a carryover basis. The executors requested an extension of time pursuant to Reg. §301.9100-3 to file the Form 8939 to make the Section 1022 election and to allocate basis provided by Section 1022 to eligible property transferred as a result of Decedent's death.

The IRS allowed the late election, noting that the estate of a decedent dying in 2010 could elect not to have the estate tax apply to the estate, and instead obtain a modified carryover basis. Section 1022(a) provides that property acquired from a decedent who died in 2010 and whose estate makes this election is treated as transferred by gift, and the basis of the person acquiring the property from such a decedent is a modified carryover basis (the lesser of the decedent's adjusted basis or the fair market value of the property at the date of death, with certain adjustments, including an aggregate basis increase and a spousal property basis increase). The election into modified carryover basis is made by filing a Form 8939 on or before January 17, 2012. Notice 2011-76, 2011-40 I.R.B. 479. The IRS will grant extensions of time to file a Form 8939 and will accept a Form 8939 filed after the due date only in four limited circumstances, one of which is where the requirements of Reg. §301.9100-3 are satisfied. The IRS stated that the executors had met those requirements and granted an extension of the time in which to file Form 8939.

K. Penalties: *Hake*

Late filing penalties sometimes waived, sometimes not waived, for executors' reliance on advice of counsel. *Estate of Hake v. United States*, 234 F. Supp. 3d 626 (M.D. Pa. Feb. 10, 2017) (slip copy), *app. filed* (3rd Cir., May 4, 2017).

Ricky and Randy Hake were the executors for the estate of their late mother, Esther Hake. At Esther's death, her five children were involved in a family dispute over her care and the value of her assets, which dispute impaired the executors' ability to administer the estate efficiently. As neither executor had any probate or related tax experience, they hired an estate attorney to advise them. The executors intended to file their estate tax return in a timely manner, but the disputes made it difficult to obtain appraisals and to value the estate assets. Their attorney obtained a one-year extension of the time to pay the tax and a six-month extension of the time to file the estate tax return. *See* Reg. §20.6081-1. The attorney told the executors that they had a one-year extension for both. The executors paid the tax before the one-year extension had run, but they filed the return after the six-month extension (though before the one-year extension they thought that they had). The IRS assessed a $197,868.26 penalty for late filing, with $17,202.44 of interest.

The U.S. District Court (Magistrate Judge Carlson) held that the executors had reasonable cause for filing their estate tax return late, because they had relied on their attorney to tell them when the return was due. The court noted that the case was not governed by *United States v. Boyle*, 469 U.S. 241, 245 (1985), because the executors did not rely on their attorney to file the return. Rather, they had relied on their attorney for legal advice on when the return was due, and then they had filed the return within the time they were told. The question, therefore, was whether reliance on an attorney for legal advice is reasonable cause for late filing. Relying on the prior holdings of the Third Circuit, the court held that it is. Citing *Estate of Thouron v. United States*, 752 F.3d 311, 314 (3d Cir.

2014); *Hatfried, Inc. v. Commissioner*, 162 F.2d 628, 633-35 (3d Cir. 1947); and *Girard Investment Co. v. Commissioner*, 122 F.2d 843, 848 (3d Cir. 1941)). The court also noted that the Tax Court has held that reasonable cause may exist for late filing when the taxpayer relies on an expert's incorrect advice. *See Estate of La Meres v. Commissioner*, 98 T.C. 294, 318 (1992). The court therefore granted the executors' motion for summary judgment.

> **Note:** The circuits are split on this issue. Compare *Estate of Liftin v. United States*, 754 F.3d 975 (C.A. Fed., 2014), *aff'g* 111 Fed. Cl. 13 (Fed. Cl., 2013), reconsideration *denied* (2013); *Knappe v. United States*, 713 F.3d 1164 (9th Cir. 2013), *cert. denied*, 134 S. Ct. 422, 187 L. Ed. 2d 280 (2013) (reliance on advice of counsel is reasonable cause only if the advice itself is reasonable); with *Estate of Thouron v. United States*, 752 F.3d 311 (3d Cir., 2014), *vac'g and rem'g* 2012 WL 5431009, 110 A.F.T.R.2d 2012-6572 (E.D. Pa., 2012); *Sanderling, Inc. v. Commissioner*, 571 F.2d 174, 178-79 (3d Cir. 1978); *Hatfried, Inc. v. Commissioner*, 162 F.2d 628, 633-35 (3d Cir. 1947), and *Girard Investment Co. v. Commissioner*, 122 F.2d 843, 848 (3d Cir. 1941) (reliance on advice of counsel is inherently reasonable).

But the estate was not entitled to attorneys' fees. *Estate of Hake v. United States*, 2017 WL 1550023, 119 A.F.T.R.2d 2017-1654 (M.D. Pa, May 1, 2017).

After successfully seeking an abatement of penalties and interest for the late-filed estate tax return, the estate then sought attorney's fees under Section 7430.

The estate's net worth was nearly $8.2 million on the date of death, which significantly exceeded the $2 million net worth limitation for a claim of attorney's fees under Section 7430(c)(4)(D). Also, while the District Court had held that the penalties must be abated because the taxpayer relied on the incorrect advice of counsel, the circuits are split over whether this justifies abatement. The court (Magistrate Judge Carlson) noted that attorney's fees cannot be awarded if the IRS's position was "substantially justified." The court stated that this means "justified to a degree that could satisfy a reasonable person" or having a "reasonable basis both in law and fact." *Pierce v. Underwood*, 487 U.S. 552, 563–65 (1988). The court held that the IRS's position drew substantial support from case law construing the Supreme Court's decision in *United States v. Boyle*, 469 U.S. 241 (1985), and, therefore, was both "justified to a degree that could satisfy a reasonable person" and had a "reasonable basis both in law and fact." *Id.* 2017 WL 1550023 at *3.

> **Note:** The circuits are, indeed, split on this issue, but the position of the Court of Appeals for the Third Circuit, in which this case lies, seems quite well-settled, as shown by the discussion of the substantive issue, above.

L. Estate Tax Closing Letters and Their Substitutes: Notice 2017-12

IRS provides guidance on methods available to confirm closing of the estate tax return examination. Notice 2017-12, 2017-5 I.R.B. 742 (Jan. 6, 2017).

Prior to June 1, 2015, the IRS issued estate tax closing letters for every estate tax return filed. In a June 16, 2015 update to the "Frequently Asked Questions on Estate Taxes" on the IRS website, the IRS indicated that for all estate tax returns filed on or after June 1, 2015, estate tax closing letters will be issued only upon request by the taxpayer. Taxpayers are asked to wait at least four months after filing the estate tax return to make the closing letter request "to allow time for processing." Apparently, this change in procedure was made in light of cuts to the IRS budget and in light of the fact that a closing letter does little good for the new types of returns filed solely to elect portability (because the statute of limitations on that return for determining the DSUE amount does not run until the statute of limitations runs on the surviving spouse's return). Estates that owe estate taxes will almost routinely want to request the closing letter before making estate distributions.

This notice on the IRS website says that for returns filed before June 1, 2015, estates can expect to receive a closing letter, if requested, about four to six months after the return is filed unless the return is selected for examination or reviewed for statistical purposes.

This new procedure has been widely criticized by planners. The IRS responded by describing a procedure by which the taxpayer could obtain an account transcript, which would serve the purpose of a closing letter. In early December 2015, the IRS added a webpage entitled "Transcripts in Lieu of Estate Tax Closing Letters" describing the process.

Notice 2017-12 provides guidance on the methods available to confirm the closing of an examination of the estate tax return. The Notice recalls that the IRS had previously announced that it would no longer issue estate tax closing letters as a matter of course and notes that state and local agencies have come to rely on closing letters for confirmation that the IRS has closed its examination of the estate. It then states that in the absence of a closing letter, an account transcript, which is a computer generated report reflecting current account information, can be relied on as a substitute for the closing letter. But the IRS pointed out that a closing letter is not equal to a closing agreement and that under certain circumstances, the IRS can reopen the examination. A taxpayer can confirm the closing of the IRS's examination of an estate tax return by requesting a transcript of the account. If the account transcript contains a transaction code of "421," this, similar to the receipt of an estate tax closing letter, will confirm the closing of the IRS's examination of the return.

> **Note:** Some practitioners have found it very difficult to learn how to access, and to access, the account transcript for an estate. There have been reports of many hours and frustrating phone calls that sometimes still have not resulted in access to the transcript.
>
> Executors and their representatives can request an account transcript by submitting IRS Form 4506-T, "Request for Transcript of Tax Return," by mail or facsimile, but such requests should be made no earlier than four months after filing the estate tax return. Attorneys, accountants, and others who represent a decedent's estate should include Form 4506-T on the list of specific authorizations when filling out an IRS Form 2848, "Power of Attorney."

M. Liens

1. Cases: *Holmes*, *Johnson*, *Meyers*, *Simmons*

Fifth Circuit Court of Appeals allows collection of estate tax. *United States v. Holmes*, 693 Fed. Appx. 299 (5th Cir. June 6, 2017), *aff'g* 2016 WL 4363398 (S.D. Tex. 2015).

Barbara and Kevin Holmes were the beneficiaries and fiduciaries of the estate of Shirley Bernhardt. They filed a timely estate tax return reporting an estate of $2.88 million and paying $700,000 in estate tax. On audit, the IRS assessed a deficiency of $1,225,577. The Holmeses filed a petition in the Tax Court and ultimately were held to owe an additional $215,264, which they also did not pay. The IRS placed liens on their assets and sent a Notice of Intent to Levy. The Holmeses filed a Request for a Collection Due Process or Equivalent Hearing, and sent it by certified mail. The IRS claimed that they had not received the request, but the Holmeses had a return receipt and insisted that they had timely requested the hearing. The IRS sued to foreclose its lien, and the Holmeses raised the defense of the statute of limitations. The U.S. District Court for the Southern District of Texas held for the IRS.

The Court of Appeals for the Fifth Circuit (Judge Costa) affirmed. The court noted that the IRS has ten years from the date of the assessment in which to bring suit to collect the taxes. Section 6501(a)(1). The ten years had expired before it filed suit, but the court noted that the period of limitations is suspended during a hearing on the liability. The taxpayers argued that the hearing process was not actually initiated until Kevin sent his letter to prove that the IRS had received the request in October. The court held that the taxpayer had a duty of consistency, and that estoppel prevented them from arguing that they had legitimately requested a hearing, as shown from their return receipt, and then later arguing that the return receipt was not adequate evidence of their request.

Fiduciaries not liable for unpaid estate taxes because property was included in the gross estate under Section 2033 and the estate obtained a special lien under Section 6324A. *United States v. Johnson*, 224 F. Supp. 3d 1220 (C.D. Utah, Dec. 1, 2016), *app. filed* (10th Cir., June 7, 2017).

The decedent's revocable trust held the stock of a hotel, a company that had a Nevada gaming license. Two of her children, Mary Carol S. Johnson and James W. Smith were the successor trustees and executors of her estate. The residue of the estate was left to the trust. The trust instrument made pre-residuary gifts, directed the payment of debts, expenses, and taxes, and left the balance to four family limited partnerships, one for the family of each of the decedent's children. The decedent's estate tax return showed a gross estate at nearly $16 million, and a federal estate tax liability of approximately $6.6 million, of which $4 million was paid with the return. The estate elected to pay the estate taxes on the Hotel interest in installments under Section 6166. At the suggestion of the IRS executor, Johnson furnished documents for a special lien under Section 6324A, to relieve the executors and trustees of personal liability for the deferred estate taxes. The hotel later went bankrupt and was liquidated, with all proceeds going to its creditors. The IRS assessed the outstanding estate taxes against the executors and trustees.

The U.S. District Court for the Central District of Utah (Judge Waddoups) held executors and trustees had no personal liability for the unpaid estate taxes. The court explained that the trustees' liability extended only to assets that were included in the gross estate under Sections 2036 or 2038, but that the revocable trust assets were actually includible under Section 2033, because the decedent did not surrender her beneficial interest in the trust assets by transferring them to a trust that she could revoke and of which she was trustee. *See* Rev Rul. 75-553, 1975-2 C.B. 477. The executors, furthermore, were not personally liable for estate taxes under 31 U.S.C. §3713(b), because the special estate tax lien under Section 6324A had relieved them of personal liability.

The IRS claimed that there was no discharge under Section 2204, because the executors never specifically requested a discharge. The court was not convinced that a separate written request for discharge was required, but even if it was the communications between the fiduciaries and the IRS satisfied that requirement. The court also held that the fiduciaries had validly requested a special lien under Section 6324A, because they had (a) made an election by applying to the IRS office (Reg. §301.6324A-1(a)); (b) filed a proper agreement satisfying the requirements of Reg. 301.6324A-1(b); and (c) provided lien property (collateral) that satisfied the requirements of the statute, that it "can be expected to survive the deferral period, and are designated in the agreement" (Section 6324A(b)(1)). The court disagreed with the IRS that the stock was not likely to survive the deferral period, noting that the defendants' expert at that time stated that the stock was likely to survive the deferral period. The Government's expert report was found wanting, because it set forth no specific facts suggesting that the hotel's financial stability or history were not as represented.

> **Note:** Procedural rules often seem boring and of little practical value, but a case like *Johnson v. United States* shows that, in their proper context, they can be truly and impressively dispositive. The decedent's estate in Johnson may have owed several million dollars in unpaid estate taxes, but the procedural issues resulted in no family member being liable for that deficiency.

But recipients of assets received by means other than a will or state law governing the distribution of a deceased person's property could be liable for unpaid estate taxes ten years later. *Estate of Meyers v. Commissioner*, T.C. Memo. 2017-11

Ruben A. Meyers died in November 2005. On February 15, 2007, the executor filed a federal estate tax return and began making installment payments pursuant to Section 6166. In 2007 through 2013, the estate made the required payments. In 2014, the estate became delinquent. A revenue officer was assigned to collect the delinquent payments. On October 7, 2014, the revenue officer filed the Notes of the Federal Tax Lien ("NFTL") and shortly thereafter notified the executor that the NFTL had been filed and of this right to a Collection Due Process ("CDP") hearing. On October 29, 2014, the revenue officer notified the executor of the IRS's intent to levy to collect the delinquent tax and of his right to a CDP hearing. The unpaid liability for estate tax, interest, and penalties was then $380,000. The estate timely submitted a request for a CDP hearing asking for an offer in compromise and stating that he was unable to pay the balance due and requesting withdrawal of the NFTL.

After the submission of the request form, the revenue officer made an inappropriate contact with the settlement officer assigned to conduct the CDP hearing. As a result, the case was assigned to another settlement officer. A face to face meeting was set for April 9, 2015. Prior to the hearing, the executor provided the settlement officer with the financial information but did not submit a completed offer in compromise.

At the hearing, the executor stated that, paying the delinquent estate tax liability from probate assets would require the sale of family farm lands that would be difficult to liquidate. He suggested that the IRS take action to collect the delinquent liability from third parties that had received cash or liquid non-probate assets. He also represented that he had no access to non-probate assets as a source of funds to pay the estate tax liability. As a result of the hearing, the settlement officer determined that the estate did not qualify for non-collectible status or hardship, but that the IRS could pursue collection of the estate tax from non-probate assets. The NFTL was kept in place because the petitioner had not provided sufficient justification for withdrawal.

The special estate tax lien against the family farm expired on November 15, 2015, ten years after decedent's death. The IRS had not taken any action to attach or otherwise collect the estate tax liability with respect to the non-probate assets. The Tax Court (Judge Halpern) held that while the ten-year period for imposing personal liability could still be open after expiration of the ten-year special estate tax lien against the family farm and the probate estate. Although the lien begins to run as of the date of death, the ten year collection period runs from the date of assessment.

The Government's income tax lien must be satisfied before the executor's fees. *Matter of Simmons v. Spiekhout*, 2017 WL 3261781, 120 A.F.T.R.2d 2017-5368 (S.D. Ind. July 31, 2017).

Frederick Simmons married Deborah Scott, and the couple had one child, Erick. The couple divorced in 1998, and their divorce decree provided, in part, that Frederick would pay certain amounts for child support, maintenance, their child's health insurance benefits, and any of his uninsured health care costs. The agreement also required that Frederick hold Deborah harmless from any and all encumbrances on certain real property owned by the couple, the title to which Deborah quitclaimed to Frederick ("the Property"). Frederick later married Raelinn Spiekhout, who survived him and became executor of his estate, the principal asset of which was the Property. The estate was subject to numerous claims, including Deborah's claim for past due child support, alimony, medical expenses, and insurance expenses, and federal claims for unpaid income and trust fund taxes. The state court approved sale of the Property and declared the estate insolvent, finding that it had only $266,873 of assets and over $1.8 million of claims. The state court ordered the estate closed as insolvent and ordered distribution of the proceeds from the sale of the Property. The United States removed the case to federal court and contested the state court's disposition of the tax lien, and the U.S. District Court for the Southern District of Indiana also approved the sale of the Property, and Raelinn moved to determine the priority of various claims. The District Judge referred the motion to a Magistrate Judge, who recommended allowing the Government priority interest for the proceeds from the sale of the Property. The executor objected.

The District Court (Judge Pratt) overruled the objection. Raelinn argued that her claim for fiduciary fees took priority over the Government's tax claims, but the court held that the Government had properly filed notice of its federal tax liens and that the executor is not a “purchaser, holder of security interest, mechanics lienor, or judgment lien creditor,” such as would provide priority over the Government’s tax lien. Section 6323. The court held that funeral and administrative expenses have no priority over a federal tax lien in the settlement of an estate, and that the Federal Tax Lien Act, rather than the Federal Priority Statute, governs whether the Government tax liens have preference to the proceeds from the Property. *United States v. Estate of Romani*, 523 U.S. 517 (1998) (Federal Tax Lien Act, rather than federal priority statute, under which a claim of United States Government “shall be paid first” when debtor’s estate cannot pay all of its debts, is governing statute when Government claims preference in insolvent estate of delinquent taxpayer.”). Accordingly, because Raelinn’s interest did not fall under any of the enumerated exceptions in the Federal Tax Lien Act, 28 U.S.C. §6323, the Government’s tax liens had priority. The Government agreed, however, that, if documentation were provided evidencing payments made by Raelinn to maintain the Property, it would allow her unreimbursed expenses to be paid ahead of the federal tax liens.

2. New Procedure for Release of Estate Tax Lien:

Under Section 6324(a), the general estate tax lien attaches for 10 years on all property includible in the decedent’s gross estate. The general estate tax lien does not have to be recorded; it is automatic. If the collateral for the lien is property of the estate, the automatic estate tax lien under Section 6324(a) on that property is extinguished by the special estate tax lien for Section 6166 deferred tax under Section 6324A.

For PROBATE assets, property that is purchased or transferred is still subject to the lien in that person’s possession, except that if property is transferred to a purchaser or holder of a security interest and if the executor has been discharged from personal liability for the estate tax under Section 2204, the lien no longer applies to the transferred property, but the lien attaches to the consideration received from the purchaser. Section 6324(a)(3). For that reason, any purchaser of probate property should request documentation that the executor has been discharged from personal liability under Section 2204 or request that the IRS release the lien. (Despite the existence of this automatic lien, however, many purchasers of real estate do not request a lien discharge.)

For NONPROBATE assets, the rules are quite different, as illustrated in Legal Advice Issued by Field Attorneys (LAFA) 20061702F (issued March 21, 2006; released April 28, 2006). Nonprobate property transferred to a purchaser or holder of a security interest is no longer subject to the lien; a similar lien, however, attaches to all of the transferor’s property. Section 6324(a)(2). The specific issue in LAFA 20061702F was whether pledging property was a “transfer” for purposes of this special rule that divested transferred property of the lien. The LAFA held that it was. It pointed out, though, other special rules that apply for nonprobate property under Section 6324(a): (1) the beneficiary is personally liable for the estate tax; (2) the lien remains to the extent that the value of the collateral exceeds the balance of the loan to the lender; and (3) there is a lien against the beneficiary’s property.

Until recently, the responsibility for processing Form 4422, “Application for Certificate Discharging Property Subject to Estate Tax Lien” was shared by the offices of the Director, Specialty Collection, Offers, Liens and Advisory, and the Director, Specialty

Examination Estate & Gift Tax. Estate & Gift Tax processed applications when the federal estate tax return had not yet been filed or was under audit. Specialty Collection, Offers, Liens and Advisory processed applications when there was a balance due, when an estate tax closing letter had been issued, or when a special election allowing deferral of payment of the tax liability had been made.

New Procedure Instituted in 2016. Prior to June 1, 2016, obtaining a discharge was fairly straightforward; the lien would typically be released within 10 days of sending the Form 4422 to the IRS (or hand delivering it to a local IRS estate and gift tax office). Significant changes in the procedures for estate tax lien discharges were instituted beginning June 1, 2016. The IRS shifted responsibility for working all applications requesting a discharge of the estate tax lien to Specialty Collection, Offers, Liens and Advisory. Unfortunately, Specialty Collection, Offers, Liens and Advisory was not as familiar as Examination Estate & Gift Tax with the special issues raised in the context of an estate administration. For example, under Specialty Collection, Offers, Liens and Advisory, the IRS began to require that the entire net proceeds from a sale of property that was subject to an estate tax lien be deposited into an escrow account or the estate's estate tax account with the IRS, in order for the IRS to release the lien. This created serious cash flow problems for some estates, particularly when the estate might not otherwise owe any estate taxes because of the application of the unified credit and the marital deduction.

IRS Response. In response to questions raised by practitioners and professional groups, the IRS has now issued a new Memorandum, SBSE-05-0417-0011 (April 5, 2017), providing guidance regarding how Specialty Collection, Offers, Liens and Advisory would process a request to discharge property subject to an estate tax lien. They key provisions of this new guidance include:

- **Purpose of Lien Discharge.** The Memorandum explains that the primary purpose of the estate tax lien discharge is not to evidence payment or satisfaction of the estate tax, but to permit the transfer of property free from the lien in case it is necessary to clear title.
- **Protecting Interests of the Government.** In determining whether to grant an estate tax lien discharge, the IRS must consider whether the estate tax liability is adequately provided for, meaning that the Government's interest in collecting the estate tax is secured under Section 6325(c) and the accompanying Treasury Regulations.
- **What to Consider.** Forms 4442 and the related documents submitted, internal and external records (such as market comparisons) to estimate or substantiate the tax liability should be considered in determining how much or if any of the sale proceeds must be held or paid over to the Government in exchange for a certificate of discharge.
- **No Return Required.** If Advisory or Examination Estate & Gift determines that the estate was not required to file an estate tax return, then no discharge certificate should be issued, but, instead, Letter 1352, Request for Discharge of Estate Tax Lien, should be issued selecting the applicable paragraph for no estate tax return

filing requirement.

- **Nontaxable Estate.** If the Form 4422 indicates that the estate tax return will be non-taxable, then a discharge without an escrow may be appropriate. If a marital or charitable deduction is being claimed, additional documents should be obtained for review including the will and/or trust that authorize those deductions.

- **Estimated Additional Estate Tax.** If the Form 4422 shows an estimated estate tax greater than the net proceeds from the property being sold, and no estimated payment has been made, then the net proceeds should be paid or escrowed before granting the discharge. If the Form 4422 shows an estimated estate tax liability, and the estate has filed an extension to file the tax estate tax return (Form 4768) and paid the full estimated tax liability, then a discharge without an escrow may be appropriate. If the Form 706 is filed and the reported tax is paid, then a discharge without an escrow may be appropriate.

- **Property Double the Amount of the Liability**. Under Section 6325(b)(1), a certificate of discharge may be issued if it is determined that the remaining property of the estate subject to the estate tax lien has a fair market value that is at least double the amount of the unsatisfied liability secured by the estate tax lien and that the amount of all other liens on such property that have priority over the estate tax lien.

- **Part Payment.** A certificate of discharge may be issued for any part of the property subject to the estate tax lien if the IRS determines that an adequate amount has been paid in partial satisfaction of the estate tax liability secured by the lien. The amount cannot be less than the value of the IRS's interest in the property to be discharged.

- **No Value.** A certificate of discharge may be issued if it is determined that the Government's interest in the lien property has no value, considering all facts and circumstances, including other liens and encumbrances with priority over the federal tax lien.

- **Substitution of Proceeds of Sale (Escrow Agreement).** A certificate of discharge may be issued if property subject to the estate tax lien is sold and the IRS determines that the sales proceeds should be held in escrow as a fund subject to the estate tax lien in the same manner and with the same priority as the estate tax lien had with respect to the discharged property. Whether to require an escrow and the amount of the escrow is within the IRS's discretion, based on all relevant facts and circumstances. Reasonable and necessary expenses incurred in connection with the sale of the property or administration of the sale proceeds will be paid from the proceeds of the sale before the satisfaction of any claims. The IRS has discretion to allow distributions from escrow for allowable expenses of administering the estate before the tax liability is determined.

- **Right of Substitution of Value.** An owner has the right under Section 6325(b)(4) to receive a certificate of discharge on any property subject to an estate tax lien if the owner deposits an amount equal to the value of the IRS's interest in the property, or furnishes an acceptable bond in a like amount sufficient to cover the IRS's interest in the property.

Revised Form 4422. The IRS has issued a revised Form 4422, Application for Certificate Discharging Property Subject to Estate Tax Lien (March 2017), which must be submitted to the IRS along with the supporting documents described in the instructions to Form 4422. The IRS will also have to be given a title insurance commitment showing the legal description. The instructions provide: "If the property consists of real estate, attach a separate legal description and a preliminary title report for each parcel." The estate will have to produce evidence that the selling price is a fair price, such as with an appraisal or perhaps a letter from a real estate broker who knows the market and comparable properties. The instructions to Form 4422 say to "show the value of the property and the basis of the valuation." The form should be submitted "at least 45 days before the transaction date."

If an escrow approach is used, the IRS will supply an escrow agreement (and it will not agree to any changes to the agreement). The IRS must approve the escrow agent, and one of the requirements is that the escrow agent be bonded. The IRS should be given a draft of the closing statement showing the net sale proceeds, so the IRS manager can prepare the escrow agreement. The escrow agreement will reflect the legal description of the property for which the discharge is requested, and the net sale proceeds. The IRS will fax (but not email) the escrow agreement, which must be signed by the executors, the escrow agent, the IRS manager in charge of this new process, and that IRS manager's supervisor (often located in a different city). The process of finalizing the escrow will take some time; executors and their advisors should not wait until the closing is near to begin the process.

The IRS will initially issue a conditional commitment, which will allow the sale to close. The actual certificate discharging the lien is not issued until the IRS has confirmation that the funds are in the possession of the escrow agent.

If the escrow approach is used, an estate tax closing agreement is required to obtain the release of the funds. Query whether a transcript with the code "421" will suffice for this purpose? Notice 2012-12, 2012-6 I.R.B. 365, suggests that it would.

Under the relaxed procedures described in the April 5, 2017, Memorandum, collection officers are reminded that under Section 6325(c), a certificate of discharge of the lien may be issued "if the Secretary finds that the liability secured by such lien has been **fully satisfied or provided for**" (emphasis included in the quotation in the Memorandum). The Memorandum describes various situations in which the officer may exercise discretion to issue the certificate of discharge because the estate tax liability "has been fully satisfied or provided for." Those situations include:

- The estate is not required to file an estate tax return (in which event "Letter 1352" is issued in lieu of a certificate of discharge);
- The Form 4422 indicates that the estate is non-taxable based on the estimated gross estate and estimated deductions (but if the collection officer has a question

regarding the effect of any deductions, the officer should submit the application to the Examination Estate & Gift group before making a decision):

- The estate filed an extension request and paid the full estimated estate tax (but if the collection officer has a question regarding the effect of any deductions, the officer should submit the application to the Examination Estate & Gift group before making a decision);
- The estate filed Form 706 and paid the reported tax (but the collection officer "*should submit* an SRS [*i.e.*, Specialist Referral System] referral to Examination Estate & Gift before making a decision on the application" regarding the estate tax computation or questions regarding the effect of any deductions);
- The remaining property of the estate subject to the estate tax lien has a fair market value that is at least double the amount of the unsatisfied liability secured by the estate tax lien (Section 6325(b)(1));
- An "adequate amount" (not less that the value of the interest in the property being discharged) has been paid in partial satisfaction of the estate tax liability (Section 6325(b)(2)(A));
- The property subject to the lien has no value (Section 6325(b)(2)(B));
- Funds held in escrow may be released in the officer's discretion for paying allowable expenses of administering the estate or when the officer later determines that the estate tax liability is adequately provided for or after verification that all assessments (tax, interest, and penalty) have been made (IRM 5.5.2.6, & 5.12.10.3.4); and
- The owner deposits an amount equal to the value of the IRS's interest in the property or furnishes an acceptable bond (IRM 12.10.3.5).

The revised procedures are useful, but problems will remain. Estates often need the cash from property sales to pay expenses or debts, but the IRS wants all of the net sales proceeds even though plenty of assets remain to pay estate taxes. Collection officers are encouraged (and in the case of an estate that filed a Form 706 and paid its tax, the officer is *directed*) to contact the estate and gift tax group before making a decision. Collection officers typically are not familiar with estates or estate tax deductions or calculations, and the lack of familiarity will require coordination with the estate and gift tax group and will slow the approval process. Timing is a serious concern because real estate transactions are often time-sensitive.

> **Note:** For older clients who anticipate that real estate will be sold after their deaths to pay administration expenses or state taxes, consider contributing the real estate into a single member LLC prior to death. The estate tax lien applies to the membership interest in the LLC, not to the underlying real estate.

N. Inspector General's Critique of Exam Process

Report from Treasury Inspector General For Tax Administration Regarding Estate and Gift Tax Return Examination Process. The Treasury Inspector General for Tax

Administration (TIGTA) released a report on September 26, 2017, entitled "Improvements Are Needed in the Estate and Gift Tax Return Examination Process" (Reference Number: 2017-30-081). The report reviewed the audit processing of estate and gift tax returns during Fiscal Year 2016. The following is the conclusion:

> TIGTA's review of the classification, prioritization, and inventory assignment processes identified improvements that are needed in the Internal Review Manual (IRM) guidance, classification sheet documentation, and managerial oversight. TIGTA found that:
>
> - There is minimal IRM guidance for case classification, prioritization, and inventory assignment processes.
> - Some classification sheets, when filled out by classifiers, are difficult to read or are incomplete.
> - A single employee prioritizes cases selected for examination during classification sessions and assigns these cases to the field for examination, and a lack of documented managerial reviews over the processes poses risks.
>
> Also, case documentation guidelines were not followed in 18 (47%) of 38 randomly sampled estate tax examinations and in 17 (46%) of 37 randomly sampled gift tax examinations.
>
> …
>
> TIGTA made several recommendations to improve the examination of estate and gift tax returns, including the creation of a legible classification sheet; revisions to the IRM; strengthening of internal controls; and develop guidance on the circumstances in which it is advisable to propose and issue inconsistent notices of deficiency in estate and gift tax examinations.
>
> In response to the report, IRS officials agreed with the recommendations and plan to take appropriate corrective actions.

IV. Federal Fiduciary Income Tax Developments

A. 65-Day Election: PLR 201710003

Trust granted extension of time to make 65-day distribution election for irrevocable trust. Letter Ruling 201710003 (issued Dec. 1, 2016; released March 10, 2017).

In this letter ruling, an irrevocable trust filed its federal income tax return on a calendar year basis. The trustee of the trust made a distribution within the first 65 days of Year 2 and intended to have the Distribution considered to be paid or credited on the last day of Year 1 as permitted under Section 663(b). The Section 663(b) election inadvertently was not timely made on the income tax return filed for the trust.

Applying the standards of Reg. §§301.9100-1 and 301.9100-3, the IRS granted the request of the trust for an extension of time to make the distribution election. Under Reg.

§301.9100-3, relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that the grant of relief will not prejudice the interest of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied upon a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election. The IRS found that these requirements had been met.

B. Grantor Trusts: Power to Substitute Assets: *Benson v. Rosenthal*

Substituting a promissory note for assets of a trust is sometimes difficult. *Benson v. Rosenthal*, 2016 WL 2855456 (E.D. La. 2016) (slip copy), *mot. for partial summary judgment denied*, 2016 WL 6649199 (E.D. La. Nov. 10, 2016) (slip copy).

Thomas Benson established various trusts for the benefit of his daughter, Renee, and two grandchildren, Rita and Ryan. These trusts ultimately held ownership interests in various entities that in turn own, among other things, the New Orleans Saints and Pelicans franchises, the New Orleans Fox television affiliate, and other businesses and investments. Thomas held a power to reacquire or exchange trust assets for assets of equivalent value, without the approval of any fiduciary. Thomas wrote to the trustee stating his intention to exchange the trust assets for promissory notes of equivalent value, and included a preliminary schedule of values of the trust assets, a Notice of Exchange, and blank promissory notes containing a valuation adjustment clause that would adjust the notes automatically to a later-determined appraised value. The transfer also included certain real estate and the forgiveness of nearly $100 million of indebtedness owed to Thomas by some of the trusts. The trustee refused. Thomas sent additional documents including security. The trustee again said no. Thomas hired an independent professional appraiser the trustee had used in the past to value the trust assets and gave the trustee new promissory notes of specific values and collateral assignments securing each of those notes, in face amounts based on the independent appraisal. Again, the trustee rejected the proffered exchange. Thomas sued to force the exchange and the trustee moved to dismiss either because (1) the exchange attempted was really a loan; or (2) the substitution was ineffective.

The U.S. District Court for the Eastern District of Louisiana (Judge Milazzo) refused to dismiss the suit. The court noted that the trustee had the right to lend the trust funds to the grantor upon appropriate terms and conditions, and the grantor had the power to substitute trust assets for other assets of equal value without the approval or consent of the trustee. The trustee cited *Mark Vance Condiotti Irrevocable GST Trust*, No. 14CA0969 (Col. App. 2015), which had held that a purchase of trust assets for a promissory note was a borrowing, rather than a substitution. The Louisiana court, however, found that the authorities relied upon in *Condiotti* were distinguishable because the promissory notes offered by the grantors in *Condiotti* and in the precedents it cited were unsecured. The court also noted that (1) the trust instruments require that a substitution be for property of equivalent value, with no explicit exclusion of a promissory note; (2) the notes are clearly assets having value; and (3) the real estate and loan forgiveness that Thomas offered as part of the substitution are further proof that a loan was not intended.

On September 8, 2016, Thomas delivered promissory notes to the trustee that had been reformed to accommodate modifications required by the NFL. The new notes were non-recourse, bore a higher interest rate and shorter term, and were of equivalent value to the earlier notes. The defendant then filed a motion for summary judgment, raising the same arguments that had earlier lost, but with respect to the new notes. The court found that the reformation did not change the legal analysis of the court.

> **Note:** The problem of whether or not an exchange of a promissory note for assets of the trust is the type of exchange anticipated by Section 675(4)(C) will arise only in cases where the relationship between the trustees or beneficiaries of the trust and the grantor of the trust have soured significantly. That will be a minority of situations, but it will occur from time to time. The best advice that one can give, in light of the conflicting precedents, is that the grantor should hire an appraiser to appraise both any hard-to-value assets of the trust and the promissory note being proffered, and that the note should be secured. Those two elements appear to give significant support to the validity of a grantor's attempt to substitute assets by using a promissory note. If the trust instrument expressly precludes the grantor from borrowing, however, the use of the substitution clause may be impaired.

C. "ING" Trusts: PLRs 201650005, 201653001-201653009, 201718005, 201718006, 201718010, 201718012 & 201742006

Transfers to a directed trust shift income but are not completed gifts, and the trust is probably not a grantor trust. Letter Rulings 201650005 (issued Aug. 26, 2016; released Dec. 9, 2016); 201653001-201653006 (issued Sept. 21, 2016; released Dec. 30, 2016); 201653007-201653009 (issued Aug. 16, 2016; released Dec. 30, 2016); 201718005, 201718006, 201718010 and 201718012 (issued Dec. 20, 2016; released May 5, 2017); 201742006 (issued July 10, 2017; released Oct. 20, 2017).

In the general fact pattern of these rulings, Grantor created an irrevocable trust for Grantor's own benefit and that of certain other family members. During Grantor's lifetime, the trustee must distribute net income and principal to Grantor and the other beneficiaries as directed by a distribution committee and/or Grantor, as follows: (a) at any time, the trustee, pursuant to the direction of a majority of the distribution committee, with Grantor's written consent, must distribute to Grantor or the beneficiaries such net income or principal as directed by the distribution committee; (b) at any time, the trustee, as directed by the unanimous vote of the distribution committee members other than Grantor, must distribute to Grantor or the beneficiaries such net income or principal as directed; and (c) at any time, Grantor, in a nonfiduciary capacity, may distribute to any one or more of the beneficiaries such amounts of the principal (including the whole thereof) as Grantor deems advisable to provide for their health, maintenance, support, and education. The initial distribution committee is Grantor and Grantor's children and in some cases grandchildren. The distribution committee must always have at least two members other than Grantor.

The IRS ruled generally that, as long as there is a distribution committee, the trust is not a grantor trust (absent application of Section 675, on which the IRS declined to rule), contributions of property to the trust are not a completed gift subject to federal gift tax by Grantor, distributions of property by the distribution committee from the trust to Grantor will not be a completed gift subject to federal gift tax by any member of the distribution committee, and distributions of property by the distribution committee from the trust to any beneficiary other than Grantor will not be a completed gift subject to federal gift tax by any member of the distribution committee other than Grantor. The IRS evaluated grantor trust status by considering the powers of the distribution committee under Sections 673, 674, 676, 677, and 679. It declined to rule on grantor trust status under Section 675 because the application of the rules of Section 675 depend on the actual administration of the trust.

> **Note:** For more on this technique for avoiding state income taxes on trust income, see Akhavan, "DINGing State Income Taxes in Artwork Transactions," 153 Tr. & Est. 31 (June 2014); Blattmachr & Lipkind, "Fundamentals of DING Type Trusts: No Gift Not a Grantor Trust," 26 Prob. Pract. Rptr. 1 (April 2014); Pulsifer and Flubacher, "Eliminate a Trust's State Income Tax," 145 Tr. & Est. 30 (May 2006); Schaller, "Reduce State Tax with DINGs, NINGs, WINGs, and Other ThINGs," 41 Est. Plan. 23 (April 2014); Schoenblum & Schoenblum, "Avoiding State Income Tax with the Right Kinds of Trusts," 41 Est. Plan. 19 (May 2014); Steiner, The Accidentally Perfect Non-Grantor Trust, 144 Tr. & Est. 28 (Sept. 2005).

D. "Beneficiary Deemed Owner Trust" ("BDOT")

[The following analysis is contributed by Steve Akers.]

Letter Ruling 201633021 (issued April 29, 2016; released Aug. 12, 2016; discussed in ¶106.1 of last year's materials) approved the fascinating concept of one trust being treated as the owner of another trust for income tax purposes under Section 678(a). In that ruling, Trust 1 and Trust 2 had the same beneficiaries and same distribution provisions. Trust 1 had the power to withdraw the income from Trust 2 each year, which power lapsed at the end of each calendar year.

The IRS ruled that because of Trust 1's withdrawal right, Trust 1 was the deemed owner of the portion of Trust 2 over which it held the withdrawal power. Because Trust 1 had the power to withdraw the income of Trust 2, which Trust 2 defined as capital gains, as well as dividends, interest, fees, and other amounts characterized as income under Section 643(b), Trust 1 effectively was treated as the deemed owner of all the taxable income of Trust 2. Reg. §1.671-2(e)(6), Example 8 is consistent with this result. In that example, T1 transferred some assets to T2, retaining the power to revoke T2 and revest the assets in T1; the regulation concludes that T1 is treated as the owner of T2 under Section 678(a).

The concept of a "Beneficiary Deemed Owner Trust" ("BDOT") builds on the application of Letter Ruling 201633021

a. Underlying Statutory Provision

Section 678 includes these relevant provisions:

> (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:

> (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.

b. Overview Description of BDITs and BDOTs.

What has been termed the "beneficiary defective inheritor's trust" (BDIT) by Richard and Steve Oshins, if a trust is not a grantor trust as to the trust's settlor and if a beneficiary has a Crummey power to withdraw **all of the contributions** to a trust, the beneficiary would be the deemed owner of the trust under Section 678(a)(1) during the period of time while the withdrawal power exists and arguably under Section 678(a)(2) after the withdrawal power has lapsed (or within the words of Section 678(a)(2) has been "partially released" assuming the lapse is treated as a release for Section 678 purposes). *See, e.g.,* Richard A. Oshins, *The Beneficiary Defective Inheritor's Trust ("BDIT"): Finessing the Pipe Dream*, CCH Practical Strategies (Nov. 2008); Jonathan Blattmachr, Mitchell Gans & Alvina Lo, *A Beneficiary as Trust Owner: Decoding Section 678,* 35 ACTEC L.J. 106 (Fall 2009). The approach uses withdrawal powers over the **entire contribution** to the trust and **relies primarily on Section 678(a)(2)** following lapses of the withdrawal powers. Under this approach, relatively small gift transfers (typically $5,000) are made to the trust so that the lapse of the withdrawal power does not result in the beneficiary being treated as having made a transfer to the trust, which would cause partial estate inclusion in the beneficiary's estate. The practical problem with the BDIT is how to leverage a small $5,000 gift to a trust into a significant size through later transactions with the trust. (See paragraph l below for a further discussion of BDITs and potential planning concerns with BDITs.)

Ed Morrow suggests another approach, in which the beneficiary has the right to withdraw an amount equal to all of the trust's taxable income in any given year (from all of the trust assets) but does **not have the right to withdraw the entire contribution** to the trust. The approach **relies primarily on Section 678(a)(1)** because the beneficiary holds a withdrawal over taxable income *each* year. This approach does not have the limitation of allowing only small gifts to the trust; gifts of any size could be made to the trust because there is no concern of keeping the entire contribution within the "5 or 5" power amount. Mr. Morrow calls this a "beneficiary deemed owner trust ("BDOT"). For an outstanding summary and analysis of this approach, see Ed Morrow, *IRC 678(a)(1) and the "Beneficiary Deemed Owner Trust" (BDOT),* LEIMBERG ESTATE PLANNING NEWSLETTER #2516 (Sept. 5, 2017).

For another excellent discussion of the approach with helpful examples, watch for Stacy Eastland's paper "Putting It All Together: Some of the Best Estate Planning Strategies We See That Reduce Both Income and Estate Taxes In the Uncertain Age of Tax Reform," scheduled for delivery for the first time at the Estate Planning Council of Greater Miami 6th Annual Estate Planning Symposium on February 6, 2018.

c. Why the BDOT Works Under Section 678(1)(1)

Observe the highlighted words below in Section 678(a)(1):

> A person other than the grantor shall be treated as the owner of **any portion** of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus **or the income** therefrom in himself…

The BDOT approach is based primarily on the "**OR** income" phrase in Section 678(a)(1).

It is easy to ignore or misinterpret the "power … to vest … the income" portion of Section 678(a)(1), since there have been fewer reported cases, ruling and articles on trust structures that only allow withdrawal powers over taxable income, yet dozens of PLRs and articles on withdrawal powers over corpus. Treatise have very little if any discussion of this potential variation.

Yet *there is no reason to ignore the "or the income" in the statute and no requirement under Section 678(a)(1) that a beneficiary/powerholder have any power over corpus beyond the income attributed to corpus to shift all the income taxation to the beneficiary. Id.*

"Income" in Section 678 Means Taxable Income. 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. Reg. §1.671-2(b). (In contrast, for purposes of the non-grantor trust provisions of Subchapter J (Parts A-D, F), a reference to income generally means trust accounting income. Reg. §1.643(b)-1.)

Withdrawal Power Should Exist over All Taxable Income. 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 trust agreement merely provides that the beneficiary may withdraw "income," under state law principles that would generally refer to 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. 83-12.

Case Law and Letter Ruling Support. Case law supports the conclusion that a power to withdraw taxable income attributable to trust principal, without the power to withdraw the principal itself, causes the powerholder to be taxable on the taxable income attributable to trust principal. *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)).

Letter Ruling 201633021 (discussed above) also supports this conclusion. In that ruling, trust #1 had the power to withdraw from trust #2 "any dividends, interest, fees and other amounts characterized as income under Section 643(b) of the Code" and the net short term capital gains and the net long term capital gains. Trust #1 did **not** have the power to withdraw principal of trust #2 beyond the taxable income. The ruling concluded that all of the taxable income of trust #2, including the net capital gains, were taxed to trust #1 under Section 678(a)(1).

Whether Taxable Income Amount Is Actually Withdrawn Is Irrelevant Under Section 678. 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. Indeed, 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; *Trust No. 3 v. Commissioner,* 285 F.2d 102 (7th Cir. 1060). Failure to withdraw the portion of taxable income that exceeds the greater of $5,000 or 5% of the trust assets, however, could have an effect for transfer tax purposes and for purposes of creditor access to the trust assets, as discussed below.

d. Withdrawal Power over Net Taxable Income Amount Should Be Exercisable from All Trust Assets; Impact of Lapse of Withdrawal Power in Excess of "5 or 5" Power

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% 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) [*see* Section 2514(e)], and the portion of the trust attributable to such excess amount would be included in the powerholder's gross estate for estate tax purposes [*see* Section 2041(b)(2)].

For most years, the net taxable income of a trust will be less than 5% of the trust value. To use the full trust value in order the measure the 5% amount, the beneficiary should be able to withdraw the net taxable income amount from all of the trust assets. *See* Rev. Rul. 66-87 (where beneficiary had the power to withdraw accounting income, the 5% element is calculated based just on the accounting income, not all trust assets, reasoning that "the annual trust income … is 'the assets out of which … the exercise of the lapsed powers could have been satisfied'" and apparently assuming that that the trust agreement did not permit the withdrawal power to be satisfied from all trust assets).

If the amount of the net taxable income that can be withdrawn in a particular year exceeds the "5 or 5" amount, the preferred approach would be either (a) for the powerholder to withdraw such excess amounts, or (b) for the withdrawal power to include a "hanging power" so that the amount lapses year only up to the "5 or 5" amount. If the beneficiary has continuing aggregate unlapsed powers, the beneficiary's estate would include that full amount in the beneficiary's gross estate at the beneficiary's death.

e. Spendthrift Protection Issues

The beneficiary's creditors ordinarily could not reach assets in a third-party spendthrift trust. Does that change because the beneficiary had the power to withdraw assets from the trust; is the beneficiary treated as a transferor to the trust as to that portion of the trust? If so, the trust may nevertheless be protected from the beneficiary's creditors if a state "self-settled trust" law applies. Even if the trust does not provide creditor protection for all self-settled trusts where the settlor is a discretionary beneficiary, almost all states treat the withdrawal powers that were within the "5 or 5" amount as not causing the beneficiary to be treated as having made a transfer to the trust for creditor access purposes. *E.g.,* Tex. Prop. Code §§112.035(e) (lapse in any year not exceeding 5 or 5 amount [or gift tax annual exclusion amount if greater]) & §112.035 (f)(B)(3) (present withdrawal power not exceeding 5 or 5 amount). *See* Ed Morrow, *IRC 678(a)(1) and the "Beneficiary Deemed Owner Trust" (BDOT)*, LEIMBERG ESTATE PLANNING NEWSLETTER #2516 n.64 (Sept. 5, 2017)(also references a 50-state survey chart prepared by Mr. Morrow regarding trust assets subject to withdrawal powers).

f. Not a Grantor Trust as to the Grantor

The normal grantor trust rules typically "trump" Section 678. Section 678(b) provides that "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." The reference in Section 678(b) to "income" means taxable income (as discussed in paragraph c above), so Section 678(a) would clearly not apply to a power to withdraw taxable income if the trust is otherwise a grantor trust as to the original settlor of the trust.

g. Testamentary Trust of Which Surviving Spouse Is Deemed Owner Under Section 678

Following a spouse's death, testamentary trusts created for the surviving spouse could be treated as owned by the surviving spouse for income tax purposes, allowing the surviving spouse to enter into sale transactions with the trusts without incurring recognition events and to allow the surviving spouse to pay the ongoing income tax of the credit shelter trust to build more value in the trust that would pass free of estate tax at the surviving spouse's subsequent death. (For a QTIP trust, the withdrawal power should include the greater of the net taxable income or the trust accounting income in order for the trust to satisfy the qualifying income interest for life requirement of a QTIP trust. *See* Section 2056(b)(7)(B); Reg. §20.2056(b)-7(d)(2) making reference to §20.2056(b)-5(f), including §20.2056(b)-5(f)(8) (spouse has the right exercisable at least annually to require distribution to herself of the trust income).

If both the credit shelter trust and the marital trusts are treated as owned by the surviving spouse for income tax purposes under Section 678, the credit shelter trust could engage in estate freezing transactions with the marital trust to shift future appreciation from the marital trust to the credit shelter trust (to minimize estate inclusion at the surviving spouse's subsequent death and to maximize accumulations in the GST exempt trust) but without having a current recognition event for income tax purposes.

h. Broad Use for Beneficiaries of Testamentary Trusts

This approach might be used broadly for testamentary trusts, to permit the beneficiary to have the flexibility of entering into transactions with the trusts and to allow the trusts to grow more quickly by having the beneficiary pay income taxes with respect to trust income with the beneficiary's outside assets (to maximize the amount that would be excluded from the beneficiary's estate and to maximize the amount that might accumulate in GST exempt trusts). To the extent that the beneficiary did not want to pay the income tax with outside assets, the beneficiary could exercise the withdrawal power over a sufficient amount to pay the income tax attributable to the trust income.

i. Use with Inter Vivos Trusts

The BDOT approach could be used for inter vivos trusts as well. To the extent that the trust is legitimately created and funded by a third party, the trust would be treated as owned by the beneficiary for income tax purposes in future years. Thus, the trust would achieve the general advantages of the BDIT trust, but the severe restrictions on the amount that could be funded into a BDIT would not apply. The BDOT could be funded with a large enough amount so that the beneficiary could sell assets to the trust under a traditional "rule of thumb" approach of having 10% equity in the trust without the necessity of using guarantees or other approaches to justify having the trust purchase substantial assets from the beneficiary in return for large notes from the trust.

Alternatively, a "standard" inter vivos grantor trust could provide that following the grantor's death, the beneficiary would have the withdrawal power over all taxable income or grant a protector the authority to grant such a withdrawal power to a beneficiary. The trust would be a grantor trust as to the original grantor for the grantor's lifetime and thereafter the trust would be (or could be if the protector granted the beneficiary a withdrawal right over taxable income) deemed to be owned by the beneficiary/powerholder under Section 678.

j. Protector Powers to Afford Flexibility

To address the concern that a beneficiary might repeatedly actually imprudently exercise the withdrawal power, a protector could have the ability to eliminate the withdrawal power going forward (similar to the provision allowing a donor to the trust to provide that a Crummey withdrawal power would not apply as to particular future gifts to the trust).

k. Advantage of BDOT Provisions with Trust Planning Under Letter Ruling 201633021

If an existing trust (T1) is not exempt from the GST tax, one planning approach would be for someone (likely the same donor) to create a new trust (T2) that would be almost identical to T1 and that would give the existing non-exempt T1 the ability to withdraw an amount equal to the entire taxable income (including capital gains) from the assets of T2. GST exemption would be allocated to T2. T2 would be funded with enough assets to justify a substantial purchase of assets (*i.e.*, within the "10% equity folklore safe harbor"). T1 might subsequently sell appreciating assets to T2 in return for a fixed relatively low-interest note, to (hopefully) shift value to the exempt T2 over time. The sale would not be a recognition event because T1 would be the deemed owner of T2 under Section 678. Letter Ruling 201633021 (indeed, under the facts of that ruling, T1 only had the power to withdraw taxable income including capital gains income from T2). If T1 had the power to withdraw all of the assets from T2 and did not do so, query whether that would be treated as some type of contribution to the exempt T2 requiring GST exemption allocation to prevent T2 from becoming partially non-exempt. That potential GST exemption allocation issue does not exist if T1's withdrawal power is limited to the taxable income and if the trust has a hanging withdrawal power so that all such withdrawal powers can be lapsed out within the 5 or 5 amounts. In that manner, T1 would never be treated as having made a transfer to T2, thus not raising the issue of a "transferor" allocating GST exemption.

l. Potential Concerns with BDIT Transaction

A number of IRS private letter rulings treat the holder of a Crummey power as the owner of the portion of the trust represented by the withdrawal power under Section 678(a)(1) while the power exists and under Section 678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust. *See e.g.* Letter Rulings 201039010, 200949012, 200147044, 200104005, 200022035, 200011058, 200011054 through 200011056, 199942037, and 199935046. Even so, potential technical concerns may arise with BDITs. *See generally* Luke T. Tashjian, *The Use of Beneficiary Defective Trusts in Modern Estate Planning*, 48 REAL PROP., TRUST AND EST. L.J. 353 (Fall 2013).

The BDIT transaction is not on the Treasury Priority Guidance Plan, but the IRS has expressed concern with the "BDIT" in two ways. The IRS added the "sale to a BDIT" transaction to its "no-ruling" list for the first time in 2013. Rev. Proc. 2013-3, 2013-1 I.R.B. 113, §4.01 (43, 48-52) (no rulings as to Sections 678, 2035, 2036, 2037, 2038, and 2042). In addition, the sale to grantor trust legislative proposal that was included in prior administration budget proposals specifically refers to the "deemed owner under the grantor trust rules," which undoubtedly is a reference to trusts treated as being owned by the beneficiary under Section 678. This is the IRS's "shot across the bow" suggesting that the IRS is questioning the BDIT concept, though not expressing reasons why it does not work. A particular focus of the IRS will be to determine how a trust goes from having a value of $5,000 from an initial trust contribution to having a value of millions of dollars through highly leveraged transactions.

V. Charitable Planning

A. Trustee's Authority to Make Charitable Distributions: CCA 201651013

A trust modified by court order was not entitled to claim either a charitable income tax deduction under Section 642(c)(1) or a distribution deduction under Section 661. Chief Counsel Advice 201651013 (issued Sept. 8, 2016; released Dec. 16, 2016).

In this Chief Counsel Advice, Parent Trust was a GST Exempt trust for the benefit of two children during their respective lifetimes and then for the benefit of their respective descendants. Each child was given the power to appoint the income among the descendants of the grantor, the spouses of those descendants, and charities. Child One died having exercised his power of appointment over one-half of the income of the parent Trust in favor of his descendants. Parent Trust continued to be administered as a single trust until year Y, distributing one-half of its income among the descendants of Child One and one-half to Child Two.

The trustees and beneficiaries of Parent Trust entered into a settlement agreement to split the Parent Trust into two trusts. Trust A was for the benefit of Child One's descendants and Trust B was for the benefit of Child Two.

The settlement agreement was contingent on a favorable state court order and on receipt of a private letter ruling stating that the division would not cause either Trust A or Trust B to lose its generation-skipping tax exemption. The favorable letter ruling was issued. No federal income tax rulings were requested or granted in the letter ruling.

Subsequently, the trustees of Trust B filed an additional petition requesting certain modifications including changing Child Two's limited testamentary power of appointment to an inter vivos power and asking that he be allowed to immediately exercise such inter vivos power to appoint X percent of the income and principal to Foundation One and Y percent to Foundation Two thus causing the trust to terminate. Each of Foundation One and Foundation Two were private foundations. Foundation One was preexisting while Foundation Two was newly created to receive funding when Trust B terminated. The Court approved the modification and termination of Trust B and the distribution of the trust assets to Foundation One and Foundation Two was completed.

On its original Form 1041, Trust B did not claim any deductions for the payments to Foundation One and Foundation Two. On its amended return for the year of termination, the trust claimed a deduction for the entire amount of income as a charitable income tax deduction less certain attorney and preparer fees.

The Chief Counsel's office advised that with respect to Section 642(c)(1), payments must be made pursuant to the terms of the governing instrument to be deductible under Section 642(c). The CCA stated that the payments would not qualify under Section 642(c), simply because they were pursuant to a modified governing instrument. It distinguished the Supreme Court's decision in *Old Colony Trust Company v. Commissioner*, 57 S. Ct. 813 (1937), because unlike *Old Colony*, there was no conflict with respect to Trust B subsequent to the division of the Parent Trust. The trust terms were unambiguous and the purpose of the court order was not to resolve a conflict but to obtain economic benefits that the parties believed they would receive from the modification of the Parent Trust. As a result, the modification was not presumed to be pursuant to a governing instrument because a modification arising from a conflict will be considered pursuant to the government instrument.

With respect to availability of the deduction under Section 661, the Chief Counsel's office said that although there is "genuine ambiguity" in the code and legislative history where the charitable payments have failed to meet the requirements of Section 642(c), whether they were deductible under Section 661, the better reading of the law was found in a regulation under Section 663, which indicates that Section 642(c) provides the only deduction available for charitable payments by estates and trusts.

B. Strings on Charitable Gift: *Fakiris*

A bargain sale with strings attached yielded no charitable contribution deduction. *Fakiris v. Commissioner*, T.C. Memo. 2017-126 (June 28, 2017).

In 2001, the taxpayer's LLC paid $700,000 to purchase a dilapidated movie theater in Staten Island. The taxpayer had wanted to tear down the theater and replace it with a highrise building, but he encountered substantial community opposition. Along came the Richmond Dance Ensemble, a nonprofit organization that had yet to obtain its tax-exempt status as a charity. The taxpayer was willing to make a bargain sale of the theater to the Richmond Dance Ensemble but was nervous that the organization was not yet tax-exempt. So the parties worked out an arrangement through which the LLC would convey the property to another charity, WEMGO Charitable Trust, which would then convey the property to the Richmond Dance Ensemble. That transaction occurred in 2004, with WEMGO paying $470,000 to the LLC.

One provision of the bargain sale contract stated:

> Purchaser [WEMGO] shall be prohibited from selling the premises for the first five (5) years after delivery of the deed. Notwithstanding the aforesaid, Seller may transfer the premises to Richmond Dance Ensemble Inc. once it receives its 501C(3) [*sic*] status from the Internal Revenue Service. The provisions of this paragraph shall survive closing.

Relying on this provision, the IRS determined that the transfer was not a completed gift because of the seller's retained ability to redirect transfer of the property to Richmond Dance Ensemble. That meant the taxpayer was not entitled to a charitable contribution deduction, and that the taxpayer faced an accuracy-related penalty.

The Tax Court (Judge Gale) held that the IRS was right. After noting that the quoted provision of the sale contract contained an internal contradiction (how can WEMGO be prohibited from selling the premises if during that time the taxpayer can force the transfer to Richmond Dance Ensemble?), the court concluded that the parties intended "that, for the first five years after delivery of the deed to WEMGO, [the LLC] could direct WEMGO to convey the [theater] to Richmond Dance in the event the latter was recognized by the IRS as tax exempt…." That rendered the gift transfer conditional, meaning no deductible charitable contribution was made. The court then upheld the application of an accuracy-related penalty.

C. "Qualified Farmer or Rancher": *Rutkoske*

Sale of farmland in the year of donation thwarts farmers. *Rutkoske v. Commissioner*, 149 T.C. No. 6 (Aug. 7, 2017).

The taxpayers, two brothers, were members of an LLC that owned 355 acres leased as farmland. In 2009, the LLC conveyed a conservation easement to the Eastern Shore Land Conservancy, a charitable organization, in exchange for just over $1.5 million cash. An appraisal determined that the unencumbered value of the farmland was $4.97 million but the post-easement value of the land was $2.13 million. The LLC then sold the property to an unrelated purchaser for just under $2 million, resulting in a capital gain of just over $1.75 million.

In addition to reporting their shares of LLC's gain from the sale of the land, the taxpayers reported their shares of the gift element from the bargain sale (about $1.34 million) as a charitable contribution. The taxpayers classified themselves as "qualified farmers" within the meaning of Section 170(b)(1)(E)(v), thus entitled to a deduction from the contribution equal to 100% of their "contribution bases" (essentially, their adjusted gross incomes) instead of the 50% limit normally applicable to donations of conservation easements.

The problem is that to be a "qualified farmer," more than 50% of one's gross income must be from the trade or business of farming. The taxpayers were farmers alright, but if you fold in their shares of the LLC's gain from the sale of the farm, less than half of their incomes came from their farming activities. The brothers claimed the gain from the sale of the farm should count as gross income for farming, but the Tax Court (Judge Jacobs) held that the sale of the property is not a farming activity, so the gain from the sale is not gross income from a farming business. As a result, the taxpayers could only deduct an amount equal to 50% of their respective contribution bases; the rest must be carried over to later taxable years. The court observed:

> We recognize that the statute makes it difficult for a farmer to receive a maximum charitable contribution deduction by disposing of a portion of property in a year in which he/she donates a conservation easement, especially in a State with high land values. But it is not our task to rewrite a statute.

D. Value: *Gardner*

The Tax Court upholds the denial by the IRS of most of the charitable deduction claimed by a donor for a gift of big game specimens. *Gardner v. Commissioner*, T.C. Memo. 2017-165

A reader of this opinion immediately knew that the taxpayer was unlikely to receive a favorable opinion when the court opened its opinion by stating that "[t]o paraphrase Ernest Hemingway, there is no hunting like the hunting for a tax deduction." Paul Gardner was an avid big game hunter who in 2006 opted to downsize his trophy big game specimen collection by donating less desirable specimens in the collection to the Dallas Ecological Foundation. Relying on an appraisal, he claimed an income tax charitable deduction of $1,425,900.10. Because of the percentage limitations on the income tax charitable deduction, Gardner exceeded the maximum allowable charitable deduction for 2006 and carried the balance of the deduction over to 2007 and 2008.

In auditing Gardner's 2006 to 2008 income tax returns, the IRS determined that the value of the specimens contributed was at most $163,045. As a result, the IRS determined additional tax owed of $137,647 for 2007 and $274,228 for 2008.

Gardner used an appraiser recommended by the Dallas Ecological Foundation to appraise the specimens for purposes of the income tax charitable deduction. After a conversation with the appraiser, Gardner chose a total of 177 specimens from his collection for donation to the ecological foundation. The court noted that none of the specimens was of record quality. The appraiser's report used the replacement cost method to determine the fair market value of these items. The appraiser estimated what it would cost to replace each item with a specimen of like quality by tallying up the expected out of pocket expenses for traveling to a hunting site, being on safari for the requisite number of days, killing the animal, removing and preserving the given body parts, shipping the specimen back to the United States, and defraying the taxidermy costs of stuffing, mounting, and otherwise preparing the item for display. He considered factors such as the prorated unit cost, shipping fees, and taxidermy fees. For example using his replacement cost approach, the appraiser valued the tanned skin of a Central Asian sheep at $75,600 on the theory that it would cost that much to bag another similar sheep. A mount of the horns of a desert big horn sheep was valued at $56,800. At the time that he drafted his appraisal, the appraiser knew that Gardner intended to claim an income tax charitable deduction for the 177 specimens. After Gardner transferred the 177 specimens to the Dallas Ecological Foundation, the Dallas Ecological Foundation apparently put the donated specimens in storage and subsequently either sold them or gave them away.

The IRS offered an expert in taxidermy as its appraiser. The IRS's appraiser used the market approach to determine the fair market value of the specimens. The IRS's appraiser also consulted market data from auction houses, online auction sites, and other websites specializing in hunting specimens. The IRS's appraiser determined that the aggregate fair market value of the 177 specimens was $41,140 if there were no defects in the specimens. However, he also observed defects in many of the specimens and reduced his appraised value as a result of those defects to $34,240.

Gardner, at trial, did not use the appraiser who had appraised the specimens for purposes of the income tax charitable deduction. Instead he presented two experts. One was a technical consultant at the Museum of Natural History and the second was an art historian and appraiser, neither of whom assigned a dollar value to the 177 specimens. Instead, they were witnesses only to support the use of the replacement cost as the proper valuation methodology. Because Gardner failed to seriously challenge the IRS's appraisal and introduced no evidence of market prices, the court accepted the $163,045 value that the IRS allowed in notice of deficiency and permitted and income tax charitable deduction only for that amount.

E. Extension of Time to Make Election: PLR 201721003

IRS grants an extension of time to trust to make a charitable contribution election. Letter Ruling 201721003 (issued Feb. 7, 2017; released May 26, 2017).

The trustee of an irrevocable trust made charitable contributions during Year 2. He intended to have the contributions to be considered to be paid in Year 1 as permitted under Section 642(c). However, due to inadvertence, the Section 642(c) election was not made. Under Section 642(c), if a charitable contribution is paid after the close of a taxable year and on or before the last day of the year following the close of the taxable year, then the trustee may elect to treat such contribution as paid during the first taxable year. The election is made by filing with the income tax return a statement which states the name and address of the fiduciary, identifies the estate or trust for which the fiduciary is acting, indicates that the fiduciary is making an election with respect to contributions treated as paid during such taxable year, gives the name and address of each organization to which any contribution was paid, and states the amount of each contribution and the date of actual payment.

The IRS found here that the requirements of Reg. §§301.9100-1 and 301.9100-3 had been met. Under those regulations, relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and if the grant of the relief will not prejudice the interests of the government.

F. Substantiation

1. Substantiation in General: *Ohde*, *Luczaj*, *Oatman*, *Barnes*

No deduction for unsubstantiated or inadequately substantiated charitable gifts. *Barnes v. Commissioner*, T.C. Memo. 2016-212 (Nov. 22, 2016); *Oatman v. Commissioner*, T.C. Memo. 2017-17 (Jan. 17, 2017); *Luczaj & Associates et al. v. Commissioner*, T.C. Memo. 2017-42 (March 8, 2017); *Ohde v. Commissioner*, T.C. Memo. 2017-137 (July 10, 2017).

***Barnes*. Travel for church inadequately documented.** Cari Barnes did volunteer work for Williams Temple Church as its "Special Events Coordinator," and in which capacity she ordered food for events hosted at the church, reserved party space, and purchased supplies. She had the authority to approve reimbursements from the church, and for a number of her expenditures she approved her reimbursement request herself. In addition, in August 2008, she went on a trip to Africa during which she visited schools and orphanages, in addition to regular sight-seeing. She paid $5,112 to a travel agency for the trip, which covered her airplane tickets, meals, and lodging. The IRS disallowed the cost of the Africa trip and some of her unreimbursed expenses over two years.

The Tax Court (Judge Morrison) sustained the IRS assessment, noting that the trip was both for pleasure and to assist the Church in its operations, and that the costs were deductible only to the extent that the taxpayer could validly apportion them between these two parts. She had received a letter from the church stating that she had paid $5,112 to go on the trip, but the court noted that the letter did not enumerate the services she provided to the church, whether the church provided any goods or services in return, or a description and good-faith estimate of the value of any goods or services provided by the church, as required by Section 170(f)(8)(B). Therefore, the costs of the trip were not deductible. Similarly, she had received no proper acknowledgment with respect to the unreimbursed expenses, and they, too, were not deductible.

***Oatman*. No contemporaneous written acknowledgement.** Shirley Ann Oatman and her husband, Stewart Thomas Oatman, claimed a $7,950 charitable income tax deduction for gifts made by cash or check. The IRS denied $4,290 of the deduction for lack of a cotemporaneous written acknowledgement.

The Tax Court (Judge Ashford) held for the IRS. Section 170(f)(8)(B) allows such a deduction (for contributions of $250 or more) only if the taxpayer receives a contemporaneous written acknowledgment of the contribution by the charity that states the amount contributed, whether the charity provided any goods or services in consideration, and that includes a description and good-faith estimate of the value of any goods or services provided by the charity.

The taxpayers asserted that the *Cohan* rule should be available to establish the amount of the charitable gifts, but the Tax Court disagreed, noting that since 2006, the requirement of a contemporaneous written acknowledgement has been absolute and cannot be addressed by substantial compliance or the *Cohan* rule. *See* Pension Protection Act of 2006, Pub. L. No. 109-280, sec. 1217(a), 120 Stat. at 1080 (adding Section 170(f)(17)).

***Luczaj & Associates*. No records or contemporaneous written acknowledgement.** The taxpayers claimed a charitable contribution deduction of $4,455 for 2011 (of which the IRS conceded $595), and of $4,025 for 2012, of which the IRS conceded $230. The taxpayers allegedly made donations of cash and food to various charities, but contended that their records for 2011 had been lost in a household move, and the taxpayers could not for either year identify the charities to which they made the alleged gifts.

The Tax Court (Judge Lauber) held for the IRS. The court explained that, for all charitable contributions, the taxpayer must maintain bank records, a receipt or letter from the recipient charity, or other reliable written records showing the name of the donee and the date and amount of the gift. Section 170(f)(17); Reg. §1.170A-13(a)(1). For all contributions of $250 or more, the taxpayer must obtain a "contemporaneous written acknowledgment" from the donee. Section 170(f)(8)(A). If a donee-charity provides goods and services in exchange for a contribution, the gift is not deductible to the extent of the goods and services. Reg. §1.170A-1(h). In the absence of any such substantiation, the deductions were denied.

***Ohde*. No substantiation for gifts of more than 20,000 items to Goodwill Industries.** Mark and Rose Ohde claimed an income tax charitable deduction of $145,250 for over 20,000 items donated to Goodwill Industries in 2011. This included 3,454 items of clothing, 115 chairs, 36 lamps, 22 bookshelves, 20 desks, 20 chest of drawers, 16 bed frames, 14 filing cabinets, and 3,153 books. For each delivery, Goodwill gave them a one-page, generic receipt stating no quantities or values.

For 2007 through 2010, the Ohdes had claimed income tax charitable deductions for non-cash charitable contributions aggregating $292,143. For 2012 and 2013, the Ohdes claimed income tax charitable deductions for non-cash charitable contributions aggregating $104,970. The Tax Court (Judge Lauber) found none of the taxpayers' testimony creditable, disallowed the entire deduction, and sustained an accuracy-related penalty.

2. Special Rules for Contributions of Vehicles: *Izen*

Failure to comply with the special contemporaneous written acknowledgment requirements for contribution of qualified vehicle costs taxpayer a $338,080 deduction. *Izen, Jr. v. Commissioner*, 148 T.C. ___ (No. 5) (March 1, 2017)

Joe Alfred Izen, Jr. contributed a 50% interest in a 1969 model Hawker-Siddley DH125-400A private jet to the Houston Aeronautical Heritage Society, tax-exempt organization that operates an aircraft museum. Joe and an associate had together bought the plane in December 2007 for $42,000, each paying one-half of the purchase price. Joe claimed a

$338,080 income tax deduction for the contribution on an amended income tax return for taxable year 2010. In 2012, the IRS mailed Joe a notice of deficiency. In April 14, 2016, Joe filed an amended income tax return that included (1) an acknowledgment letter addressed to Joe's co-owner and signed by the donee's president, dated December 30, 2010, (2) a Form 8283 executed by the donee's managing director, dated April 13, 2016; (3) a copy of an "Aircraft Donation Agreement" allegedly executed on December 31, 2010, by the donee's president but bearing no other signatures, and (4) an appraisal dated April 7, 2011, opining that the fair market value of petitioner's 50% interest in the aircraft, as of December 30, 2010, was $338,080.

The Tax Court (Judge Lauber) granted the IRS a summary judgment denying the deduction in full, finding that the taxpayer had failed to comply with the special substantiation requirements under Section 170(f)(12) that apply to contributions of "used motor vehicles, boats, and airplanes." Joe stated that he had not included the acknowledgement with his original 2010 return because the donee had not yet completed and filed its Form 1098-C for the gift, which was corroborated by the donee. The letter accompanying the amended return was not a contemporaneous written acknowledgement because it was not addressed to Joe (but, rather, to his co-owner), it did not include Joe's name and identification number, and it did not state whether the donee had provided goods or services in consideration for the gift vehicle. The aircraft donation agreement between the co-owners contained some of the required information, but it was not signed by either donor and did not include all of the required data, including the taxpayer's identification number. Also, there was no contemporaneous document filed by the donee that could be read together with this agreement to satisfy the requirements of the Code.

3. Failure to Include Basis Information: *RERI Holdings I, LLC*

Tax Court denies income tax charitable donation for a gift of an LLC interest. *RERI Holdings I, LLC v Commissioner*, 149 T.C. No. 1 (July 3, 2017).

RERI Holdings I, LLC ("RERI") donated an LLC interest that was subject to a prior estate for years through 2020 to the University of Michigan in August 2003. RERI had purchased the LLC interest in March 2002 for $2,950,000. However, on its 2003 partnership return, RERI claimed an income tax charitable contribution deduction of $33,019,000 for the transfer to University of Michigan. The income tax return for RERI contained a Form 8283 Appraisal Summary that disclosed the March 2002 purchase, but left blank the place for "donor's cost or other adjusted basis". Two years after receiving the gift, the University of Michigan sold the LLC interest for $1,940,000 to another LLC indirectly owned by RERI.

The IRS disallowed RERI's deduction entirely on the grounds that the transaction was a sham for income tax purposes or lacked any economic substance. RERI moved for summary judgment in the Tax Court on the grounds that neither the sham transaction doctrine nor the lack of economic substance doctrine applied to the charitable gift. The Tax Court (Judge Halpern) held that both the sham transaction doctrine and the lack of economic substance doctrine applied and denied summary judgment to RERI.

The IRS then moved for partial summary judgment that the actuarial tables under Section 7520 could not be used to value the future interest that RERI contributed to the

University of Michigan and that RERI had failed to substantiate the value of its contribution with a qualified appraisal. The court denied summary judgment to the IRS on its motion for partial summary judgment.

The court at trial noted that the omission of basis from the Form 8283 materially violated the substantiation rules because the cost basis would have alerted the IRS to a potential overvaluation of the charitable gift. As a result, the omission cannot be excused on grounds of substantial compliance. The court then noted and found that the actuarial factors under Section 7520 did not apply. It also found that the fair market value of the property contributed to the University of Michigan on the date of the contribution was $3,462,886 and that the gross valuation misstatement penalty would apply.

G. Conservation Easements

1. New Listed Transaction: Notice 2017-10

A syndicated conservation easement is added as listed transaction under Section 6011. Notice 2017-10, 2017-4 I.R.B. 544 (Jan. 23, 2017), clarified and modified by Notice 2017-29, 2017-20 I.R.B. 1243 (May 15, 2017), and Notice 2017-58, 2017-42 I.R.B. 326 (Oct. 16, 2017).

Treasury has added to the catalogue of listed tax-avoidance transactions that must be reported under Sections 6111 and 6112 and Reg. §1.6011-4(b)(2) certain syndicated conservation easement transactions. Notice 2017-10 identifies as badges of tax-avoidance that the transaction (a) purports to give investors charitable contribution deductions significantly greater than the amount invested; (b) involves investments in a partnership or other pass-through entity that owns or acquires real property; (c) may include additional tiers of pass-through entities; (d) syndicates ownership interests in the pass-through entity or in one or more of the tiers of pass-through entities; (e) uses promotional materials suggesting to prospective investors that an investor may be entitled to a share of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment; (f) obtains what purports to be a qualified appraisal that greatly inflates the value of the conservation easement based on unreasonable conclusions about the development potential of the property; (g) contributes a conservation easement encumbering the property to a tax-exempt entity.

The Notice states that promotions related to such syndications suggest that investors who hold their direct or indirect interests in the pass-through entity for one year or less may rely on the pass-through entity's holding period in the underlying real property to treat the donated conservation easement as long-term capital gain property under Section 170(e)(1).

The IRS stated that it intends to challenge the purported tax benefits from this transaction based on the overvaluation of the conservation easement, and possibly also based on the partnership anti-abuse rule, economic substance, or other rules or doctrines. The IRS also noted that the charitable donee will not be treated as a party to or participant in the transaction.

2. Continuing Parade of Cases: *RP Golf, BC Ranch, II, L.P., McGrady, Ten Twenty Six Investors, 310 Retail, LLC, Big River Development, L.P., Palmolive*

Building Investors, LLC

Conservation (including façade) easements continue to raise many issues. *RP Golf v. Commissioner*, 860 F.3d 1096 (8th Cir. Feb. 7, 2017), *aff'g* T.C. Memo. 2016-80; *BC Ranch, II, L.P. v. Commissioner*, 867 F.3d 547 (5th Cir. Aug. 11, 2017), *rev'g and rem'g Bosque Canyon Ranch, L.P. v. Commissioner*, T.C. Memo. 2015-130; *McGrady v. Commissioner*, T.C. Memo. 2016-233 (Dec. 22, 2016); *Ten Twenty Six Investors v. Commissioner*, T.C. Memo. 2017-115 (June 15, 2017); *310 Retail, LLC v. Commissioner*, T.C. Memo. 2017-164 (Aug. 24, 2017); *Big River Development, L.P. v. Commissioner*, T.C. Memo. 2017-166 (Aug. 28, 2017); *Palmolive Building Investors, LLC v. Commissioner*, 149 T.C. ___ (No. 18) (Oct. 10, 2017).

***RP Golf*. Subordination must be in place at time of the gift.** RP Golf, LLC, which operates two private golf courses, granted a conservation easement to the Platte County Land Trust, a qualifying charity. The stated purpose of the easement was to "foster the preservation of open areas, conservation of the state's forest, soil, water, plant and wildlife habitats, and other natural and scenic resources." The property was 278 acres and the easement was appraised for $16.4 million, which amount the taxpayer deducted. The IRS denied the deduction.

The Tax Court (Judge Paris) held that the facts showed that the taxpayer did not actually own the entire property. Part of the property continued to be owned by a related entity that had never executed a written transfer of title to the partnership. Thus, that part of the deduction had to be denied on that grounds. With respect to the part of the property owned by the taxpayer, the court found that it was subject to pre-existing, unsubordinated mortgages on the date of the grant. The banks agreed to subordinate their rights 100 days after the date of the gift. The land was not, therefore, protected in perpetuity and the gift was not a qualified and deductible contribution easement.

On appeal, the Court of Appeals for the Eighth Circuit (Judge Benton) affirmed the denial of the deduction, finding that the taxpayer did not meet the requirements for a deductible conservation easement, because the banks that lent money to the company did not subordinate their mortgages to the donee before the easement was transferred. The court agreed with the Ninth and Tenth Circuits that Section 170 requires this subordination to be in place at the time of the gift. *See Minnick v. Commissioner*, 796 F.3d 1156, 1169 (9th Cir. 2015); and *Mitchell v. Commissioner*, 775 F.3d 1243, 1248 (10th Cir. 2015). The court rejected the argument that, even without contemporaneous subordination, the risk of a default was so remote as to be negligible. The court held that the "so remote as to be negligible" standard does not apply to the requirement of subordination; that requirement is absolute. The taxpayer also argued that it met the "protected in perpetuity" requirement under Section 170 even though the lender's rights were not subordinated until after the transfer, because the lender had orally agreed to subordinate its rights. But the court agreed with the Tax Court that the taxpayer had failed to prove the existence of such oral agreements.

***BC Ranch, II, L.P.* Permitting parties to change the subject properties may be allowed in some cases.** BC Ranch II, L.P. was general and tax matters partner of Bosque Canyon Ranch, L.P. Bosque Canyon Ranch bought a 3,729-acre tract of land for nearly $5 million and began to sell limited partnership interests that entitled the owners to build on specific homesites. In 2005, Bosque Canyon gave a conservation easement over 1,750 acres of the land to the North American Land Trust (NALT), and it claimed an $8.5 million charitable contribution deduction. In 2007, BC Ranch II claimed another $7.5 million charitable contribution deduction for a second easement gift.

The easement agreements stated that the encumbered property could not be used for residential, commercial, institutional, industrial, or agricultural purposes, but the donor retained, among other rights, the right to raise livestock, hunt, fish, trap, cut down trees, and construct buildings, recreational facilities, skeet shooting stations, deer hunting stands, wildlife viewing towers, fences, ponds, roads, trails, and wells. The easement agreements also stated that the donor and the donee could, by mutual agreement, modify the boundaries of the subject parcels, provided that any such modification could not "in the Trust's reasonable judgment, directly or indirectly result in any material adverse effect on any of the Conservation Purposes" and "[t]he area of each Homesite parcel … [could] not be increased." NALT prepared baseline documentation showing the encumbered property. The IRS denied the deductions, and found that both taxpayers were liable for accuracy-related penalties.

The Tax Court (Judge Foley) held for the IRS, finding that the deeds of easement did not constitute qualified conservation easements because they permitted the parties to change the land that would be the subject of the easement. The court stated that it was inadequate to assure perpetuity of the easements that any modifications to the boundaries of the parcels were subject to the reasonable judgment of the NALT, the exterior boundaries of the property subject to the easements could not be modified, and the overall amount of property subject to the easements could not be decreased. The court, relying on *Belk v. Commissioner*, 140 T.C. 1, 10-11 (2013), *supplemented by* T.C. Memo. 2013-154, *aff'd*, 774 F.3d 221 (4th Cir. 2014), stated that on the date of the gift, the easement was not a perpetual restriction on the property. The court also held that the baseline documentation provided by the charity "was unreliable, incomplete, and insufficient to establish the condition of the relevant property on the date the respective easements were granted."

The court also noted that the taxpayers failed to make available to the NALT documentation satisfying Reg. §1.170A-14(g)(5)(i), which provides that the donor of a conservation easement who reserves rights the exercise of which may impair the conservation interests associated with the property, must provide the donee, before the gift is made, with documentation sufficient to establish the condition of the property at the time of the gift. The taxpayers' reserved rights to conduct various activities (*i.e.*, hunting, trapping, construction, etc.) had the potential to impair the easements' conservation interests, but the taxpayers did not provide the required documentation.

The Tax Court also upheld imposition of gross valuation misstatement penalties under Section 6662(h).

On appeal, a divided Court of Appeals for the Fifth Circuit reversed and remanded the case to the Tax Court. The majority opinion (Judge Wiener), held that the Tax Court wrongly relied on *Belk*, in which the Fourth Circuit and the Tax Court held that a provision that allowed the parties to substitute other land for the land originally restricted under the easement failed the perpetuity test of Section 170(h). The court distinguished the easement in *Belk,* which permitted a change in the boundaries of the subject property, from the easement in *BC Ranch,* which allowed only a reshuffling of the boundaries of the homesite parcels within the subject tracts and precluded any increase in the acreage of the homesite parcels. The BC Ranch easements did not allow any change in the exterior boundaries of the easements or in their total acreages; only the lot lines of one or more the five-acre homesites could change and then only within the easements and with NALT's consent. The court noted that the Government's own expert had stated that the unencumbered homesite parcels had roughly the same per-acre value as the rest of the ranch that is encumbered by the easements, and that changing the boundaries of some of the homesite parcels would not return any value to the taxpayers. Also, the charity's benefit was particularly assured by its discretion to withhold consent to any modifications in its "reasonable judgment," as long as its actions were not arbitrary or capricious.

The court also reversed the Tax Court regarding the taxpayer's baseline documentation. The Tax Court had held that (1) the baseline documentation was untimely, (2) some of the documents were created too early, (3) some of the documents were created too late, and (4) some of the documents were inaccurate. The Fifth Circuit, however, faulted the Tax Court for reaching this conclusion without considering significant information contained in the record, including: (1) aerial photographs and detailed maps, (2) photographs of the ranch taken by a NALT biologist on April 1, 2004, (3) the "Habitat Assessment" report prepared by IES, based on site surveys in April 2004 and December 2005, (4) photographs of the ranch taken by NALT's president in August 2003, (5) the NALT biologist's April 12, 2004 report on the presence and approximate habitat of the gold-cheeked warblers, and (6) a site plan BCR I sent to NALT in September 2005 depicting the location of homesite parcels in relation to the identified habitat areas. The court held that, together with the documents that the Tax Court acknowledged in its opinion, these documents were more than sufficient to establish the condition of the property prior to the donation.

In dissent, Judge Dennis questioned the court's "impermissibly lax standard when reviewing the claimed deduction," citing the traditional doctrine that deductions are a matter of legislative grace and must therefore be strictly construed:

> I am sensitive to the majority opinion's implication that a broader interpretation of §170(h) would assist conservation efforts by encouraging the donation of conservation easements. However, all tax deductions are designed to serve some public good and yet are narrowly and strictly construed. It is not our domain to decide that the goal served by this deduction is more important than that served by any other.

Judge Dennis would have affirmed the Tax Court, citing precedent that the perpetual use restriction must attach to a defined parcel of property. Here, Judge Dennis observed, "the forty-seven five-acre homesites that may be substituted with initially-protected land represent 6.69% of the 3,509-acre easement tract—a significant portion of the total." Besides, nothing in the agreement requires that boundary changes be made solely for conservation purposes.

McGrady. **Gift of easement deductible because of charitable motivation.** Phyllis McGrady and Christopher R. Antoniacci made two separate gifts of real property adjoining their residence in Bucks County, Pennsylvania. The taxpayers gave the Heritage Conservancy, a local charity, a fee simple interest in one parcel, and they gave the local Township a conservation easement over a second parcel. Both parcels adjoined the taxpayers' residence. The Township was committed to protecting land in its natural state and preserving as far as possible the agricultural heritage of Bucks County, and Heritage was dedicated to environmental conservation in Bucks County and adjoining areas. The taxpayers deducted $4.7 million over several years for the two contributions. The IRS timely disallowed the deductions and assessed accuracy-related penalties.

The Tax Court (Judge Lauber), sustained the deductibility of the two contributions, but reduced the amount of the contributions by $1 million. The IRS argued that the charitable deductions should be denied for lack of donative intent, and because they did not meet the substantiation requirements. In the alternative, the IRS argued that the gifts were substantially overvalued. The court refused to find any "quid pro quo exchange," noting that neither of the gifts were conditioned on any reciprocal benefit. The IRS stressed that the taxpayers were motivated by a desire to protect their privacy and to prevent suburban development from spoiling the attractive views from their residence, but the court pointed out that nothing in the negotiated gifts gave the taxpayers any special right to control the future use of the property to achieve these goals, beyond the basic character of the conservation easement and the known present goals of the donees. The benefits to the taxpayers were merely incidental to the charitable gifts.

Ten Twenty Six Investors. **Failure to record deed promptly costs the deduction.** Ten Twenty Six Investors was a limited partnership that owned a ten-story New York City warehouse built in 1928. The warehouse was designed by Cass Gilbert, who also designed the Woolworth Building and the United States Supreme Court Building. The partnership contributed a façade easement over the building to the National Architectural Trust, Inc. (NAT). NAT accepted the deed of easement on December 30, 2004, but it did not record the deed until December 14, 2006. The taxpayer claimed an $11.4 million deduction for the contribution, which the IRS denied. The IRS also imposed an overvaluation penalty under Section 6662(a) and (b).

The Tax Court (Judge Thornton) held that no deduction was allowed for the contribution, because the failure of the donee to record it meant that, in the year of the gift, the easement was not perpetual as Section 170(h)(5)(A) requires. *See also Belk v. Commissioner*, 140 T.C. 1, 12 (2013), *aff'd*, 774 F.3d 221 (4th Cir. 2014). State law controls whether the restriction protecting the property was so granted in perpetuity. Applicable state law (New York) expressly provided that a conservation easement is created only when the deed is recorded. NYECL sec. 49-0305(4) (McKinney Supp. 2017); Z*arlengo v. Commissioner*, T.C. Memo. 2014-161; *Rothman v. Commissioner*, T.C. Memo. 2012-163 (reaching the same result), supplemented by T.C. Memo. 2012-218; and *Mecox Partners LP v. United States*, 117 A.F.T.R.2d 2016-593, 2016 WL 398216, at *5-*7 (S.D.N.Y. 2016). Thus, the failure to record it in the year of the gift meant that the gift was not then perpetual. The taxpayer argued that the deed created a restrictive covenant at common law, even without timely recording, but the court held that the perpetuity requirement of Section 170(h)(2)(C) and (5)(A) requires enforceability by successors in interest, and without recordation, the risk of unenforceability was not so remote as to be negligible. Also, the court noted, NAT or its successors would not have been able to enforce the easement against a buyer who bought the property before the deed was recorded.

310 Retail, LLC. **Easement deed itself constitutes contemporaneous written acknowledgement.** 310 Retail LLC's contributed a façade easement over a 1924 landmark building sometimes known as the Strauss Building, in Chicago, Illinois. 310 Retail contributed the easement to the Landmarks Preservation Council of Illinois (LPCI) in December 2005, by a deed of gift. The deed was executed contemporaneously with the gift of the easement. The deed stated that LPCI would monitor the donor's compliance with the easement restrictions and authorized LPCI to inspect the premises to ensure compliance. The deed contained no reference to any goods or services being furnished by LPCI to the donor and it recited no receipt by LPCI of any consideration for providing goods or services. The parties explicitly stated their understanding that "[t]his instrument, including the exhibits attached hereto, reflects the entire agreement of Grantor and Grantee" and that "[a]ny prior or simultaneous correspondence, understandings, agreements, and representations are null and void upon execution hereof unless set out in this instrument." The donor did not, however, receive a timely letter from LPCI acknowledging that LPCI had received the contribution and that no goods or services were transferred to the donor in exchange. (LPCI sent such a letter three years later.) The donor initially cited two tax returns filed by LPCI (Form 990), as together constituting a contemporaneous written acknowledgment, but it later agreed, in light of *15 West 17th St., LLC v. Commissioner*, 147 T.C.___ (No. 19) (2016), that these returns did not meet the requirements of a contemporaneous written acknowledgment. The donor deducted $26.7 million, based on a qualified appraisal, but the IRS disallowed the entire deduction, claiming that the donor had no contemporaneous written acknowledgment.

The Tax Court (Judge Lauber) held that the deed itself satisfied the requirement of a contemporaneous written acknowledgement. The court noted that the deed of easement itself stipulated that the easement was given to LPCI in exchange for nothing, in order satisfy the charitable gift requirements of Section 170. The court agreed that a contemporaneous written acknowledgement need not take any particular form, and may, for example, be a letter, postcard, or computer-generated form. It may even, the court stated, be the deed of easement, though most deeds of easement do not often meet the requirements of a contemporaneous written acknowledgment. *See Simmons v. Commissioner*, T.C. Memo. 2009-208, *aff'd*, 646 F.3d 6 (D.C. Cir. 2011); *Schrimshher v. Commissioner*, T.C. Memo. 2011-71. The key is that the deed must state expressly that the donee furnished no consideration for the transferred easement. In this case, the court noted that easement's merger clause (stating that the writing constituted the entire agreement) and the statement that the easement was given without consideration met the requirements of a contemporaneous written acknowledgment.

Big River Development, L.P. **Again, the easement deed itself constitutes contemporaneous written acknowledgement.** Four days after *310 Retail* was decided, the Tax Court reached the same result on similar facts. Big River Development, L.P. contributed a façade easement over a 1901-1902 factory building it owned in Pittsburgh, Pennsylvania that Big River had renovated into a luxury apartment complex known as the Cork Factory Lofts. The deed of easement, executed in favor of the Pittsburgh History and Landmarks Foundation (PHLF) provided, in relevant part, that Big River "grants and donates" the easement to PHLF pursuant to Section 170(h) of the Internal Revenue Code, in perpetuity. It recognized that PHLF would monitor Big River's compliance with the easement restrictions and authorized PHLF to inspect the premises to ensure compliance, and it included a one-time $93,500 fee to help defray the costs of this monitoring. The deed did not reflect any valuable goods or services being furnished by PHLF to Big River, and it included a merger clause stating that the deed reflected the parties' entire agreement, and invalidating any "prior or simultaneous correspondence, understandings, agreements, and representations" Over two years later, PHLF gave Big River a written acknowledgement of the gift, stating that it had provided Big River with no goods or services in exchange for the contribution. Big River obtained an appraisal and deducted $7.14 million as a charitable contribution. The IRS disallowed the deduction, noting that Big River had received no contemporaneous written acknowledgement of the gift, as required by Section 170(f)(8).

The Tax Court (Judge Lauber), agreeing with the taxpayer, held that the deed itself constituted an adequate contemporaneous written acknowledgement. The court noted that it had repeatedly held that a deed of easement could satisfy the requirements of Section 170(f)(8), though not all such deeds did so. *See 310 Retail, LLC v. Commissioner*, T.C. Memo. 2017-164; *RP Golf, LLC v. Commissioner*, T.C. Memo. 2012-282; *Averyt v. Commissioner*, T.C. Memo. 2012-198. The court noted that Section 170(f)(8)(B) requires that a contemporaneous written acknowledgement include (i) the amount of cash and a description (but not value) of any property other than cash contributed; (ii) whether the donee provided any goods or services in consideration, in whole or in part, for the contributed property; and (iii) a description and good faith estimate of the value of any goods or services so provided. The court also noted that an acknowledgment is "contemporaneous" only if the donee provides it to the taxpayer on or before the date on which the taxpayer's return is filed or required to be filed. Section 170(f)(8)(C)(i) and (ii). In this case, the acknowledgement provided by PHLF was not contemporaneous, but the easement deed contained the required information. The court noted that the deed was similar to the deeds in *310 Retail, LLC* and *RP Golf, LLC*, and that the merger clause was an affirmative indication that PHLF had supplied no goods or services. The only references to consideration are an initial reference to "consideration of Ten Dollars ($10.00) * * * [and] other good and valuable consideration," which even the government agreed had not been actually provide and was merely boilerplate language with no legal effect for purposes of Section 170(f)(8). The monitoring services by PHLF were not a consideration provided, for this purpose, but rather the charity's discharge of its own responsibilities.

Palmolive Building Investors, LLC. **Tax Court insists on subordination of lender's rights on date of the gift.** The taxpayer, Palmolive Building Investors, LLC, owned "the Palmolive Building" on North Michigan Avenue in Chicago, Illinois, which it acquired for approximately $58.5 million in 2001. In 2004, Palmolive transferred a façade easement to the Landmarks Preservation Council of Illinois, a qualified charity. The building was subject to two mortgages, and before executing the easement deed, Palmolive obtained mortgage subordination agreements from the lenders. The deed, however, states that if the easement is ever extinguished through a judicial proceeding, the claims of the lending banks are superior to those of the donee organization with respect to the proceeds received from the condemnation, until the mortgage is satisfied. Palmolive claimed a charitable contribution deduction for more than $33 million, which the IRS disallowed, finding that the charity's interest was not protected in perpetuity because of the deed provisions in favor of the lender. The IRS also imposed a gross valuation misstatement penalty under Section 6662(h) and substantial understatement of tax or substantial misvaluation penalties under Section 6662(a) or 6662(b).

The Tax Court (Judge Gustafson) held for the IRS, finding that the easement deed did not satisfy the perpetuity requirements, because it provides the mortgagees with prior claims to extinguishment proceeds in preference to the donee. The taxpayer argued that the decision of the First Circuit in *Kaufman v. Shulman*, 687 F.3d 21 (1st Cir. 2012), *aff'g in part, vacating in part, and remanding in part Kaufman v. Commissioner*, 136 T.C. 294 (2011), *and* 134 T.C. 182 (2010) permitted a more lenient interpretation of the conflicting language in the deed and the transfer documents, and alternatively, that a savings clause in the deed resolved the question in favor of the charity. In *Kaufman v. Shulman*, the court rejected the Government's argument that it is mandatory that the donee be entitled to a share of any disposition proceeds proportionate to its interest. *See* Reg. §§1.170A-14(g)(2) and 1.170A-14(g)(6)(ii). The First Circuit reasoned that, if any easement donor later fails to pay taxes, a lien on the property may arise in favor of the Government, and that such lien cannot be subordinated to the donee's interest. Thus, no easement contribution would ever be deductible if the regulation required that the donee always have a right to a share of the proceeds on termination of the easement. The Tax Court disagreed with this analysis, finding that the analysis of the regulations is based on the property rights extant when the easement is granted, not those that might later arise. The Tax Court noted that this case would be appealable to the Seventh Circuit, and that it would not follow *Kaufman v. Shulman* outside of the First Circuit. The Tax Court also held that the defects in the deed were not cured by a provision that purported to amend the deed retroactively to correct such errors, because the requirements of Section 170 must be satisfied on the date of the gift.

3. Valuation Misstatement Penalty: *Partita Partners LLC*

Valuation misstatement penalty may be imposed even though the claimed charitable deduction was denied on other grounds. *Partita Partners LLC v. United States*, ___ F. Supp. 3d ___ (S.D.N.Y. July 10, 2017).

In 2008, Partita Partners LLC claimed a federal income tax deduction of $4,186,000 for a donation of a preservation easement in the façade of a building owned on the Upper East Side of New York City. The building was constructed in the 1870s and was part of the Upper East Side Historic District since 1981. Partita made its donation to the Trust for Architectural Easements and, as part of its deed of easement, reserved 2,700 square feet for future development rights. The IRS disallowed the deduction in 2014 and assessed a 40% underpayment penalty against Partita asserting that Partita made a gross valuation misstatement. In the alternative the IRS argued that a 20% underpayment penalty on grounds of negligence, substantial understatement of income tax, or a substantial valuation misstatement should be imposed under Section 6662.

The court granted a motion for partial summary judgment filed by the United States and held that the donation of the façade easement did not preserve the building's entire exterior as required for the income tax charitable deduction, and therefore Partita was ineligible for the $4,186,000 dollar deduction that it claimed.

The remaining issue was the challenge to the underpayment penalty. Here, the court denied the plaintiff's motion for partial summary judgment. It noted that the language of Section 6662(d) and authority in the Second Circuit permits the application of a penalty when the deduction is also disallowed on grounds other than valuation. It cited *United States v. Woods*, 134 S. Ct. 557 (2013), which resolved a split among the circuits and held that where transactions have no legitimate business purpose or economic substance and the IRS denied deductions in their entirety, the imposition of a valuation misstatement penalty is still appropriate.

H. Charitable Remainder Trusts

1. Termination of a Flawed CRUT: PLRs 201714002 & 201714003

The IRS addresses the tax consequences of the termination of a charitable remainder unitrust that was badly designed and badly administered. Letter Rulings 201714002 and 201714003 (issued Dec. 21, 2016; released April 7, 2017).

In each of these two letter rulings, A formed a trust that was intended to qualify as a Charitable Remainder Unitrust ("CRUT"). A and B served as co-trustees of the trust.

Under the trust agreement, the trust was required to make quarterly payments to A for the shorter of A's life or twenty years. If A died prior to the expiration of the 20-year term, the payments would be made for the balance of the 20-year term to B or B's designated successor. At the end of the 20-year term, the remaining assets of the trust would be distributed to X or a subsequently named charity.

This trust was a net income only CRUT, which paid the lesser of the unitrust percentage or the actual income earned by the trust each year. The CRUT contained make-up provisions so that in any year in which the actual income of the trust exceeded the designated unitrust percentage, the excess could be used to make up deficiencies in payouts from prior years.

Because A's assets consisted primarily of low-basis non-dividend paying stocks, A and B engaged C to provide financial and estate planning advice. C recommended that A and B engage D for legal advice on estate planning and charitable giving. C and D ultimately recommended that A create a Charitable Remainder Unitrust and that A should transfer low-basis capital assets in the trust in order to avoid the imposition of capital gains taxes on the subsequent sale of those assets by the trust. A and B were advised that this arrangement would allow the CRUT to sell the stock in the future without incurring capital gain taxes and that the trust would serve both as an estate planning vehicle and a charitable giving vehicle.

According to the ruling request, D represented to A and B that no gift taxes would be due upon creation of the trust because the gift would be incomplete as to the successor recipients at the time. To achieve this result, A would retain the right to change the successor recipients. However, when D drafted the trust agreement, D failed to reserve A's right to change the successor recipients. As a result, the interests of the successor recipients at the time the trust agreement was executed were complete and the gift to the successor recipients become complete, causing gift taxes to be due and owing. However, when gift tax returns were prepared by A's accountant, the accountant relied on the advice given by D, the lawyer, that no gift tax was owed.

The ruling request noted that C, the financial adviser, had represented to A and B that the trust assets would generate a specific return and that the trust would receive a guaranteed return of a specific percentage on the fair market value of the trust assets during A's lifetime or the 20-year term of the trust. The assets of the CRUT were invested in annuities and insurance products that C was licensed to sell. These types of investments made it difficult for the trust to generate the promised annual return and the trust never received the promised return. During the years that the unitrust amount was payable to A before A's death, the trust never generated sufficient income, without including capital gain, to meet the represented payout. Based on the erroneous advice provided by C and D, the trustees of the trust the trustees erroneously determined the amount to be distributed to the unitrust beneficiary in Year 1, Year 2 and Year 3 by improperly including capital gains in the trust income to be distributed.

In addition, based on the erroneous advice of C and D that the CRUT was not subject to estate tax in A's estate, A added additional assets to the trust in the subsequent years after the initial funding of the trust. The purpose of these additions was to further reduce the assets in A's taxable estate.

After A's death within the 20 year term of the trust, B became the successor unitrust recipient and the sole trustee. Upon realizing the problems with the CRUT, B petitioned the court to reform the trust agreement. The charitable beneficiary of the trust and the state attorney general objected to the reformation and B's first petition was dismissed. B submitted a second petition for reformation, which was also dismissed.

B then filed a third petition to either reform or terminate the trust. The court in ruling on the third petition declared the trust as void ab initio. The court's ruling was contingent on the trust receiving a favorable ruling from the IRS that provided that the declaration would not result in additional federal income tax consequences. If the trust did not receive a favorable rendering from the IRS that no income tax was owing, the trustee was to file a statement to that effect with the court and upon such filing, the trust would be declared to be terminated and, after payment of all amounts due and owing to the IRS and the State Department of Revenue from the assets of the trust, the trust would be distributed to a unitrust income recipient. B died after the date that the court order was issued and B's surviving spouse, E, was successor trustee and the unitrust recipient.

The IRS first ruled that, taking into account both Rev. Rul. 80-58, 1980-1 C.B. 181, and Rev. Proc. 2016-3, 2016-1 I.R.B. 126, it was unable to provide a favorable ruling that the court's declaration the trust was void ab initio would have no federal income tax consequences. Revenue Ruling 80-58, which did not involve a trust, stated that the legal concept of rescission refers to the abrogation, cancelling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have had had no contract been made. However, the annual accounting period principle requires the determination of income at close of each taxable year without regard to subsequent events. In Rev. Proc. 2016-3, the IRS stated that the question of whether a completed transaction may be rescinded for income tax purposes is an area in which rulings will not be issued.

As a result, the court's order would not void the trust ab initio and would default to the termination of the trust. The ruling then held that the trust was not to be respected as a CRUT because the trust did not function exclusively as a charitable remainder trust throughout its existence, since it distributed amounts in excess of its annual net income to the income beneficiary.

The IRS then ruled that the trust would be a split interest trust subject to Section 4947(a)(2) and thereby treated as a private foundation for purposes of the imposition of certain excise taxes. These included the tax on taxable expenditures for distributions for non-charitable purposes and taxes for self-dealing for making distributions to E who was a disqualified persons if distributions were made prior to the termination of the trust's private foundation status. The trust would need to file income tax returns and pay any income tax owed plus interest and penalties for any open years.

2. Conversion to a Grantor Trust: PLRs 201730012, 201730017 & 201730018

Conversion of a charitable lead annuity trust from a non-grantor trust to a grantor trust would not have adverse income tax consequences for the grantor and would not result in an income tax charitable deduction to the grantor in year of conversion. Letter Rulings 201730012, 201730017 and 201730018 (issued May 1, 2017; released July 27, 2017).

These three letter rulings dealt with the same fact situation. Grantor created a charitable lead annuity trust ("CLAT") for a term of years. The CLAT was established as a non-grantor trust for income tax purposes, and each year the CLAT received an income tax charitable deduction pursuant to Section 642(c)(1) for the amounts of gross income included in the annual annuity paid to the charity.

The CLAT sought to convert from a non-grantor trust to a grantor trust by an amendment to the CLAT to allow the grantor's sibling to act as a "substitutor" with the power to acquire and reacquire trust principal by substituting property of equivalent value in a non-fiduciary capacity pursuant to Section 675(4)(C). In connection with the conversion, the grantor sought the following rulings:

1. The conversion of the CLAT from a non-grantor trust to a grantor trust would not be a taxable transfer of property held by the trust to the grantor as settlor for income tax purposes and result in adverse income tax consequences to the grantor;
2. The conversion of the CLAT from a non-grantor trust to a grantor trust would not be an act of self-dealing; and
3. The conversion of the CLAT from a non-grantor trust to a grantor trust would not result in an income tax charitable deduction for the grantor in the year of the conversion.

The IRS ruled that the conversion of the CLAT from a non-grantor trust to a grantor trust was not a transfer of property to the grantor from the CLAT and therefore would not result in adverse income tax consequences to the grantor. This runs counter to the thinking of some commentators who believe that that the conversion should be treated as a transfer to the person who will now be treated as the owner for income tax purposes.

The IRS then ruled that conversion of the trust from a non-grantor trust to a grantor trust was not an act of self-dealing under Section 4941 because the person who would be named to have a power of substitution within the meaning of Section 675(4) was a sibling of the grantor. Section 4947(a)(2) applies Section 4941 to charitable lead trusts, which, in turn, imposes an excise tax on acts of self-dealing between a disqualified person and the charitable lead trust. The substitutor was not a disqualified person because a sibling of the grantor is not treated as a family member in Section 4946. Consequently, the conversion of the trust would not be an act of self-dealing because no disqualified person was involved.

The IRS also held that the grantor would not be entitled to take an income tax charitable deduction because the conversion was not a transfer of property from the non-grantor trust to the grantor trust for income tax purposes.

The IRS expressed no opinion as to whether the proposed conversion would have any gift tax consequences to the grantor or as to whether an act of self-dealing might occur upon the exercise of the power to substitute assets.

> **Note:** This ruling is consistent with CCA 200923024 (issued Dec. 31, 2008; released June 5, 2009), which similarly concluded (in a ruling involving an abusive transaction) that the conversion of a nongrantor trust to a grantor trust was not a taxable transaction, noting that treating the conversion as a taxable transaction would have an impact on non-abusive transactions.

3. Investment in a College Endowment: PLRs 201729013 & 201729014

The IRS finds no unrelated business taxable income with respect to the investment of charitable remainder trust in endowment units of a College. Letter Rulings 201729013 and 201729014 (issued April 11, 2017; released July 21, 2017).

These are parallel letter rulings. The first deals with the consequences to a College indirectly of investing the assets of a charitable remainder trust in the College's endowment. The second deals with the consequences to the charitable remainder trust.

In Letter Ruling 201729013, the College was a tax-exempt educational institution and the College's endowment was managed by the College's Trustee Committee on Investment. The trust was a straight charitable remainder unitrust described in Section 664(d)(2). The College was the sole trustee of the charitable remainder trust and, in that capacity, was the legal owner of the assets of the trust. The College was also the sole remainder beneficiary of the trust. The College did not charge any fee for the management of the trust. It may recover its actual costs of administering the trust as a charge against the trust. The assets of the charitable remainder trust were managed by an outside investment firm and the investment returns had been lower than the return on the endowment of the College. To improve this, the College wanted to enable the charitable remainder trust to participate in the return on the endowment.

The College proposed to create a contractual obligation under which the College would issue a contract right to the charitable remainder trust for its endowment units. The value of the units, both at the time of acquisition and at the time of redemption, would be based on the value of all underlying investment assets held in the endowment. Each unit would give the charitable remainder trust the right to receive periodic payments equal to the number of units owned multiplied by the same spending rates that the College established for the endowment. This would allow the trust to receive an investment return equal to that of the endowment. The trust would treat payouts to its beneficiaries up to the endowment spending amount as ordinary income regardless of the character of the underlying income of the endowment. The charitable remainder trust in this letter ruling was representative of a number of charitable remainder trusts of which the College was the trustee and the sole remainder beneficiary.

The IRS ruled that the contractual arrangement under which the College would issue units to the trust, make payments on the units, and be reimbursed to cover the costs applicable to the management of the endowment or administration of the trust, would not generate unrelated business taxable income to the College. This result would apply to this particular charitable remainder trust or any other charitable remainder trust for which the College had or would have the sole charitable interest and for which the College would be the trustee.

The IRS distinguished the entity in this letter ruling from the entity described in Rev. Rul. 69-528, 1962-2 C.B. 127. That Revenue Ruling describe an organization that was formed to provide investment services on a fee basis exclusively to tax exempt organizations. That organization received funds from unrelated exempt organizations and invested the proceeds. The IRS ruled in Rev. Rul. 69-528 that providing investment services on a regular basis for a fee is a trade or business ordinarily carried on for a profit, and that the activity will constitute an unrelated trade or business even if the services were regularly provided by one tax-exempt organization for other tax-exempt organizations. In the first letter ruling, the College was distinguishable from the entity described in Rev. Rul. 69-528. The College would not charge any fees for managing the trust assets and it would recover only the actual cost of managing the endowment as a charge against the endowment and any costs of administering the trust as a charge against the trust. Since the College would receive no income from providing management services to the trust, the services provided would not generate any income that could be characterized as unrelated business taxable income within the meaning of Section 513.

In Letter Ruling 201729014, the IRS held that the investment by the charitable remainder trust in the units would not give the trust any ownership interest or rights in the assets of the endowment. As a result, the exchange of assets currently held by the trust for units with respect to the College's endowment, the receipt of payments with respect to the units, and the holding and redemption of the units would not generate unrelated business taxable income to the trust. This was because Section 512(b)(1) excludes income from certain passive investments from being treated as unrelated business income for exempt organizations including charitable remainder trusts. The circumstances of the charitable remainder trust indicated that the investment in the College's endowment would be a passive investment. The trust's investment in units and holding units would not give the trust any ownership interest or rights in the endowment. The trust would not have any power of control or direction with respect to the endowment. Instead the units represented a mere contractual right to receive periodic payments from the endowment, as determined by the College.

VI. Other Federal Tax Developments of Interest

A. Inflation-Adjusted Amounts for 2018: Rev. Proc. 2017-58

The IRS provides the 2018 inflation-adjusted amounts for tax exemptions, deductions, brackets, and other tax items. Rev. Proc. 2017-58, 2017-45 I.R.B. 19.

Selected adjusted income and gift and estate tax inflation adjustments for 2018 are:

- Gift tax annual exclusion – Increases from $14,000 to $15,000.
- Estate tax exemption (basic exclusion amount) – Increases from $5,490,000 to $5,600,000, as do the gift tax and GST exemptions.
- Top income tax bracket of 39.6% – Increases

  from $470,700 to $480,050 for married individuals filing jointly,

  from $444,550 $453,350 for heads of households,

  from $418,400 to $426,700 for unmarried individuals,

  from $235,350 to $240,025 for married individuals filing separately, and

  from $12,500 to $12,700 for estates and trusts.
- Special use valuation under Section 2032A – Increases from $1,120,000 to $1,140,000.
- Annual exclusion gifts to non-citizen spouse – Increases from $149,000 to $152,000.
- Notice of large gifts from foreign persons – Increases from $15,799 to $16,111.
- Section 6166 "2 percent" interest limit on estate tax installment payouts – Increases from $1,490,000 to $1,520,000.
- Standard deduction –

  Increases from $12,700 to $13,000 for married individuals filing jointly,

  increases from $9,350 to $9,550 for heads of household, and

  increases from $6,350 to $6,500 for unmarried individuals and married individuals filing separately.
- Personal exemption – Increases from $4,050 to $4,150.
- Kiddie tax exemption – Remains $1,050.

- Amount parents may elect to include in their own gross income for kiddie tax purposes – Remains $10,500.

B. A Visual Guide to the Federal Tax Rates for 2018

By Samuel A. Donaldson
(Adapted from Rev. Proc. 2017-58)

<table>
<tr><th colspan="2">Taxable Income Exceeding</th><th colspan="4">2018 Federal Income Tax Rates for Individuals</th></tr>
<tr><td>Unmarried</td><td>Joint</td><td>Ordinary Income</td><td>Adjusted Net Cap Gain* & Qualified Dividends</td><td>Medicare Surtax on Earned Income**</td><td>Medicare Surtax on Net Investment Income</td></tr>
<tr><td>$0</td><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">2.9%</td><td rowspan="5">0%</td></tr>
<tr><td>$9,525</td><td>$19,050</td><td>15%</td></tr>
<tr><td>$38,700</td><td>$77,400</td><td>25%</td><td rowspan="5">15%</td></tr>
<tr><td>$93,700</td><td>$156,150</td><td>28%</td></tr>
<tr><td>$195,450</td><td>$237,950</td><td rowspan="2">33%</td></tr>
<tr><td>AGI over $200,000***</td><td>AGI over $250,000***</td><td rowspan="3">3.8%</td><td rowspan="3">3.8%</td></tr>
<tr><td>$424,950</td><td>$424,950</td><td>35%</td></tr>
<tr><td>$426,700</td><td>$480,050</td><td>39.6%</td><td>20%</td></tr>
</table>

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and Section 1202 stock).

** Includes employer contribution of 1.45% (Section 3111(b)(6)), individual contribution of 1.45% (Section 3101(b)(1)), and additional tax of 0.9% for adjusted gross income over $200,000 for an unmarried individual and $250,000 on a joint return (Section 3101(b)(2), for years after 2012).

*** Note too that unmarried individuals with adjusted gross incomes in excess of $266,700 and joint filers with adjusted gross incomes in excess of $320,000 are subject to the phase-out of both personal exemptions and itemized deductions.

C. Section 108 – Insolvency Exclusion: *Schieber*

A defined benefit plan is not an "asset" for purposes of applying the insolvency exclusion. *Schieber v. Commissioner*, T.C. Memo. 2017-32 (Feb. 9, 2017)

The taxpayers, a married couple, had about $906,000 of debt attached to a parcel of investment real estate. The creditor, a bank, cancelled about $418,000 of the debt together with accrued interest. On their joint federal income tax return, the taxpayers took the position that a portion of the cancelled debt was excluded under Section 108(a)(1)(B). This provision excludes the cancellation of indebtedness from gross income if (and to the extent) the taxpayer was insolvent immediately prior to the cancellation. The taxpayers claimed to have assets totaling about $925,000 and liabilities totaling about $1,218,000 (including the debt that was partially cancelled by the creditor), leaving them insolvent to the tune of about $293,000 immediately before the creditor's action.

On the return, the taxpayers excluded $346,000 of the $418,000 debt cancellation from gross income, and no one seems to know how the taxpayers arrived at that conclusion. The IRS claimed that the entire $418,000 of debt discharge income should be included in the couple's gross income because the taxpayers were not insolvent immediately before the discharge. In reaching this conclusion, the IRS included a defined benefit pension plan held by one of the taxpayers in connection with her employment. If the defined benefit plan counts as an asset, the IRS would be correct in requiring the couple to report the entire amount of the cancelled debt in gross income.

But the Tax Court (Judge Morrison) agreed with the taxpayers that a defined benefit plan is not an "asset" for purposes of determining whether (and to what extent) a taxpayer is insolvent. Although the Code supplies no definition of an "asset" for purposes of the insolvency exclusion, there is case law indicating that assets exempt from creditor claims count as assets under Section 108 because even assets exempt from creditor claims can still give a taxpayer "the ability to pay an immediate tax on income" from cancelled debt. Yet the Tax Court observed that a defined benefit plan is not such an asset. The taxpayers "could not use their interest in the pension plan to immediately pay a tax liability because they were entitled only to monthly payments under the plan and could not convert their interest in the plan to a lump-sum cash amount, sell the interest, assign the interest, borrow against the interest, or borrow from the plan." Accordingly, the court ruled that the taxpayers were insolvent by about $293,000 before the debt was cancelled, so they could exclude that portion of the cancelled debt from gross income.

D. Section 162 –Business Expenses

1. Tax Benefit Rule and Death: *Backemeyer*

The tax benefit rule is trumped by death, as a farm widow is allowed to deduct costs her late husband had already deducted. *Estate of Backemeyer v. Commissioner*, 147 T.C. No. 17 (Dec. 18, 2016).

Julie Backemeyer's husband, Steve ran his Nebraska farming business as a sole proprietorship, though some of the land was titled in Steve's name and some of it in Julie's. In 2010, Steve bought seed, chemicals, fertilizer, and fuel ("farm inputs") to use in conjunction with his 2011 crops. Steve died in March 2011, before using most of the inputs, and they passed at his death to a family trust. Steve's 2010 joint income tax return with Julie included a deduction for the farm inputs. After Steve's death, Julie took up farming. The trust distributed the farm inputs to Julie and she used them in her 2011 planting. Julie sold the crops grown with these inputs, and deducted the value of the inputs from the gross proceeds. The IRS denied Julie $235,693 of these deductions, and imposed a $15,684 accuracy-related penalty under Section 6662(a).

The Tax Court (Judge Laro) permitted the widow to deduct the full value of the inputs that she had expended, despite the prior deduction for the same items on her joint income tax return with her late husband. The IRS conceded that Julie's treatment of the inputs was correct; she received the assets with a stepped-up basis and contributed them to her sole proprietorship, entitling her to a deduction. The IRS relied on the Supreme Court's holding in *Bliss Dairy, Inc. v. United States*, 460 U.S. 3709 (1983), in which a cash-basis corporation deducted the cost of cattle feed, and then distributed its assets to its shareholders in a nontaxable liquidation. The shareholders operated the business in noncorporate form, and deducted their basis in the feed as an expense. The Supreme Court held that the liquidation converted the feed from a business to a nonbusiness use, which was inconsistent with the prior deduction, and it applied the tax benefit rule. The IRS argued that when Steve died and left the inputs to his trust, they were converted from business to nonbusiness assets. Julie took them with a stepped-up basis and reconverted them to business assets. The IRS argued that this entitles Julie to deduct her basis in the inputs, but also requires her recognize income related to the conversion.

The Tax Court disagreed, noting that the tax benefit rule applies if: (1) an amount was deducted in a year prior to the current year, (2) the deduction resulted in a tax benefit, (3) an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based, and (4) a nonrecognition provision of the Code does not prevent the inclusion in gross income. The court explained that *Bliss Dairy* involved the nonrecognition of gain on a liquidating distribution by a corporation to its shareholders, whereas in this case the transfer occurred at death. The Supreme Court recognized in *Bliss Dairy* that its decision did not extend necessarily to transfers by gift or death. 460 U.S. at 386, note 20. The court concluded that "a transfer at death is not 'fundamentally inconsistent with the premise' on which the section 162 deduction is initially based" and, therefore, the tax benefit rule should not apply.

2. Substantiation: *Taylor*

Taxpayers demonstrate how not to maintain a mileage diary. *Taylor v. Commissioner*, T.C. Memo. 2017-99 (June 1, 2007).

The taxpayers, a married couple, each held jobs: Avery had a recycling business and Katrina worked at a local hospital. Katrina also claimed to operate a bill collecting business on the side. Their 2012 joint return claimed a total deduction in excess of $74,000 for vehicle mileage expense. The IRS disallowed the deduction for lack of adequate substantiation. The Tax Court (Judge Lauber) agreed.

The taxpayers at trial produced a spreadsheet documenting the mileage expense with respect to four vehicles that they claimed were used for business and personal use (though the original return had mentioned only two vehicles and had stated they were used entirely for business purposes). The spreadsheet purported to show 132,456 miles in business travel for 144 different trips, but the court noticed a few inconsistencies. First, the spreadsheets were created only after the matter came to the Tax Court. Second, no entry shows the actual time spent at one destination or what specific tasks were performed there; instead, all 144 entries state that the trip was to "Distribute Informational Brochures/Market." Third, in several cases the ending odometer reading for one trip is higher than the beginning reading for the next trip. Fourth (and best of all), the entry for March 10 claims Katrina drove 1,696 miles that day. By the court's computations, that meant "she would have had to drive at an average speed of 70 miles per hour for 24 consecutive hours while still squeezing in time for rest stops and a client meeting." Finally, the average length of each trip was 920 miles, which would consume a full day. "We are not persuaded," wrote the court, "that Mrs. Taylor could have taken 144 full-day trips of this length while concurrently holding a full-time job at [the] Hospital."

The court also upheld the assessment of a negligence penalty against the couple, despite Katrina's insistence that the spreadsheet entries were accurate.

E. Section 402 – Hardship Waiver for IRA Rollover: *Trimmer*

Taxpayer is entitled to a hardship exception from 60-day rule on retirement plan

rollover. *Trimmer v. Commissioner*, 148 T.C. No. 14 (April 20, 2017).

John C. Trimmer was an officer with the New York Police Department for 20 years until his retirement on April 30, 2011, when he was 47 years old. Before retiring, John was offered a job as a security guard with the New York Stock Exchange, but after he retired, the new job fell through. John began experiencing symptoms of a major depressive disorder; he became antisocial, irritable, and uncommunicative with his wife and two sons, rarely left his house, had trouble sleeping, lost weight, neglected his hygiene and grooming, stopped coaching his sons' sporting events and stopped attending their school events, and "kind of just didn't do much of anything."

After his major depression had set in, John received from his retirement accounts distribution checks for $99,990 and $1,680. The checks lay on his dresser at home for over a month until he deposited them into his and his wife's joint bank account. John's wife, Susan, did not know what needed to be done with the retirement plan distributions and assumed that John was handling them, since he had customarily handled large investment decisions and taxes.

The retirement plan issued Forms 1099-R, "Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc." reporting the distributions as taxable. It wasn't until several months later, when his return preparer started to work on the 2011 return, that John learned of the 60-day rollover requirement. He immediately rolled the funds into an IRA. The funds deposited into the joint account had never been used for anyone's benefit.

When the IRS examined the 2011 return and mentioned the need to include the distributions in gross income, John wrote a letter to the IRS requesting a hardship waiver from the 60-day rollover requirement. Such a waiver is available under Section 402(c)(3)(B), but John did not cite the statute. The IRS denied the request and assessed a deficiency.

The Tax Court (Judge Thornton) held that (a) the IRS examination division had the authority to consider the request for a hardship waiver (b) the Tax Court had jurisdiction to review the denial of John's request for a hardship waiver; (c) in the facts and circumstances of this case, it would be "against equity or good conscience", under Section 402(c)(3)(B), to deny the requested hardship waiver; and (d) the distributions were not currently taxable and the early distribution penalty was inappropriate. The court noted that the 60-day limitation on rollovers can be waived under Section 402(c)(3)(B) "where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement."

Rev. Proc. 2003-16, 2003-1 C.B. 359 provides guidance about applying for hardship waivers, and requires that the taxpayer apply for it by submitting a request for a private letter ruling. Rev. Proc. 2016-47, 2016-37 I.R.B. 346, issued after the return examination in this case, also permits request of a hardship waiver during an audit, if the "taxpayer follows all procedures required by the financial institution for depositing the funds into an eligible retirement plan within the 60-day period … and, solely due to an error on the part of the financial institution, the funds are not deposited" within the 60-day period.

The IRS argued that the hardship waiver provisions are inapplicable because John failed to request a private letter ruling and pay the associated fee. The court held that neither the Code nor Rev. Proc. 2003-16 precludes an IRS examiner from considering a hardship waiver during the course of an examination. Also, Revenue Manual (IRM) pt. 4.10.7.4(2) (Jan. 1, 2006) states: that "Examiners are given the authority to recommend the proper disposition of all identified issues, as well as any issues raised by the taxpayer." The 2016 modification of Rev. Proc. 2003-16 did not create a new authority for IRS examiners to consider hardship waivers during examinations, but rather clarified the existence of that authority. Notably, John's auditor never declined to consider the request or demand that John submit a private letter ruling; she only wrote to John that he need not do anything more and that the IRS would contact him. Thus, John's administrative request for a hardship waiver was sufficient and should have been considered.

The IRS argued that the Tax Court lacked jurisdiction to review its exercise of discretion in denying a hardship waiver, but the court quickly rejected that position, noting the well-accepted doctrine that judicial review is available for acts of administrative discretion. On the merits, the court held that that IRS should have granted John's request for a hardship waiver because his failure to meet the rollover requirement was attributable to his disability. "If anything," noted the court, "the fact that he left two checks totaling over $100,000 on his dresser at home for over a month before depositing them in the bank vividly evidences his impaired mental condition." The court thus concluded that the two distributions should be excluded from gross income and that the 10% penalty under Section 72(t) should not apply.

F. Section 408 – IRA Beneficiary Designations: PLRs 201706004, 201707001 & 201736018

Rulings show that reformation of a decedent's IRA beneficiary designation is sometimes effective and sometimes ineffective to extend the distribution period or permit a rollover. Letter Rulings 201706004 (issued Nov. 3, 2016; released Feb. 10, 2017); 201707001 (issued Nov. 8, 2016; released Feb. 17, 2017); 201736018 (issued June 9, 2017; released Sept. 8, 2017).

Letter Ruling 201706004: Naming as beneficiary a trust that is never created cannot be fixed. Decedent named an *inter vivos* trust Decedent created as beneficiary of an IRA. It appears, however, that the trust was never created. Decedent died before the required beginning date. B was Decedent's surviving spouse and the sole beneficiary under his will. B wanted to roll over the retirement benefits to an IRA, but the IRA custodian refused to accept her request, because the trust, rather than B, was named as beneficiary. B, as Decedent's executor, obtained a local court order approving the change in the beneficiary of the IRA from the non-existent trust to B. The IRA custodian had stated that this would be accepted as authority to distribute the benefits to B.

The IRS ruled that, because there was no designated beneficiary on the date of Decedent's death, B could not be the designated beneficiary. Reg. §1.401(a)(9)-4, Q&A-4. There is, therefore, no designated beneficiary of Decedent's IRA. An IRA without a designated beneficiary cannot be an inherited IRA, as defined in Section 408(d)(3)(C)(ii). Thus, the entire IRA balance must be distributed by the end of the calendar year which contains the fifth anniversary of the date of Decedent's death. Reg. §1.401(a)(9)-3, Q&A-2. The IRS also stated, however, that B was the distribute or payee of the IRA for income tax purposes, and as such any amounts payable from the IRA to B in the first four years after the year in which Decedent died are not required minimum distributions, and may be rolled over to B's own IRA.

> **Note:** The requirement that the rollover can occur only in the first four years is the result of the application of the five-year rule, due to the absence of a designated beneficiary and the fact that the decedent died before the required beginning date. In essence, the IRS in this ruling describes an alternate way to obtain the same effect as in a spousal rollover, at least during the first four years after Decedent's death. The IRA may not be a spousal IRA, but it will be a rollover IRA, so that spouse can delay the first required minimum distribution until she reaches age 70½. It may also be noted that, in this case, Decedent's IRA must make its distribution directly to B, and may not be able to do a direct IRA to IRA transfer.

Letter Ruling 201707001. Court reformation of a beneficiary designation to correct a scrivener's error permitted, along with roll-over. Decedent died before reaching the required beginning date (age 70½). Decedent was survived by Spouse, who was Decedent's spouse, and by two adult children from a prior marriage. Spouse has one adult child from a prior marriage. All of Decedent's and Spouse's assets were community property. Decedent died owning seven Roth IRAs and one traditional IRA, which were listed as trust assets on the schedule to the couple's joint revocable trust. At Decedent's death, the revocable trust, of which Spouse was then the sole trustee, created a survivor's trust, a by-pass trust, and a marital trust. The survivor's trust received Spouse's separate property and part of her community property; the survivor's trust was revocable by Spouse. The bypass trust received an amount of Decedent's assets and his share of the community property sufficient to use Decedent's unified credit. The marital trust was deductible as a QTIP trust. The trust directs that Spouse shall receive any IRA distributions that are paid to the by-pass or the marital trusts.

Spouse and Decedent communicated to their attorney that they wanted Spouse to have the flexibility to elect to treat the IRAs as her own if she survived. The attorney caused the death beneficiary designation forms for four of the Roth IRAs to name the trust as beneficiary, and Spouse understood that she could do a spousal rollover of these amounts by first allocating them to the survivor's trust. The other three Roth IRAs and the traditional IRA named the marital trust as the beneficiary. Spouse obtained a local court order reforming the marital trust beneficiary designations retroactively, to show the trust as the primary beneficiary, and Spouse then allocated four of the Roth IRAs to the survivor's trust and one-half of the other three Roth IRAs and one-half of the traditional IRA to the survivor's trust, with the rest of each of those IRAs being allocated to the marital trust. Spouse proposes establishing Roth and Traditional IRAs in her name to take a roll-over from the survivor's trust.

The IRS stated that (1) the IRAs rolled over to the survivor's trust are not inherited IRAs or inherited Roth IRAs for purposes of Section 408(d)(3); (2) Spouse will be treated as the payee or distribute of those accounts, even though she had not been individually designated as beneficiary; (3) the spousal rollover is a proper rollover pursuant to Section

408(d)(3) and constitutes a valid election to treat each of the survivor's trust retirement accounts as Spouse's own, under Reg. §1.408-8, Q&A-5; (4) Spouse is not required to include any portion of the assets distributed pursuant to the rollover in her gross income for the year of the rollover; (5) starting the year after the rollover, Spouse is not required to withdraw the required minimum distribution from her Roth IRAs, under Section 408A(c)(5), but she will be required to take minimum required distributions from her regular IRA and be treated as its owner.

The key was that the IRAs passed to the trust upon Decedent's death, that Spouse was sole trustee and had the sole authority to determine which trust assets were to be allocated to each of the subtrusts, that she allocated the entirety of four of the Roth IRAs as well a one-half of the traditional IRA and one-half of each of the three remaining Roth IRAs to the survivor's trust, and the remainder of the IRAs to the marital trust, and that under the terms of the survivor's trust, Spouse could withdraw all trust assets at any time. Under these circumstances, Spouse cannot treat Decedent's Roth IRAs or traditional IRA as her own, because the trust was named as the beneficiary of each of the IRAs, but her rights over the survivor's trust make her the individual for whose benefit the accounts are maintained. Accordingly, if Spouse receives a distribution of the proceeds of Decedent's Roth IRAs and Decedent's traditional IRA, she may roll over the distribution (other than the required minimum distribution amounts required to have been distributed or to be distributed in accordance with Section 401(a)(9)) into a Roth IRA and a traditional IRA established and maintained in her name.

Letter Ruling 201736018: Early termination of a trust results in direct payment to the spouse, which can be rolled over. Decedent maintained IRA X and died after age 70½. Decedent designated his estate as the beneficiary of IRA X, and upon his death IRA X became a part of Decedent's residuary estate, all of which was left to Trust X, an unfunded trust created during Decedent's lifetime, with Daughter as trustee. Trust X required that after Decedent's death, all income of the trust be paid to Surviving Spouse, together with certain principal distributions. At Surviving Spouse's death, five percent of the principal of Trust X would be distributed to Church A, and the balance would be distributed to the living issue of Decedent and of Surviving Spouse. Surviving Spouse was the executor of Decedent's estate.

After Decedent's death, Surviving Spouse and Decedent's three children petitioned a state court to terminate Trust X and to distribute the assets of Decedent's estate outright to Surviving Spouse, relying on applicable state law that permits termination of a trust in certain circumstances. The court ordered that Trust X be terminated and that the executor of Decedent's estate pay all probate funds to Surviving Spouse.

The IRS stressed that the early termination of the trust was valid under applicable state law, and that, therefore, it treated the proceeds of IRA X to be received by Surviving Spouse as being paid directly from the IRA to her. As a result, she will be treated as the payee or distributee of IRA X for purposes of Section 408(d)(1). IRA X should not be treated as an inherited IRA with respect to Surviving Spouse, and Surviving Spouse should be eligible to roll over the distribution from IRA X into an IRA set up and maintained in her name.

G. Section 408A – Roth IRAs and "Substance Over Form": *Summa Holdings*

A scathing rejection of the application of the "substance over form" doctrine, *Summa Holdings, Inc. v. Commissioner*, 848 F.3d 779 (6th Cir. Feb. 16, 2017).

In this case, the Sixth Circuit Court of Appeals refused to apply the substance over form doctrine, using very strong language to repudiate the IRS's attempt to recharacterize corporate dividends to a Roth IRA as dividend payments to the shareholders followed by contributions by the shareholders to their Roth IRAs (far in excess of contribution limits). Taxpayers funded their Roth IRAs within contribution limits, and an initial stock investment by the Roth IRA of $1,500 grew to over $ 3 million within eight years. The rather complicated fact situation involved Roth IRAs that owned shares in a C corporation that in turn owned a domestic international sales corporation (DISC). The net effect of the DISC arrangement is to "transfer export revenue to the export company's shareholders as a dividend without taxing it first as corporate income." When the dividend is paid to the Roth IRA, it does not have to treat the dividend as income (a regular IRA would have to treat the dividend as unrelated business taxable income). The IRS treated this as an abusive scheme to accumulate massive amounts in the Roth IRA, far in excess of the permitted contribution limits that an individual could contribute to the Roth IRA. The Tax Court agreed and applied the substance over form doctrine to recharacterize the DISC commissions as dividends to the shareholders and then as regular contributions to Roth IRAS (far exceeding the contribution limits).

The Court of Appeals for the Sixth Circuit disagreed, excoriating the IRS for not applying the normal rules applicable to DISCs and Roth IRAs. Writing for a unanimous panel of the court, Judge Sutton struck the tone in the opening paragraphs (emphasis added):

> Caligula posted the tax laws in such fine print and so high that his subjects could not read them…. That's not a good idea, we can all agree. How can citizens comply with what they can't see? And how can anyone assess the tax collector's exercise of power in that setting? The Internal Revenue Code improves matters in one sense, as it is accessible to everyone with the time and patience to pour over its provisions.
>
> In today's case, however, the Commissioner of the Internal Revenue IRS denied relief to a set of taxpayers who complied in full with the printed and accessible words of the tax laws…. He acknowledged that the family had complied with the relevant provisions. And he acknowledged that the purpose of the relevant provisions was to lower taxes. But he reasoned that the effect of these transactions was to evade the contribution limits on Roth IRAs and applied the "substance-over-form doctrine" … to recharacterize the transactions as dividends from Summa Holdings to the Benensons followed by excess Roth IRA contributions. The Tax Court upheld the Commissioner's determination.
>
> **Each word of the "substance-over-form doctrine," at least as the Commissioner has used it here, should give pause. If the government can undo transactions that the terms of the Code expressly authorize, it's fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. "Form" *is* "substance"**

> **when it comes to law. The words of law (its form) determine content (it's substance). How odd, then, to permit the tax collector to reverse the sequence – to allow *him* to determine the substance of a law and to make it govern "over" the written form of the law – and to call it a "doctrine" no less.**
>
> As it turns out, the Commissioner does not have such sweeping authority. And neither do we. Because Summa Holdings used the DISC and Roth IRAs for their congressionally sanctioned purposes—tax avoidance—the Commissioner had no basis for re-characterizing the transactions and no basis for me characterizing the law's application to them. We reverse.

Additional excerpts of this extraordinary opinion are quoted at length (with emphasis added) to illustrate the scathing rejection of the IRS's application of the substance over form doctrine in this context:

> **It's one thing to permit the Commissioner to recharacterize the economic substance of a transaction—to honor the fiscal realities of what taxpayers have done over the form in which they have done it. But it's quite another to permit the Commissioner to recharacterize the meaning of statutes—to ignore their form, their words, in favor of his perception of their substance.**
>
> As originally conceived and as traditionally used, the substance-over-form doctrine has something to it…. When the courts decide how to classify a transaction, they focus, quite appropriately, on the transaction's workaday realities, not the labels used by the taxpayers. Take "income." If a taxpayer receives something of value, 26 U.S.C. §61(a), he can call it whatever he wants—this, that, or something else. What the taxpayer cannot do is claim that the label he affixes on the transaction precludes it from being "income" under the Code or prevents the courts from treating it as "income" under the Code.
>
> …
>
> But these economic-substance principles—which undergird the traditional use of the substance-over-form doctrine—do not give the Commissioner purchasing power here…. By congressional design, DISCs are all form and no substance, making it inappropriate to tag Summa Holdings with a substance-over-form complaint with respect to its use of DISCs.
>
> The same is true for the Roth IRAs. They, too, are designed for tax-reduction purposes…. All IRAs are permitted to hold shares of stock, some of which may increase markedly in value over time and some of which may generate considerable dividends over time. Whether Congress's decision to permit Roth IRAs to our own DISCs was an oversight makes no difference. It's what the law allowed.
>
> …
>
> That leaves the Commissioner to invoke another, distinct version of the substance-over-form doctrine. **When two potential options for structuring a transaction lead to the same end and the taxpayers**

choose the lower-tax path, the Commissioner, claims the power to recharacterize the transactions as the higher-taxed equivalents. It's not that the transactions don't have economic substance (they do) or that the Code forbids them (it doesn't). Instead, the Commissioner simply stipulates that the "real" transaction is the higher-taxed one, and that the lower-taxed route, often the more complex of the two, is a mere "formality" he can freely disregard. The Commissioner claims the right to assert this power against "any given transaction[,] based on [the] facts and circumstances" of the arrangement…. That is a much broader (and more worrisome) version of the doctrine.

…

As *Court Holding* suggests, the line between disregarding a too-clever-by-half accounting trick and nullifying a Code-supported tax-minimizing transaction can be elusive. Some cases from our court, fact specific though they are, offer hints of a broad reading of *Court Holding*, saying that the Commissioner may recharacterize transactions, even those with economic substance, if they have no "valid, non-tax business purpose." … Decisions from our sister courts also straddle the line between holding that the transactions were a sham and suggesting that the Commissioner has a broad power to recharacterize transactions that minimize taxes, **though none of them holds that a tax-avoidance motive alone may nullify an otherwise Code-compliant and substantive set of transactions.**

It's fine—indeed essential—to attend to economic realities in deciding whether one of these terms ["income," "reorganization," "debt," "contribution," or "dividend"] covers a transaction. But it's odd to reject a Code-compliant transaction in the service of general concerns about tax avoidance. **Before long, allegations of tax avoidance begin to look like efforts at text avoidance. What started as a tool to prevent taxpayers from placing labels on transactions to avoid tax consequences they don't like runs the risk of becoming a tool that allows the Commissioner to place labels on transactions to avoid textual consequences he doesn't like.**

…

When the Commissioner says that the transaction amounted in substance to a Roth IRA contribution, all he means is that the purpose of the transaction was to funnel money into the Roth IRAs without triggering the contribution limits. True enough. **But the substance-over-form doctrine does not authorize the Commissioner to undo a transaction just because taxpayers undertook it to reduce their tax bills.**

Note that this broad recharacterization power travels along a one-way street. To our knowledge the Commissioner has never use this power to reclassify the form of a taxpayer's Code-compliant transaction to *reduce* his tax liabilities in the service of broader purposes of the Code. But if this were a legitimate doctrine, why wouldn't it run in both directions? Many provisions of the Code owe their existence solely to tax-reducing purposes: to lower current taxes or to shelter income from taxes over time.

…

Even if we were willing to endorse the Commissioner's recharacterization power in its full flowering form—disregarding transactions based solely on an individual's tax-minimizing motive—he could not use it here. No court has used this power to override statutory provisions whose only function is to enable tax savings, as the Commissioner seeks to do in this instance…. The point of these entities [DISCs and Roth IRAs] *is* tax avoidance. The Commissioner cannot place ad hoc limits on them by invoking a statutory purpose (maximizing revenue) that has little relevance to the text-driven function of these portions of the Code (minimizing revenue).

…

The Commissioner adds that the "critical point" of his argument is that the tax benefits Summa Holdings has enjoyed were "unintended by both the Roth IRA and DISC provisions." … He may be right. And he may be right that permitting these DISC-Roth IRA arrangements amounts to dubious tax policy. **But the substance-over-form doctrine does not give the Commissioner of a warrant to search through the Internal Revenue Code and correct whatever oversights Congress happens to make or redo any policy missteps the legislature happens to take.**

…

… The last thing the federal court should be doing is rewarding Congress's creation of an intricate and complicated Internal Revenue Code by closing gaps in taxation whenever that complexity creates them.

H. Section 741 – Sale of Partnership Interests: *Watts*

The Tax Court rules that a partnership interest was sold, not abandoned, and no amortizable intangible was created either. *Watts v. Commissioner*, T.C. Memo. 2017-114 (June 14, 2017).

The taxpayers sold their interests in a partnership that owned and operated retail golf stores. The tax return claimed the transaction gave rise to a $750,000 loss, which the return treated as an ordinary loss on the basis that the partnership interests were abandoned and not sold. The IRS, not surprisingly, maintained that the transaction was a sale of the partnership interests and that the ensuing loss was a capital loss under Section 741.

At trial, the taxpayers conceded that the abandonment loss claim was erroneous. Instead, the taxpayers argued that the substance of the transaction was not a sale that generated capital loss but rather a transaction creating an amortizable Section 197 intangible that generated ordinary deductions. Specifically, they maintained that the transaction, in which the taxpayers received no payment for their interests but continued to have rights to property leased by the acquiring party, created a "right to recovery of basis" that's amortizable under Section 197. The Tax Court (Judge Nega) rejected that intent to recharacterize the deal, noting that the transaction was in form and substance a sale structured such that the taxpayers had no immediate rights to payments.

Instead of accepting the loss, however, the taxpayers then returned to the theory that the partnership interests had been abandoned. But the court rejected that theory too, noting that under the Code there are only two situations where a partnership interest is "abandoned" as opposed to "sold:" (1) where the partner was not personally liable for the partnership's recourse debts, or (2) where the partner had limited liability and had no economic risk of loss for the partnership's nonrecourse debts. Since the taxpayers submitted no evidence as to the applicability of either exception, the court applied the general rule that treats the disposition as a sale or exchange of the partnership interest.

I. Section 1001 – Variable Prepaid Forward Contracts: *McKelvey*

Settlement date extensions did not constitute an exchange of variable prepaid forward contracts. *Estate of Andrew McKelvey v. Commissioner*, 148 T.C. No. 13 (April 19, 2017).

In 2007, the decedent, the founder and CEO of the job search website monster.com, entered into two "variable prepaid forward contracts" ("VPFCs"), one with Bank of America and one with Morgan Stanley. Under the VPFCs, the decedent received lump sum cash payments totaling about $193.5 million in exchange for his agreement to transfer shares of stock in Monster Worldwide, Inc., beginning in 2008. The exact number of shares to be delivered to each bank depended on the per-share value of the stock as of the settlement dates. When 2008 came, but before the scheduled settlement dates, the decedent paid cash consideration totaling about $11.5 million to the banks in exchange for their agreements to extend the settlement dates until 2010. A few months later, the decedent died.

In auditing the decedent's 2008 federal income tax return, the IRS took the position that the decedent recognized a capital gain of nearly $201 million upon execution of the extension agreements. The gain, said the IRS, consisted of $88 million in short-term gain from swapping the old VPFCs for new VPFCs and nearly $113 million in long-term gain from the constructive sale of the Monster shares under the VPFCs.

The estate challenged the assessment, arguing that Rev. Rul. 2003-7, 2003-1 C.B. 363, allowed the estate to treat the VPFCs as "open transactions," meaning there is no recognized gain or loss until stock is transferred at the settlement date(s). The open transaction doctrine applies because "a taxpayer entering into a VPFC does not know the identity or amount of property that will be delivered until the future settlement date arrives and delivery is made." But the IRS did not contest that the original transactions qualified for the open transaction doctrine. The dispute is whether the execution of the extension agreements resulted in taxable exchanges of old VPFCs for new VPFCs. The estate claimed that the extensions served only to postpone the settlement dates, while the IRS equated the extensions to swapping one VPFC (with settlement date in 2008) for another (with a settlement date in 2010). Because there was no case authority on point here, the Tax Court was charting new waters.

Reg. §1.1001-1(a) says that an exchange is not a taxable event unless the properties swapped "differ materially either in kind or in extent." The Tax Court (Judge Ruwe) thus reasoned that the extensions were taxable exchanges only if the VPFCs were "property" of the decedent and, further, only if what the decedent held after the extensions was materially different from what he held before the extensions. The estate argued that the VPFCs were not "property" of the decedent at the time of the extensions since at that time all he had was an obligation to deliver the requisite number of shares to each bank. In other words, an "obligation" is not "property." The Tax Court agreed. "Although the original VPFCs did provide decedent with a right to receive cash prepayments," wrote the court, "once those prepayments were received … decedent was left only with obligations to deliver under the terms of the VPFCs and retained no further property rights with respect to the contracts." This analysis, said the court, is consistent with the open transaction treatment provided under Rev. Rul. 2003-7.

The court rejected the IRS position that the extensions closed the original VPFCs and thus triggered realization of gain. The court observed that the extensions "did not clarify the uncertainty of which property decedent would ultimately deliver to settle the contracts. … Because decedent's obligation to deliver a variable number of shares (or the cash equivalent) was controlling, it remained uncertain whether decedent would realize a gain or loss upon discharge of his obligations, not to mention the characterization of such gain or loss."

The IRS also argued that the extensions constituted a constructive sale of the stock under Section 1259. But the court observed that Section 1259 applies only to forward contracts where the amount of property to be delivered is "substantially fixed." The number of shares deliverable here, by contrast, could not be known until each settlement date. Moreover, reasoned the court, the IRS already stipulated that Rev. Rul. 2003-7 applied to the VPFCs at issue, a position inconsistent with the argument that Section 1259 applies to treat the transactions as realization events.

J. Section 1031 – Reverse Like-Kind Exchanges: *Bartell*

Reverse like-kind exchanges outside the safe harbor are possible, but the IRS doesn't like them. *Estate of Bartell v. Commissioner*, 147 T.C. 140 (Aug 10, 2016); Action on Decision 2017-6, 2017-33 I.R.B. 194 (Aug. 14, 2017).

Bartell Drug Co., an S corporation owned by the decedent and his two children, owns and operates a chain of retail drugstores in western Washington. The company decided to acquire a new parcel of real estate in Lynwood, Washington, on which to construct and operate a new retail location. But it also wanted to do it via a Section 1031 exchange where possible. Accordingly, after negotiating the purchase of the Lynwood location, the company assigned all of its rights in the purchase agreement to a third-party exchange facilitator. A subsequent agreement between the company and the facilitator provided that the facilitator would buy the property and give the company the right to buy for a set price for a stated period. Using bank financing guaranteed by the company, the facilitator acquired title to the Lynwood property in August 2000. The company then constructed a drugstore on the property, and when construction finished in June 2001, the company leased the store from the facilitator from that time until December 2001, when the facilitator conveyed the property to the company after receiving full payment as provided under their agreement (and as explained more fully below).

Meanwhile, in 2001, the company entered into a contract to sell an existing parcel of property in Everett, Washington, to another, unrelated buyer. The company then entered into a different exchange agreement with a different qualified intermediary and assigned its rights under the sale agreement (along with its rights under the earlier agreement with the facilitator) to that intermediary. The intermediary then sold the Everett property, used the proceeds of that sale to buy the Lynwood property, and conveyed the Lynwood property to the company.

The company realized a $2.8 million gain on the sale of the Everett property, but it took the position that the gain was excluded under Section 1031 because these events essentially equated to a like-kind exchange of the Everett property for the Lynwood property. The statute covers not only "simultaneous" swaps of land for land, but also "deferred" exchanges. In the typical ("forward") exchange, the taxpayer sells a parcel of land and uses the proceeds to buy another parcel of land within a particular timeframe. But in this case, the taxpayers were seeking to qualify a "reverse" exchange, for the Lynwood property had been identified and acquired before the Everett property was sold.

While the regulations are silent about "reverse" exchanges, the IRS has established a safe harbor in Rev. Proc. 2000-37, 2000-2 C.B. 308, under which some reverse exchanges can work. But the safe harbor can apply only to arrangements made with an "exchange accommodation titleholder" on or after September 15, 2000, and the company's arrangement with the intermediary in this case preceded this date. Because the revenue procedure did not apply, then, the parties had to figure out whether a legitimate "exchange" took place that could qualify for nonrecognition.

The IRS argued that the company already owned the Lynwood property by the time the Everett property was sold. It was thus too late to engage in a like-kind exchange of the Everett property, for an exchange requires "that the taxpayer not have owned the property purportedly received in the exchange before the exchange occurs; if he has, he has engaged in a nonreciprocal exchange with himself." The IRS claimed that the company (not the facilitator) owned the Lynwood property and thus had all the benefits and burdens of ownership in the Lynwood property by the time the Everett property was sold. The facilitator, it argued, had no equity interest in the property, made no economic outlay to acquire the property, was not at risk with respect to the property, and had no interest in the improvements made (and funded) by the company.

But the taxpayers pointed to controlling precedent establishing that the facilitator need not assume the benefits and burdens of ownership to have title to the property. That precedent said one like the facilitator could obtain title "solely for the purpose of the exchange" and thus preclude a prohibited "self-exchange." The Tax Court (Judge Gale) agreed, and while it observed that this precedent does indeed elevate form over substance, it works to qualify transactions like the one at issue in this case. The IRS pointed to more recent precedent emphasizing the benefits and burdens of ownership, but the court found important distinctions: the precedent involved a case where the taxpayer itself acquired the replacement property first (obviously different from the case here where the company did not have title until all aspects of the exchange were complete), and it came from a non-controlling jurisdiction.

The court observed that while this transaction spanned 17 months, a period far longer than any of those from the precedents favorable to the taxpayer, "the caselaw provides no specific time limit on the period in which a third-party exchange facilitator may hold title to the replacement property before the titles to the relinquished property and replacements properties are transferred in a reverse exchange."

A little over a year after the Tax Court's decision, the IRS issued a nonacquiescence, stating:

> For transactions outside the scope of the deferred exchange regulations, the Service does not follow the court opinions that take the view that for 1031 purposes an exchange facilitator may be treated as the owner of replacement property regardless of whether it has the benefits and burdens of ownership. … Taxpayers that use accommodating parties outside the scope of Rev. Proc. 2000-37 have not engaged in an exchange if the taxpayer, rather than the accommodating party, acquires the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property.

K. Section 1041 – Transfers Incident to Divorce: PLRs 201707007 & 201707008

These rulings are discussed in Part III.A.1.

VII. State Taxation

A. Changes to State Transfer Tax Laws: Delaware, Minnesota, New Jersey

Several states make changes to their transfer tax laws in 2017.

Delaware passed legislation in 2017 to sunset its estate tax as of January 1, 2018.

Minnesota increased its exemption for 2017 from $1,800,000 to $2,100,000 retroactively, and increased its exemption to $2,400,000 in 2018, $2,700,000 in 2019, and $3,000,000 in 2020 and thereafter..

New Jersey, pursuant to legislation enacted in 2016, has repealed its estate tax effective January 1, 2018. For 2017, the New Jersey threshold was $2,000,000 up from $675,000 in 2016. New Jersey did not repeal its inheritance tax.

B. Skip Fox's 2018 State Death Tax Chart (as of November 1, 2017)

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
Alabama	None	Tax is tied to federal state death tax credit. AL ST §40-15-2.		
Alaska	None	Tax is tied to federal state death tax credit. AK ST §43.31.011.		
Arizona	None	Tax was tied to federal state death tax credit. AZ ST §§42-4051; 42-4001(2), (12).		

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		On May 8, 2006, Governor Napolitano signed SB 1170, which permanently repealed Arizona's state estate tax.		
Arkansas	None	Tax is tied to federal state death tax credit. AR ST §26-59-103; 26-59-106; 26-59-109, as amended March, 2003.		
California	None	Tax is tied to federal state death tax credit. CA REV & TAX §§13302; 13411.		
Colorado	None	Tax is tied to federal state death tax credit. CO ST §§39-23.5-103; 39-23.5-102.		
Connecticut	Separate Estate Tax	As part of the two year budget, which became law on September 8, 2009, the exemption for the separate estate and gift taxes was increased to $3.5 million, effective January 1, 2010, the tax rates were reduced to a spread of 7.2% to 12%, and effective for decedents dying on or after January 1, 2010, the Connecticut tax is due six months after the date of death. CT ST §12-391. In May 2011, the threshold was lowered to $2 million retroactive to January 1, 2011.	On July 10, 2015, the Governor of Connecticut signed Senate Bill 1502, which implemented the biannual budget. The budget bill included a $20 million dollar cap on the amount of Connecticut estate and gift tax for both residents and nonresidents. This cap is effective for decedents dying on or after January 1, 2016, and was estimated to affect taxable estates greater than $170.5 million. The state exemption remains at $2 million.	$2,000,000
Delaware	None	Tax sunsetted as of January 1, 2015 The federal deduction for state death taxes is not taken into account in calculating the state tax. DE ST TI 30 §§1502(c)(2).	On July 2, 2017, the Governor signed HB 16, which sunsets the Delaware Estate Tax on December 31, 2017.	
District of Columbia	Pick-up Only	Tax frozen at federal state death tax credit in effect on January 1, 2001. In 2003, tax imposed only on estates exceeding EGTRRA applicable exclusion amount. Thereafter, tax imposed on estates exceeding $1 million.	On June 24, 2015, the D.C. Council made changes to the D.C. Estate Tax. The changes include possible increases in the D.C. estate tax threshold to $2	$2,000,000

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		DC CODE §§47-3702; 47-3701; approved by Mayor on June 20, 2003; effective retroactively to death occurring on and after January 1, 2003. No separate D.C. QTIP election.	million in 2016 and to the federal threshold of $5 million indexed for inflation in 2018 or later. Both increases are subject to the District meeting or exceeding certain revenue targets. The target for increasing the exemption to $2,000,000 was met in 2016 and became effective in 2017.	
Florida	None	Tax is tied to federal state death tax credit. FL ST §198.02; FL CONST. Art. VII, Sec. 5		
Georgia	None	Tax is tied to federal state death tax credit. GA ST §48-12-2.		
Hawaii	Modified Pick-up Tax	Tax was tied to federal state death tax credit. HI ST §§236D-3; 236D-2; 236D-B The Hawaii Legislature on April 30, 2010 overrode the Governor's veto of HB 2866 to impose a Hawaii estate tax on residents and also on the Hawaii assets of a non-resident or a non-U.S. citizen.	On May 2, 2012, the Hawaii legislature passed HB 2328, which conforms the Hawaii estate tax exemption to the federal estate tax exemption for decedents dying after January 25, 2012.	$5,600,000 (indexed for inflation for deaths occurring after January 25, 2012)
Idaho	None	Tax is tied to federal state death tax credit. ID ST §§14-403; 14-402; 63-3004 (as amended Mar. 2002).		
Illinois	Modified Pick-up Only	On January 13, 2011, Governor Quinn signed Public Act 096-1496, which increased Illinois' individual and corporate income tax rates. Included in the Act was the reinstatement of Illinois' estate tax as of January 1, 2011 with a $2 million exemption. Senate Bill 397 passed both the Illinois House and Senate as part of the tax package for Sears and CME on December 13, 2011. It increased the exemption to $3.5 million for 2012 and $4 million for 2013 and		$4,000,000

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		beyond. Governor Quinn signed the legislation on December 16, 2011. Illinois permits a separate state QTIP election, effective September 8, 2009. 35 ILCS 405/2(b-1).		
Indiana	None	Pick-up tax is tied to federal state death tax credit. IN ST §§6-4.1-11-2; 6-4.1-1-4.	On May 11, 2013, Governor Pence signed HB 1001, which repealed Indiana's inheritance tax retroactively to January 1, 2013. This replaced Indiana's prior law enacted in 2012, which phased out Indiana's inheritance tax over nine years beginning in 2013 and ending on December 31, 2021 and increased the inheritance tax exemption amounts retroactive to January 1, 2012.	
Iowa	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. IA ST §451.2; 451.13. Effective July 1, 2010, Iowa specifically reenacted its pick-up estate tax for decedents dying after December 31, 2010. Iowa Senate File 2380, reenacting IA ST §451.2. Iowa has a separate inheritance tax on transfers to others than lineal ascendants and descendants.		
Kansas	None	For decedents dying on or after January 1, 2007 and through December 31, 2009, Kansas had enacted a separate stand-alone estate tax. KS ST §79-15, 203.		
Kentucky	Inheritance Tax	Pick-up tax is tied to federal state death tax credit. KY ST §140.130. Kentucky has not decoupled but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election.		

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
Louisiana	None	Pick-up tax is tied to federal state death tax credit. LA R.S. §§47:2431; 47:2432; 47:2434.		
Maine	Pick-up Only	For decedents dying after December 31, 2002, pick-up tax was frozen at pre-EGTRRA federal state death tax credit, and imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law) (L.D. 1319; March 27, 2003). On June 20, 2011, Maine's governor signed Public Law Chapter 380 into law, which will increase the Maine estate tax exemption to $2 million in 2013 and beyond. The rates were also changed, effective January 1, 2013, to 0% for Maine estates up to $2 million, 8% for Maine estates between $2 million and $5 million, 10 % between $ 5 million and $8 million and 12% for the excess over $8 million. On June 30, 2015, the Maine legislature overrode the Governor's veto of LD 1019, the budget bill for fiscal years 2016 and 2017. As part of the new law, the Maine Exemption is tagged to the federal exemption for decedents dying on or after January 1, 2016. The tax rates will be: 8% on the first $3 million above the Maine Exemption; 10% on the next $3 million above the Maine Exemption; and 12% on all amounts above $6 million above the Maine Exemption. The new legislation did not include portability as part of the Maine Estate Tax. For estates of decedents dying after		$5,600,000

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		December 31, 2002, Sec. 2058 deduction is ignored in computing Maine tax and a separate state QTIP election is permitted. M.R.S. Title 36, Sec. 4062. Maine also subjects real or tangible property located in Maine that is transferred to a trust, limited liability company or other pass-through entity to tax in a non-resident's estate. M.R.S. Title 36, Sec. 4064.		
Maryland	Pick-up Tax Inheritance Tax	On May 15, 2014, Governor O'Malley signed HB 739, which repealed and reenacted MD TAX GENERAL §§7-305, 7-309(a), and 7-309(b) to do the following: 1. Increases the threshold for the Maryland estate tax to $1.5 million in 2015, $2 million in 2016, $3 million in 2017, and $4 million in 2018. For 2019 and beyond, the Maryland threshold will equal the federal applicable exclusion amount. 2. Continues to limit the amount of the federal credit used to calculate the Maryland estate tax to 16% of the amount by which the decedent's taxable estate exceeds the Maryland threshold unless the Section 2011 federal state death tax credit is then in effect. 3. Continues to ignore the federal deduction for state death taxes under Sec. 2058 in computing Maryland estate tax, thus eliminating a circular computation. 4. Permits a state QTIP election.		$4,000,000
Massachusetts	Pick-up Only	For decedents dying in 2002, pick-up tax is tied to federal state death tax credit. MA ST 65C §§2A. For decedents dying on or after January 1, 2003, pick-up tax is frozen at federal state death tax credit in effect on December 31, 2000. MA		$1,000,000

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		ST 65C §§2A(a), as amended July 2002. Tax imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. See, Taxpayer Advisory Bulletin (Dec. 2002), DOR Directive 03-02, Mass. Guide to Estate Taxes (2003) and TIR 02-18 published by Mass. Dept. of Rev. Massachusetts Department of Revenue has issued directive, pursuant to which separate Massachusetts QTIP election can be made when applying state's new estate tax based upon pre-EGTRRA federal state death tax credit.		
Michigan	None	Tax is tied to federal state death tax credit. MI ST §§205.232; 205.256		
Minnesota	Pick-up Only	Tax frozen at federal state death tax credit in effect on December 31, 2000, clarifying statute passed May 2002. Tax imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount. MN ST §§291.005; 291.03; instructions for MS Estate Tax Return; MN Revenue Notice 02-16. Separate state QTIP election permitted.	On May 30, 2017, the governor signed H.F. No. 1, increasing the Minnesota estate tax exemption for 2017 from $1,800,000 to $2,100,000 retroactively, and increases the exemption to $2,400,000 in 2018, $2,700,000 in 2019, and $3,000,000 for 2020 and thereafter. A provision enacted in 2013 to impose an estate tax on non-residents who own an interest in a pass-through entity which in turn owned real or personal property in Minnesota was amended in 2014 to exclude certain	$2,400,000

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
			publicly traded entities. It still applies to entities taxed as partnerships or S Corporations that own closely held businesses, farms, and cabins.	
Mississippi	None	Tax is tied to federal state death tax credit. MS ST §27-9-5.		
Missouri	None	Tax is tied to federal state death tax credit. MO ST §§145.011; 145.091.		
Montana	None	Tax is tied to federal state death tax credit. MT ST §72-16-904; 72-16-905.		
Nebraska	County Inheritance Tax	Nebraska through 2006 imposed a pick-up tax at the state level. Counties impose and collect a separate inheritance tax. NEB REV ST §77-2101.01(1).		
Nevada	None	Tax is tied to federal state death tax credit. NV ST Title 32 §§375A.025; 375A.100.		
New Hampshire	None	Tax is tied to federal state death tax credit. NH ST §§87:1; 87:7.		
New Jersey	Inheritance Tax only	For decedents dying after December 31, 2002, pick-up tax frozen at federal state death tax credit in effect on December 31, 2001. NJ ST §54:38-1 Pick-up tax imposed on estates exceeding federal applicable exclusion amount in effect December 31, 2001 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. The exemption was increased to $2 million in 2017 and the pick-up tax, but not the inheritance tax, is eliminated as of January 1, 2018. The executor has the option of	On October 14, 2016 Governor Christie signed Assembly Bill A-12, which was the tax bill accompanying the Assembly Bill A-10, which revised the funding for the state's Transportation Fund. Under this new law, the Pick-Up Tax had $2 million exemption in 2017 and was be eliminated as of January 1, 2018. The new law also eliminates the tax on New Jersey real and tangible property of a non-resident decedent.	

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		paying the above pick-up tax or a similar tax prescribed by the NJ Dir. Of Div. of Taxn. NJ ST §54:38-1; approved on July 1, 2002. In *Oberhand v. Director, Div. of Tax*, 193 N.J. 558 (2008), the retroactive application of New Jersey's decoupled estate tax to the estate of a decedent dying prior to the enactment of the tax was declared "manifestly unjust", where the will included marital formula provisions. In *Estate of Stevenson v. Director*, 008300-07 (N.J.Tax 2-19-2008) the NJ Tax Court held that in calculating the New Jersey estate tax where a marital disposition was burdened with estate tax, creating an interrelated computation, the marital deduction must be reduced not only by the actual NJ estate tax, but also by the hypothetical federal estate tax that would have been payable if the decedent had died in 2001. New Jersey allows a separate state QTIP election when a federal estate tax return is not filed and is not required to be filed. The New Jersey Administrative Code also requires that if the federal and state QTIP election is made, they must be consistent. NJAC 18:26-3A.8(d).	The repeal of the pick-up tax does not apply to the separate New Jersey inheritance tax.	
New Mexico	None	Tax is tied to federal state death tax credit. NM ST §§7-7-2; 7-7-3.		
New York	Pick-up Only	Tax frozen at federal state death tax credit in effect on July 22, 1998. NY TAX §951. Governor signed S. 6060 in 2004, which applies New York Estate Tax on a *pro rata* basis to non-resident decedents with property subject to New York Estate Tax. On March 16, 2010, the New York Office of Tax Policy Analysis,	The Executive Budget of 2014-2015, which was signed by Governor Cuomo on March 31, 2014 made substantial changes to New York's estate tax. The New York estate tax exemption, which was $1,000,000	$5,250,000 (April 1, 2017 through December 31, 2018)

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		Taxpayer Guidance Division issued a notice permitting a separate state QTIP election when no federal estate tax return is required to be filed such as in 2010 when there is no estate tax or when the value of the gross estate is too low to require the filing of a federal return. See TSB-M-10(1)M. Advisory Opinion (TSB-A-08(1)M (October 24, 2008) provides that an interest in an S Corporation owned by a non-resident and containing a condominium in New York is an intangible asset as long as the S Corporation has a real business purpose. If the S Corporation has no business purpose, it appears that New York would look through the S Corporation and subject the condominium to New York estate tax in the estate of the non-resident. There would likely be no business purpose if the sole reason for forming the S Corporation was to own assets.	through March 31, 2014 has been increased as follows: April 1, 2014 to March 31, 2015: $2,062,500 April 1, 2015 to March 31, 2016: $3,125,000 April 1, 2016 to March 31, 2017: $4,187,500 April 1, 2017 to December 31, 2018: $5,250,000 As of January 1, 2019, the New York estate tax exemption amount will be the same as the federal estate tax applicable exclusion amount. The maximum rate of tax will continue to be 16%. Taxable gifts within three years of death between April 1, 2014 and December 31, 2018 will be added back to a decedent's estate for purposes of calculating the New York tax. The New York estate tax will be a cliff tax. If the value of the estate is more than 105% of the then current exemption, the exemption will not be available.	

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
			On April 1, 2015, as part of 2015-2016 Executive Budget, New York enacted changes to the New York Estate Tax. New York first clarified that the new rate schedule enacted in 2014 applies to all decedents dying after April 1, 2014. Previously, the rate schedule only applied through March 31, 2015. New York then modified the three year gift add-back provision to make it clear that the gift add-back does not apply to any individuals dying on or after January 1, 2019. Previously, the gift add-back provision did not apply to gifts made on or after January 1, 2019. New York continues to not permit portability for New York estates and no QTIP election is allowed.	
North Carolina	None		On July 23, 2013, the Governor signed HB 998, which repealed the North Carolina estate tax retroactively to January 1, 2013.	
North Dakota	None	Tax is tied to federal state death tax credit. ND ST §57-37.1-04		
Ohio	None	Governor Taft signed the budget bill, 2005 HB 66, repealing the Ohio estate (sponge) tax prospectively and granting credit for it retroactively.		

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		This was effective June 30, 2005 and killed the sponge tax. On June 30, 2011, Governor Kasich signed HB 153, the biannual budget bill, which contained a repeal of the Ohio state estate tax effective January 1, 2013.		
Oklahoma	None	Tax is tied to federal state death tax credit. OK ST Title 68 §804 The separate estate tax was phased out as of January 1, 2010.		
Oregon	Separate Estate Tax	On June 28, 2011, Oregon's governor signed HB 2541, which replaces Oregon's pick-up tax with a stand-alone estate tax effective January 1, 2012. The new tax has a $1 million threshold with rates increasing from 10% to 16% between $1 million and $9.5 million. Determination of the estate for Oregon estate tax purposes is based upon the federal taxable estate with adjustments.		$1,000,000
Pennsylvania	Inheritance Tax	Tax is tied to the federal state death tax credit to the extent that the available federal state death tax credit exceeds the state inheritance tax. PA ST T. 72 P.S. §9117 amended December 23, 2003. Pennsylvania had decoupled its pick-up tax in 2002, but has now recoupled retroactively. The recoupling does not affect the Pennsylvania inheritance tax, which is independent of the federal state death tax credit. Pennsylvania recognizes a state QTIP election.		
Rhode Island	Pick-up Only	Tax frozen at federal state death tax credit in effect on January 1, 2001, with certain adjustments (see below). RI ST §44-22-1.1. Rhode Island recognized a separate	On June 19, 2014, the Rhode Island Governor approved changes to the Rhode Island Estate Tax by increasing the	$1,515,156 (2017)

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		state QTIP election in the State's Tax Division Ruling Request No. 2003-03. Rhode Island's Governor signed into law HB 5983 on June 30, 2009, effective for deaths occurring on or after January 1, 2010, an increase in the amount exempt from Rhode Island estate tax from $675,000, to $850,000, with annual adjustments beginning for deaths occurring on or after January 1, 2011 based on "the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U)... rounded up to the nearest five dollar ($5.00) increment." RI ST §44-22-1.1.	exemption to $1,500,000 indexed for inflation in 2015 and eliminating the cliff tax. The exemption for 2018 is $1,537,656.	
South Carolina	None	Tax is tied to federal state death tax credit. SC ST §§12-16-510; 12-16-20 and 12-6-40, amended in 2002.		
South Dakota	None	Tax is tied to federal state death tax credit. SD ST §§10-40A-3; 10-40A-1 (as amended Feb. 2002).		
Tennessee	None	Pick-up tax is tied to federal state death tax credit. TN ST §§67-8-202; 67-8-203. Tennessee had a separate inheritance tax, which was phased out as of January 1, 2016.	On May 2, 2012, the Tennessee legislature passed HB 3760/SB 3762, which phased out the Tennessee Inheritance Tax as of January 1, 2016. The Inheritance Tax Exemption was increased to $1.25 million in 2013, $2 million in 2014, and $5 million in 2015. On May 2, 2012, the Tennessee legislature also passed HB 2840/SB2777, which repealed the Tennessee state gift tax retroactive to January 1, 2012.	
Texas	None	Tax was permanently repealed effective as of September 15, 2015 when Chapter 211 of the Texas Tax		

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		Code was repealed. Prior to September 15, 2015, the tax was tied to the federal state death tax credit.		
Utah	None	Tax is tied to federal state death tax credit. UT ST §59-11-102; 59-11-103.		
Vermont	Modified Pick-up	In 2010, Vermont increased the estate tax exemption threshold from $2,000,000 to $2,750,000 for decedents dying January 1, 2011. As of January 1, 2012 the exclusion is scheduled to equal the federal estate tax applicable exclusion, so long as the FET exclusion is not less than $2,000,000 and not more than $3,500,000. VT ST T. 32 §7442a. Previously the estate tax was frozen at federal state death tax credit in effect on January 1, 2001. VT ST T. 32 §§7402(8), 7442a, 7475, amended on June 21, 2002. No separate state QTIP election permitted.		$2,750,000
Virginia	None	Tax is tied to federal state death tax credit. VA ST §§58.1-901; 58.1-902. The Virginia tax was repealed effective July 1, 2007. Previously, the tax was frozen at federal state death tax credit in effect on January 1, 1978. Tax was imposed only on estates exceeding EGTRRA federal applicable exclusion amount. VA ST §§58.1-901; 58.1-902.		
Washington	Separate Estate Tax	On February 3, 2005, the Washington State Supreme Court unanimously held that Washington's state death tax was unconstitutional. The tax was tied to the current federal state death tax credit, thus reducing the tax for the years 2002-2004 and eliminating it for the years 2005–2010. *Hemphill v. State Department of Revenue*, 153 Wash. 2d 544 (Wash. 2005). In response to *Hemphill*, the Washington State Senate on April 19	On June 14, 2013, Governor Inslee signed HB 2075, which closed an exemption for marital trusts retroactively immediately prior to when the Department of Revenue was about to start issuing refund checks, created a deduction for up to $2.5 million for certain family	$2,129,000 (2017)

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		and the Washington House on April 22, 2005, by narrow majorities, passed a stand-alone state estate tax with rates ranging from 10% to 19%, a $1.5 million exemption in 2005 and $2 million thereafter, and a deduction for farms for which a Sec. 2032A election could have been taken (regardless of whether the election is made). The Governor signed the legislation. WA ST §§83.100.040; 83.100.020. Washington voters defeated a referendum to repeal the Washington estate tax in the November 2006 elections. Washington permits a separate state QTIP election. WA ST §83.100.047.	owned businesses and indexes the $2 million Washington state death tax threshold for inflation. The exemption for 2018 is $2,193,000.	
West Virginia	None	Tax is tied to federal state death tax credit. WV §11-11-3.		
Wisconsin	None	Tax is tied to federal state death tax credit. WI ST §72.01(11m). For deaths occurring after September 30, 2002, and before January 1, 2008, tax was frozen at federal state death tax credit in effect on December 31, 2000 and was imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. Thereafter, tax imposed only on estates exceeding EGTRRA federal applicable exclusion amount. WI ST §§72.01; 72.02, amended in 2001; WI Dept. of Revenue website. On April 15, 2004, the Wisconsin governor signed 2003 Wis. Act 258, which provided that Wisconsin will not impose an estate tax with respect to the intangible personal property of a non-resident decedent that has a taxable situs in Wisconsin even if the non-resident's state of domicile does		

State	Type of Tax	Effect of EGTRRA (2001) on Pick-Up Taxes and Gross Estate Thresholds	Legislation Affecting State Death Tax	2018 State Death Tax Threshold
		not impose a death tax. Previously, Wisconsin imposed an estate tax with respect to the intangible personal property of a non-resident decedent that had a taxable situs in Wisconsin if the state of domicile of the non-resident had no state death tax.		
Wyoming	None	Tax is tied to federal state death tax credit. WY ST §§39-19-103; 39-19-104.		

C. Cases

1. State Estate Taxes: *Ackerley* (WA), *Brooks* (CT)

Gift tax paid within three years of death is part of the Washington taxable estate and is subject to Washington estate tax. *Estate of Ackerley v. Department of Revenue*, 389 P.3d 583 (Wash. Feb. 16, 2017).

The federal estate, gift, and generation-skipping transfer taxes are known collectively as "wealth transfer" taxes because, by Sections 2 and 9 of Article I of the United States Constitution, Congress may not impose an unapportioned direct tax on property. That explains why the Sixteenth Amendment is critical to the federal income tax, because it authorizes a direct tax on income. Other federal taxes must be excise taxes. In the case of wealth transfer taxes, the transfer of wealth, and not the wealth itself, is the subject of taxation.

Most state laws that impose an estate tax (only Connecticut imposes a gift tax) piggy-back on the federal estate tax, including its mandate that there must be a transfer to justify a taxable event. Therein lies the genesis of the argument the Ackerley estate unsuccessfully.

Ackerley died on March 21, 2011. In 2008 and 2010, Ackerley had made substantial gifts and paid the required federal gift taxes, which amounted to over $5.5 million. Upon his death, his estate was required by Section 2035(b) of the federal Internal Revenue Code to include the value of the gift taxes paid in his federal taxable estate because Ackerley died within three of making the gifts. Ackerley's estate thus included the gift taxes in its federal estate tax return. When the estate filed its Washington estate tax return, it did not include the $5.5 million in federal gift taxes paid as part of the Washington taxable estate. The Washington Department of Revenue issued a notice of assessment, notifying Ackerley's estate that it owed additional Washington estate taxes on the amount of the federal gift taxes paid.

Ackerley's estate disputed this, claiming that the Washington estate tax was imposed only on "transfers" of property and the payment of gift taxes within three years of death was not a transfer of property. The Washington Supreme Court upheld the lower court's decision that Ackerley's estate was required to pay Washington State estate tax on federal gift taxes paid with three years of death because those federal gift taxes paid within three years of death fall within the definitions of "transfer" and "Washington taxable estate." It noted that the federal taxable estate is “grossed up” for estate purposes with gift taxes paid within three years of death. The court found that in establishing its separate state estate tax in 2005, the Washington legislature clearly defined the “Washington taxable estate” to be the same the “federal taxable estate. Therefore, the federal gift tax paid within three years of death must be included in the “Washington taxable estate” because in is included in the “federal taxable estate.”

A dissent noted that

> the gift taxes Ackerley paid during his life do not shift any interest in any property at the time of Ackerley’s death, there is no transfer of property, and without some transfer or other shifting of property rights upon death, the estate tax does not fall upon the gift taxes paid during Ackerley’s life.

But it was clear to the court that the gift taxes paid within three years of death transferred with the rest of Ackerley’s estate because the legislature clearly intended a broad definition of “transfer,” consistent with federal law. The court cited *Fernandez v. Wiener*, 326 U.S. 340 (1945), to show that the definition of transfer is a broad requirement. In *Fernandez,* the United States Supreme Court had stated:

> The power of Congress to impose death taxes is not limited to taxation of transfers at death. It extends to the creation, exercise, acquisition, or relinquishment of any power or legal privilege which is incident to the ownership of property, and when any of these is occasioned by death, it may as readily be the subject of the federal tax as the transfer of property at death.

Because the gift taxes paid within three years of death transferred with the rest of the taxable of estate at Ackerley’s death, they were subject to Washington estate tax.

A QTIP trust is subject to state estate tax when the surviving spouse dies, even if the estate of the first spouse to die received no state estate tax benefit from it. *Estate of Brooks v. Commissioner of Revenue Services*, 159 A.3d 1149 (Conn. May 23, 2017).

There is a fundamental “contract” underlying the federal estate tax marital deduction. The basic requirement of all forms of qualified marital deduction transfer (outright transfer, or a general-power-of-appointment or QTIP marital trust) is “payback” inclusion in the estate of the surviving spouse (under Section 2033, 2041, or 2044). Congress has, in effect, said that “We won’t tax these assets in your estate, provided that you leave them in a form that will cause inclusion in your spouse’s estate.” As a result, the marital deduction is not designed to reduce the estate tax for a married couple. Instead, it merely defers the tax until death of the surviving spouse.

The equity of this “payback” notion is illustrated by *In re Estate of Bracken*, 290 P.3d 99 (Wash. 2012), a state death tax case in which the court denied the Washington State Department of Revenue’s effort to require inclusion of QTIP trusts in the estates of surviving spouse decedents, because there was no state law QTIP marital deduction allowed (because there was no state death tax) in the estates of the trust settlors. These trusts *did* qualify as marital deduction QTIP trusts in the estate of the first spouse to die for federal estate tax purposes, and the state death tax was a piggyback on the federal inclusion. But having garnered no state death tax benefit in the settlor's estate, *Bracken* correctly held that it was not appropriate for the Department to seek payback inclusion when the surviving spouse beneficiary died.

In response to *Bracken*, the Washington legislature amended its Estate and Transfer Tax Act to specifically allow the Washington Department of Revenue to tax QTIP trusts, regardless of when created or whether the state had granted a marital deduction in the estate of the settlor spouse. *See* Wash. Rev. Code §83.100.048. This amendment was upheld as constitutional in *Estate of Hambleton v. Dep't of Revenue*, 335 P.3d 398 (Wash. 2014), notwithstanding that it puts the "contract" in a different light than exists for federal estate tax purposes.

Consistent with the Washington legislation, *Estate of Ackerley v. Department of Revenue*, 389 P.3d 583 (Wash. 2017) (discussed above), subsequently held that federal gift tax included in a decedent's federal gross estate under Section 2035(b) (the so-called "gross up" rule) also is subject to state estate tax, because the state tax piggybacks on the federal taxable estate. Essentially these developments reveal an effort to tie state estate tax to the federal estate tax return, making whatever is includible for federal purposes also includible for state estate tax purposes. And they indicate that the state death tax posture is fundamentally different than that at the federal level.

In this context, then, consider the facts in *Brooks*, in which the settlor of two QTIP trusts died in Florida, which has no state estate tax. These trusts qualified for the federal estate tax marital deduction but served no state death tax deferral function because there was no state death tax to be deferred. Add the complication that the surviving spouse relocated to and subsequently died in Connecticut, which does have an estate tax. These QTIP trusts didn't garner a deferral of Connecticut estate tax either, because the trust settlor did not die in Connecticut. Nevertheless, Connecticut successfully imposed its estate tax on these QTIP trusts when the surviving spouse died, based on the logic in both *Bracken* and *Ackerley*, that the state estate tax piggybacks on the federal gross estate and QTIP trusts are includible in the federal gross estate of a surviving spouse. The lack of deferral and notions of payback notwithstanding, the court also stating that termination of the surviving spouse's life estate is a "sufficient 'shifting at death of particular incidents of property' to properly impose an excise tax" on the transfer of wealth.

> **Note:** If the facts had been reversed, and the surviving spouse in *Brooks* had qualified for the estate tax marital deduction in Connecticut but then moved to and died in Florida, there would be no state tax. The fundamental principle articulated in *Brooks* is that the law of the surviving spouse's domicile at death is the applicable law for purposes of the state death tax imposed, again regardless of the federal payback concept.

2. State Income Taxation of Trusts: *Fielding* (MN)

Trust income from out-of-state sources held immune from state income tax. *Fielding v. Commissioner of Revenue*, 2017 WL 2484593 (Minn. Tax Ct.)

The topic of state income taxation of trust income that is not distributed to a beneficiary has been the subject of several recent decisions. For example, in 2016 *Kaestner Family Trust v. North Carolina*, 2015 WL 1880607 (N.C. Super. Ct.), *aff'd*, 789 S.E.2d 645

(N.C. Ct. App. 2016), held that taxation of undistributed trust income based solely on the North Carolina residence of trust beneficiaries violates both the Due Process and the Commerce Clauses of both the State and Federal Constitutions. (The appellate court did not address the Commerce clause issue). As a result, the North Carolina statute that taxes "income of [a] trust that is for the benefit of" a resident beneficiary, even if that trust has no other contacts with the state, was held unconstitutional.

Massachusetts law taxes trust income if at least one grantor, one beneficiary, and one trustee are inhabitants of Massachusetts. *Bank of America v. Commissioner of Revenue*, 54 N.E.3d 13 (Mass. 2016), involved only the question whether the trustee was an inhabitant (the parties stipulated that the trust was created by a Massachusetts grantor and that trust income was "accumulated for the benefit of a known inhabitant"). The court concluded that the corporate trustee, as trustee (not based on its actions as a corporation), was an "inhabitant" based on its in-state maintenance of over 200 branch offices, and conduct of trust administration activities.

Quill v. North Dakota, 504 U.S. 298 (1992), is a lodestar decision holding that Due Process requires "sufficient contacts" with a state that make it "fair and reasonable" for the State to impose the taxes involved. For example, a state constitutionally may tax trust beneficiaries on income distributed to them. But *Kaestner* confirmed that a State may not tax *undistributed* trust income based on the mere residence of the beneficiaries within the State.

Most recently, ***Fielding v. Commissioner of Revenue***, 2017 WL 2484593 (Minn. Tax Ct.), addressed whether Minnesota may tax the worldwide income of an irrevocable inter vivos trust based solely on the fact that the trust's settlor was a domiciliary of Minnesota when the trust was created. The court rejected the State's argument that the state had a perpetual constitutional nexus based on that one factor. Based again on Due Process and Commerce Clause objections, the court held that gain and income from sources outside Minnesota were immune to local income taxation at the trust level, lacking other contacts such as trust administration within Minnesota.

With respect to state taxation, due process imposes two constraints. First, there must be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." Second, "the income attributable to the State for tax purposes must be rationally related to 'values connected with the taxing State.'"

Due process nexus actually "embodies two discrete inquiries: first, is there a minimum connection with (and hence, jurisdiction over) the taxpayer; second, is there a minimum connection with (and hence, jurisdiction over) the activity the state seeks to tax."

According to the court, residence of a trust beneficiary would allow the state to tax trust income distributed to that beneficiary, regardless of its source. But some other nexus must exist for it to tax trust income not distributed to Minnesota domiciliaries. One such nexus would be income sourced to Minnesota – but only to the extent of taxing that source income. Residence of the grantor at the time the trust was created was not a sufficient nexus to continue to tax nonsource income.

Two elements of the exceptionally well-written opinion are notable. One is that the court distinguished *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999), which many observers believe would support the state's taxation in *Fielding*. According to the court the principle factor that supported state income taxation in *Gavin* was that a noncontingent beneficiary was a Connecticut domiciliary, which the court regarded as meaning that "domicile of the grantor alone is not sufficient to justify the resident tax treatment" of the *Gavin* trust. According to *Fielding*, "state protections must be contemporaneous with the accumulation of the income to be taxed" and "[i]t is unsurprising that courts universally rejected state efforts to tax trusts as 'residents' based solely on the domicile of the grantor at the time an *inter vivos* trust became irrevocable."

The other notable element is the court's insistence that irrevocable inter vivos trusts are distinguishable from testamentary trusts for nexus-generating purposes, agreeing with the notion expressed by some that "[t]he case for asserting jurisdiction to tax a testamentary trust based on the domicile of the decedent … is probably a stronger one because of the connection that a testamentary trust has to the state's probate courts … given the continuing supervisory relationship which [state] courts have with respect to administration of such a trust." Although not the subject addressed in *Fielding*, quaere the notion that any on-going connection attributable to creation of a testamentary trust via the will of a long-since deceased settlor is sufficient. The suggestion alone may be another reason to favor inter vivos trusts unless state income taxation is not a relevant consideration.

VIII. Notable Non-Tax State Law Developments

[Except as noted in Part VIII.C.2, this Part VIII is contributed by Jeff Pennell.]

The following materials were prepared with the notion that the applicable exclusion amount and generation-skipping transfer tax exemption are sufficient to protect over 99% of all decedent estates from federal wealth transfer taxation. As such, many estate planners are focused on issues that affect the "middle rich," for whom competent estate planning services are necessary but planning motivated by minimizing wealth transfer tax is not. This may be a new orientation for some estate planners, after many years of tax-centric planning. Numerous interesting and new state law nontax issues deserve attention, and developments that have a wider significance than the particular state's law are useful learning tools. Both notions inform these selections.

Due to deadlines for printed materials, the coverage of developments here covers November 2016 through October 2017.

Elsewhere in these Institute materials is a chapter of developments related to fiduciary liability and litigation. This material seeks to avoid overlapping that topic. In addition, the following summaries seek to strike a balance between providing too little information for readers to be alert to a development that might be useful to their practice, and so much information that readers will not read the description. Our intent is to encourage readers to read the original sources whenever possible – inevitably there are other issues in the cases reported that may impact a reader's reliance on the development. The highlights here are designed to give important data without forcing readers to study the entirety of an original document. But, there is no substitute for reading the original source if a topic is directly relevant to your clientele or practice, and particularly if litigation about the topic is involved. Don't rely on these summaries.

Finally, a disclaimer: These materials are intended to assist readers as a learning aid but do not constitute legal advice. Given their purpose, they may not discuss exceptions, qualifications, or other relevant information that may affect their utility in any situation. Diligent effort was made to ensure the accuracy of these materials but the author and the Institute assume no responsibility for any reader's reliance on them and encourage all readers to verify all items by reviewing all original sources and considering all consequences before applying any concept involved.

A. Drafting

Lapse and Antilapse. At common law a bequest would fail if it was to a beneficiary who died before the testator died (a lapsed bequest). Unless pursuant to an obligation (such as a property settlement agreement) or for tax purposes, it seldom would make sense to add the bequest to the predeceased beneficiary's estate and require another administration of that property. So, unless the testator's will provided otherwise, a bequest to a predeceased beneficiary was not regarded as a bequest to that beneficiary's estate. The common law thus provided that a preresiduary disposition to a predeceased individual would fail and the subject property would fall into and pass with the residue, while a residuary bequest would fail and, because there is no residue of the residue, would pass by intestacy. Only if the bequest was to a class, any member of which survived the testator, would the gift not lapse and instead pass to the surviving class members.

These consequences can and often should be altered by the testator's will, because legislation that precludes lapse (antilapse statutes) often produces results that are contrary to the testator's intent. For example, the issue under many antilapse statutes is the breadth of their coverage, because not all predeceased beneficiaries are included under the statute's application. Many statutes apply only to relatives and do not include a bequest to a testator's spouse. *See*, *e.g.*, the latest version of Section 2-603(b) of the Uniform Probate Code (UPC), which is applicable only with respect to grandparents, descendants of grandparents, or step-children of the testator (or of a donor of a power of appointment that is being exercised). In cases not covered by the statute, traditional lapse rules continue to apply, which often is undesirable. But not always.

In re Estate of Watkins, 2017 WL 3149610 (Tenn. Ct. App.), involved a Tennessee antilapse statute that *did* apply to the decedent's surviving spouse, which meant that the decedent's stepchildren took her residuary estate to the exclusion of the decedent's descendants. Antilapse was applicable because the decedent's will did not anticipate that her husband might not survive her, it was not revised after his death, and it failed to dispose of the residue if he did not survive (he died nearly 16 years before she did). Extrinsic evidence suggested that passing her residuary estate to his children by a prior marriage was not the decedent's intent. Yet the decedent's 21 year-old will never was revised or revoked.

It is fair to suggest that an estate plan is not well designed if the destination of a testamentary disposition must be determined under either the common law lapse rules or an antilapse statute. If a beneficiary predeceases the testator, the will should designate the alternate disposition in a way that overcomes the otherwise governing effect of the common law or statutory rules. But a study of antilapse statutes, particularly the latest version of UPC §2-603(b)(3), illustrates that overriding application of the statute may be easier said than done, which makes drafting in anticipation of lapse a chore that should not be taken lightly. In this respect, state law should be inspected carefully because intuitive drafting may not be effective.

For example, UPC §2-603(b)(3) provides that the use of words of survivorship alone is not sufficient to preclude application of the antilapse rule. Required is a statement that the descendants of the named beneficiary are not to take if the beneficiary is not alive, or an alternative disposition of the gift if it lapses. That is, it will not suffice to provide for "X if X survives me." Instead, the document would need to say "to X if X survives me, and if not to Y" or "to X and not to X's descendants." This probably would have been the decedent's preferred result in *Watkins*, because her intestate estate would have passed to her own descendants and not to her stepchildren.

Ademption by Extinction. Also known simply as "ademption" (as distinguished from ademption by satisfaction, which commonly is known as just "satisfaction") ademption by extinction is a traditional wills concept that deals with a specific gift of property that the decedent no longer owns at death. In many states it now also applies to gifts from trusts, and may reflect refinements that address special situations, such as a "mere change of form" or destruction of gifted property under circumstances such that a replacement gift could not be made by the donor. An example of the latter exception is a gift of an asset that is destroyed in the same event that killed the decedent, such as a bequest of an automobile that the donor was driving when struck and killed by a drunk driver. Rather than adeem, insurance proceeds from destruction of the auto in the accident may be substituted for any gift of the car.

An example of the former exception might be an exchange of one parcel of realty for another, such that replacement Blackacre could pass to the beneficiary of a specific devise of Greenacre. This exception is more difficult to apply given the historic notion that realty is not fungible – that no two parcels are the same – so that replacement property is not treated as a "mere change of form" and is not as easy to identify as might be the substitution of one automobile for another.

The distinction between the inability and the replacement exceptions may explain why some states have embraced one but not the other. For example, Iowa jurisprudence embraces the inability exception but not the replacement approach, which is advanced by UPC §2-606(a)(5). Indeed, the Iowa legislature has considered and adopted select provisions of the UPC, but not the mere-change-in-form approach. Selective adoption of UPC provisions causes Iowa courts to regard failure to enact certain changes as purposeful. For example, ***In re Steinberg Family Living Trust***, 894 N.W.2d 463 (Iowa 2017), concluded that a specific gift of an Iowa farm was not excepted from ademption by acquisition of a Minnesota property in a Section 1031 like-kind exchange. Notwithstanding the federal income tax treatment of the two properties as a mere-change-in-form (as if no sale or exchange occurred), the Iowa court held that the beneficiary would be disappointed by the swap, which occurred while the trust's settlor was alive and competent to amend the trust.

Two aspects of this are notable. One is the court's application of the ademption concept to a trust, and the other is the court's rejection of a like-kind exception. Under Section 1031 like-kind is a very broad concept when dealing with realty (dirt is dirt), which would regard an exchange of a farm in Iowa as like-kind for a penthouse apartment in New York City. UPC §2-606(a)(5) is only slightly more surgical, addressing "real property … acquired as a replacement for specifically devised real property." It too could apply to a tract of timberland exchanged for a feedlot, or perhaps even a condo. Which may explain why the Iowa legislature did not enact that provision. In *Steinberg* the two properties differed in value by several hundred thousand dollars but otherwise appear to have both been farmland. Nevertheless the court held that the specific devisee was disappointed by the settlor's failure to amend the trust to refer to the replacement property.

The lesson for drafters is to specify whether replacement property should be substituted for a specific gift, or a particular gift adeems. An easy example might be a gift of stock in a corporation that might be acquired in a takeover or merger, in which replacement stock could take the place of the gifted stock. A less easy example might be the farmland in *Steinberg*, in which one parcel may have been managed or farmed by the specific devisee and the replacement for it may be located at some distance and has no special significance to the beneficiary of the former plot. In a jurisdiction that has selectively enacted Uniform Law provisions a drafter can more easily determine the "hot button" issues on which a specific provision likely is appropriate. Additional attention and caution is appropriate in a case like *Steinberg* in which a conflict of laws may apply if state laws may differ.

Apportionment of Gross-Up Rule Estate Tax Liability. The effects of inter vivos gifts on a state law estate tax apportionment regime are difficult to predict. This recently was illustrated by ***Estate of Sommers v. Commissioner***, 149 T.C. No. 8 (2017), which was very odd in that it denied summary judgment to both the government and the taxpayer, in favor of a third-party "intervenor" (the donees of inter vivos net gifts). The primary question was whether New Jersey state law would apportion estate tax caused by the Section 2035(b) gross-up rule to those donees. Framed as a question of first impression in New Jersey, the Tax Court undertook to determine the state law result, without the benefit of a New Jersey court decision on point. The Tax Court cited and followed *In re Estate of Coven*, 559 N.Y.S.2d 798 (Surr. Ct. 1990), and *In re Metzler*, 579 N.Y.S.2d 288 (App. Div. 1992), and rejected several other state court determinations involving situations that were more ordinary than *Sommers*.

In *Sommers* and in *Coven* each decedent's will directed that federal estate tax be paid out of the decedent's probate estate. Included in each decedent's federal estate tax computation base were gifts made inter vivos, and those gifts caused the balance of the decedent's estate to be taxed in a higher marginal federal estate tax bracket. In *Sommers*, the gifts also were made within three years of the decedent's death, they were large enough to fully consume the donor's unified credit, and thereby caused payment of gift tax. That payment triggered application of the three-year gross-up rule in Section 2035(b), which required inclusion in the decedent's gross estate of the gift tax, which was paid in *Sommers* by the donees under a net gift agreement.

The question in *Coven* and *Metzler* was simply whether the donee of an inter vivos gift should bear the estate tax attributable to inclusion of the gift itself in the calculation of the estate tax under the unified tax system found in Section 2001. Different in *Sommers* was the question whether the donees should pay the estate tax attributable to Section 2035(b). In each case the court rejected the apportionment argument because neither the decedent's will nor state law apportioned taxes against property transferred by gift during life.

In *Sommers*, the Section 2035(b) gross-up rule was regarded as inadequate to cause the donees to be regarded as transferees of any property that was includible in the decedent's gross estate. To the contrary is *Shepter v. Johns Hopkins University*, 637 A.2d 1223 (Md. Ct. App. 1994), in which taxes otherwise payable from the residue, which passed to a charity, were apportioned against the beneficiary of an inter vivos gift that constituted an adjusted taxable gift. That transfer boosted the federal estate tax marginal bracket but otherwise was not includible in the decedent's gross estate for federal estate tax purposes. The court held that full apportionment as adopted in states that enacted the Uniform Estate Tax Apportionment Act should include donees of gifts that are included in the federal estate tax computation. The notable element of *Shepter* is that a subsequent version of the Uniform Estate Tax Apportionment Act specifically declined to apportion estate tax to the donees of inter vivos taxable gifts. And, by ch. 55 of Acts 1995, the Maryland legislature effectively rejected the result in *Shepter*, stating that the reference in Md. Code Ann., Tax – General §7-308(a)(4) to persons to whom federal estate tax may be apportioned does not include the recipient of an adjusted taxable gift from the decedent that is not includible for federal estate tax purposes, "notwithstanding any holding or dictum to the contrary in *Shepter v. Johns Hopkins University*."

Sommers also refused to follow *In re Estate of Necaise*, 915 So. 2d 449 (Miss. 2005), which held that the decedent's will effectively imposed an apportionment result on the donee of an inter vivos gift that fully constituted that beneficiary's share of the decedent's total wealth. Like *Shepter* it allocated estate tax at death as if the inter vivos gift was included in the estate and then fully apportioned the estate tax liability.

A third case discussed but also rejected in *Sommers* is *Bunting v. Bunting*, 768 A.2d 989 (Conn. App. Ct. 2000), in which the decedent made a sizeable inter vivos gift to a child, as to which the gift tax was less than the available unified credit. At death that gift, added to the taxable estate, caused the remaining property to incur estate tax in excess of the unified credit. The decedent directed payment of all taxes from the residue of the estate, which was smaller than the combined state and federal taxes due at death. The court concluded that the decedent never anticipated that the inter vivos gift would cause taxes to be generated and therefore could not have intended for the tax payment provision to relieve the inter vivos donee of responsibility to pay estate taxes attributable to inclusion of the taxable gift in the adjusted taxable gifts base for estate tax computation purposes. Therefore, as in *Shepter* and *Necaise*, the *Bunting* court apportioned estate tax to the donee of that inter vivos gift. On similar facts, *Metzler* held that the state tax apportionment statute (which was enacted prior to unification of the estate and gift taxes in 1976) could not have intended to apportion tax to the donee of the lifetime gift, and therefore could *not* require the donee to contribute to the estate tax liability.

Sommers dismissed each of *Shepter*, *Necaise*, and *Bunting* "as illustrating courts' willingness to require apportionment of estate tax to donees of lifetime gifts, without express statutory authorization, to reach what may be perceived as an equitable result." The lodestar in such cases is to determine the decedent's intent, which may not be equitable. In all likelihood the decedent never considered the question, and the results in these cases is a stew of contradictory authority, begging for resolution either by state law or by an express provision in the decedent's estate planning documents. Experience suggests that few tax payment provisions do so, and most state laws also do not establish who should pay the federal estate tax attributable to inter vivos gifts, much less the gift tax includible in the estate under Section 2035(b).

A convenient result, but one not dictated by state laws, would be to regard the gross-up tax as part of the gift and regard the donee thereof as responsible for any estate tax attributable thereto. The taxpayer made this argument in *Sommers* to no avail. This suggestion itself has the inconsistent consequence of treating the federal estate tax attributable to the gift tax being paid as different from the gift tax itself, which makes it hard to determine the decedent's intent, regardless of whether the donor paid the gift tax without charge to the donee or the donee expressly agreed to pay the gift tax under a net gift agreement (such as was involved in *Sommers*). Imposing both the gift tax and then any estate tax attributable to the gift tax (a net gift) is a viable approach that would minimize the value of the gift (both liabilities, imposed on the donees, serve to reduce the gift tax cost) and (it is hoped) avoid the controversy regarding intent that was litigated in *Sommers*.

Estate planners must especially consider the client's intent with respect to the gross-up tax issue if significant inter vivos gifts are being considered upon which gift tax may be paid within three years of the donor's death, particularly if there will be insufficient assets in the estate to pay the tax on the Section 2035(b) gross-up tax amount without invading otherwise deductible bequests. This could occur if a testamentary marital deduction gift is made in a situation in which the decedent totally utilized the unified credit during life and, therefore, has no nonmarital assets with which to pay federal estate tax attributable to Section 2035(b) inclusion. This was the case in *Sommers*, in which a second issue (not resolved, the court rejecting a motion for summary judgment) was the estate tax marital deduction consequences of the court's holding that the donees were not responsible for the estate tax attributable to Section 2035(b) inclusion of the gift tax paid.

A point made by the drafter of the current version of the Uniform Estate Tax Apportionment Act is that apportionment of the Section 2035(b)-generated estate tax to a donee also may not be viable (without some testamentary enforcement mechanism), or appropriate. *See* Kahn, The 2003 Revised Uniform Estate Tax Apportionment Act, 38 Real Prop., Prob. & Tr. J. 613, 630 (2004), cited by the *Sommers* opinion. By way of illustration, consider an actual California controversy that was resolved via arbitration, for which no case citation is available. Parent P intended to bequeath the entire P family business to child A. When A's siblings B and C discovered P's intent (and raised a ruckus) P agreed to transfer $5 million to each of them inter vivos, in exchange for their written waiver of any estate entitlement and their agreement not to contest P's will. P's estate planner anticipated P's impending demise and amended the tax payment direction in P's estate plan to provide that any gift tax on the two $5 million gifts would reduce A's bequest if P died before the gift tax on these two transfers was paid. P lived long enough to pay the gift tax but died within three years. So the gross-up rule in Section 2035(b) required inclusion of the gift tax dollars and the question was whether the federal estate tax attributable to inclusion of the gift tax dollars should be apportioned to B and C (because they received the gifts), or to A. P's estate planner never anticipated this question, and P's will was silent on the question. P's intent was that B and C would receive their $5 million gifts totally free-and-clear, but state law embraced full apportionment and the result reached (by the arbitrator) was that B and C should pay the Section 2035(b)-generated federal estate tax because that seemed the equitable result – they having received the gifts that generated the gift tax that spawned the Section 2035(b) inclusion. All notwithstanding the donees' anticipation, and contrary to P's intent.

Two other issues were involved in *Sommers*. One was the deductibility of the decedent's outstanding gift tax liability under Section 2053, which the court rejected because the donees of the gifts were obliged to pay that gift tax under the parties' net gift agreements. Saying that outstanding gift tax normally would be deductible under Reg. §20.2053-6(d), in this case the decedent was entitled to reimbursement if the estate paid that gift tax, which negated the deduction. The other issue was the estate tax marital deduction consequences of the estate tax attributable to Section 2035(b), to the extent the estate was obliged to pay that tax out of assets otherwise passing to the decedent's surviving spouse. Correctly citing Section 2056(b)(4), the court rejected the notion that the marital deduction would not be reduced if the estate paid that tax liability. For reasons not revealed in the opinion, the government joined with the estate in moving that the donees should pay that gift tax, which is difficult to understand. The net result of the court's holding is that the donees will not be forced to pay the estate tax generated by the gross-up rule, which will cause the marital deduction to be reduced to the extent the estate tax is imposed on property otherwise passing to the surviving spouse. And that works to the government's advantage.

Equitable Apportionment. If an estate qualifies for Section 2032A special use valuation, state law ought to (but virtually always does not) address whether the benefit of the reduction in value, and the corresponding reduction in tax, should inure to the benefit of the recipient of the qualifying property. One argument is that both the value reduction and the tax benefit flowing from that should benefit the qualified heir, because any disqualifying sale or act that causes recapture of the tax benefit will be a liability imposed against the qualified property. By Section 2032A(c)(5) the qualified heir is personally responsible for the additional tax on recapture (although the recipient may post a bond to be relieved of that liability). On the other hand, some families might regard the special use property as the crown jewel asset and that receipt of it is benefit enough without also giving that recipient the additional tax reduction benefit.

An intriguing question is whether the decedent's tax clause otherwise addresses these questions, especially the recapture tax burden that may be incurred years in the future.

Known as equitable apportionment, the first concept is that the property that generates a tax reduction should receive the benefit of that reduction. This is the logic underlying the nearly universal allocation of estate tax away from a marital bequest that qualifies for the

Section 2056 marital deduction (along with the reality that imposition of tax on a marital bequest will reduce the deduction and correspondingly increase the tax liability). Equitable apportionment is especially prescient with respect to Section 2032A because of the recapture tax potential, but very few cases have addressed the issue.

In re Estate of Eriksen, 716 N.W.2d 105 (Neb. 2006), raised the question whether the decedent's tax payment provision directed against statutory equitable apportionment, which the court apparently thought would apportion the tax savings attributable to either special use valuation or any deduction (only the latter of which was expressly mentioned in the statute). *In re Estate of Nevius*, 2007 WL 4577908 (Kan. Ct. App.), remanded to the trial court to apply the Kansas version of the Uniform Estate Tax Apportionment Act and direct the tax saving to two sons who made the qualified use election and away from one daughter who refused to encumber her land with the special use election. The appellate court did, however, provide for an alternate holding if the trial court specifically found that the decedent intended for some other apportionment rule to apply.

In a state that has no apportionment statute, ***Centrue Bank v. Voga***, 2017 Il. App. 2d 160690, rejected the notion of apportioning the full tax benefit of a Section 2032A election to the qualified heir who received that property, saying that apportionment of the full tax saving to the qualified heir would contravene the decedent's pro rata tax payment provision. Curiously, however, the court thought that *rejection* of the claimed apportionment *was* equitable apportionment ("unless the instrument specifies otherwise, the federal estate tax will be equitably apportioned" – meaning prorated). However, the court did apportion the aggregate estate tax among the beneficiaries based on the federal estate tax value of the assets each beneficiary received, meaning that the qualified heir enjoyed the benefit of reduced valuation under Section 2032A in establishing a smaller share of the aggregate taxes owed. So the qualified heir benefited from the Section 2032A valuation reduction but did not capture the full tax saving spawned by that election. Without saying so, the net effect is something of a split-the-baby result.

A curious application of a theory similar to apportionment of the tax saved by virtue of a Section 2032A valuation reduction also was rejected by *In re Estate of Siebrasse*, 678 N.W.2d 822 (S.D. 2004), in which one child successfully challenged the valuation of property that passed to that one child, and claimed the benefit of the full tax reduction attributable to that success. The court rejected this child's claim to a greater share of the tax saving than the child's pro rata portion, based on the value of the entire estate. In essence the child's effort benefited the other estate beneficiaries pro rata. That is basically the same result as in *Centrue*.

The complexity of this issue is illustrated by California's apportionment provision, Cal. Prob. Code §20114, which expressly addresses these issues but also may produce inequities. As such, it may be instructive for drafters whose state law is silent or similarly problematic. The following example is drawn from Klug, The Effect of Special Valuation on Estate Tax Apportionment: A Plea for Uniform Legislation, 1 Prob. & Prop. 6 (Mar./Apr. 1987). He illustrates a reduction in tax due to Section 2032A of $97,500, but the qualified heir's pro rata share of the federal estate tax was only $76,500. Here the entire liability apportioned to the qualified heir would be offset by the apportioned benefit, and the excess $21,000 of tax benefit would be allocated to other estate beneficiaries (to avoid wasting it). If, however, a subsequent recapture event occurred, the qualified heir would be required to pay the full $97,500 of tax attributable thereto. Thus, the other takers would have shared in the benefit but would bear none of the recapture risk.

The full $97,500 of benefit might be allocated to the recipient of the qualified property if there was sufficient tax liability apportioned to that beneficiary (not all attributable to the qualified property) against which the benefit could be allocated, but this may not be the case. And allocation of the full benefit to all takers pro rata would be even more unfair (unless all takers were made responsible for the recapture tax, which would create administrative problem and reduce the incentive for the qualified heir to avoid a recapture event). Another alternative in administering the estate would be to make only a partial Section 2032A special use valuation election, to reduce the tax by only the amount of benefit that the qualified heir could enjoy, to avoid improper dispersion of the benefit. In any case, a side agreement might be executed whereby the other takers would agree to indemnify the recipient of the qualified property to the extent of the $21,000 excess tax liability.

Also problematic are the temporal interest rules. If the qualified property was placed into a trust and the life tenant was the party causing recapture, the corpus of the trust nevertheless would incur the tax in most cases, constituting another form of inequity. Illustrating that this is not universally true, see *Estate of Libeu*, 253 Cal. Rptr. 456 (Ct. App. 1988), in which both income and remainder beneficiaries were required to pay the tax. As these issues reveal, drafters working with Section 2032A must consider fashioning a result that is equitable and that reflects the decedent's intent, all in light of Section 2032A(c)(5) and any relevant state law. For example, with respect to temporal interests, the document might provide that any recapture tax will be imposed entirely on the income beneficiary if recapture was caused by a cessation of qualified use, but that the tax will be imposed in a manner that properly amortizes it against the income and remainder interests if recapture occurs because the land or business interest was sold.

Beneficiary Standing re: Trustee Removal. A continuing controversy under the Uniform Trust Code (UTC) is the extent to which a remainder beneficiary has standing to challenge trustee action or inaction – or even to obtain an accounting that would reveal how the trustee has performed – while the trust settlor is alive (and, in some states, competent). ***In re Abbott***, 890 N.W.2d 469 (Neb. 2017), hewed to the notion that "duties of the trustee are owed exclusively to the settlor" under UTC §603(a). Nevertheless, UTC §706 gives standing to a broader class to request removal of a trustee. "The settlor, a cotrustee, or a beneficiary may request the court to remove a trustee," and "beneficiary" includes any "person … [with] a present or future beneficial interest in the trust, vested or contingent." *See* UTC §103(3)(A). Consequently, the court was put on notice regarding trustee performance and then, on its own motion, the court determined that the trustee had "committed a serious breach of trust" and was removed, in that case for violation of the trustee's duty of impartiality.

Abbott involved a revocable inter vivos trust, while the settlor was still alive. In a seemingly similar case, ***In re Trelew Trust***, 2017 WL 1337487 (Mich. Ct. App.), involved trustee removal and replacement in an irrevocable trust, after the settlor's death, but it similarly addressed the question of which beneficiaries were authorized to remove and replace the trustee. An express provision in the Trelew Trust authorized "the then beneficiaries of this trust, acting by majority vote" to participate in the removal and replacement of the trustee. The controversy centered on the meaning of "then" beneficiary. The assertion made by a vested remainder beneficiary relied on the definition of "beneficiary" under the UTC, essentially the same as *Abbott* held under UTC §103(3)(A). The court rejected the notion that vested and contingent beneficiaries all were included, saying that the trust's reference to a "then" beneficiary meant something different than every vested or contingent beneficiary, because otherwise "then" would be superfluous, adding nothing to the reference to "beneficiary." In drafting such a provision, might a trust better replace "then" with "current" (which is the conclusion that the court reached) or even "income" to refer to those beneficiaries bestowed with the removal and replacement power?

Trustee Removal via Amendment. UTC §706(b) permits trustee removal under specified circumstances, such as (1) commission of a "serious breach of trust," (2) "lack of cooperation among cotrustees," (3) "unfitness, unwillingness, or persistent failure" to perform, or (4) "a substantial change of circumstances or removal is requested by all of the qualified beneficiaries," but only if a court "finds that removal of the trustee best serves the interests of all of the beneficiaries and is not inconsistent with a material purpose of the trust." Apparently because they thought it was not possible to make the case under §706(b), the beneficiaries instead sought approval of a petition to modify the trust under UTC §411 to add a power to remove and replace the trustee. In ***Trust Under Agreement of Taylor***, 124 A.3d 334 (Pa. Super. Ct. 2015), *rev'd*, 164 A.3d 1147 (Pa. 2017), the Superior Court granted the petition by just three of the four beneficiaries under the state law iteration of UTC §411(e)(1), which provides that

> If not all of the beneficiaries consent to a proposed modification … of the trust under (a) [requiring consent of *all* the beneficiaries] …, the modification … may be approved by the court if the court is satisfied that (1) if all the beneficiaries had consented, the trust could have been modified …, and (2) the interests of a beneficiary who does not consent will be adequately protected.

In essence, then, the beneficiaries accomplished an end-run around the constraints of §706(b), presumably because they could not satisfy any of its four provisions, *and* they did not have unanimous consent.

As reported in ¶906.1 of the 2017 State Law Developments material, a dissent to the lower court's opinion was correct in viewing the lower court's approval of this approach as eviscerating the trustee removal provision in §706(b)(4), permitting trustee removal only when all of the beneficiaries consent. That dissent carried the day on appeal, the high court in Pennsylvania reversing on the ground that the §706 removal provision is the "exclusive provision on removal of trustees" and that the §411 general modification provision cannot be reconciled as an alternative to the more specific provision that establishes more severe requirements for removal and replacement of trustees. "[S]tatutory sections are not to be construed in such a way that one section operates to nullify, exclude or cancel another …."

Note that Restatement (Third) of Trusts §65 would allow the beneficiaries to use trust modification to remove a trustee if doing so would not be inconsistent with a material purpose of the trust, but UTC §411 is not that broad. Which reveals the important lesson that the UTC and the Restatement were drafted to be consistent with each other in many respects, but there are differences between them and, in the end, statutory provisions trump anything that the Restatement represents to be the preferred approach.

Punctuation Matters. Drafting wills and trusts is hard, and it takes time to get it right. Sometimes even the punctuation – the existence or omission of a comma – can make the difference. Rush jobs, and tailored alterations to standard forms, are the most likely source of error, and increase the need for interpretation.

Drafting legislation is the same, and probably entails more thought and time, review and more inspection by many more observers and critics. Which makes a legislative defect more surprising than a mistake in a provision cobbled together for a single client. The error that spawned litigation in ***Price v. Lotlikar***, 397 P.3d 54 (Or. Ct. App. 2017), was in a provision modeled after a definition now found in UPC §1-201(23):

> (23) "Interested person" includes heirs, devisees, children, spouses, creditors, beneficiaries, and any others having a property right in or claim against a trust estate or the estate of a decedent ….

There were actually two issues in *Price*, one of which the latest version of the UPC resolved. Notice the difference between the UPC above, and the corresponding Oregon law:

> 111.005(19) "Interested person" includes heirs, devisees, children, spouses, creditors and any others having a property right or claim against the estate of a decedent….

Wording has been added to the current version of the UPC ("beneficiaries" and "a trust estate or"), but also the comma before the phrase (which is common to both provisions) "and any others having a property right or claim." One question is whether "creditors and any others" is meant to be one class of persons with an interest. The UPC now makes it clear that these are different classes – creditors being distinct from "any others." This was resolved by addition of the comma after creditors. But still unclear is whether all those distinct classes of persons – heirs and beneficiaries and children and spouses and creditors – all must have a property right or claim, or only the "others" who are listed last. For example, is an "heir" an interested person even if that person has no property right or claim against the estate?

How could the question arise, that an heir would not have a property right or a claim against an estate? After all, if a decedent died intestate (including if the decedent's will is invalid), then the heirs who would take under state law certainly have an interest in the estate. Imagine that there is no challenge to the validity of the decedent's will, and that beneficiary A is entitled to the entire estate. Decedent's surviving sibling (S) is the decedent's closest surviving relative, making S the decedent's heir at law. Executor B is accused of defrauding the estate, and S petitions the probate court to adjudicate B's improprieties. If A is not aware, or is not interested in pursuing the question, may S litigate the question as an interested person? As put by the *Price* court, is an heir an "interested person" just by virtue of being an heir, or must that heir also have a property right or claim against the estate of the decedent?

The UPC definition provision contains an added sentence that refines the definition of "interested person" by saying that "[t]he meaning as it relates to particular persons may vary from time to time and must be determined according to the particular purposes of, and matter involved in, any proceeding." Does that resolve the question – if, for example, a successful challenge to B's administration has no financial consequence to S? *Price* holds that S is not an interested person for this purpose.

Because this is not a question that often arises, the real learning from *Price* is what it says about the challenge of drafting clear and unambiguous provisions. How might these provisions be crafted to avoid the question? One alternative would be to eliminate the illustrations of interested persons ("heirs, devisees, children, spouses, creditors, beneficiaries") and just refer to "any person with a property right in or claim against a trust estate or the estate of a decedent." Sometimes examples or lists confuse rather than clarify an issue. Another approach would be to reorder the provision to refer to persons with a property right or claim, adding "*such as*" or "*may include*" an heir, devisee, child, spouse (and so on).

A third alternative is noted by the *Price* court, discussing "the doctrine of the last antecedent" that normally provides that "qualifying words and phrases" refer "solely to the last antecedent" – the last word, phrase, or clause that can be made an antecedent. Here that would be "any others." The way to show that a qualifying phrase ("having a property interest or claim") is meant to apply to all the antecedents rather than just to the immediately preceding one is to add a comma before the phrase in question. So, the suggestion is that adding a comma after "person" and before "having" would suffice. The problem with this last suggestion is that there is a common exception to the doctrine of the last antecedent if the qualifying phrase is every bit as applicable to every prior antecedent as it is to the last antecedent, in which case the qualifying clause must be read as applicable to all the prior words and not just to the last antecedent. Meaning that the doctrine is not terribly useful.

The point here is not how (or whether) to redraft the UPC (or Oregon law) but, rather, to highlight how the drafting chore can be complicated by addition of illustrations, and even by the placement of the punctuation. Drafting is hard, it requires substantial thought, including about how a provision might be read by someone other than the drafter. Knowing arcane rules of grammar and construction may help, but there are rules and exceptions too voluminous to apply or rely upon (or even to recall).

What Does "Per Stirpes" Mean? This development presents an object lesson about drafting documents that employ legal terms that have been staples of wealth transferors for centuries. The intended disposition couldn't be more basic: (quoting from the trusts involved) "to grantor's issue then living, per stirpes." A slightly different (better?) form might be "to testator/settlor's then living descendants, by right of representation," with a definition (probably in the boilerplate provisions later in the document) of what "right of representation" means.

The controversy in ***Schwerin v. Bessemer Trust Co.***, 2017 WL 1017792 (Conn. Super.

Ct.), arose because this distribution occurred after the death of all members of a group of individuals. In one of the two trusts involved this group included the settlor, the settlor's surviving spouse, the settlor's children, and several grandchildren who were alive when the trust was drafted. The other trust was created by the settlor's mother, so the group was similar but defined differently to reflect the generational differences. The point is that, when distribution would occur, the first living taker would be several generations younger than the settlor.

The losing plaintiffs argued that the intent was to make the division among bloodlines "equally among the members of the oldest generation that could possibly take a gift." For example, equal shares would be created for the living grandchildren and their predeceased siblings who left living descendants. This would mean that, if one child had three children and another child had only one, then four shares would be created and this would direct 75% of the wealth to the three children of the one child. As thus used, "per stirpes" would mean that the "stirpes" or shares should be determined at the grandchild level – the level at which the first division would be made would be the first level at which any taker was alive. This is not the traditional definition of per stirpes, and it did not prevail in *Schwerin*. Instead, the court held that the first division occurs at the first level below the individual whose descendants are taking. In the illustration that meant the settlor's two children, regardless of whether either child was living at that time. The fact in *Schwerin* that no child could be alive did not alter this traditional application of the common law definition of taking by the stirpes. Two shares would be created, one passing to the three children of the first child (or their descendants) and all of the other passing to the bloodline descendants of the sole child of the other child.

Some state laws – those derived from the Uniform Probate Code, in particular – alter "the right of representation" to make the first division at the first level at which a beneficiary is alive, as argued by the plaintiffs. But the term "per stirpes" is not typically used to describe that form of representation. Instead, "per capita" or "per capita at each generation" generally is used to describe the two different alternatives found (in the original 1969 version of the UPC and the 1990 revision, respectively). The *Schwerin* court held that state law followed the traditional common law, which is what most drafters likely would intend when using the quoted language from these trusts.

The question is: how might a drafter more clearly articulate a settlor's intent to avoid litigation such as that resolved in *Schwerin*? Here the answer might have been to divide and distribute in equal shares among the living children of the settlor (knowing that there would be none when distribution would occur) and deceased children of whom descendants were then living. That would make clear that the bloodline division would be based on equal shares determined at the first generation below the settlor, even though none of the children would then be alive. Drafting in that manner would be less succinct, but it might have avoided this controversy. Because such a traditional concept as "per stirpes" can be subject to several arguable interpretations, perhaps adding a few extra words is a reasonable compromise when drafting documents to minimize the risk of misinterpretation.

Contrast this with ***In re Dooley Trust***, 383 P.3d 773 (Okla. 2016). The settlor created marital and nonmarital trusts. The nonmarital trust made modest bequests to three grandchildren and then distributed the residue of that trust outright to two other grandchildren (A and B), in equal shares. The marital trust (which appears to be a QTIP) benefitted the settlor's surviving spouse (S) for life, remainder to A and B "per stirpes." There was no condition of survivorship and, because this remainder was a future interest, state law also did not imply a survivorship condition. Did the settlor use the term "per stirpes" to accomplish the goal of requiring A and B to be alive to take?

The Dooley family was unlucky, in terms of longevity. The settlor survived all four of the settlor's children. A, B, and S all survived the settlor, but A and B each predeceased S and each died without descendants. So the question raised was who will take the remainder of the settlor's marital deduction trust when S ultimately dies. B's surviving spouse claimed the entire marital trust remainder because A named B as sole beneficiary of A's estate, and B named B's spouse as beneficiary of B's estate. If the shares of A and B vested when the settlor died, because survivorship was neither explicitly nor implicitly required, then B's surviving spouse would be entitled. On the other hand, if the words "per stirpes" meant that A and B did not have vested interests (and because A and B died without descendants), then the remainder of the marital trust was the settlor's intestate property, in which case it ought to pass in part to S (depending on state law, probably one-third to S as the settlor's the surviving spouse) and the balance to other heirs of the settlor (probably the five grandchildren named in the opinion – A and B and three who took modest outright bequests when the settlor died).

The dissent correctly notes that the court botched the end result because, as the settlor's intestate property, they declared that it will pass entirely to S (as beneficiary of the marital trust income – for whatever reason that makes sense). If that were correct, then S's life estate and the remainder would merge to create a fee simple, and the trust would terminate, which clearly was not the settlor's intent in this QTIP trust. The most important lesson to be learned from *Dooley* is that "per stirpes" is overused and underappreciated – drafters appear not to understand its true meaning. The opinion does not indicate who drafted the settlor's estate plan. Signed on the same date that the settlor married S, after 13 years of living together, the settlor died just over one month later, suggesting that this was end-of-life planning, perhaps without legal advice. Perhaps the settlor obtained the trust (off the internet?) and engaged in self-help. Long term, the message told by *Dooley* is that the only growth area in the estate preservation or planning corner of the law is litigation, such as this to interpret or construe badly drafted documents.

What Does "Contents" Mean? ***Bogar v. Baker***, 2017 WL 4220083 (Ohio Ct. App.), concluded that "contents of said real estate" is ambiguous in the context of a gift of 31 acres of real estate used as a farm that included a house and out building. The parties litigated whether the devisee of the farm was entitled to vehicles and farm equipment located at that property and used in the farm operation. Like a gift of a dwelling with all personal property located in that home, the question is whether assets unrelated to the devise (such as intangibles, including stocks, bonds, or certificates of deposit) are meant to be included simply because they were found within the dwelling. The court in *Bogar* remanded for a determination based on extrinsic evidence to resolve what it regarded as the latent ambiguity whether these valuable implements were meant to be included in the devise of the farm itself. Does "contents" typically mean furniture, cutlery, cooking and cleaning tools, shop equipment, and the like? Or can it include vehicles and expensive specialty implements used in operating the farm? Would it matter if the devisee was the person to whom the decedent leased the property and who was acting as tenant farmer, or the one of several family members who was instrumental in operating the farm? The critical issue in many states is whether evidence of such connections is admissible, or must the document be interpreted based on a "four corners" analysis of the language of the will, without evidence outside the document? These kinds of controversies arise when drafters use stock language without considering the special circumstances of the particular client's situation.

Right to Occupy Versus Life Estate. This topic was addressed in ¶913.2 of last year's materials and deals with an issue that appears to be of new interest, relating to the difference between granting a beneficiary a life estate or a mere right to occupy property. *Cluett v. Gregg*, 2016 WL 5415408 (Conn. Super. Ct.), addressed that difference in the context of a child who was granted possession of a dwelling that was larger than he needed, but was denied the right to sublet a portion of it to generate monies that he needed to pay expenses that the document imposed on him.

Quezada v. Ramirez, 2017 WL 2609539 (Cal. Ct. App.), involved a trust that owned a dwelling and that terminated at the settlor's death. Distribution was to three children in equal shares, subject to the right of one of those children to occupy the dwelling for up to 50 years. The court held that the three children became undivided equal tenants in common, subject to the right to occupy in the one child. Specifically the court held that the right of occupancy was not the same as a life estate, that no merger of the two interests in the one child occurred, and that existence of the right to occupy was not inconsistent with the equal tenancy in common interests of the three children.

In re Testamentary Trust u/w/o Northcraft, 2017 WL 943248 (Penn. Super. Ct.), involved a successive right to occupy granted to the decedent's children and then grandchildren, prioritized by their respective ages. Upon the death or disclaimer of the youngest of them the remainder passed to great-grandchildren. The case arose because all the parties agreed to terminate the trust, the court ruling that none of them had any property interest or right to convey anything. Theirs was a "right to reside," not a life estate. The court thus rejected a child's claim to the remainder and to reimbursement for expenses incurred to maintain the property. In another setting such a ruling might be favorable if the parties wished to establish that their action terminating the trust was not a taxable transfer for state or federal income or wealth transfer tax purposes.

Various legal issues may turn on whether a life estate or a right to occupy is bestowed. For example, a life estate granted to a surviving spouse could qualify for the estate tax marital deduction as a qualified terminable interest property, but a mere right to occupy might flunk the QTIP all-income annually requirement. A state law principal-and-income statute may allocate expenses between a life estate and remainder, but may not apply to a mere right to occupy. Exclusivity of possession and what is meant to occur if the beneficiary ceases to occupy the property – and for what period of time – also may need to be addressed in a document creating a right to occupy.

Other issues may be determined by state or local law, such as whether any property tax benefit is available for a life tenant but not a beneficiary with a mere right of occupancy. Examples might be homestead, or exemptions for elderly owners, or even provisions that freeze property tax reassessments until title is transferred. In addition, it might be that a life estate is an exempt asset for Medicaid qualification but a right of occupancy is not (or there may be no law on the question, and it could be vice-versa under the standards applied in a particular jurisdiction). Finally, an ownership interest is required to qualify for §121 nonrecognition of gain on sale of a principal personal residence, but in the alternative a right to occupy does not appear to be an interest that constitutes or carries out income to a beneficiary for Subchapter J income tax purposes.

Exercise of Swap Power in IDGT. A common approach to making an irrevocable inter vivos trust "defective" for income tax grantor trust purposes is for the settlor to retain a Section 675(4)(C) "power to reacquire the trust corpus by substituting other property of equivalent value" (commonly known as a swap power). Occasionally an exchange is made to permit highly appreciated property inside the trust to be included in the settlor's gross estate at death, to garner new basis under Section 1014 and wipe out the appreciation for income tax purposes. No matter that the appreciation is includible for estate tax purposes, because an equivalent amount of other property is removed from the settlor's gross estate in the swap. Because the trust is a grantor trust, no gain or loss realization occurs on the exchange. So, what could possibly go wrong?

Schinazi v. Eden, 792 S.E.2d 94 (Ga. Ct. App. 2016), illustrates one answer to the question. The defendant was the plaintiff's wife when the trust was created, with herself as trustee for the benefit of their daughter. He was a research doctor at a major research university who invented a number of patented antiviral drugs, and the trust corpus was a limited partnership interest that apparently owned intellectual property rights in drugs that the settlor invented. The settlor assigned his limited partnership interest to the trust in exchange for a note from the trust for $7 million. Over six years later the settlor sought to exercise his exchange power to reacquire the partnership interest in exchange for a note for over $58 million (the trust having performed as intended, to receive and shelter the significant appreciation in the value of the partnership interest). The problem was, the trustee now was the settlor's *former* spouse and she objected to the exchange on the ground that the new note was not an asset of equivalent value. "Some evidence indicates that the value of the partnership interest increased just days after the tender …." In addition, "[a]lthough [the settlor] had the right to reacquire the interest, he failed to follow the necessary steps to complete the acquisition" under the terms of the limited partnership agreement. In the game of tax minimization, fiduciary duty, formalities for effective transfers, and vituperation will crush tax planning every time!

B. Litigation

Insurance Churning Was Elder Abuse. The significance of ***Mahan v. Chan Insurance Agency, Inc.***, 2017 WL 3614276 (Cal. Ct. App.), vacating 218 Cal. Rptr. 3d 808 (Cal. Ct. App. 2017), is in finding that a state's elder abuse statute can apply to a claim of financial abuse that involved assets held by a third-party trustee of a revocable insurance trust.

The gist of the complaint in *Mahan* is sufficiently common that the court quoted Elder Law expert, Larry Frolik, as follows:

> Many older policyholders have years-old whole-life policies that have accumulated a sizable cash surrender value. An insurance agent encourages them to trade in these policies and buy new ones that pay higher death benefits. This practice, known as churning, earns the agent a large sales commission while substantially increasing the policyholder's premium cost.

The plaintiffs are Fred and Martha. At the time of the alleged acts he was an 82-year-old attorney "suffering from confusion and cognitive decline" and she was a 75-year-old with Alzheimer's. The defendants allegedly persuaded them to use the cash value in two survivor-life permanent policies with an aggregate annual premium cost of $14,000 and aggregate death benefits of approximately $1 million, to purchase a single nine-year term policy on Fred's life, providing $1.17 million of death benefits, at an initial cost of the $250,000 cash value in the existing policies and over $100,000 in annual premiums, generating $100,000 of commissions to the defendants. If he lives that long, the policy will lapse at Fred's age 91, with no residual value. At this stage of the litigation those alleged facts were taken as true, and the defendants did not refute them.

Instead, their defense is that the plaintiffs have no standing. Because the policies that were replaced were owned by the trust, which was created and trusteed "for estate planning purposes" by the plaintiffs' daughter, who the court regards as a willing but ignorant pawn who totally relied upon her father's guidance. According to the opinion this daughter was "cut out of the loop" and signed documents that often were presented in blank. Instead of arguing (at this phase of the case) that they didn't do it, or that it wasn't wrongful, or that there were no damages, the defense argued (successfully at the trial level) that there was no compensable wrong to the plaintiffs. Although they financed these purchases (and had to dip into their other assets to pay the significantly increased premiums), the policies were not owned by the plaintiffs and the premiums were their "voluntary contribution to the trust," not to the defendants.

Why would the plaintiffs undertake such a transaction (erroneously billed as a Section 1035 income-tax-free exchange, which did not qualify because of the differences in insured lives), other than because they were duped? Their primary complaint is based on the California Elder Abuse Act and, given the dramatic financial realities involved, perhaps the only surprise is that the trial court agreed with the defendants. The appellate court's reversal on this appeal is what anyone would expect, and only the logic applied is questionable. Which is why *Mahan* may prove to be significant. If allowed to stand, it establishes that the transfer of funds to the trust at the behest of the defendants' scheme satisfies the Act's requirement of a deprivation of property rights carried out "by means of an agreement, donative transfer, or testamentary bequest" that is actionable as elder financial abuse. "The [defendants] deprived the Mahans of property indirectly, using the Trust as an instrument of their scheme." If the case does not settle, surely the defendants will offer more of a defense, such as alleging that the daughter should have been more attentive as trustee, or that caveat emptor should apply, or even that there were legitimate reasons for the exchange of policies. None of that was addressed or resolved at this initial stage of the litigation.

Incidents of Ownership. ***Lee v. Rogers Agency***, 517 S.W.3d 137 (Tex. Ct. App. 2017), is not a tax case, but it addresses an issue flowing from an assignment of life insurance policies to an irrevocable life insurance trust (ILIT) and a question typically regarded as significant under Section 2042. The issue arose in the plaintiff's action to recover damages suffered due to alleged misrepresentations made by the defendants in the sale of life insurance policies. That action was brought under the Texas Deceptive Trade Practices Act and the Texas Insurance Code (these were the "extra-contractual" claims, meaning causes of action not derived from the insurance policy/contracts themselves). The court's holding potentially *could* be useful to taxpayers in a tax case, but might not be regarded as precedential in any federal court in any tax-related controversy. Nevertheless, the court's analysis is a useful reminder of several state law principles of traditional trust law.

The court's holding regarding life insurance "incidents of ownership" is an amalgam of decisions from several United States Courts of Appeal and states that "incidents of ownership" in life insurance policies only include powers to control the proceeds or income from life insurance policies, or the policies themselves. The issue was relevant because the insurance policies at the heart of the dispute were transferred by the plaintiff to the ILIT, and the question was whether the plaintiff's assignment of those policies carried the plaintiff's extra-contractual causes of action to the trustee. This was important because the trustee had been a party in a class action against the insurer for the same practices that supported the plaintiff's causes of action. If the plaintiff had assigned those rights when the ILIT was formed, then the suit was foreclosed by a resolution in that class action. The court found, however, that the plaintiff only intended to relinquish any incidents of ownership over the insurance contracts that might cause Section 2042 inclusion in the plaintiff's estate for estate tax purposes, and that the plaintiff's extra-contractual causes of action were not incidents of ownership, meaning that the plaintiff still owned them and was not barred by resolution of the class action.

The court made a surprising statement regarding incidents of ownership in its footnote 11, that "[i]nasmuch as the Trustee paid nothing for the policies, he suffered no loss by their cancellation. … Only [the plaintiff] suffered any loss in this case." If cancellation of the underlying policies was not a loss to the ILIT as owner of the policies, then what is the measure of the loss to the plaintiff who was settlor of the trust? Having paid a single premium of almost $240,000 for three $1 million face value life insurance policies, does the footnote mean that the only loss is the premiums paid and not the promised, contractual payout on maturation of the coverage? Is restitution of the premiums paid the only recovery that the plaintiff can expect? One might think that the proper recovery would put the trust back into the position it would have occupied had the defendant's actions not been wrongful. Perhaps that was foreclosed by the class action, so the plaintiff's only injury is having been duped by the defendant's misrepresentations. The court appears to say that the economic recovery for that injury is return of the premiums paid. And, most importantly, recovery of the premiums is not an incident of ownership. That holding is consistent with tax authority that the right to control policy dividends is not an incident of ownership. This is sensible because payment of premiums is not itself a factor for Section 2042 inclusion. The court correctly holds that the right to recover the premiums paid is not an incident of ownership.

Another element in the case is noteworthy. The trustee was a member of the class because the trustee received notice of the class action and did not opt out. As such, resolution of the class action was res judicata for the trust. The defendants alleged that this foreclosure of the trust also foreclosed the settlor, which the court rejected saying that "for a non-party [to the class action] to be bound under … the res judicata defense … the defendant must establish that there was a prior or ongoing 'substantive legal relationship' between the non-party and a party to the previous litigation." Holding that there was none in this case, the court stressed that a trust settlor and the trustee are not in privity with each other. After the settlor has parted with ownership the trustee's duties run exclusively to the beneficiaries, not to the settlor. Nor does the settlor have standing to enforce the trust.

There have been calls to modify this traditional standing rule – particularly in the context of enforcement of charitable trusts – but *Lee* illustrates that there would be unexpected consequences of such a change. Here, for example, if the settlor had an ongoing relationship with the trust, then res judicata might have precluded the settlor's independent action for those losses that are compensable under the extra-contractual causes of action.

The court properly recognized that, had the settlor been foreclosed from suing the defendants – for example, because of a class action of which the settlor was a class member – that preclusion of the predecessor owner would bind the trustee as a successor owner, taking all of the settlor's rights, title, and interest in the insurance policies transferred to the trust. But foreclosure does not work in reverse. Res judicata of the successor owner (the trust) does not preclude the predecessor owner from pursuing its own causes of action.

A final potentially significant element of the case is that the settlor's extra-contractual rights under state law were nonassignable, meaning that there could be no finding that the settlor's transfer of the policies also was a transfer of the settlor's extra-contractual rights. It is possible that a different result could apply under different state law in other jurisdictions.

Compensation for Caregivers' Services? Intestacy, the elective share, contracts to make (or not revoke) a will, and pre- or post-marital agreements are traditional ways that caregivers seek compensation for their services. Historically cases seeking a rightful share of a disabled or infirm decedent's estate involved a decedent who was the title holder of the family's wealth and a surviving spouse who was dependent financially on the decedent. If married, there were several mechanisms to provide for a disappointed surviving spouse, including a will contest to defeat a parsimonious will (causing an intestacy) or the surviving spouse could reject the will in favor of the elective share. In less common situations it might be possible to establish a marital agreement that the decedent breached.

Changes in the nuclear family, care giving by faux-family or just friends, and nontraditional relationships all challenge these traditions. In the elder care arena in particular, there has been a significant increase in financial abuse of the elderly, often by caregivers. And there are more claims that a decedent made a "contract to make a will" to entice someone to provide care for life in exchange for "being taken care of" when the decedent died. These cases often end in litigation by the disappointed caregiver who feels inadequately compensated.

Reported in ¶903.3 of last year's materials, ***Gilbert v. Hoover***, 487 S.W.3d 898 (Ky. Ct. App. 2016), involved an unmarried "live-in companion" of the decedent who filed a creditor's claim for over $400,000 for "services rendered" over a 66 month period ending in the decedent's death. Although there was no documented agreement, the claim was that there was "an implied contract for compensation." The court rejected that claim, based on a presumption that care provided by family members are meant to be gratuitous. That result reflected an unfortunate Catch-22 for Gilbert, who was not a family member. The court noted that the gratuitous-service presumption applies to care provided by family members, and it acknowledged that Gilbert was neither a blood relative nor married to the decedent. But the court also concluded that "the record plainly demonstrates that Gilbert and the decedent] enjoyed a familial relationship," justifying the court in applying the presumption. That put Gilbert in a no-win position.

Estate of Henry v. Woods, 77 N.E.3d 1200 (Ind. Ct. App. 2017), involved very similar facts. The caregiver eventually moved in with the decedent, they socialized as would a married couple, and she was disappointed by the decedent's failure to provide for her as he promised. Again the decedent's heirs relied on the presumption of gratuity, arguing that the decedent and the claimant "operated as a family" and, although never married, they "lived together in a family relationship." Nevertheless, the court honored a claim for compensation, basing its judgment on either an implied contract or an action for quantum meruit based on unjust enrichment (the opinion does not make clear which theory was controlling). But the award was only roughly one-third of the amount claimed.

In re Estate of Proffitt, 2017 WL 2211088 (Kan. Ct. App.), differs in that the decedent was married and the surviving spouse was entitled to an intestate share of half. Instead she asserted breach of a contract to make an "I-love-you" will, providing 100% of the decedent's estate to the surviving spouse, subject to an agreement that the survivor would leave everything either spouse owned in equal shares to the decedent's two children and the survivor's two children. Presented with nearly unrefuted evidence of the agreement (including testimony of an estate planning attorney that the decedent sought to effect that plan but died before it could be drafted), the court relied on constructive fraud to find for the survivor. That approach was needed to avoid application of the state nonclaim statute, and its foundation was the existence of a confidential relation, flowing from the fact of marriage, and that the survivor had commingled her assets with those of the decedent. The constructive fraud was the decedent's failure to honor the spouses' agreement.

The result in *Proffitt* is an extreme example of a court finding a way to circumvent all manner of rules to achieve what it regarded as an equitable result. Not long ago this result would have been an unthinkable end run on the rigid law of Wills, and legions of cases have denied relief in similar circumstances. Especially intriguing is the *Proffitt* court's award of only a life estate to the survivor, with a remainder as anticipated by the spouses in favor of the four children of the two spouses. Instead of causing the decedent's estate to be held in trust, with the same life estate and remainder, the court carried out the terms of the spouses' agreement. The opinion acknowledged that the estate planner to whom the decedent turned, too late, encouraged the use of a trust, which would preclude the survivor from disposing of the spouses' property in a different manner than the spouses agreed (leaving the decedent's intended beneficiaries with only their own cause of action to enforce the spouses' agreement). In addition, the court's order allows the survivor to invest and consume the decedent's property with virtually none of the guidance or constraints that would apply to a trust that would protect the remainder beneficiaries.

Financial Abuse of the Elderly. Reported in ¶911.1 of last year's materials were cases dealing with a widespread controversy that implicates the principle reflected in UTC §603 that a revocable inter vivos trust is the functional equivalent of a will. As such, while the settlor is alive, all rights of beneficiaries other than the settlor are subject to the settlor's control, and the trustee's duties run exclusively to the settlor. This informs the suspended application of the trustee's §813 duty to inform and report to beneficiaries, which does not apply while the settlor is alive. The net result of this principle is that remainder beneficiaries – following the settlor's retained enjoyment – have no standing to litigate perceived abuses by a trustee before the settlor's death, on the ground that only the settlor has a cause of action for anything that occurs during the settlor's life.

The right to demand accountings belongs to a settlor's executor (guardian or conservator, if one is appointed) if the settlor becomes incompetent prior to death. That remedy fails in two respects. One is because the same person whose performance is in question as trustee also may be that executor. The other is that often one purpose of a funded inter vivos trust is to avoid the need for a court appointed executor for the settlor.

Some courts allow remainder beneficiaries to obtain an accounting and to sue for any premortem breach of fiduciary duties, but only after the settlor's death. The problem with that approach is that financial abuse of the settlor was not prevented and, at that point, the fiduciary may be judgment proof, so no effective recovery is viable.

These issues are difficult because courts acknowledge that a settlor should have the same right to privacy regarding premortem transactions as would a testator, whose beneficiaries typically do not have standing to examine the testator's premortem financial activities. These issues are complicated by the reality that financial abuse of the elderly is omnipresent, whether the abuse is perpetrated by the holder of a durable power of attorney, a court-appointed executor, a trustee of a revocable inter vivos trust, or just someone who is able to flim-flam an elderly individual. Courts struggle to address these conflicts.

Into this fray stepped ***Hauser v. Hauser***, 796 S.E.2d 391 (N.C. Ct. App. 2017), in which one child sought to avert questionable transfers made by a second child, who was accused of undue influence over their parent, who was still alive and who had not been declared incompetent. One count of the action sounded in tort, as an intentional interference with an expected inheritance. Also involved was an effort to secure an accounting that might expose misfeasance by the second child as holder of a durable power of attorney. No indication is given why the plaintiff did not seek to declare their parent to be incompetent, nor whether state law gave third parties the right to challenge actions by the holder of a durable power. The court merely held that state law does not recognize the tort of intentional interference during the life of a testator, nor did it entitle a potential beneficiary of an estate to an accounting.

An inter vivos trust could grant the right to accountings to a third party (such as a remainder beneficiary, a trust protector, or a court-appointed executor). Many settlors likely abhor the notion of litigation brought during their lifetime, and believe that the holder of a durable power or a trustee will protect their interests rather than abuse their fiduciary position. Developments confirm that these are significant issues. Financial abuse of the elderly is rampant and often involves fiduciaries who misuse their authority. The UTC approach may need modification, and trust settlors may alter the rules that apply. As in most planning contexts, the challenge is designating fiduciaries (especially successor fiduciaries) and establishing and enforcing oversight that is effective but not too intrusive.

Recovery of a Bailment. The usual statute of limitation for making a claim against a decedent's estate entails notice to known or reasonably ascertainable creditors, triggering a nonclaim statute that typically limits the creditor's time for making a claim to something like 60 or 90 days. *See, e.g.*, UPC §3-801. ***Moulden v. Hundley***, 2017 WL 4848560 (Kan. Ct. App.), was different, in that the plaintiff claimed property from the estate pursuant to an alleged bailment, by which the decedent was found to be in possession of furniture that the plaintiff loaned to the decedent for personal use. Unlike two classic automobiles, the titles to which were transferred by the plaintiff to the decedent and therefore constituted completed gifts, the furniture was left with the decedent with the understanding that it would be returned to the plaintiff. As to this property the statute of limitation for an action of recovery was deemed to begin much later, after the decedent died, a constructive bailment arose with the decedent's surviving spouse, and then a demand for return was filed by the plaintiff against the surviving spouse. The spouse did not contest the plaintiff's ownership of the furniture, meaning that the bailment statute of limitation was applicable, and it didn't began years after the decedent's death when the plaintiff asked for return of the furniture, which the spouse refused.

Malpractice Liability Statute of Limitation. Given all that goes into the estate planning endeavor, it is only natural that mistakes occur, which raises questions regarding malpractice liability. One popular misconception is that this area of practice is so complex that certain mistakes are prima facie not actionable, because certain elements of the art are beyond mastery. This misconception is augmented by the community standard defense, which states that a mistake is not actionable if the planner performed no less competently than the average in the community in which that planner practices. The problem with that defense is the inability to define the proper "community" in which to measure the average or minimum competence of estate planners in general, particularly with respect to matters that are impacted by the federal tax laws.

The most commonly miscited example of the too-complex-to-be-liable notion is the exposure of the attorney who prepared the testamentary trust that violated the Rule Against Perpetuities in *Lucas v. Hamm*, 364 P.2d 685 (Cal. 1961). Involved was the so-called administrative infinality or administrative contingency rule (sometimes referred to as the "magic gravel pit" rule, which presumes that any act – such as extracting gravel from a quarry – could extend forever). The trust was distributable five years after administration of the settlor's estate terminated, which conceivably could occur after expiration of the permissible period of the Rule. The court held that failure to anticipate application of this special aspect of the Rule was not negligence, explaining that the trust actually would violate the Rule only if estate administration might not be completed within the period of lives in being plus 16 years, and that the likelihood of such a delay was so remote that an attorney exercising ordinary skill in the same circumstance might make the same mistake.

Contrary to many popular misconceptions and statements about the case, however, the court did *not* accept the attorney defendant's blanket assertion that the Rule Against Perpetuities is so difficult that any violation is excusable. Indeed, the appellate court specifically noted that general practitioners who are faced with a difficult aspect of a specialized subject such as this must seek the aid of an expert. That court's imposition of liability on the attorney *was* reversed, but the California Supreme Court did not agree with the argument that no perpetuities violation can be malpractice.

A more recent example is ***Security Bank & Trust Co. v. Larkin, Hoffman, Daly & Lindgren***, 897 N.W.2d 821 (Minn. Ct. App. 2017), in which the alleged malpractice was failure to consider application of the generation-skipping transfer (GST) tax to a bequest to an unrelated beneficiary who was more than 37.5 years younger than the decedent (making that beneficiary a skip person and exposing the plan to an unanticipated GST tax). Some might argue that the lack of a single case dealing with a substantive GST tax issue (as opposed to the chronological exemption) in the 40+ years since original enactment of the GST tax in 1976 is proof positive that few planners (or government officials) actually pay attention to the GST tax. In this case the estate paid over $1.6 million in GST tax, however, and the opinion suggests that there were planning options that could have avoided, deferred, or minimized that unexpected impost.

Far more interesting about both *Lucas* and *Security Bank* was each court's treatment of the attorney defendant's argument that the plaintiff lacked standing to sue because the plaintiff (the estate's executor) was not the client and therefore was not in privity of contract with the attorney defendant. Although there is abundant authority supporting a strict privity requirement, most of it is not current. Indeed, the only states in which relatively recent cases can be found that specifically respect the privity defense in an estate planning context were reported by Beglieter, First Let's Sue All the Lawyers – What Will We Get: Damages for Estate Planning Malpractice, 51 Hastings L.J. 325, 327 n.19 (2000), and a follow up in Beglieter, The Gambler Breaks Even: Legal Malpractice in Complicated Estate Planning Cases, 20 Ga. St. U.L. Rev. 277 (2003), as Maryland, Nebraska, New York, Ohio, Texas, and Virginia. Alabama has since joined the list. *See*, *e.g.*, *Robinson v. Benton*, 842 So. 2d 631 (Ala. 2002). Subsequent decisions in several of these states make the privity bar even less reliable than when Beglieter wrote about it. *See*, *e.g.*, *Thorsen v. Richmond Soc. for the Prevention of Cruelty to Animals*, 786 S.E.2d 453 (Va. 2016), holding that an intended third-party beneficiary of an attorney-client contract may sue the attorney for malpractice in will drafting; *Smith v. O'Donnell*, 288 S.W.3d 417 (Tex. 2009) (the executor of a decedent's estate may prosecute the same legal malpractice action that the decedent could have pursued if still living); *Schneider v. Finmann*, 933 N.E.2d 718 (N.Y. 2010) (similar). *See also McDonald v. Pettus*, 988 S.W.2d 9 (Ark. 1999), and *Nevin v. Union Trust Co.*, 726 A.2d 694 (Me. 1999) (denying beneficiary actions against drafting attorneys on privity grounds, but only because the decedents' executors could assert the causes of action instead). This modern result favors a disappointed beneficiary's tort or contract action to redress an attorney's estate planning mistakes. Today the privity defense is a minority rule in the estate planning context, with cases following the modern trend in estate planning situations in several dozen states. *See* Annot., What constitutes negligence sufficient to render attorney liable to person other than immediate client, 61 A.L.R.4th 464.

Because a decedent's estate often is unaffected by an attorney's negligence (for example, unless additional taxes or administration expenses are incurred, the estate may be unreduced by a mistake that alters the relative interests of the estate's beneficiaries), the executor of the estate (or the trustee of a negligently drafted trust) may not have standing to sue to recover damages suffered by intended beneficiaries. That obviously was not the source of the defendant's argument in *Security Bank*, in which the estate incurred significant GST tax. Instead, the defendant's notion was that local law only gives an executor standing to pursue a cause of action owned at death by the deceased client, under a survival regime, and that this cause of action arose too late to constitute the decedent's cause of action.

Part and parcel of the defense in *Security Bank* is a daunting aspect of malpractice exposure for estate planners in general: when does the statute of limitation begin to run? This is a function of when the cause of action arises, and then when it must be brought. One alternative is to say that the action arose on the date of "occurrence," meaning at the time of the negligent representation. Another is a "damage" rule, which doesn't start the statute to run until some damage has occurred as a result of the alleged malpractice. Many states follow a "discovery" rule, meaning that the statute does not begin to run until the plaintiff should have discovered the error, which in many cases is not until the estate planning client died, or even later. *See* Annot., When statute of limitations begins to run on action against attorney for malpractice based upon negligence – view that statute begins to run from time client discovers, or should have discovered, negligent act or omission – application of rule to property, estate, corporate, and document cases, 15 A.L.R.6th 427. In a few jurisdictions the statute of limitation is said to begin running when the attorney ceases to represent the client. In estate planning, this frequently produces the same result because the representation ends only when the client dies. Of some concern in this respect, *Hale v. Groce*, 730 P.2d 576 (Ore. Ct. App. 1986), held that the defendant attorney's participation in a reformation proceeding to correct the attorney's drafting error served as an estoppel to a statute of limitation defense to a subsequent malpractice case. And, contrary to the common assertion that some issues are not worth worrying about because they arise (if at all) long after the estate planner has died (*e.g.*, many GST tax mistakes), it has been held that a claim for malpractice may survive the planner's death, with liability of the planner's firm. *See, e.g., McStowe v. Borenstein*, 388 N.E.2d 674 (Mass. 1979).

Security Bank applied the damage rule and held that the cause of action arose when the client executed the estate planning documents because it was then that the client's estate "failed to protect against liability" from the GST tax "and became less valuable because of that liability." This meant that the statute began to run earlier than under other alternatives, which was favorable to the plaintiff because it meant that, under the Minnesota survival statute, the cause of action existed prior to the client's death and therefore the executor owned it, giving it standing that otherwise might not have existed.

Other avenues might be more attractive to plaintiffs in other circumstances. For example, ***Rigoni v. Westrate***, 2017 WL 4700041 (Mich. Ct. App.), also applied a date of execution rule for the beginning of a statute of limitation on a claim for malpractice in estate planning, with the result that Rigoni's claim was time-barred. The interesting aspect of that holding was a discussion of the plaintiff's "ongoing representation" claim that would have extended the statute, with the court stating that "a distinction must be made between actions taken by counsel as part of an ongoing attorney-client representation … and whether [any] new action occurs pursuant to a current, as opposed to a former, attorney-client relationship." In that case the execution of documents was deemed to terminate the former relationship, and an inquiry a decade later was not adequate to extend the accrual date for legal malpractice claims. The court rejected the plaintiff's argument that "any action taken by an attorney that relates to a matter resolved through earlier representation would either resurrect the past attorney-client relationship, or establish the existence of an ongoing relationship." That holding is favorable in terms of limiting the duration of any malpractice claim from the previously-completed representation. However, it raises an issue whether a renewed representation requires a new conflict of interest waiver, a new representation agreement, and so forth.

Privity Defense Remains Relevant. A decedent's estate often is unaffected by an advisor's negligence. For example, unless additional taxes or administration expenses are incurred, the estate may be unreduced by a mistake that alters the relative interests of the estate's beneficiaries. As a result, the executor of the estate (or the trustee of a negligently drafted trust) may have no standing to sue to recover damages suffered by intended beneficiaries.

Beginning with *Biakanja v. Irving*, 320 P.2d 16 (Cal. 1958), the majority of states today reject the privity defense to a malpractice claim in a negligent will drafting situation. Instead, states apply an exception to the privity defense in the estate planning context as a matter of public policy. Thus, liability will be found if (1) the estate planning engagement was intended to benefit the plaintiff, (2) the harm to the plaintiff attributable to the attorney (or other advisor's) mistake was foreseeable, (3) it is certain that the plaintiff suffered injury, (4) the connection between the defendant's conduct and the injury was immediate, (5) there is a strong public policy of preventing future harm that is fostered by imposing liability on the advisor notwithstanding the plaintiff's lack of privity, and (6) the imposition of liability to beneficiaries of negligent planning does not impose an undue burden on the advisor's profession.

In the legal malpractice context, normally a testator's intent to benefit distributees designated in a will gives those beneficiaries the right to sue for any breach of the contract between the attorney and the testator. But not always. For example, in *Espinosa v. Sparber, Shevin, Shapo, Rosen & Heilbronner*, 612 So. 2d 1221 (Fla. 1993), a disappointed beneficiary could not prove the decedent's intent, and the estate did not suffer a loss, so negligence of a drafting attorney essentially went without redress.

This also was the case in ***Estate of Agnew v. Ross***, 152 A.3d 247 (Pa. 2017), which rejected extrinsic evidence that would establish that the decedent intended to amend a trust at the same time that he executed a revised will. An amendment was drafted to that trust, which the attorney admitted was never presented to the decedent for execution, due to the attorney's oversight. Nevertheless, the court did not permit the use of this extrinsic evidence to show the decedent's intent, resulting in disappointed beneficiaries being denied redress for the attorney's alleged error. Because they were not named as beneficiaries in an executed document, those beneficiaries lacked standing to sue. "[A]n executed testamentary document naming an individual as a legatee is a prerequisite to that individual's ability to enforce the contract between the testator and the attorney he hired to draft that particular testamentary document." And "public policy considerations weigh against allowing a party to use an unexecuted testamentary document to establish standing to sue the testator's lawyer for breach of contract as a third-party beneficiary" because there was no reliable evidence of the decedent's intent.

This result defeats a disappointed beneficiary's action to redress certain alleged estate planning mistakes – both of commission and omission. In essence, it breathes continued life into the privity defense, even though that concept is a minority principle in the estate planning context. Indeed, the two most common impediments to proving a malpractice case against an estate planning professional are whether it is certain that the plaintiff suffered an injury and whether imposition of liability imposes an undue burden on the professional. For example, if the allegation is that the decedent intended to benefit the plaintiff in an amount greater than the decedent's will bequeaths, typically the issues are (1) whether the plaintiff may introduce extrinsic evidence of the decedent's alleged intent and (2) whether the burden on the drafting attorney to disprove this alleged intent to avoid liability many years after the estate planning representation ended is too great.

Cases such as mistakes in execution or the proper application of state law relating to the rights of a pretermitted heir present much easier facts to address in this connection than others. On the other hand, a case alleging that an advisor failed to follow a testator's instructions about inclusion or the amount of a bequest would pose a far more difficult situation. Which underscores that the ability to establish malpractice by a third-party beneficiary of the advisor-client contract continues to be problematic.

Diversity Jurisdiction Involving Trusts. The traditional common law of trusts regards a garden-variety trust as a relationship, not an entity, meaning that the trust itself has no jural personality – it cannot sue or be sued. Instead, suit is instigated by or against the trustee as fiduciary, and not by or against the trust. If a plaintiff wins a suit against the trustee, then the question turns to whether the trustee is entitled to indemnification or reimbursement by the trust. If a recovery is won by a trustee as plaintiff, then that property is subject to the same fiduciary duties as is any other trust asset.

Draft versions of the final volume of the Restatement (Third) of Trusts included provisions that advanced a notion that a trust itself could be the plaintiff or defendant in litigation, but the concept was abandoned and does not appear in the final product. A recent case illustrates why the question is multi-faceted and complex.

Loubier Irrevocable Trust v. Loubier, 858 F.3d 719 (2d Cir. 2017), addressed the question whether diversity jurisdiction in federal court existed, which turned on whether the trusts involved took the citizenship of their trustee or of their beneficiaries. A conflicted body of precedent exists on that question, which may seem odd, given the traditional rule that trusts have no jural existence (instead, it is the trustee that appears in litigation). Quoting from a 2016 decision by the Court of Appeals for the Fourth Circuit, the *Loubier* court noted that "[d]espite over two centuries of federal litigation involving trusts, the method for determining a trust's citizenship [is] long unsettled and the subject of much debate." The *Loubier* opinion laid out Supreme Court jurisprudence that essentially informs either result, much of it turning on the nature of the trust involved (a business trust in one case, a REIT in another, but most trusts being garden-variety property ownership and donative transfer vehicles).

Noting a rift between circuits, and unclear Supreme Court jurisprudence, the *Loubier* court concluded that "for these traditional trusts, it is the citizenship of the trustees holding the legal right to sue on behalf of the trusts, not that of the beneficiaries, that is relevant to jurisdiction" of the federal courts in diversity actions. "[B]ecause the party trusts … are traditional trusts, establishing only fiduciary relationships, they are incapable of being hauled into court except through their trustees. Thus, it is the trustees' citizenship that must determine diversity, not the citizenship of trust beneficiaries."

That traditional result is the most practical resolution in a typical asset-transfer context, especially given that the class of beneficiaries of many garden-variety trusts is subject to change through exercise of powers to appoint or in the discretion of either the trustee or a faux-fiduciary (such as a trust protector or distribution director). In other contexts the traditional rule can generate problems, such as in determining to whom the ethical duties of a lawyer hired by a trustee are owed. *See*, *e.g.*, Pennell, Representations Involving Fiduciary Entities: Who Is the Client?, 62 Fordham L. Rev. 1319 (1994).

Further, what is the proper result if a judgment is rendered against the fiduciary rather than against the trust proper? If the trustee is without assets and was in breach of trust, then no effective enforcement of a judgment could be had against the trustee and reimbursement or indemnification is not available from the trust. In such a case the plaintiff, entitled to recompense, may be left without recovery. Alternatively, if the fiduciary acted without fault and is entitled to reimbursement or indemnification, what merit is there in a two-step process by which the trustee satisfies a judgment and then recovers reimbursement from the trust?

Given the centuries-old history of the common law of trusts, *Loubier* reminds us of the disconcerting reality that these fundamental questions still remain to be addressed.

Enforcement of In Terrorem Provisions. In the United States today the majority approach to enforcement of anti-contest (in terrorem) provisions is reflected in UPC §§2-517 and 3-905, which establish that "a provision in a will purporting to penalize an interested person for contesting the will or instituting other proceedings relating to the estate is unenforceable if probable cause exists for instituting proceedings." The challenging aspect in these formulations is the "probable cause" standard.

Cases in numerous states address the validity question in various ways, all of which seem to boil down to a rule that typically provides that no-contest provisions are *not* enforceable if a challenge was brought "in good faith," "based on reasonable grounds," that was "not frivolous or vexatious," or something similarly vague or vacuous. The comment to §3-905 refers to Restatement (Third) of Property (Wills and Other Donative Transfers) §8.5 comment *c* for a definition of probable cause as "evidence that would lead a reasonable person … to conclude that there was a substantial likelihood that the challenge would be successful." Restatement (Second) of Property: Donative Transfers §9.1 comment *j* referred to whether "the beneficiary relied upon the advice of disinterested counsel sought in good faith after a full disclosure of the facts."

The point is that there is widespread agreement that something like good faith, probable cause, or reasonable grounds is enough to disable an anti-contest provision, but there is no general agreement on what the requisite standard means. ***In re Estate of Workman***, 2017 WL 706342 (Iowa Ct. App.), addresses that question in a state that has adopted the UPC generally but that did not embrace §2-517, leaving "intact longstanding case precedent on the subject" that regards in terrorem provisions as unenforceable against a contest brought "in good faith and for probable cause." According to the court, "good faith" and "probable cause" are applied interchangeably.

> Persons have "probable cause for initiating civil proceedings against" others if they "reasonably believe[] in the existence of facts upon which [the] claim is based and reasonably believe[] that under such facts the claim may be valid at common law or under an existing statute, or so believe[] in reliance upon the advice of counsel received and acted upon." "Probable cause exists when, at the time of instituting the proceeding, there was evidence that would lead a reasonable person, properly informed and advised, to conclude that there was a substantial likelihood that the challenge would be successful. A factor that bears on the existence of probable cause is whether the beneficiary relied upon the advice of independent legal counsel sought in good faith after a full disclosure of the facts."…
>
> The "good faith" requirement has been variously interpreted, with jurisdictions applying definitions that can be categorized along a continuum from a subjective to an objective standard …. [O]ur good faith precedent gauges the strength of the challenger's will contest action by asking whether "a jury question was presented on the issues" and how long the jury deliberated.

The court continued to state that the good faith and probable cause standards could apply factors that bear on a challenger's *subjective* belief but that the court preferred an *objective* standard. In *Workman* one deciding factor was that the case was tried to a jury. The dissent took this to show that the lower court regarded there to be adequate evidence to overcome a motion for summary judgment, which that judge argued should suffice. The majority opinion instead regarded it as significant that the jury only "deliberated for sixty-three minutes" before deciding against the contest, which the court took to indicate that the case was weak or lacking in the objective factors that would inform good faith, probable cause, reasonable belief, and so forth.

Whelan v. Sanford, 2017 WL 1632443 (Cal. Ct. App.), addressed the enforcement question in the context of two significant factors. One was legislation in California, which has struggled (perhaps more than in any other jurisdiction) with the question of when to enforce anti-contest provisions. The other was an apparent over-reach by a successor trustee who sought court approval for a self-interested result. The unpublished opinion is not citable, which is unfortunate given the court's summary of the California Law Revision Commission's study and then recommendations regarding enforcement of anti-contest clauses:

> [N]o contest clauses are … supported by a number of important public policy interests, including respecting a transferor's ability to control the use and disposition of his or her own property and to avoid the cost, delay, public exposure, and additional discord between beneficiaries involved in litigation over the transferor's estate plan. … [H]owever, … other public policy concerns "can trump a transferor's intention to create a no contest clause." … [A]s a matter of general public policy, "a person should have access to the courts to remedy a wrong or protect important rights." … [A] no contest clause should be applied conservatively to avoid a forfeiture that is not intended by the transferor. … And … important public policy interests support judicial supervision of an executor, trustee, or other fiduciary.

Accordingly, the Commission recommended that a no contest clause should be enforceable only in response to three types of contests: (1) a direct contest …, brought without probable cause; (2) a creditor claim; and (3) a challenge to a transfer of property amounting to a forced election.

The plaintiff in *Whelan* asserted a right to a broker's commission in addition to the trustee's regular fee for the sale of a trust's most significant asset, alleging an oral understanding with the trust's settlor. The no contest provision specifically identified any action "based on: (i) a quantum meruit theory … [or] (iii) any alleged oral agreement … claiming that the Settlor agreed to give … anything to such person …." According to the court, "any beneficiary with a creditor's claim based on an oral agreement must make an election between pursing such claim or taking under the Trust." Seeking extraordinary compensation for the trustee's sale of a trust asset was the plaintiff's downfall.

The debate over the legitimate and effective use of litigation-suppressing provisions in wills and trusts is far from being resolved. Many courts exhibit a strident dislike for any effort to deny access to the truth-determination function that they serve. Meanwhile, some planners and their clients show a similar distaste for unfounded efforts to disrupt or defeat a transferor's intent. Among techniques that may prove useful, planners and drafters may find that (1) using anti-contest provisions sparingly – only in cases in which legitimate concerns about anticipated ill-founded challenges exist, (2) shy of committing testamentary libel, stating the concerns and facts as known and viewed by the transferor for the treatment of an expectant contestant and inclusion of such a provision, and (3) establishing for a particular situation an objective standard or test that should be applied in deciding the good faith or probable cause requirement.

Family Settlement Agreements. Indiana law expressly permits "family settlement agreements" to compromise any contest or controversy regarding admission, construction, validity, or the rights of any beneficiary or heir under a testator's will. Designed to encourage the compromise and resolution of actions that otherwise would sound in probate, "family settlement agreements are favorites of the law … uniformly upheld and sustained … to preserve the peace and harmony of families." The question resolved by *Salcedo-Hart v. Burningham*, 656 F. App'x 888, 892 (10th Cir. 2016), relied upon by ***In re Estate of Kent***, 2017 WL 3662480 (Ind. Ct. App.), is whether *prospective* heirs or beneficiaries may create a binding settlement agreement prior to the death of their anticipated decedent. To which each court answered "why not"?

Kent involved a testator who disinherited a child and a step-child, and divided his estate essentially equally between two other children. When terminally ill, the testator asked these two beneficiaries to sign an agreement, presumably in anticipation of postmortem conflict. One of those children purported to rescind the agreement several days after its execution (and before the testator died). Postmortem that child raised the issue whether premortem family settlement agreements are authorized by Indiana law, and sought to invalidate the agreement based on the purported rescission.

Finding no clear indication in the statute regarding the legislature's intent about the timing of family settlement agreements, the court held that there was no reason to deny premortem efforts to minimize family conflict. *Kent* also regarded "the desire to carry out the wishes of the testator" to be adequate consideration for a contract that may be rescinded "only when one party avers that he has performed a substantial part of his obligations under a contract and that the other party refused to perform its obligations." The court enforced the agreement because the child who sought to invalidate it had not performed any obligations under the agreement.

A handful of jurisdictions authorize premortem probate, by which a testator presents a will to the probate court for a determination that it is properly executed, not the product of undue influence or lack of capacity, or otherwise infirm. A common concern is that premortem probate requires notice to all potentially affected or interested parties, which can generate controversy even earlier than the testator's death. As a result, only Alaska Stat. §13.12.530 et seq.; Ark. Code Ann. §28-40-202; Nev. Rev. Stat. §30.040; N.H. Rev. Stat. Ann. §552.18; N.C. Gen. Stat. §28A-2B; N.D. Cent. Code §30.1-08.1-01; and Ohio Rev. Code Ann. §2107.081 appear to authorize such a process. The family settlement agreement might be an alternative method by which potential conflict may be averted, especially in states that lack premortem probate. Although individuals who don't sign the agreement would not be bound, those who the testator most expects to be combatants presumably can be mollified by a compromise agreement, and litigation potentially avoided (albeit, in *Kent* and *Salcedo*, the litigation simply shifted to contest the validity of the agreement itself).

Many courts are averse to enforcement of anti-contest (in terrorem) clauses. *See* Casner & Pennell, ESTATE PLANNING §3.1.2 (8th ed.) for an extended discussion. Coupled with a premortem family settlement, however, it may be that many of these courts would be less distressed by the consequences of an anti-contest provision that is triggered by a signatory's effort to rescind or invalidate that favored form of compromise.

No-Contest Provision with a Dash of Ethics Violation. ***In re Trust of Hildebrandt***, 388 P.3d 918 (Kan. Ct. App. 2017), affirms a district court ruling, which affirmed a district magistrate judge's grant of a petition (consented to by all of a trust's beneficiaries) to change the trustee. So at three successive levels the named trustee unsuccessfully sought to prevent being replaced, in the process alleging that the petition triggered an in terrorem provision that applied if a beneficiary "objects to any provision … or interferes … with the administration of the trust …." On both scores the trustee lost in all three courts. Two elements of the decision are noteworthy.

The first is that trust modification – here to alter the successor trustee – was authorized by the Kansas version of UTC §411(b). It permits modification of a noncharitable irrevocable trust without consent of the settlor (who, in *Hildebrandt*, was deceased) "upon consent of all of the beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust." The court did not mention UTC §706(b)(4), which permits removal of a trustee if "removal is requested by all of the qualified beneficiaries, [if] the court finds that removal of the trustee best serves the interests of all of the beneficiaries and is not inconsistent with a material purpose of the trust …." Notwithstanding each provision's reliance on the concept, "material purpose" is not defined in the UTC. So the substantive issue of interest is the court's conclusion that the successor trustee designation was not a material purpose of the trust. In the process the court rejected the trustee's assertion that the no-contest provision meant that "all of the provisions of [the] trust were material."

The second element of interest was the trustee's assertion that naming a preferred family member as successor trustee was contrary to the settlor's intent that there be "an independent, third-party successor trustee" – meaning *it*. Which raised the question: why did the settlor name the trustee who was being removed? Here is the ethics violation. The settlor and his brother executed identical trusts that named both brothers as initial cotrustees, "to provide for the continuation of the joint farming operation created by" the two brothers. The settlor was dead, but the surviving brother stated that the independent third-party trustee idea was suggested by the drafting attorney, not by either settlor. This is not unusual – often a drafting attorney includes provisions without express request or even implicit approval by a client – the assembly of governing instruments normally requires attorney discretion. Indeed, the exercise of experience and judgment is what clients seek when obtaining professional assistance.

Nevertheless, who did the drafting attorney regard as essential to proper administration of the trust, as successor trustee? Surely you guessed this already: the drafter himself (or, if unable to serve, then "two senior members" of his firm). The drafter was deceased – which may explain why no ethics complaint was involved in *Hildebrandt*. The oft-objecting successor independent trustee was the law firm that had succeeded to the drafter's firm.

A prudent trustee might object to a petition and require a court determination, as part of its duty to ensure that all changes are appropriate, and to protect itself against any potential liability. Doing so through three judicial levels seems a bit aggressive, however. In fact it actually may have been unwise, because it shined a spotlight on the apparent violation of the anti-solicitation dictates of Model Rule 1.8.

It also raises the question whether insertion of the no-contest provision was the settlors' idea or another form of over-reach by the drafting attorney. In that regard, consider ***In re Palmieri***, 54 Misc. 3d 1205 (N.Y. Surr. 2016), a case involving undue influence. The drafter asserted that "she does not ordinarily use in terrorem clauses and could not remember why she inserted … a broad in terrorem clause" in the decedent's final estate plan, which "deviate[d] from the decedent's long-standing estate plan and contradicts the trial testimony that decedent wanted to divide her estate equally between her two daughters." One legitimate explanation for inclusion of the in terrorem clause might have been the drafter's expectation that deviation from an equal division would cause the disfavored daughter to challenge the will. The drafter's testimony confirmed "that the inclusion of the in terrorem clause was at [the drafter's] suggestion, and not decedent's request." But she did not remember why that was her suggestion? This is enough to raise a few questions, which may be answered by a few added facts.

The daughter who benefitted from the decedent's final plan was married at the time to the "chair of the trusts and estates department" of a nationally known and well-regarded law firm, who "practices law in the private client area, advises clients with regard to estate planning issues, including wills and personal tax matters." This son-in-law "'probably' acted as decedent's attorney during the course of knowing his mother-in-law" but did not draft the decedent's final estate plan. For that the decedent employed a lawyer who attended law school with the son-in-law ("he 'showed her the ropes' in law school") and who the son-in-law recommended. That lawyer "revised [an earlier] instrument based upon [the son-in-law's] direction" and communicated with the son-in-law via email ("Can you use your influence so that I can close the file?") when the decedent delayed execution of a prior document. Adding further fuel to the fire, the son-in-law and his wife, the favored daughter, were significantly affected by "the financial crash of 2008" (they were unable to pay a $270,000 joint income tax liability). The decedent's final estate plan was crafted and signed in 2009, which raised the specter that the son-in-law and his wife, the favored daughter, exerted undue influence and created the suspicion that the in terrorem clause was an element of the same overreach.

Disinheritance of the one daughter may have been the right thing to do, and insertion of the in terrorem clause may have been appropriate in anticipation (based on experience in the context of such a dynamic) of the challenge that did occur. *Palmieri* highlights the stakes involved and underscores the reality that the goal of discouraging a contest was not reached. In fact, the existence of the provision may have added fuel to the allegation of undue influence, because a wrongdoer who understands what they are doing will seek to discourage oversight by the disfavored beneficiary.

Confidential Relations and Undue Influence. Undue influence is difficult to prove because frequently it does not occur in public. As a result, many states establish a presumption of undue influence if the transferee was in a confidential relation with the transferor and was not a natural object of the transferor's bounty. If those elements are established, then the burden shifts to the transferee to disprove that there was undue influence. The aspect of ***Willey v. Willey***, 385 P.3d 290 (Wyo. 2016), that may be notable is a conclusion that inter vivos and testamentary transfers differ for purposes of assessing whether either was motivated by undue influence. The consistent principle as between each form of transfer is that "courts will zealously scrutinize transactions between parties who are in a confidential relationship." So, for example, a gift to someone who is not a natural object of the donor's bounty is more suspect if that person was in a confidential relation to the donor – such as a caregiver, a fiduciary, a business partner, a member of the clergy, or a close advisor. There is nothing unusual in that concept. But, according to *Willey*, "[t]he rules as to the validity of gifts between parties in a fiduciary relation are applied with greater strictness to a gift inter vivos, by which a donor parts with something for which he still has some use, than to a gift by a will." That notion is unusual.

The theory suggests that greater scrutiny is called for because an inter vivos transferor's use of something during life has not yet terminated, as it does at death. So it is less likely that a transferor will part with something during life for less than adequate and full consideration. Meaning that lack of adequate consideration for an inter vivos transfer is more telling than a testamentary transfer, and is more subject to scrutiny if a confidential relationship is involved.

According to *Willey*, the consequence of this difference is in placing the burden of proof. According to the opinion, "if the transaction is inter vivos, the burden will shift to the party defending the transaction if a confidential relationship between the grantor and grantee is established." That statement may not accurately state the rule in all states, the majority rule being that the burden will shift at death as well, if the confidential relationship existed.

As a practical matter, the burden of proof – where it begins and whether it shifts – may not be a major consideration in litigation involving facts that strongly suggest undue influence. But in a close case, the existence of a burden of proof may tip the scale, or place one party at a disadvantage that is more likely to evoke a settlement.

The concept about the difference between inter vivos and testamentary transfers is intriguing in its own right, because it makes it easier to understand why even very wealthy clients often resist the recommendation to make transfers during life rather than waiting until death. Sometimes known as the endowment factor, the concept is that assets have a greater value to their owner than to someone who would acquire them. Which affects valuation as well, liquidation value (what a willing buyer is offering to acquire an asset) being lower than replacement cost (what a seller is asking, based on the value of the item to them). Valuation in tax cases is based on replacement cost, because typically it is higher, and these realities make the "willing-buyer, willing-seller" construct somewhat unrealistic in cases involving assets that do not routinely trade on an established market (such as the stock market).

C. Asset Protection

1. Cases

Validity of Domestic Asset Protection Trusts. Domestic asset protection trusts (DAPTs) are most controversial to the extent they purport to permit domiciliaries of states without asset protection legislation to settle their wealth in trusts authorized by legislation in another state that does authorize DAPTs. Thus, for example, the effort of some state legislatures to lure out-of-state wealth to local trustees with legislative changes such as modification or repeal of the Rule Against Perpetuities, elimination of state income or wealth transfer taxation on non-domiciliary trusts, and self-settled asset protection trust legislation has spawned extensive discussion. For four reasons, ***Klabacka v. Nelson***, 394 P.3d 940 (Nev. 2017), does little to address the validity of DAPTs in their most challenging context.

The most important reason for this is because both parties – spouses embroiled in a divorce – were Nevada residents. So there was no effort by a domiciliary of a state without DAPT legislation to move wealth to a DAPT jurisdiction to garner spendthrift protections not available under their home state law. It has always seemed most clear that a state legislature could enact DAPT laws that disfranchise its own domiciliary creditors. It is notable that no DAPT jurisdiction is a major commercial center. These are state legislatures that need not consider a strong creditor lobby.

Second, each trust predated any dispute between the spouses, so there was no judgment of any creditor that could raise voidable or fraudulent transfer issues.

Third, the spouses transmuted their community property and each created their own identical DAPT, which negates any notion that one spouse was "hiding" wealth that otherwise would be subject to the support, alimony, or property settlement claims of an innocent spouse.

Finally, it took litigation to the state's highest court to resolve the controversy, requiring it to reverse lower court orders that exposed the DAPT assets to claims of the settlor's spouse. This probably means that establishing the protection sought was a lengthy and expensive proposition, particularly given that the Supreme Court's conclusions are not especially useful in those situations that much DAPT planning is meant to address. It also bears noting that the lower court's determinations were very wrong, so the Supreme Court of Nevada did not go out of its way to validate the planning involved. But the judicial travel shows that a wild-hare lower court seeking to achieve what it appears to be equity can be a real danger, even in a state with clear DAPT legislation.

For what little more they are worth, the facts in *Klabacka* are stark and somewhat unusual, in terms of the sorts of situations in which DAPT planning is most likely. The parties were married for a decade before they executed their marital property agreement, transmuting their community property into separate property. Another eight years later they created the DAPT trusts, each with the settlor's own separate property. Another eight years passed before the divorce action was instituted. So this was not planning done in anticipation of divorce and, as the court found, "there is no evidence that the trust[s were] created to hinder, delay, or defraud known creditors." In addition, according to the court, Nevada stands alone on a critical element of the recovery sought. "[T]he 'key difference' among Nevada's self-settled spendthrift statutes and statues of other [DAPT] states …' is that Nevada abandoned the interests of child- and spousal-support creditors.'" As a result, a claim that the Restatement (Third) of Trusts §59 and most DAPT states would permit, for either variety of support, was not enforceable in Nevada. Meaning that this portion of the court's holding should not necessarily be expected, even in other DAPT states.

Most important, however, is the question that *Klabacka* did not (need to) answer – and that no other DAPT case has yet addressed: would the judgment of a court in one state, that a DAPT in another state is ineffective to shield assets from the court's order, be entitled to full-faith-and-credit in the state where the DAPT was being administered? For example, would Nevada refuse to enforce the order of a sibling state that sought to reach the trust assets in a situation like *Klabacka* in which the parties were not Nevada domiciliaries? That story has not yet been written.

Third-Party Trust Interests in Divorce. The principle issue for consideration here is whether a former spouse may reach the assets of a trust that was created for a beneficiary by a third party. For these purposes, imagine that Parent (P) created the trust for an adult married child (C) and wishes to preclude C's spouse (S) from ever reaching any of the trust assets in the event that C and S divorce. The traditional rule in the majority of states is that property acquired during a marriage by gift, devise, bequest, or inheritance is not marital property. That rule *ought* to mean that S is not entitled to any portion of a trust created by P for C. But this notion is undergoing change as state laws chip away at the traditional principle.

Even if the traditional rule still applies, in many dissolution cases an expectancy or inheritance may be *considered* when a court divides or distributes marital property. The beneficial interest is not itself regarded as marital property, but it is regarded as an economic circumstance that the court may consider when determining an equitable distribution of the marital property. This concept is widespread, and is just one step shy of counting that beneficial interest as marital property.

In addition, trust monies previously distributed to a beneficiary may be marital property. Either via commingling or as an addition to the spouses' marital property. Corpus distributions are not our concern here, but trust income may be a different story. The standard rule is that income from nonmarital property remains nonmarital property, but some states regard income from nonmarital property to be marital property. In some states the income from separate/nonmarital property (including trust income) is community/marital property. And in some cases an important element is whether the beneficiary only ever has an income interest, as opposed to a present or future interest in the trust property (the income from which is marital property).

The developing trend is for courts to simply ignore the marital/nonmarital distinction and determine an equitable distribution in dissolution of marriage with all of each spouse's wealth in mind, including inherited wealth, interests in a trust, and income from a trust interest. Of particular interest in this context is Massachusetts G.L. c. 208, §34, which requires a court to consider any "opportunity for future acquisition of capital assets and income" when dividing the wealth of divorcing spouses – and not just when determining what alimony to award. This is a critical distinction, because considering a potential inheritance to determine ongoing support or alimony entitlements is one thing, allowed in many jurisdictions, but Massachusetts courts are not limited in this respect. Here is what the Massachusetts statute provides:

> Upon divorce … the court … may make a judgment for either of the parties to pay alimony to the other …. In addition … the court may assign to either husband or wife all or any part of the estate of the other …. In fixing the nature and value of the property, if any, to be so assigned, the court … shall consider the length of the marriage, the conduct of the parties during the marriage, the age, health, station, occupation, amount and sources of income, vocational skills, employability, estate, liabilities and needs of each of the parties, the opportunity of each for future acquisition of capital assets and income, and the amount and duration of alimony, if any, awarded …. The court may also consider the contribution

> of each of the parties in the acquisition, preservation or appreciation in value of their respective estates ….

In *Lauricella v. Lauricella*, 565 N.E.2d 436 (Mass. 1991), the Supreme Judicial Court analyzed the interest of a husband in a trust holding real estate established by his father which (1) gave the beneficiaries no power to require partition or distribution of trust assets; and (2) contained a spendthrift clause that purported to prohibit alienation or anticipation of a beneficiary's interest in the trust. The probate judge had reasoned that the father's trust was not a marital asset because this trust had nothing to do with the marriage: the husband was neither settlor nor the trustee, and the trust could be amended to eliminate the husband's beneficial interest. But the Supreme Judicial Court disagreed, concluding that the husband's interest in the trust was includable in the marital estate subject to equitable division under G.L. c. 208, §34. Although the husband's interest was subject to divestment and contingent upon his surviving until the termination of the trust, the *Lauricella* court noted that the husband had a present, enforceable, equitable right to the use of the trust property for his benefit, as well as a vested right to receive his share of the trust property upon termination of the trust according to its terms.

Lauricella held that: "The husband's interest is unlike a mere expectancy of the type that this court has held to be outside of the divisible estate under §34." Moreover, "[t]he fact that valuation of the interest may be difficult does not alter its character as a divisible asset, … nor does its inalienability change its character as divisible."

Trust property is thus vulnerable to equitable division under G.L. c. 208, §34. "When the future acquisition of assets is fairly certain, and current valuation possible, the assets may be considered for assignment under §34." Although the court requires that current valuation be possible, such valuation need not be easy. It need not be "susceptible of precise calculation" to be divisible under §34. Thus, trust property is includible in the marital estate subject to equitable division under G.L. c. 208, §34 if the beneficiary's likelihood of receiving his interest in the trust is not "too remote or speculative for inclusion within the estate." And, if a beneficiary's interest in the trust is too remote or speculative for inclusion within the marital estate of the beneficiary in divorce, it is nevertheless appropriate to consider his or her beneficial interest "under the §34 criterion of 'opportunity of each [spouse] for future acquisition of capital assets and income' in dividing the marital property."

This Massachusetts jurisprudence is expansive, and the state of the law there (as elsewhere) is confused. For example, the rule in Massachusetts is that a court should make "reasonable assumptions" about expectancy interests, but use caution when taking any expectancies into account. Notice the absence of any consideration of spendthrift trust protections, or notions of inherited wealth as being nonmarital property that is not subject to equitable distribution in dissolution.

From an earlier case, *Davidson v. Davidson*, 474 N.E.2d 1137 (Mass. Ct. App. 1985), comes a better understanding of this trend:

> While "[p]roperty concepts have not become immaterial," implicit in our appellate decisions is the rejection of the notion that the content of the estates of divorcing parties ought to be determined by the wooden

> application of technical rules of the law of property. We think an expansive approach, within the limits of the marital partnership concept, is appropriate. The purpose of §34 is to "empower[] the courts to deal broadly with property and its equitable division incident to a divorce proceeding. Such broad discretion is necessary in order that the courts can handle the myriad of different fact situations which surround divorces and arrive at a fair financial settlement in each case."

As a planning response, one suggestion is to create totally discretionary spray trusts rather than trusts with more easily valued interests. Better yet, create totally discretionary spray *group* trusts, in which no beneficiary has an exclusive right to receive anything at any time. *See, e.g.*, *In re* Marriage of Eddy, 569 N.E.2d 174 (Ill. App. Ct. 1991), which involved a wife who had no income from gainful employment but she had income from "investments, gifts, and trusts" – including as one of several beneficiaries of trusts created by a grandparent that granted the trustee discretion to distribute income and principal to her, her parents, and other unnamed individuals under a standard (best interests and welfare). Although the court conceded that the lower court could *consider* her present interest in the trust, it held that the lower court improperly treated her interest because she was not the exclusive beneficiary.

Originally contra to this notion was ***Pfannenstiehl v. Pfannenstiehl***, 37 N.E.3d 15 (Mass. Ct. App. 2015), *rev'd and rem'd*, 55 N.E.3d 933 (Mass. 2016). A group/pooled trust was held for 3 children and 8 grandchildren when one child was divorced. The court made an award to that child's spouse because the trust distribution provision used a standard (comfortable support, health, maintenance, welfare, and education) that the court regarded as "ascertainable" (not in the Section 2041 sense, welfare being impermissible), and therefore as enforceable by the beneficiary. According to the court, a different result would have applied if the trustee's authority was "wholly discretionary … with no distribution standards." The lower court was influenced by the trust having consistently made equal distributions to the settlor's three children until just before the one child's divorce action began, at which time all distributions to that child ceased entirely. Those distributions had supported the life style to which the child's family had become accustomed, and the court concluded that the trustee was obliged to continue to make distributions, that the cut-off was a "manipulation," and that "the spendthrift provision is being invoked as a subterfuge to mask the [child's] income stream and thwart the division of the marital estate in the divorce." These damaging facts (and wrongful "scorched earth" tactics in the divorce action itself) influenced the lower court's final determination, including an award of attorney fees to the child's former spouse.

On appeal in *Pfannenstiehl* the Supreme Judicial Court concluded that the child's

> interest in the [group] trust is "so speculative as to constitute nothing more than an expectanc[y]" and thus that it is "not assignable to the marital estate." [But] … on remand, the judge pursuant to G.L. c. 208, §34, may consider that expectancy as part of the "opportunity of each [spouse] for future acquisition of capital assets and income," in the judge's determination of a revised equitable division of the marital property.

Thus, the discretionary nature of the group trust served a useful purpose in preventing an absolute award to the spouse of a portion of the trust itself. But it is likely that the judge on remand will nevertheless consider the trust as a factor in dividing the spouses' property between them.

Validity of Revocable Inter Vivos Trusts. Fundamentally, ***United States v. Johnson*** 224 F. Supp. 3d 1220 (D. Utah 2016), is a Section 6166 deferred-payment-of-tax case in which the qualifying closely held business became insolvent. The government is seeking to collect unpaid taxes from beneficiaries of the decedent's estate and trust. The latest decision in the case is a reconsideration of a prior order. It is broken into two parts. In one the beneficiaries who also were successor trustees of the decedent's inter vivos trust are being pursued under Section 6324A based on a lien to secure the Section 6166 election to defer payment of the estate tax liability. The other is the more interesting development, in which the beneficiaries are being pursued under Section 6324(a)(2) in their individual capacity as transferees of the decedent's estate and trust.

The Section 6324(a)(2) element is eye-catching because the court held that the beneficiaries are *not* liable as transferees of the trust, because the trust was not includible in the settlor's gross estate under Sections 2036 and 2038 (the so-called "string provisions"). This was a surprise, because the settlor created a funded, revocable, inter vivos, self-trusteed declaration of trust for her lifetime benefit. That noninclusion "good news" is offset by the "bad news" reason for the court's unconventional conclusion: that, instead of under the string provisions, the trust assets are deemed to be includible under the broad-based probate estate inclusion rule in Section 2033. As if the decedent's transfers into the trust were not valid or effective probate avoidance transfers under state law.

That conclusion raises concerns for state trust law purposes, not the least of which being the potential that a funded, self-trusteed declaration of trust is not valid during the settlor's remaining lifetime.

Two living children of the decedent (D) were cotrustees of a trust of which D was the settlor and the sole trustee at the time of her death. D retained an unlimited power to alter, amend, revoke, or terminate the trust (a power that normally triggers estate tax inclusion under Section 2038(a)(1)). She also was the sole income and corpus beneficiary during life, with the power as trustee to make distributions to herself without limitation (together these interests and powers normally trigger estate tax inclusion under Section 2036(a)(1) and (a)(2)).

At her death D's will poured the residue of her estate into the trust, which divided into shares for D's descendants (referred to in the opinion as her "heirs"). The primary asset involved was stock in a Nevada hotel that held a gaming license. Valued for estate tax purposes at over $11.5 million, that stock qualified for deferred payment of estate tax under Section 6166.

Nevada law required special approval for a trust to own stock in a casino. When a special permit for the trust's ownership was set to expire, the trustees chose not to seek permanent approval of the trust's ownership. Instead, the trustees distributed the stock to the trust beneficiaries. About $1.5 million of estate tax was unpaid at that time. A distribution agreement signed by each beneficiary committed them to pay the remaining estate tax as it came due. The children also executed a Section 6324A special lien for the estate tax deferred under Section 6166.

The hotel declared bankruptcy about five years later, before the deferred estate tax was fully paid. Upon which the government sought to collect the outstanding tax liability from the children under Section 6324(a)(2). At a first hearing on that question the court held that the two children who were the successor trustees were personally liable for the estate tax deficiency because the trust was includible in D's gross estate under Sections 2036(a) and 2038(a). This follows because Section 6324(a)(2) requires that the subject estate property be included in the gross estate under any of Sections 2034 through 2042 – those being the provisions that cause inclusion of several varieties of nonprobate property (including life insurance proceeds, deferred compensation and annuities, and property subject to a general power of appointment). That set up the issue for a hearing in which the children argued that the trust assets instead were includible under Section 2033 as probate property, because the trust effectively was not a valid entity that could hold those assets. This inclusion would negate application of Section 6324(a)(2).

Presented with this question of the proper provision for inclusion of the trust assets, the court concluded in the children's favor and held that Section 6324(a)(2) did not apply. It held that none of the Section 2034-2042 nonprobate inclusion provisions was applicable. Rather, the trust assets were subject to estate tax inclusion under Section 2033. The court concluded that D retained "full beneficial ownership of all Trust assets during her lifetime" and failed to make any transfer to any other beneficiary prior to her death. As a result, under Utah state law, no valid trust existed prior to D's death.

That conclusion is at odds with many decades of case law and statutory reforms that make clear that funded, revocable, self-trusteed, inter vivos trusts are valid will substitutes. The notion that such trusts are valid is so well-entrenched in American law today that the Uniform Trust Code now provides that, during the life of the settlor of such a trust, the trustee owes no duties to anyone except the settlor. Meaning that future interest beneficiaries have no standing to challenge trustee actions while the settlor is alive and competent. That UTC position is viable only because the validity of such a trust is beyond question under today's jurisprudence.

Johnson turns this acceptance of such trusts on its head. It provides the exact opposite of what the UTC intends – holding that the trust does not constitute a transfer for purposes of the string provisions prior to the settlor's death. Meaning that the trust assets are includible under Section 2033 as if nothing was transferred into the trust inter vivos.

Perhaps *Johnson* can be limited to its facts. The court made much of the fact that D was trustee and that trust income and principal could be withdrawn without restriction by D as grantor during her lifetime. "Only upon the grantor's death were the Trust assets to be distributed … to the various beneficiaries of the Trust." If the trust settlor ceased to serve as trustee prior to death, then the facts of *Johnson* should be distinguishable.

Unfortunately, the court also held that, although "creation of the Trust changed the legal title of the Trust assets from ownership by Decedent personally to ownership by Decedent as the trustee of the trust … the beneficial ownership of the Trust assets never changed during Decedent's lifetime. … [T]he transfer of title to the Decedent as trustee did not change Decedent's beneficial ownership of the Trust assets during her lifetime [and] the beneficiaries of the Trust merely had a 'hope and expectation' of inheriting a beneficial interest in the Trust assets, rather than any actual ownership interests during Decedent's lifetime." This vision is directly contrary to the law as it has developed over the past half century.

Among the authorities relied upon by the court was Technical Advice Memorandum 8940003, the distinguishing fact being that at the settlor's death the corpus of the trust involved in that TAM was distributable to the settlor's estate. In that context the government held that there was no other beneficiary of the trust during the settlor's life, which is a correct but inapposite conclusion in this context. The *Johnson* court's opinion did not appreciate the distinction, saying instead that the case for Section 2033 inclusion in *Johnson* was even stronger because the TAM did not entail the settlor acting as trustee. This confirms that the *Johnson* court did not understand the nature of fiduciary duties and the need for a third party – even a contingent future interest beneficiary – to be able to assert the fiduciary's duties. That element was lacking in the TAM, notwithstanding that a third party was acting as trustee, but it existed in *Johnson*, which is why the cases are not the same.

The court's misconception is confirmed by the other authority cited in *Johnson*, being Rev. Rul. 75-553, 1975-2 C.B. 477, which again entailed a trust that poured back to the settlor's probate estate at the settlor's death. That Ruling expressly stated the operative rule that Sections 2036 and 2038 are not applicable "unless someone other than the decedent receives a beneficial interest in the transferred property" during the settlor's life. That interest existed in *Johnson* in the remainder beneficiaries but not in the Ruling. Again, the *Johnson* court did not appreciate this distinction. Instead it held that "the Decedent here beneficially owned all of the Trust assets up until the time of her death." That notion simply is not correct.

The *Johnson* court's conclusion will be unfortunate if it serves as precedent for a state court to hold that a revocable, inter vivos, self-trusteed, declaration of trust is not a valid probate avoidance device. That risk is magnified in a jurisdiction that has enacted UTC §603(a), providing that the rights of other beneficiaries are subject to the control of the settlor and the duties of the trustee are owed exclusively to the settlor while the trust is revocable and the settlor is not incapacitated to revoke the trust. The intent of §603(a) is not to suggest that the trust is not yet valid, yet a misunderstanding of this provision could lead to a *Johnson* result in any UTC jurisdiction. Which would be a wrong and unfortunate result in cases that do not entail the special Section 6324(a)(2) lien that is the driving subject in *Johnson*.

Unless the Government successfully appeals *Johnson*, the court's conclusion could create unwarranted difficulties unanticipated by trust drafters in the many American jurisdictions that have adopted the UTC. As it is, §603(a) has produced some heartburn in terms of which (if any) beneficiaries may complain about trustee performance while the settlor of a revocable trust is alive. *Johnson* would compound the difficulties already created by §603(a) in cases that involve efforts by remainder beneficiaries to hold trustees accountable for fiduciary breaches during the settlor's lifetime. All revealing that seemingly settled concepts regarding the validity of inter vivos trusts and the objects of a fiduciary's duties are coming under review.

Johnson says nothing about probate avoidance or formalities of execution, and it is a one-off decision in the sense that it doesn't avoid estate tax inclusion. It only works to protect the beneficiaries from transferee liability under Section 6324(a)(2). No planner would likely take advantage of the court's ruling, so *Johnson* may be a decision that planners should dismiss as result-oriented and fundamentally wrong-minded.

Nevertheless, in thinking about the tax implications of *Johnson*, what difference does it make that inclusion is generated under Section 2033 rather than Section 2036 or 2038? There are a handful of provisions that distinguish between probate property and nonprobate property, none of which the *Johnson* court considered. For example, Section 2053(b) provides a different rule, in terms of timing requirements, for the deduction of expenses of administration of property "not subject to claims" – which Reg. §20.2053-8 regards as nonprobate property. Does *Johnson* mean that the probate property rule is applicable to the sort of trust involved in *Johnson*? This could be taxpayer favorable, because Section 2053(a) does not impose a similar limitation on when those administration expenses must be incurred. And Section 2207B is a right of reimbursement for estate tax attributable to property includible in the gross estate under Section 2036, whereas Section 2205 essentially imposes the liability for estate tax on the probate estate. Which rule is applicable to the property in the *Johnson* trust? A well-drafted tax apportionment provision will circumvent the need to resolve that question.

On the other hand, it seems unlikely that the *Johnson* decision could alter fundamental state law concerns such as requirements for valid execution of a trust document, the elective share of a surviving spouse, or whether creditors have access to such a trust, either inter vivos or postmortem. But you never know what precedent a state court might seize in litigation involving a trust designed to provide lifetime administration and then avoid probate.

Garnishment Defeats Spendthrift Protection. Spendthrift trust protection against creditors is subject to various limitations. For example, many state laws (like UTC §503) provide exceptions to spendthrift protection for claims to child or spousal support. Government claims also may be immune to spendthrift protection. Nor does spendthrift protection necessarily restrict creditor rights to attach a beneficiary's right to receive immediate distributions. Rather, spendthrift protection may only serve to preclude acceleration of beneficial interests, not attachment of distributions once the beneficiary becomes entitled. As to them, a proper garnishment order may be applied to enforce this creditor entitlement, essentially mandating that the trustee pay directly to the creditor anything that is immediately distributable to the beneficiary. UTC §502(c) provides otherwise, but may not control in the type of situation described in this development. Thus, a garnishment order against a trust may not differ from a garnishment order against a debtor's wages, which may be enforceable against a trust interest in the same manner (and potentially subject to the same limitations).

Some trust drafters seek to avoid garnishment by using an "in-hand-payment" clause, directing the trustee to make distributions only to the beneficiary personally. These provisions do not appear to add any protection beyond that of a garden-variety spendthrift provision itself. *See, e.g., Brent v. Maryland Central Collection Unit*, 537 A.2d 227 (Md.

Ct. App. 1988). In addition, they would not add anything to the protection of UTC §502(c). Nevertheless, in some trusts a facility-of-payment provision permits the trustee to make distributions for the benefit of a beneficiary, such as by paying their rent or mortgage, paying for groceries or prescriptions. These are nearly the exact opposite of an in-hand-payment provision in the sense that they are meant to deal with a beneficiary who is not competent due to age of other capacity. These provisions are not normally meant to preclude payment to creditors – as would be the intent of a spendthrift provision or an in-hand-payment provision – but rather to allow payment to trade creditors for the convenience of the beneficiary.

Two recent cases involving California law (not a UTC jurisdiction) illustrate the difference between spendthrift protection and garnishment. ***United States v. Harris***, 854 F.3d 1053 (9th Cir. 2017), involved a federal claim for restitution for amounts stolen from an employee benefit plan. Harris was beneficiary of two discretionary support trusts created by third parties, each containing spendthrift provisions and both giving Harris an interest that was subject to the trustee's "absolute discretion." In ***Carmack v. Reynolds***, 391 P.3d 625 (Cal. 2017), confirmed sub nom. by *In re Reynolds*, 867 F.3d 1119 (9th Cir. 2017), a bankruptcy trustee sought to determine the bankruptcy estate's interest in a third-party spendthrift trust as to which Reynolds had disclaimed a right to receive $250,000 immediately, $100,000 a year for ten years, and then one-third of the trust remainder. Each case allowed the plaintiff to reach monies held by the trust that were distributable to the beneficiary.

Citing 28 U.S.C. §3002(12), *Harris* held that garnishment under federal law may reach "property," which includes "any present or future interest, whether legal or equitable, in real, personal (including choses in action), or mixed property, tangible or intangible, vested or contingent, wherever located and however held (including community property and property held in trust (including spendthrift and pension trusts))." The court did not need to address whether 28 U.S.C. §3002(12) would prevail over state law in a UTC jurisdiction.

The fact that amounts were payable to Harris "subject to the absolute discretion of the trustees" (limited by standards for health, maintenance, support, education, and best interests) was not prohibitive, because absolute discretion always is subject to court review, meaning that Harris had a property interest that fell within the purview of the federal statute. In addition, citing *Drye v. United States*, 528 U.S. 49 (1999), Harris' alleged disclaimer of his trust interests also did not defeat the garnishment. An important factor was the court's final observation: "The government is not attempting to compel distributions from the trusts. However, any current or future distributions from the trusts to Harris shall be subject to the continuing writ of garnishment, until the restitution judgment is satisfied."

Carmack similarly rejected the beneficiary's effort to preclude creditor attachment via disclaimer (on the eve of declaring bankruptcy), and held that the bankruptcy trustee could "reach a sum up to the full amount of any distributions that are currently due and payable to the beneficiary even though they are still in the trustee's hands." Again, this was not an acceleration of future rights of the beneficiary, which a spendthrift clause effectively prevents. Instead, it is merely an immediate right to receive that which is due and payable to the beneficiary.

Adventures with Spendthrift Trusts. Textbook spendthrift law provides that a settlor may not permit beneficiaries to make voluntary assignments of beneficial interests while precluding only involuntary attachment by creditors. To be effective, a valid spendthrift provision must prohibit both. Nevertheless, even if assignment is a violation of a spendthrift provision, a beneficiary who assigns a beneficial interest may not complain if the trustee honors that assignment. ***Trust of Middleton***, 2017 WL 1032737 (Penn. Sup. Ct.), applied both of these rules in an unusual context.

As part of a family settlement agreement, the trust beneficiary purported to irrevocably assign all principal distributions from a spendthrift trust to a trust that the beneficiary created (on the same date). Sixteen years later – and one year after the beneficiary's mother died – the beneficiary "revoked and repudiated" that assignment. The trustee asserted that the settlement was intended to mollify the beneficiary's mother, who otherwise would have disinherited the beneficiary from the mother's estate. And the court recognized that revocation of the assignment might be a violation of the family settlement agreement. Nevertheless, because the trustee had not yet acted upon the assignment (no distributions of principal had been made in the sixteen-year period), the court held that the beneficiary was permitted to revoke the assignment. According to state law, a beneficiary who assigns in violation of a spendthrift provision always may revoke the assignment, because the assignment is invalid and therefore cannot be irrevocable.

Had the trustee honored the assignment the beneficiary would have been precluded from holding the trustee liable, but in *Middleton* the trustee's inaction meant that the beneficiary could revoke. Quaere whether, on its own motion, the trustee could decant the trust into the trust that the beneficiary created at the time of the original assignment. Particularly if the trust had a "facility of payment" provision that allowed distributions to or for the benefit of a beneficiary and that included the authority to distribute in a variety of ways that included deposits into a trust created by or for the beneficiary.

In re Amerson, 839 F.3d 1290 (10th Cir. 2016), raised a different aspect of a spendthrift trust provision, being that the beneficiary must assert the protection for it to be applicable. In the context of Bankruptcy Code §541(c)(2) a beneficiary may assert that a spendthrift provision that is valid under state law is enforceable under bankruptcy law as well. But, according to the court, this protection is permissive and the beneficiary's failure to assert the protection of the spendthrift provision meant that the beneficial interest was not exempt from inclusion in the beneficiary's bankruptcy estate, available to satisfy creditor claims. In that respect, the spendthrift provision acts like an affirmative defense that, if never asserted, makes the protection it provides unavailable. Nothing in the opinion suggests that the trustee (not the bankruptcy trustee) has an affirmative duty to assert the spendthrift protection on behalf of the beneficiary.

Disclaimer Fails to Defeat Creditor. A Section 2518 qualified disclaimer allows a beneficiary to avoid wealth transfer tax by renouncing property, which passes to others as if the disclaimant was deceased. A less frequent (or successful) use of disclaimer planning is anticipated by *United States v. Irvine*, 511 U.S. 224, 239-40 (1994), which stated that one "important consequence of treating a disclaimer as an *ab initio* defeasance is that the disclaimant's creditors are barred from reaching the disclaimed property." In fact, that statement was dicta, and state law summarized in Casner & Pennell, Estate Planning §7.1.6 n.240, goes both ways on the issue whether creditors can be disfranchised via a debtor's disclaimer. In addition, case law also declares disclaimers to be ineffective to defeat claims by the Federal government.

The landmark case for Federal tax lien purposes is *Drye v. United States*, 528 U.S. 49 (1999), *aff'g sub nom. Drye Family 1995 Trust v. United States*, 152 F.3d 892 (8th Cir. 1998), which held that state disclaimer law cannot preclude attachment of a federal tax lien, even if the disclaimer was timely and effective for state law (and even for federal wealth transfer tax) purposes. According to *Drye*, state law determines the taxpayer's rights or interests in the disclaimed property but federal law determines whether those rights or interests are "property" as to which a tax lien may attach. The Court regarded the taxpayer's right to either accept or disclaim the property as a sufficient "right to property" to which the federal lien could attach.

United States Small Business Administration v. Bensal, 853 F.3d 992 (9th Cir. 2017), relies on *Drye* to preclude an otherwise qualified disclaimer from defeating the SBA's collection action under the Federal Debt Collection Procedures Act (FDCPA). Involved was a small business loan that the SBA sought to collect from a distribution of the disclaimant's share of his deceased father's trust. The SBA regarded the disclaimer as a "fraudulent transfer" under the FDCPA, and the legal battle was over whether state law was controlling on the question whether the disclaimer was a "voidable transfer." That issue boiled down to a question of preemption, federal law being in direct conflict with state law. Holding that state law "is inconsistent with the FDCPA and must give way to the federal statute in light of the express preemption clause," the court relied in part on *Drye* for the proposition that the taxpayer "executed his disclaimer *after* the government already had a pre-existing interest in his property." Thus, the debtor's disclaimer failed to preclude FDCPA attachment to the inheritance.

One potential lesson from *Bensal* is that retention of the debtor's inheritance inside his father's trust, with a viable spendthrift provision, might have avoided the government's attachment prior to actual distributions to the debtor. A sprinkle or spray provision allowing the trustee to make distributions to the debtor's descendants (the same folks who would have benefitted from the disclaimer, had it been effective), would protect the inheritance for the natural objects of both the trust settlor and the debtor, immune from claims by the SBA or other creditors.

Filing a Claim in Probate. Is a creditor's claim effective if mailed to an employee or agent of the decedent, who then delivers that claim to the executor? ***Wilson v. Lawrence***, 2017 WL 1406434 (Ohio), held that mailing the claim to both the decedent's personal assistant (secretary) and the trustee of the decedent's inter vivos trust, who each promptly forwarded the claim to the executor, did not preserve the $200,000 claim. "The statute is not ambiguous.… '[A]ll creditors … shall present their claims … to the executor or administrator'," and not to an agent of the fiduciary. Moreover, the statute does not admit to "substantial compliance," and "the law should not come to the creditor's aid."

Argued by the dissent was that delivery to an agent of the executor ought to suffice. In this case delivery was to an agent or fiduciary of the *decedent*, which is not the same. But consider another suggestion made by the dissent: "Would sending a written claim by

FedEx or a private courier service fail the majority's rule?" That essentially treats the decedent's assistant or fiduciary as the *creditor's* agent, to deliver the claim. Almost certainly that also was not the case. Still, the point is cogent that the executor timely received the creditor's claim, which was not unknown to the executor in the first instance. The need for certainty, in terms of the decedent's executor determining whether a claim was timely presented, was not at issue in *Wilson*, and the court's statement that "this responsibility cannot be delegated to an agent who does not owe the fidelity required of an officer of the court" almost certainly is not true. If the person truly is the fiduciary's agent, then they certainly also owe the same duties to the court as does the fiduciary personally.

All of these matters to the side, the lesson learned is that strict compliance with the procedure for filing claims is serious business. In *Wilson* the claim was filed by the creditor's attorney, who should have determined the proper addressee for the written claim. It seems likely that the attorney who failed to comply with the statute may be required to make good the creditor's loss. Furthermore, it might be that personal liability would apply if the executor paid the claim, rather than raising the defense that was successful in *Wilson*.

2. Legislation

[This Part VIII.C.2 is contributed by Skip Fox.]

Michigan enacts Domestic Asset Protection Trust legislation

Certain states permit the settlor of an irrevocable trust to obtain spendthrift protection from an irrevocable trust if certain require are met. While Missouri was the first state to enact domestic asset protection trust legislation in 1986, few attorneys outside of Missouri paid attention to it or were even aware of it. But domestic protection trusts gained public awareness when, in 1997, both Alaska and Delaware enacted legislation permitting domestic protection trusts. Since then 14 other states have enacted legislation permitting domestic asset protection trusts to one degree or another. Colorado has a long-standing statute that many commentators believe permits settlors to obtain spendthrift protection.

Michigan is the latest state (as of November 4, 2017) to permit settlors to obtain spendthrift protection. The 18 states with statutes allowing such self-settled asset protection trusts are Alaska, Colorado, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

The basic requirements in each of the states permitting these types of trusts are:

(1) There must be a resident trustee in the state.

(2) Some of the assets of the trust must be held in the state.

(3) Some of the administration of the trust must take place in the state.

(4) The transfer of assets to the domestic asset protection trust cannot be a transfer in fraud of creditors.

(5) The trust must be irrevocable.

(6) The settlor is a discretionary beneficiary of the income and principal of the trust.

On December 5, 2016, Michigan's governor signed the Qualified Dispositions in Trust Act, which became effective on February 5, 2017. The following are some of the provisions of the Michigan statute.

Creditor Protection. For any irrevocable trust created on or after February 5, 2017, a grantor may provide that the income or principal interest of the grantor as beneficiary of the trust will be protected from creditors. The trust must be irrevocable and there must be a Michigan trustee. The Michigan trustee must arrange for custody in Michigan of some or all of the trust property and some of the records pertaining to the trust must be kept in Michigan. No creditor or other person can bring a claim against a trustee, a trust advisor, a trust director, or any other person involved in counseling on, drafting, preparing, or executing the trust.

Limitations. The grantor can retain the following rights:

(1) Direct trust and investment decisions;

(2) Remove and replace trustees;

(3) Veto distributions from the trust;

(4) Receive discretionary distributions of income and/or principal;

(5) Receive the income from the trust;

(6) Retain a special testamentary power of appointment;

(7) Receive an annuity or unitrust payment from a charitable remainder trust;

(8) Receive the annuity payments from a grantor retained annuity trust; and

(9) Receive an annuity from the trust of not more than 5% of the trust initial value.

Creditors have a two-year period after a transfer to the trust to bring an action to challenge the transfer.

Applicability. The trust must provide that Michigan law applies to the validity, construction, and administration of the trust. The trust must have a spendthrift provision.

Solvency Affidavit. At the creation of the qualified trust, the grantor must provide a solvency affidavit (called a "Qualified Affidavit") and indicate the following:

(1) The grantor has the full right, title, and authority to transfer the property to the trust;

(2) The transfer of the property to the trust will not render the grantor insolvent;

(3) The grantor does not intend to defraud a creditor by transferring the property to the trust;

(4) The grantor does not know of or have reason to know of any pending or threatened court actions against the grantor except to the extent identified in an attachment to the affidavit;

(5) The grantor is not involved in any administrative proceedings except for administrative proceedings identified on an attachment to the affidavit;

(6) The grantor is not currently more than 30 days in arrears on a child support obligation;

(7) The grantor does not contemplate filing for relief under the bankruptcy code; and

(8) The property being transferred to the trust was not derived from unlawful activities.

D. Questions of Status

Same-Sex Common Law Marriage. Various cases have established the common law marriage of same-sex couples who were precluded from an intended ceremonial marriage by discriminatory state laws that were declared to be unconstitutional in *Obergefell v. Hodges*, 135 S. Ct. 2584 (2015). ***In re Estate of Carter***, 159 A.3d 970 (Penn. Super. Ct. 2017), articulates the legal requirements for a common law marriage, and the facts present challenging questions about timing in the context of Pennsylvania's repeal of common law marriage after 2004. The lower court denied recognition of the couple's marriage, stating that same-sex marriage was not recognized in Pennsylvania until 2014, which was after common law marriages were no longer newly recognized by state law. On appeal the court reversed, stating that the facts showed that the couple began their common law marriage as early as 1996, notwithstanding that Pennsylvania did not recognize same-sex marriage. Because nonrecognition was improper, the court held that the common law marriage existed even though state law failed to honor it. Interesting about the case was that no one opposed the petition for recognition of the marriage, and the facts were extremely strong in support of the marriage.

Change in Circumstances. Drafting wills and trusts is made more difficult when the terms used are immutable but the facts and circumstances under which the provisions will apply are subject to change. Especially when the natural objects of the client's bounty are malleable. For example, in an irrevocable life insurance trust (ILIT) it is common to grant various beneficiaries annual five-or-five rights of withdrawal (Crummey powers) to qualify contributions to the trust as present interests that satisfy the Section 2503(b) gift tax annual exclusion requirements. Frequently those withdrawal rights are given to close family members who will be trust beneficiaries after maturation of the insurance payable to the trust. Crummey powers typically are given to the settlor's spouse and descendants, perhaps to in-law relatives as well.

Some of these relationships are relatively immutable, but others are easier to change. For example, it is relatively easy to divorce a spouse, but not a descendant (or the descendant's spouse). The question addressed by ***In re Aaron Living Trust***, 2017 WL 1373437 (Md. Ct. Spec. App.), is what the term "wife" meant in the context of an estate plan drafted when the settlor was married to Eileen, but the woman to whom he was married at death was Myrna. The document had been amended after his first wife died and he had remarried, but no change was made to the trust provision that said "I am married to Eileen Aaron. Any reference in this agreement to 'my wife' is a reference to Eileen Aaron." Notwithstanding the settlor's remarriage and subsequent amendment of other provisions of the trust, this provision remained unchanged. Was that an oversight, an indication of lack of capacity, or proof positive that provisions in the trust addressing a surviving spouse were meant to apply only to Eileen, who did not survive the settlor?

In this context the court stated that the general rule is "a gift to a husband or wife means a husband or wife at the date of the will, and if the husband or wife then living dies, and the designated person remarries a second time, the second spouse does not take." Quoting 4 Page, The Law of Wills §34.2 at 485-486 (rev. ed. 2004) and noting, first, that the context may show a different intent and, second, that the same rules should apply under a trust. There is little reason to think that a different rule would apply to a divorce, rather than death, of the former spouse (unless state law addresses the consequences of a divorce). Still, the drafting lesson is that the document should articulate the client's intent when using terms that could apply to more than one person (seriatim, it should be hoped, when dealing with spouses). A different intent may exist in drafting an ILIT with Crummey clause powers of withdrawal, and documents often articulate that adopted children should be treated as natural born, and that current spouses (whoever they might be) are meant to be included (recognizing that relations by marriage are transitory). A document lacking clarity might be interpreted according to the settlor's current intent, but better approaches than a court action may include the use of nongeneral powers of appointment, powers to alter or amend a trust to add or delete beneficiaries, decanting to a new trust with more clarity in definition, or a grant of withdrawal rights as defined in each document conveying any contribution to the trust in the future.

Marriage, Divorce, and Adoption. State laws frequently vary in their definition of various individuals. Most notable in the past several years have been controversies involving marriage or divorce, and adoption (and various consequences flowing from these matters).

When individuals marry, typically they have the opportunity to undo that relationship via divorce. ***Solomon v. Guidry***, 155 A.3d 1218 (Vt. 2016), reveals that this ease isn't universally true about faux-marriages. It involved a same-sex couple that entered into a Vermont civil union, before same-sex marriage was possible, and who sought to legally end that relationship. They had become North Carolina residents, where their union was not recognized and therefore could not be legally dissolved either. They had to fight through the Vermont courts to determine that they were permitted by Vermont law to return and have a Vermont court end their civil union. Those sorts of case are rare, and becoming more rare. What about when one individual adopts another – can the adoption be undone?

There are ample circumstances in which an adoptive parent – particularly following an adult adoption – concludes that the adoption was ill-advised. An impressive illustration of this involved Doris Duke, the last lineal descendant beneficiary of the Duke energy and tobacco fortune. Duke adopted an adult as her daughter, making her a remainder beneficiary of that fortune, only to later rue that decision. *See In re Trust f/b/o Duke*, 702 A.2d 1008 (N.J. Super. Ct. 1995). Although it entails a similar question of improvident adoption, ***In re Adoption of R.A.B., Jr.***, 153 A.3d 332 (Penn. Super. Ct. 2016), appears to be a matter of first impression in most states. The plaintiff originally wished to marry his same-sex partner of over 40 years but state law, at the time, prohibited him from doing so. Consequently, he adopted his partner for (according to the court) "financial and estate planning" purposes. Several years later the state law prohibition on same-sex marriage was declared unconstitutional, and the plaintiff then wished to marry his partner, only to discover that the adoption made that unlawful.

Holding that "states have permitted adults in adoptive parent-child relationships to annul an adoption in order to marry, even where the relevant adoption statute does not expressly provide for that annulment," the court cited only two cases, one of which allowed an adoptive father and his adopted daughter to marry. They did not marry originally because she was only 16 at the time, and he already was married. They sought to marry when she was 22, to legitimize their newborn child. The instant court allowed the "unopposed annulment or revocation of an adult adoption." Notable, perhaps, are the court's two limitations – that the annulment be unopposed and that the adopted child was an adult at the time of the adoption.

More normal are cases like ***Edwards v. Maxwell***, 2017 WL 1201873 (Fla. Dist. Ct. App.), which held that one child has no standing to contest the adoption of another child, even though it meant that both would be eligible beneficiaries of a discretionary trust. Because neither child had an absolute, direct, financial, and immediate interest in the trust, the child who objected to the adoption had only an indirect or contingent interest that was inadequate to provide standing to complain about the adoption. Somewhat similarly, ***Eder's Appeal from Probate***, 2017 WL 4466832 (Conn. Ct. App.), rejected a challenge by a trust settlor's biological son that the settlor's adoption of two adults was an invalid subterfuge, meant to "amend" an irrevocable trust. The two adults were brothers, children of the settlor's long-term paramour. The settlor had acted as a father figure to them, even after the settlor and their mother separated (she moved back to England) and they retained close familiar ties (including visits, participation in the brothers' respective weddings, and dealings with their children, who referred to the settlor as "grandpa" – presumably with the brothers' acceptance or encouragement). Holding that they were natural objects of the settlor's bounty, the court also acknowledged that the biological son and the settlor "had little involvement" with each other and that they had "a falling-out" before the settlor adopted the brothers. The court cited cases in which an adoption "has been considered an act of subterfuge" but did not find the subject case to be such a circumstance. Notable, perhaps, is that the adoption was by the settlor of the trust, not by a third party who was seeking to make yet another person a beneficiary (as often occurs when an adult adoption occurs).

Stephens v. Mikkelsen, 519 S.W.3d 437 (Mo. Ct. App. 2017), and ***Cohen v. Shushan***, 212 So. 3d 1113 (Fla. Dist. Ct. App. 2017), both presented conflict of laws issues derived from differences in local law, involving the effect of an adoption in *Stephens* and the definition of marriage in *Cohen*. The difficulty in *Stephens* was that Illinois law allows a child who is adopted by a step-parent to "triple-dip" (inherit as heir of the adopting step-parent and of *both* natural parents), whereas Missouri law cuts the child off from the natural parent who was not married to the adopting step-parent. Because the adoption occurred in Illinois, the parties to the adoption may have expected that the adoption would not harm the child. But the case arose in Missouri, involving a Missouri trust created by a Missouri settlor with a choice of law provision that specified Missouri law to govern both construction and administration issues. The trust remainder passed in part to the natural grandfather of the child who was adopted by the step-parent in Illinois. Because the grandfather was deceased, and his only child also was deceased, that portion then passed by right of representation, making the grandchild's adoption away from that family relevant.

In many of these sorts of cases the adoption occurred years after the trust was established, making it "normal" that the trust did not address the effect of adoption. In *Stephens* the adoption occurred decades before the trust was created, meaning that the trust drafter might have anticipated the controversy that arose, were these facts known. It is not apparent from the court's opinion whether the individuals involved were sufficiently close to the settlor that these relationship issues would have been known by the drafter, and the document made no special provision addressing adoption. The question thus was whether the natural grandchild of the deceased remainder beneficiary would receive a share of the remainder. The court held that the Missouri rule would apply, notwithstanding an Illinois court's prior declaration that this adopted child's relation to his natural parents was not altered by the adoption. In that regard, full-faith-and-credit also might have applied but the appellate court did not even address that suggestion.

Cohen involved an even more challenging question of status and a conflict of laws. The issue was the Florida rights of a surviving spouse. The decedent (who was married once in Israel, and then divorced; his daughter from that marriage was the plaintiff), established what the court (and each expert who testified in the case) referred to as the "functional equivalent" of an American common law marriage. Israeli law has what the experts referred to as "Known in Public," and the court referred to the decedent and his "reputed spouse" (in each case because the actual Hebrew term has no English counterpart). The issue was relevant because, although Florida law does not permit common law marriage, Florida law does respect common law marriages from jurisdictions where that form of marriage is considered to be valid. The argument that prevailed (made by the daughter of the decedent's prior marriage) was that the only "marriage" that counts in Israel is a religious marriage, and the decedent and his reputed spouse never participated in a religious marriage. Thus, even though they were together for over 20 years, had four children together, held themselves out as husband and wife, and to all the world "would have seemed a married couple," their Known in Public relation was not a religious marriage and, therefore, they were not married under Israeli law, which meant that they were not married for purposes of the Florida elective share of a surviving spouse. A very strong dissent argued "that a reputed spouse in Israel is the equivalent of a common law spouse in the United States" and "the recognition that Florida courts must give common law marriages from other jurisdictions" meant that it also should respect the decedent's relation as a marriage for purposes of Florida law.

The *Cohen* court never explained why a Florida probate estate and elective share claim were involved. Presumably the decedent owned Florida property, and the elective share claim meant that he died with a valid Florida will that did not adequately provide for his surviving "reputed spouse." Wise planning could have employed any of a variety of methods by which a decedent may disfranchise the elective share of a surviving spouse, even in a state with a robust elective share such as under the Uniform Probate Code or

Florida law. For more detail on that planning see Cline, Pennell, and Turnipseed, Spouse's Elective Share, 841 Estates, Gifts, and Trusts Portfolio (Tax Mgmt. 2012).

A final controversy that seemingly should have arisen before is ***In re Estate of Jagodowski***, 2017 IL App. (2d) 160723, but the trial court needed to certify two questions to the appellate court. The first was whether parentage is determined under the Illinois Parentage Act or, because the question arose in a probate context, was it a Probate Code issue? And second was who has standing to question the parentage of an individual who purports to take as a child of a decedent? The court answered the first question noting that the Probate Code "does not speak to the determination of parentage," meaning that the Parentage Act – and its statute of limitation – was controlling. In this case that meant that an action brought when the alleged child was age 31 was too late, the Parentage Act requiring action no later than two years after relevant facts were known or should have been known, but in no case later than when the alleged child reaches age 18. The court also determined that the executor of a decedent who otherwise would be entitled to maintain a proceeding but who is deceased has standing to raise or address the parentage question.

Both answers appear reasonable, making *Jagodowski* interesting because the executor was seeking to determine that the decedent – who was listed on the child's birth certificate as her father – was not in fact the DNA provider. The court's resolution of the statute of limitation question means that the effort to deny that child's status will fail.

Who's Your Momma? Two recent cases addressed the consequences of assisted reproduction and the legal status of the former same-sex partner of a child's birth mother. The question in *Partanen v. Gallagher*, 59 N.E.3d 1133 (Mass. 2016), was parental rights. *In re Brooke S.B.*, 61 N.E.3d 488 (N.Y. 2016) (consolidated cases), established parental support obligations and rights to visitation and custody. In each case one partner was the birth mother, each partner held herself out as a parent of the children, but the petitioner did not adopt the children. Each case arose after the couple terminated their nonmarital relationship (each relationship predated the Supreme Court's determination that state laws forbidding same-sex marriage are unconstitutional), and each held that the nonbirth partner had enforceable parental rights.

Similar to both of those cases, ***McCrillis v. Hicks***, 2017 Ark. App. 221, concluded that the birth-mother's same-sex partner stood in loco parentis to the child and had both visitation rights and a support obligation. (The court reversed a lower court's grant of joint custody, however.) Unusual, perhaps, about the facts was that the parties retained counsel who created a domestic partnership agreement that addressed these questions, but they never executed it.

Traditional state parentage laws focus on paternity, because the birth mother normally is clear. Now courts are being tasked with questions flowing from various forms of assisted reproduction and relationships that fall short of marriage (and the termination of those relationships that also don't qualify as divorce). The growing body of case law may abate with the ability of same-sex partners to marry, and the likelihood that those intending to raise children will take that step. Because most jurisdictions have not yet addressed these parenting questions, forum shopping may be a common tactic until an extensive body of law is established. For parental rights purposes, adoption by one or both parties is the better avenue – provided that it is allowed by state law – and marriage (followed by divorce) may address these disputes for same-sex couples the same as it does for more traditional couples.

The aspect of these disputes that may concern estate planning may be claims by a child to inherit from a "non-biological, non-adoptive" decedent who was in loco parentis to that child, and planning historically directed at nonmarital children may become as relevant for women as it has been for men.

Class Gifts. Imagine a will that distributes "in equal shares to my children, X and Y." Is that a class gift (the same as if it had read simply "in equal shares to my children" without naming X and Y) or is it a gift to individuals X and Y (the same as if the identification of them as children did not exist)? And, what difference does that make?

First, we know that X and Y must be alive to take – notwithstanding the absence of any express survivorship requirement. That's the "implied condition of survivorship" required by the common law, now expressly codified in many states (*e.g.*, by UPC §2-603). Therein lies the source of a second issue: if either X or Y fails to survive, then a so-called anti-lapse statute might apply, to salvage the gift and prevent it from failing (lapsing). Normal state law would provide that the share of a predeceased child will pass to the child's descendants (representatives), if any. If there are no descendants, then that share might pass to other named beneficiaries under a class gift version of the anti-lapse rules – provided that this is a class gift. In a well-crafted anti-lapse statute the two rules will operate together to provide that the deceased class member's representatives will take the share if there are any. The other class members would receive the share that the class member would have taken if living, only if there are no representatives of the deceased class member.

In ***Roll v. Newhall***, 888 N.W.2d 422 (Iowa 2016), the significance of the class-gift distinction was different. The question was whether X takes as a member of the class of the testator's children if X was adopted away prior to the testator's death. That is, will X be treated as no longer a child under state law if X was adopted by a third party before the testator's death? Or will X take in all events because X was named as a beneficiary and the designation as a "child" only served to better identify X (*e.g.*, according to the *Roll* court, because there might be two individuals named X and the identification would distinguish them). In *Roll* the issue arose because child X had been adopted, as an adult, by the testator's sister-in-law (that is, by X's paternal aunt, who sought to create a parent-child relationship rather than their aunt-nephew relation, because it altered the Iowa inheritance tax rate that would apply to the aunt's estate, which apparently passed to X).

The question of status as affected by adoption into or away from a family is addressed by state law. In Iowa there is a general statute and also the intestacy statute, providing that X would not take as a child if the testator died without a valid will. The court nevertheless held that a different rule could apply for purposes of a will specifically naming X as beneficiary (rather than designating a class only by their relation to the testator). Faced with the question whether X should be disqualified because X no longer was a child for state law purposes, the court concluded that the aunt's adoption did not alter the testator's intent. And, because it regarded the will as ambiguous, it applied a rule of construction that "a class gift is defined as a 'gift to two or more persons *who are not named* and have one or more characteristics in common by which they are indicated.'" Under that rule, X and Y were not meant to take as a class for class gift purposes.

The will, specifically naming X and Y and referring to them as "children," was executed one year before the adoption, and the testator lived for over six more years, meaning that there was plenty of time for the testator to amend the will if the intent was to limit the class of beneficiaries to children as defined for state law purposes. (Nothing confirms that the testator was competent to alter the will, but that appears to be the assumption.) The court was *not* troubled by the tax motive ("to avoid paying inheritance taxes" in the aunt's estate), saying that "the tax treatment of [the] gift [from the testator] is not before us." The court also noted X's argument that inheritance tax was avoided in the aunt's estate but that it was *not* avoided in the testator's estate, apparently meaning that X did not claim status as a child of the testator for inheritance tax purpose. A different result might have applied were that fact otherwise.

Curiously, the provision in *Roll* leaving the testator's estate to her children included a clause that anticipated adoption *into* her family, reading "[a]ll references to child or children shall include all children born to or adopted by me after the date this Will is executed." Did the testator really anticipate adoption, or was this just boilerplate? And if it was boilerplate, would a more expansive indication of intent regarding adoption either *into* or *away* from a family be appropriate? A more compelling observation may be that adult adoption continues to raise difficult issues that many legislatures and drafters alike have not fully considered. Indeed, adult adoption may be more controversial, and individuals' intent may be so diverse, that no "standard" provision could be crafted for use as boilerplate. Which may mean that questions such as these will continue to beguile the courts if drafters do not address them one way or the other in the documents that they craft.

In the larger context, the lesson for drafters may be that adding information to a bequest (naming X and Y *and* identifying them by their relation to the testator) is not good drafting, although most drafters would likely argue to the contrary. The Restatement of Property (Third): Wills and Other Donative Transfers §13.2 cmt. d suggests that the presumption against the language in *Roll* being a class gift is not strong, and Prof. Larry Waggoner (who was the Reporter for the Restatement) stated in his 2012 ACTEC Trachtman lecture that drafting of the variety in *Roll* (to my children, X and Y) "is never a good idea" because of the ambiguity it creates. *See* Waggoner, What's in the Third and Final Volume of the New Restatement of Property That Estate Planners Should Know About, 38 ACTEC L.J. 23, 26 (2012).

In re Estate of Dietrich, 2017 WL 4654561 (Mich. Ct. App.), which arose in Waggoner's home state, illustrates the significance of this. The bequest was "to Peter and Johann, my sons, … in equal shares" and the question arose because Johann predeceased the testator, leaving two daughters who claimed his share under the state's version of UPC §2-603. The court articulated the notion that "the fact that beneficiaries are identified by name – even if they constitute a natural class – is generally seen as indicative of an intent to make a gift to the beneficiaries individually as opposed to creating a class." In addition, the court opined that failure to expressly require survivorship supported gifts to individuals, as to which the state anti-lapse statute was applicable, meaning that Johann's daughters took the share he would have received if living, rather than the entire estate passing to Peter.

E. Fiduciary Duties

Executor Must File Return and Elect Portability. Portability of the deceased spousal unused exclusion (DSUE) amount under Section 2010(c) does nothing to benefit the estate of the deceased spouse (D). Rather, it is valuable to that decedent's surviving spouse (S), and to beneficiaries of S's estate who may use the DSUE amount to offset taxes incurred by S's subsequent taxable transfers. As a result, commentators since original adoption of portability have warned that D's executor may choose not to incur the expense to file an estate tax return to make the election, particularly if D's estate benefits individuals who are not fond of S and are not natural objects of S's bounty (such as children by D's prior marriage). This was exactly the case presented by ***In re Vose***, 390 P.3d 238 (Okla. 2017), which may be the first reported decision ordering a decedent's executor to file an estate tax return to make the portability election.

A unanimous Oklahoma Supreme Court held that (1) state courts may exercise jurisdiction over estate tax return filing issues and (2) the executor's duty to preserve estate assets compels the executor to make an available portability election. Notable in *Vose* is that S agreed to pay any costs associated with preparation of the estate tax return. It is possible that any future court's determination of whether a portability return should be filed will be conditioned upon a similar agreement by S to reimburse all costs involved.

Although D and S had a premarital agreement in *Vose*, it predated portability and did not mention the election. Absence of any provision relating to portability was no impediment to the decision in *Vose*, but future agreements might wisely include an obligation to make the portability election so as to minimize or avoid controversies such as this.

Also interesting about *Vose* is that less than 12 months elapsed between D's death and the Oklahoma high court's decision. Indeed, from original application to final determination took less than five months under an available "fast track" procedure in Oklahoma, all permitting the estate to file a timely return. State law in other jurisdictions may not make such a resolution as easy to establish.

Fiduciary Access to Digital Assets. The issue in ***Ajemian v. Yahoo, Inc.***, 2017 WL 4583270 (Mass.), will have historic consequences, which may explain why the Massachusetts high court initiated transfer of the case from the court of appeals on its own motion. But the significance of this first decision on point remains to be seen. Yahoo declined access sought by the decedent's executors to the decedent's email account, on two grounds, citing prohibitions in the Stored Communications Act (SCA) and its terms of service agreement. The court held that the SCA does not preclude the executor of a deceased email user from access to the email account. But the court remanded the question whether Yahoo's terms of service agreement allows Yahoo to refuse access to the account. That remains to be determined.

Notable is that the SCA dates back to 1986, predating creation of the world wide web. The opinion mentions the Revised Uniform Fiduciary Access to Digital Assets Act (which it said has been adopted in over two-dozen states and was pending in eight more) but does not say whether (1) Massachusetts has adopted that Act, (2) it would apply to the estate of this decedent, who died in 2006, or (3) the Uniform Act would affect this action in any way. As such, it remains to be seen whether *Ajemian* is useful to fiduciaries in other circumstances, particularly including the estates of more recent decedents.

The court *did* conclude that the SCA is no impediment to executor access to a decedent's email account. The opinion speaks in terms of state law trumping federal law, but this portion of the opinion is dicta because the court also held that, even if it applied, the SCA would not preclude access and therefore doesn't present a conflict with state law. The opinion also hints that the 15-page terms of service agreement may be unenforceable as a contract of adhesion, or because there was no meeting of the minds. As the court suggests, few users read those mind-numbing and exceedingly long agreements. But that question remains for resolution on remand.

The opposite result in *Ajemian* would have been detrimental to fiduciaries who seek access to email or social media accounts, but this decision may not be affirmatively useful otherwise. Finding that the SCA does not preclude disclosure provides cover for Yahoo and other service providers, that they have no exposure to SCA liability if they provide the requested disclosure. The court also stated that "allow[ing] a decedent's executor to accede to the release of a decedent's stored communications accords with the broad authority of a lawfully appointed executor to act on behalf of a decedent." This also could have significant implications in numerous contexts. But this isn't a surprising or novel holding.

The court's thinly-veiled suggestion that terms of service agreements may be unenforceable also could be significant in numerous other contexts. "You agree that Yahoo, in its sole discretion, may terminate your password, account (or any part thereof) or use of the Service, and remove and discard any Content within the Service, for any reason" is a remarkable concession by a user, if it really grants unfettered discretion to deny access or destroy content by unilateral fiat. That aspect of the decision is not uniquely relevant to fiduciaries, however, but it could lead to a milestone determination regarding the many millions of terms of service agreements that currently exist.

Yahoo "apparently has preserved thus far" the content of this 2006 decedent's email account, and a dissenting opinion claims that destruction after instigation of a court proceeding such as this "would violate our prohibition against the spoliation of evidence." That dissent asserted that, if a lower court held that the terms of service agreement allows destruction, then "we would surely reverse that ruling. So why remand the case to permit that possibility?" The dissent argues in favor of an immediate determination of the enforceability question against Yahoo, which may foretell the next chapter in this saga. Indeed, Yahoo wisely might just drop the issue, and this case, rather than face a negative decision that could impact it for many other purposes. Stay tuned.

F. Ethics

Invalidating Trust That Benefits Drafter. Under state law a provision in a will or trust that benefits the drafter may be presumptively invalid (and an ethics violation under Model Rule 1.8(c) unless the drafter had a close familiar relationship with the benefactor). In ***NPR Foundation v. Dimeff***, 2017 WL 1406817 (Cal.), attorney Dimeff became the sole beneficiary of the decedent's estate plan but did not actually draft the dispositive trust document. Instead Dimeff referred the settlor to Dimeff's friend, another attorney who "did not have much experience drafting estate plans" but who had represented Dimeff and who consulted with Dimeff on numerous occasions during the drafting process. Those were not the factors on which the court found that the trust was invalid, however. Nor was undue influence the primary finding on which the plan was invalidated. Instead, the court regarded Dimeff's preparation of the trust schedule of assets alone as sufficient "drafting" to trigger a state statute that invalidated the trust. "In so acting, Dimeff was 'in a position … [to] easily control or influence the distribution of property under the instrument to [his] benefit.'" According to the court, drafting the schedule made him "particularly well suited" to exert the form of influence that the state statute was enacted to guard against.

There can be little doubt, in reading the facts of *Dimeff*, that the court reached the right result, but the ground on which the decision rests could be a bit troubling in a case that did not actually involve an overreach by the attorney. Imagine, for example, *In re Boulger*, 637 N.W.2d 710 (N.D. 2001), in which the attorney was a lifelong friend of the decedent, college roommate, godfather to the decedent's child, and only later the decedent's attorney. He had represented the decedent's business for years and, when it was time to name a remote contingent beneficiary of the decedent's estate, he was named (but did not actually receive any bequest). Knowing that he should not draft the document naming him as the last beneficiary (the one who would take only if everyone named by the decedent as a primary beneficiary fails to survive), the attorney provided all the relevant client information to an independent drafter and played no direct role in the preparation of that plan. According to *Dimeff*, if the attorney provided the list of assets that ultimately became the Schedule for the client's trust, that involvement alone would trigger the statute. Should that minimal involvement tar the attorney?

In *Boulger* the client insisted that attorney Boulger draft the document, and Boulger ultimately acceded to the client's desire that no other drafter become involved. Notwithstanding that Boulger never took any property under the plan, still the court sanctioned him for the ethics violation. Similarly, the court in *Dimeff* invalidated the plan provision in Dimeff's favor as invalid (and, because he was the sole beneficiary, this effectively invalidated the entire trust). Showing that involvement in any way, and under any circumstances – snarky or otherwise – risks defeat of part or potentially all of a client's estate plan. With clear implications for estate planning attorneys.

Attorney as Executor. There is no doubt that attorney Allen properly was sanctioned by ***In re Disciplinary Action Against Allen***, 900 N.W.2d 240 (N.D. 2017). He named himself as joint tenant on bank accounts of his elderly mother, ostensibly at her request. And, after her death, while he served as executor of the estate (of which he was not a beneficiary), he sought to insinuate his child, born after his mother's death, as an equal remainder beneficiary, along with his estranged daughter. Ultimately attorney Allen was removed as executor and suspended for six months for various violations, especially including his personal conflict of interest, which triggered Rule 1.7(a), and then by seeking to represent himself as an interested party in the estate proceeding, in violation of Rule 1.9 (conflict of interest with a former client – the estate in this case). To top it off was a Rule 3.3 violation (false statement to tribunal). He dodged a Rule 8.4(c) violation (conduct involving dishonesty, fraud, deceit, or misrepresentation that reflects adversely on the lawyer's fitness as a lawyer) because the court found that there was no clear and convincing evidence of the violation.

The eye-catching element in the case is a "special" concurrence in which Justice Crothers cautioned that "if a lawyer agrees to serve in a familiar fiduciary capacity … the lawyer likely is barred from using information obtained in that capacity … in any subsequent proceeding involving the estate," citing Rule 1.7. Further, because "a lawyer serving as a personal representative always is a lawyer …, any time the lawyer ceases being either the personal representative or the lawyer for the personal representative, the lawyer will be bound by Rule 1.9 regarding former clients." Meaning that "lawyers acting as family member-executors are barred in the future from asserting any claims that may adversely affect the former client" (the estate). The opinion was written "to highlight these constraints … and to point out that today's case will broadly impact a lawyer's ability to assert future claims. Lawyers should … cautiously accept representational positions in family-related matters where they might have a personal interest that is or might be adverse to the estate."

G. Modification and Decanting

Decanting Allowed. Trusts permit the imposition of either attractive or reprehensible (depending on who you represent) "dead hand" controls over the future use of property. Coupled with judicious use of powers of appointment, trustee discretion, and trust protector provisions, flexibility to adapt trust uses to changing conditions also is attainable. This flexibility is the key to effective estate planning that adapts to changing circumstances, whether those be family, tax, or other law or circumstantial developments.

The most direct mechanism to provide for change is a power to terminate, alter, or amend a trust, which (at least for tax purposes) can be reposed in almost anyone other than the settlor (and other than the settlor's spouse if it is appropriate to avoid grantor trust income tax problems). Thus, this power could be given to a committee, another fiduciary, or a trust protector. It also *could* be given to the trustee, although in some respects that defeats the "separation of powers" or checks-and-balances nature of bifurcating this sort of authority. Whomever is the chosen holder of the authority to make changes, the issue then is to what extent and to reflect what kinds of circumstances the power should be granted, what to do with the trust property on a termination, and any tax exposure to the powerholder, especially if that person is a beneficiary.

The preferred authority to adapt to change for many planners today is a "decanting" power – the authority of a trustee to pour the contents of an existing trust into a new trust with slight variations in terms or powers. The constraint to "slight" changes is a function of the conceptual underpinning of decanting itself, which is that a trustee with the power to make corpus distributions outright to a beneficiary may instead make those distributions into another trust for the benefit of that beneficiary. *See Morse v. Kraft*, 466 Mass. 92 (2013), essentially embracing this common law notion (but declining an amicus request "to recognize an inherent power of trustees of irrevocable trusts to exercise their distribution authority by distributing trust property in further trust, irrespective of the language of the trust"). The court ruled that decanting in that case was allowable under state law, without the consent of either a court or the beneficiaries.

More recently, ***Beardmore v. JPMorgan Chase Bank, N.A.***, 2017 WL 1193190 (Ky. Ct. App.), authorized the conversion of two half-century-old trusts into a single directed trust (for investment purposes) and decanting of that trust to Delaware for what was represented to be income tax savings of 0.1% annually, that would apply in a $100 million trust that would extend for another 50 years ($100,000 per year, which the court regarded as "a significant aggregate tax savings"). The government had blessed the proposed changes in a 2014 PLR that confirmed that it would not taint the chronological exemption of the two trusts for generation-skipping transfer tax purposes.

Based on an analog to the exercise of a nongeneral power of appointment, which also permits appointment in further trust, as authorized by Restatement (Third) of Property (Wills and Other Donative Transfers) §19.14 (2011), the notion is that the power to decant does not allow the trustee to change the beneficiaries or their beneficial interests. Thus, the trust-to-trust conversion must protect the basic beneficial interests while improving trust administration or taxation. *See*, *e.g.*, *Harrell v. Badger*, 171 So. 3d 764 (Fla. Dist. Ct. App. 2015), holding a decanting to be invalid because the successor trust granted a contingent remainder interest to a new beneficiary that was different than the contingent remainder beneficiary of the original trust, in direct violation of the Florida statute authorizing decanting. But ***In re Estate of Hoppenstein***, 2017 N.Y. Misc. LEXIS 1707 (N.Y. Surr. Ct. 2017), allowed distribution of a $10 million insurance policy from a 2004 trust created by the settlor to a 2012 trust created by the same settlor, the terms of which were the same *except* the settlor's daughter and her descendants all were excluded. The court distinguished this from a decanting, saying that it was an exercise of the trustee's express power in the trust "to pay such sums out of the principal of the trust (even to the extent of the whole thereof) to the Settlor's descendants … in equal or unequal amounts, and to any one or more of them to the exclusion of the others, as the Trustees, in their absolute discretion, shall determine …."

In ***Ferri v. Powell-Ferri***, 72 N.E.3d 541 (Mass. 2017), the sole question posed by certification to the Massachusetts high court was whether the trustee could decant a third-party spendthrift trust into a new trust that altered one fundamental provision. The old trust granted the beneficiary a power to withdraw trust corpus after the beneficiary reached target ages, meaning that it would lose its spendthrift status to the extent of that withdrawal right. The new trust removed that right, the objective being to preclude or minimize any state law right of the beneficiary's soon-to-be ex-spouse to reach trust corpus in a property settlement incident to their divorce. Citing and following *Morse*, the court allowed the decanting, saying first that "if a trustee has the discretionary power to distribute property to or for the benefit of the beneficiaries, the trustee likewise has the authority to distribute the property to another trust for the benefit of those same beneficiaries. … [The] trustee's broad discretion to distribute the assets of an irrevocable trust may be evidence of a settlor's intent to permit decanting." And then, "if a settlor intended a trust's assets to be protected from creditors, he or she necessarily intended that the trustee have the means to protect the trust assets consistent with his or her fiduciary duties. … If the trustee were unable to decant the portion of trust assets made 'withdrawable' as the beneficiary reached certain age milestones, the trustee correspondingly would lose the ability to exercise his or her fiduciary duties (including the duty to invest and protect the assets' purchasing power) over those assets …."

The court did not mention any tax consequences that may attend to the beneficiary's failure to object to the removal of the withdrawal right. Arguably the change constituted a lapse or release of an inter vivos general power of appointment that would trigger gift tax under Section 2514(b) or (e), which might be acceptable to the family because estate tax would be incurred anyway, when the beneficiary died, under Section 2041(a)(2). Perhaps the beneficiary's exclusion amount would cover the gift tax liability at the time of decanting. In *Ferri* any potential gift tax exposure also may have been avoided by reserving in the beneficiary a nongeneral testamentary power of appointment that would defer completion of the gift. So, protection of the trust corpus from the claims of the beneficiary's ex-spouse, at no increase in wealth transfer tax, could be a benefit. Note that incurring gift tax on termination of the general power (in the form of the withdrawal right) would cause a loss of new basis at death (which would apply if, instead, Section 2041 was triggered when the beneficiary died). That also may have been of slight moment – there being no indication whether, for example, the trust assets might be legacy assets that the family never intended to sell.

A concurring opinion in *Ferri* took pains to "emphasize what we did not decide …: whether Massachusetts law will permit trustees in Massachusetts to create a new spendthrift trust and decant to it all the assets from an existing non-spendthrift trust where the sole purpose of the transfer is to remove the trust's assets from the marital assets that might be distributed to the beneficiary's spouse in a divorce action." Meaning that the trustee's action may not succeed in its primary objective, but the court was not willing to prevent the effort. Said the concurring opinion, "I do not offer any prediction as to whether this court might invalidate as contrary to public policy a new spendthrift trust created for the sole purpose of decanting the assets from an existing non-spendthrift trust in order to deny the beneficiary's spouse any equitable distribution of these trust assets. I simply make clear that, in this opinion, we do not decide this issue …." So, decanting may be allowed, but it may not serve the primary intended purpose.

A subsequent decision in ***Ferri v. Powell-Ferri***, 2017 WL 3386926 (Conn.), may answer the spendthrift question for purposes of the parties' divorce. The travel of the *Ferri* dispute originated in a declaratory judgment action filed in Connecticut, by the trustees, seeking a determination that the decant was valid. The Connecticut high court certified the decanting question to the Massachusetts high court, to rule on whether the decant was valid under Massachusetts law, which applied because the trust was a Massachusetts irrevocable trust. The rationale for decanting was to preclude a court from finding that the trust corpus, to the extent subject to the beneficiary's right of withdrawal, was marital property of the Connecticut couple. Accepting the *Ferri* decision by the Massachusetts high court, the Connecticut high court concluded that the beneficiary's soon-to-be ex-spouse had standing to question whether the trustee's action was proper. But the court also held that the new trust was not subject to the claims of creditors, as would be a self-settled trust. This finding was based on the undisputed notion that the beneficiary was unaware of the trustees' decision to decant, which was performed without the beneficiary's permission, knowledge in advance, or consent. This means that, under

Connecticut law, the beneficiary's interest is only a factor that a court may consider in determining alimony or support obligations, but the trust corpus is not marital property that is subject to equitable distribution. Meaning that the trustees' primary goal of protecting the trust corpus was accomplished.

As shown in *Ferri*, decanting might be favored as one means of increasing creditor protections. Court approval may be required if the trust lacks express authority, or if state law is silent regarding the power to decant. As of 2017 over two dozen state statutes allowed decanting. In addition, in July 2015 the Uniform Law Commission approved a Uniform Trust Decanting Act that is likely to produce additional state enactments of decanting authority. For up-to-date listings of statutes consult sidley.com/experience/state-decanting-statutes or www.oshins.com/images/Decanting _Rankings.pdf (last visited 23 February 2017).

Meaningful changes in any beneficiary's interest may cause income and wealth transfer tax consequences, as if the beneficiary whose interest is diminished (but who did not object) made a gift when the right to challenge the change lapsed. As a consequence, any available trust modification or reformation may be a preferable avenue for change. Indeed, in *Ferri*, perhaps the most interesting question is why the trustee did not pursue the very favorable Massachusetts procedure to modify or reform a trust, eliminating the power of withdrawal that was the apparent source of concern. Given that a court order was required to approve the decanting, would court approval of a modification be any different?

In drafting new trusts, any express authority to decant should make clear the extent of any permissible changes, such as in terms of beneficiaries who may be added or affected (*e.g.*, only the settlor's blood relatives and their spouses), powers of appointment that may be granted or withdrawn (*e.g.*, for GST tax purposes), changes to accomplish or preclude certain consequences (*e.g.*, causing grantor trust income tax exposure to the settlor of an inter vivos trust, eliminating or altering a source of wealth transfer taxation to a beneficiary or fiduciary, eliminating a spendthrift clause to permit beneficiaries to transfer their interests, or tinkering with a vesting provision to avoid violation of the rule against perpetuities), to conform to new laws (*e.g.*, increased federal security law reporting requirements), and provisions that under no circumstances may be altered (*e.g.*, anything that would cause loss of the marital deduction or a zero inclusion ratio in an exempt generation-skipping trust, provisions relating to the identity and accountability of fiduciaries, or the provision under which all of these changes are authorized).

In addition, procedures for exercise should be established (*e.g.*, only independent fiduciaries may act, only with the approval of a court of competent jurisdiction, and only to accomplish a reduction of taxes or a furtherance of the settlor's objectives). State statutory or judicial authority to reform a trust – particularly the nonadministrative or nonministerial aspects – may be too restrictive. So a decanting provision should be considered for inclusion in any trust that will have an extended duration or in which other forms of providing flexibility (*e.g.*, powers of appointment) will not be effective or appropriate. The key is that trusts permit this kind of engineering for future adaptations, and that authority should be considered carefully and provided by the document whenever possible

Decanting may be useful to change the situs (and thus the state income taxation) of a trust, moving it from a tax-expensive jurisdiction to a tax haven, or to obtain flexibility under governing laws that are more amenable to the trust. So a governing law provision ought to be included in a trust, specifying whether the law of trust administration may be altered by moving the trust for administration purposes.

In terms of the tax consequences of decanting, Notice 2011-101, 2011-52 I.R.B. 932, requested comments regarding trust decanting if trust beneficial interests are affected. (Apparently the government is not focused on transfers that only change trust administration provisions or affect state taxation of the trust or its beneficiaries.) The Notice specifically invited comments regarding the relevance and effect of various facts and circumstances that may affect one or more federal tax consequences, including (1) trust beneficial interests in principal or income are added, deleted, or changed, (2) income tax grantor trust status is altered, (3) the trust term is extended, (4) the identity of the donor or transferor for gift or GST tax purposes is changed, and (5) whether the trust is chronologically exempt from GST tax or has a zero inclusion ratio. These items highlight the government's concerns and the Notice specifies that no further PLRs will issue with respect to transfers that change beneficial interests or the applicable rule against perpetuities period, which means that taxpayers must fly blind during the current silent phase. That silence therefore increases the stakes of decanting, and places even more importance on the terms of the trust itself, authorizing decanting and specifying any limits or relevant protections.

Another source of flexibility is modification or reformation, a growing but heretofore localized trend. The circumstances in which it was granted in the past were somewhat monochromatic, with many cases making changes intended to minimize or avoid the GST tax. Most other cases still are directed at other forms of tax minimization. As relevant to this discussion, see, *e.g.*, PLRs 201436036, 201006005, and 9805025 (reformations to correct scrivener errors by converting general powers of appointment into nongeneral powers), *Dwyer v. Dwyer*, 898 N.E.2d 504 (Mass. 2008) (reformation that converted a taxable general power of appointment into a nontaxable nongeneral power); *Walker v. Walker*, 744 N.E.2d 60 (Mass. 2001) (reformation to add an ascertainable standard to limit an otherwise general power to appoint); *Hillman v. Hillman*, 744 N.E.2d 1078 (Mass. 2001) (reformation to preclude a child's exercise of an inter vivos power to appoint corpus among the settlor's "issue" from including the child personally).

Most recent is ***In re Brecher***, 2017 N.Y. Misc. LEXIS 38 (Surr. Ct.), which allowed reformation of a marital deduction formula provision to reflect changes to federal and state law in the 27 years since the will was executed and to eliminate over $500,000 of New York state estate tax. The court stated that the movement of funds from the decedent's nonmarital trust into a marital trust created under that will would "protect the testator's intent from being thwarted by a change in the tax law" and that lack of opposition from beneficiaries of the nonmarital trust indicates consent by those beneficiaries who "do not perceive the proposed remedy to be a threatened injury to them." Not addressed by the opinion was whether those beneficiaries' failure to object constitutes a gift by them to the surviving spouse, why a disclaimer by those beneficiaries would not have worked the same effect without raising that issue, and whether this state court determination would be binding on the federal government for estate tax marital deduction purposes. It should be binding on the state tax authorities and it may not have mattered for federal estate tax purposes, given the size of the decedent's basic exclusion amount.

Modification of Joint Settlor Trusts. ***In re Frei Irrevocable Trust***, 390 P.3d 646 (Nev. 2017), is the wrong case to resolve a question that the Nevada Supreme Court regarded as one of first impression (at least in Nevada). Under both the Second and Third Restatements of Trusts and UTC §411, the notion is that an irrevocable trust may be modified or terminated upon consent of all beneficiaries, even if modification or termination is inconsistent with a material purpose of the trust, *if* the trust settlor consents.

The immediate question presented in *Frei* was whether spendthrift protection is a material purpose. The court said that it is not, relying on Restatement (Second) of Trusts §338 comments *d* and *h*. The corresponding provision is Restatement (Third) §65, and UTC §411(c) provides that a spendthrift provision "is not presumed to constitute a material purpose of the trust." In *Frei* that was a linchpin holding because the objection to modification of the trust was brought by the very beneficiary who instituted the modification proceeding, who apparently discovered too late that the grant of his petition exposed his trust interest to his own creditors. Oops.

The other question is whether a joint settlor trust requires the consent of both settlors, along with all interested beneficiaries. In *Frei* that was an issue because one of the two settlors was deceased. Consent on her behalf was said to come from the surviving settlor and a child who held the deceased settlor's durable power of attorney. Unfortunately that consent came after the deceased settlor died, meaning that the durable power no longer was effective. The court's footnote 4 suggests that the court had no idea that this was a limiting fact, and it regarded the deceased settlor's consent as effective. In a properly-decided case, the question might be whether one of several settlors can consent on behalf of all of them. And, then, depending on the answer to that question, the joint settlor trust might be regarded with more or less favor than a more traditional trust with just one settlor. Quaere what a thoughtful drafter would provide in anticipation of this issue.

Locklin v. Locklin, 2017 WL 4700389 (Kan. Ct. App.), may answer that question, the court holding that a trust created by spouses, providing that "[w]e reserve the right … during our lives … to amend or revoke" was indicative of the intent to make the trust irrevocable upon the death of the first settlors to die. The negative aspect of that is that irrevocability during the life of the surviving spouse constitutes completion of any gift made to the trust, with acceleration of the wealth transfer tax liability with respect to any interests not retained by the surviving settlor, such as the remainder interest following the death of both spouses.

Material Purpose for Trust Reformations. As shown by *Frei*, a number of recent cases address the reformation or modification of trusts. This trend is likely to grow over the foreseeable future, for various reasons. One is decanting, which allows the transfer of the corpus of one trust into an entirely new trust, potentially with different provisions. Decanting is a mechanism for the wholesale correction or modification of trust terms, in some cases many years or decades after the original trust was created. If decanting is permitted, then lesser included methods of "fixing" trusts also ought to be permissible. State laws permitting decanting are becoming more widespread, and reform or modification also are common options.

A second reason why modification and reformation is a growing phenomenon is because the privity bar to attorney/advisor malpractice has collapsed nearly everywhere, meaning that a mistake can result in liability to the trust drafter or planner. Given the choice between letting an unintended result apply because a mistake cannot be cured, and then recovering from the drafter (or from a malpractice liability insurer) any damages suffered, many courts would prefer to just fix the mistake, which accelerates the process and avoids unintended windfall consequences followed by a damage recovery. Reformation or modification of the document is more efficient and less costly.

A third reason is to adapt to changing circumstances. Provisions that seemed like a good idea when drafted become obsolete, justifying modifications to better ensure continuation of the settlor's original goals. A traditional illustration is a trust restriction on investment options, often found in documents drafted in the wake of the Great Depression, when distrust of equities led some drafters to limit permissible investments to corporate or government bonds. A more unusual illustration is found in ***Hitz v. Hoekstra***, 2017 WL 1366066 (Cal. Ct. App.), in which the settlor created a trust to sustain a private college created 100 years ago. Offering only a two-year program, it had only 26 students and six full-time faculty at the time of the trial. Students paid no tuition but worked on an active ranch as part of their program of instruction. The school was one of only four remaining all-male U.S. colleges. The court was asked to modify the trust to permit admission of female students, which it did under a state statute permitting modification of administrative or dispositive provisions "if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment or the purposes of the trust." That law mirrors Restatement (Second) of Trusts §167(1), which the court held to apply, although it is hard to imagine why the consequences of gender specific enrollment was a condition that the settlor could not know or anticipate. The result seems to confirm that courts are more prone to grant relief under standards that are being applied in an expansive or flexible manner.

A fourth reason is because many less-experienced or qualified drafters believe that they can handle trust and estate matters, because they can obtain forms, and they regard drafting as the functional equivalent (or the intended end product) of estate planning. Experienced practitioners know that there is a difference between producing documents and planning, and that a totally "workable" document that effects the wrong goals is every bit as bad as messing up the drafting of documents. In the end, there are more messed up trusts these days because less qualified drafters are involved with greater frequency.

A similar reason is because individuals are doing-it-themselves. Downloading documents from the internet, and making mistakes that even modestly trained practitioners would avoid, these circumstances are a prescription for modification or reform. In these cases the need to resolve problems is a function of mistake by the settlor, rather than by any professional.

In this context, the enactment of state laws authorizing corrections is becoming more prevalent. ***In re Brakke Trust***, 890 N.W.2d 549 (N.D. 2017), is notable because there were *two* such state laws, and they were not entirely consistent. Involved was court approval of a family settlement agreement that implicated a trust. Notwithstanding that a trust was involved, the court applied a provision under state law that was modeled after the Uniform Probate Code as adopted in North Dakota, rather than the otherwise applicable state law that was modeled after the Uniform Trust Code, also as adopted in North Dakota. It is best to compare the two Uniform laws:

- Uniform Probate Code §3-1101 provides in relevant part that "[a] compromise of any controversy as to … the construction, validity, or effect of any governing instrument … if approved in a formal proceeding in the court for that purpose, is binding on all the parties thereto including those unborn, unascertained or who could not be located. An approved compromise is binding even though it may affect a trust or an inalienable interest."
- Uniform Trust Code §111(c) provides in relevant part that "[a] nonjudicial settlement agreement is valid only to the extent it does not violate a material purpose of the trust and includes terms and conditions that could be properly approved by a court under this Code or other applicable law."
- Uniform Trust Code §411(b) provides in relevant part that "[a] noncharitable irrevocable trust may be … modified upon consent of all of the beneficiaries if the court concludes that modification is not inconsistent with a material purpose of the trust."
- Uniform Trust Code §411(e) provides in relevant part that "[i]f not all the beneficiaries consent to a proposed modification … of the trust under subsection … (b), the modification … may be approved by the court if the court is satisfied that: (1) if all of the beneficiaries had consented, the trust could have been modified … under this section; and (2) the interests of a beneficiary who does not consent will be adequately protected."

Notice in particular that the Uniform Probate Code does not address whether modification is inconsistent with any material purpose of the trust that is being modified.

Brakke involved a will that poured over to a trust, and controversy challenging creation of that trust as being contrary to a family-related agreement. The settlement entailed changes that significantly changed the residuary beneficiary of the trust, which otherwise was left intact. Citing an Editorial Board Comment to the UPC provision that it "would be available to resolve controversies other than those concerning a will," the court allowed the family settlement agreement that resolved the controversy, notwithstanding the significant effect on a material purpose of the trust. All by holding that the relevant statute was the UPC-inspired provision and not the UTC-inspired provisions of state law.

Dealing again with the material purpose element of UTC-inspired state laws, ***Lewis v. Lewis***, 2016 WL 6311196 (Ky. Ct. App.), denied early termination (the ultimate modification) of a trust because the interests of unborn remainder beneficiaries were not protected, and that violated a material purpose "of guaranteeing a revenue stream … to [the settlor's] future descendants …." Whether viewed through the §411(e)(2) lens of adequate protection of the interests of beneficiaries who do not (or cannot) consent, or the §411(b) lens of modifications that are not inconsistent with a material purpose of the trust, the proposed termination in *Lewis* simply fell short, notwithstanding the offer of one descendant to entrust a portion of the termination proceeds for the future benefit of unborn descendants.

Note, finally, that not all state laws are conducive to correction of errors in do-it-yourself planning, including mistakes spawned by the use of documents downloaded from the internet. As one illustration, see ***In re Succession of Biscamp***, 211 So. 3d 472 (La. Ct. App. 2017), in which the court acknowledged that "minor deviations in form with regard to … [an] attestation clause do not render the testament invalid in the absence of any indication of fraud" but declined to overlook errors made either in the actual execution of the subject will or, at a minimum, in the attestation clause that appeared with that will. Among the execution requirements that were not acknowledged by a valid notary provision were (1) a declaration by the decedent that the document was a will, made in the presence of (2) the notary and (3) the witnesses, (4) who also signed in the presence of the notary. Many attestation formalities have been relaxed by the Uniform Probate Code because of the likelihood that they will frustrate testamentary intent. The *Biscamp* court's reluctance to allow (or forgive) deviation may have been an equity-driven reflection that the will disinherited the testator's daughters (in a jurisdiction that did not eliminate the civil law legitime entitlement of children until 1996).

H. ERISA

Property Settlement as Revocation of Beneficiary Designation. Typical state laws provide that a will provision in favor of a former spouse is revoked by operation of law. Some statutes are blunt instruments, revoking the will in its entirety. Others are more surgical, treating the former spouse as predeceased (or, in the Uniform Probate Code, as having disclaimed, which has the same effect). The most recent version of the UPC also treats provisions in favor of family members of the former spouse also as altered by operation of law. For example, the presumption is that naming a former spouse's sibling as executor or step-children as alternative contingent beneficiaries likely is not the decedent's intent following a divorce.

Even more expansive is UPC §2-804, which expands the coverage of this treatment to nonprobate transfers, such as a life insurance beneficiary designation or designation of the former spouse as beneficiary of retirement benefits. The latter has spawned significant litigation, including several Supreme Court decisions because of the interplay of state statutes and ERISA. *Egelhoff v. Egelhoff*, 532 U.S. 141 (2001), held that state laws like UPC §2-804 that impact qualified retirement benefits and employer sponsored life insurance are pre-empted by ERISA. The Court therefore concluded that divorce did *not* cause the former spouse in *Egelhoff* to be treated as predeceased for purposes of taking under the retirement plan beneficiary designation. *See In re Estate of Sauers*, 32 A.3d 1241 (Pa. 2011), *rev'g* 971 A.2d 1265 (Pa. Sup. Ct. 2009), to the same effect as *Egelhoff*, involving a life insurance beneficiary designation (which was deemed to be subject to ERISA because the insurance was part of an employee group benefit plan).

Subsequent to *Egelhoff* it was thought that UPC §2-804(h)(2) might be a valid accommodation in some circumstances, notwithstanding *Egelhoff*. The concept applied by §2-804(h)(2) is that payment should be made to the designated beneficiary, as required by ERISA, but then a post-payment cause of action may be pursued by those individuals who would receive the benefits if the state law was valid. The plan administrator would honor the beneficiary designation, but state law would impose a constructive trust on that beneficiary, which would direct the benefits to the "rightful" takers.

Hillman v. Maretta, 133 S. Ct. 1943, *aff'g* 722 S.E.2d 32 (Va. 2012), expressly rejected that constructive trust approach as applied by a Virginia statute very much like UPC §2-804(h)(2). According to both the Virginia and United States Supreme Courts, the Virginia provision imposing a constructive trust violates congressional intent that the designated beneficiary be guaranteed receipt *and enjoyment* of the benefits involved.

Hillman addressed an insurance beneficiary designation that was subject to the Federal Employees' Group Life Insurance Act, not a qualified plan subject to ERISA. Nevertheless, *Hillman* cast significant doubt on the UPC backdoor retraction of the former spouse's entitlement as being inconsistent with the objectives of ERISA pre-emption too.

Hillman specifically mentioned *Egelhoff* but it did not refer to *Kennedy v. DuPont Sav. & Invest. Plan*, 555 U.S. 285 (2009), which is consistent with the *Egelhoff* notion that the plan administrator must honor the beneficiary designation and disregard any allocation of property rights in a divorce decree (unless it is a QDRO). It stated expressly that plan administrators should not be required to inquire beyond plan documents and records to determine whether other documents, agreements, or orders alter the proper distribution of plan benefits. But the *Kennedy* Court's footnote 10 suggested that the former spouse's waiver of rights pursuant to a divorce property settlement may suffice to permit the decedent's estate or its beneficiaries to compel distribution of the proceeds from the former spouse as the designated beneficiary to those rightful takers. This is the logic of the UPC §2-804(h)(2) constructive trust approach.

That suggestion in *Kennedy* is consistent with footnote 4 in the *Hillman* opinion. It expressly identifies a statutory exception (to the Court's holding that the beneficiary designation normally controls, notwithstanding state law) that applies if the named beneficiary is in conflict with "the terms of any court decree of divorce, annulment, or legal separation." So, without saying so, *Hillman* may be consistent with *Kennedy* and together they may inform a conclusion that one way to prevent the named beneficiary from taking insurance or retirement benefits that are subject to a Federal pre-emption regime is to provide for a different distribution in a decree of divorce, annulment, or legal separation. This was the theory applied by *Walsh v. Montes*, 388 P.3d 262 (N.M. Ct. App. 2016), holding that the lower court erred in dismissing the plaintiff's theory that a waiver included in a divorce decree *could* be enforced (distinguishing *Hillman* because the plan was subject to ERISA, not FEGLIA).

Moreover, *Estate of Kensinger v. URL Pharma Inc.*, 674 F.3d 131 (3d Cir. 2012), held that a plan's administrator may rely on the beneficiary designation but that the decedent's estate *may* sue the former spouse to enforce the spouse's waiver of plan benefits as part of a divorce property settlement. Because it is appealable to the Court of Appeals for the

Third Circuit, ***In re Estate of Easterday***, 2017 WL 4367691 (Pa. Sup. Ct.), now has held that a postnuptial agreement (executed after divorce proceedings had begun) effectively waived a surviving spouse's right to receive retirement benefits in a *Kennedy*-style case. It is a one-off application of these principles in the sense that the decedent died before the divorce was decreed. The surviving spouse was named as beneficiary of the decedent's pension and retirement benefits, and withdrew the divorce action three days after the decedent died. The court nevertheless held that the spouse took those benefits subject to the estate's right to recover them, pursuant to the postnuptial agreement, specifically citing *Kensinger* for the proposition that the spouse's waiver was enforceable after the ERISA mandated payment pursuant to the beneficiary designation.

Easterday is interesting, and any appeal will be revealing, given that *Sauers* held that the Superior Court erred in "ordering Ex Spouse, the named and unmodified primary beneficiary of the ERISA-governed insurance policy, to surrender all entitlement and interests in the proceeds of that policy." The court could have held that the former spouse would take those proceeds as dictated by the beneficiary designation, which the plan administrator would honor, and then be compelled under state law to hold those proceeds and eventually remit them to the proper state law beneficiaries. Coming as the penultimate sentence of a lengthy decision that did not mention this constructive trust issue, the result may not be a rejection of it so much as a failure to consider this refinement. *Egelhoff* figures prominently in the *Sauers* decision but *Kennedy* was not mentioned; *Easterday* does not mention *Sauers*.

That suggestion in *Kennedy* regarding the divorce property settlement agreement is consistent with footnote 4 in the *Hillman* opinion. It expressly identifies a statutory exception (to the Court's holding that the beneficiary designation normally controls, notwithstanding state law) that applies if the named beneficiary is in conflict with "the terms of any court decree of divorce, annulment, or legal separation." So, without saying so, *Hillman* may be consistent with *Kennedy* and together they may inform a conclusion that one way to prevent the named beneficiary from taking insurance or retirement benefits that are subject to a Federal pre-emption regime is to provide for a different distribution in a decree of divorce, annulment, or legal separation. And the other surefire approach is to change the beneficiary after the divorce. Otherwise, reliance on state law to accomplish the change of beneficiary result may not suffice if any Federal program with pre-emption is involved.

I. Medicaid

Medicaid Qualification and the Elective Share. The leading case holding that a surviving spouse's right to an elective share is a countable asset for Medicaid qualification purposes is *Tannler v. Wisconsin Dep't of Health and Social Services*, 564 N.W.2d 735 (Wis. 1997). The court held that failure of an institutionalized surviving spouse to assert a claim against the decedent's estate constituted a disqualifying divestment under 42 U.S.C. §1396p(e)(1). Most recently, ***In re Estate of Brown***, 153 A.3d 242 (N.J. Super. Ct. 2017), held that an unexercised elective share is subject to a lien for reimbursement of Medicaid benefits received by the surviving spouse. The fact that the Medicaid recipient was disinherited by the predeceased spouse (a typical effort to qualify the surviving spouse for federal benefits) is irrelevant to the question of qualification. In this case because state law provided that eligibility considers "all … resources … which the individual … is entitled to but does not receive because of action or inaction by the individual …."

In *Brown* the survivor's heirs alleged that the elective share was not available because state law disqualifies a surviving spouse who was living separate and apart from the decedent – a form of disqualification for misconduct that is discussed in ¶916.1 of last year's materials and typically entails abandonment, sometimes coupled with adultery. In *Brown* the alleged misconduct was the fact that the surviving spouse was institutionalized in a nursing home for Alzheimer's patients – an allegation that the court rejected saying that "there must be evidence, beyond mere separation, of a cause of action for divorce to disqualify a surviving spouse from elective share rights" in the subject state. "Mere separation is not enough."

Numerous courts have addressed various elements of the concept that an elective share is a countable resource and that failure to obtain the share constitutes a disqualifying disposition or constitutes the entitlement as a countable resource. *See* Casner & Pennell, ESTATE PLANNING §3.4.7 (8th ed.). Even if it is undecided in a given jurisdiction whether the share will be charged as a countable asset even if not elected, the wise approach is not just to forsake the election in hopes that the elective share entitlement will not be treated as owned property for qualification purposes. The better approach is premortem planning that causes the elective share to be regarded as worthless, so that any deemed transfer is valueless for Medicaid disqualification purposes. For the wide range of effective planning options to accomplish this objective see Cline, Pennell, & Turnipseed, Spouse's Elective Share, 841 Estates, Gifts, and Trusts Portfolio (Tax Mgmt. 2012).

Medicaid Disqualifying Transfers. Annuities are exempt assets for purposes of Medicaid eligibility if "the annuity (I) is irrevocable and nonassignable; (II) is actuarially sound …; and (III) provides for payments in equal amounts during the term of the annuity …." 42 U.S.C. §1396p(c)(1)(G)(ii). In addition, annuities may be used to spend down or dispose of assets if "the State is named as the remainder beneficiary … for at least the total amount of medical assistance paid on behalf of the institutionalized individual …." 42 U.S.C. §1396p(c)(1)(F). Both provisions are consistent with other exceptions – the actuarially sound aspect is akin to the full-consideration exception, and the payback aspect is akin to the (d)(4)(C) special needs trust exception. *Zahner v. Department of Human Services*, 802 F.3d 497 (3d Cir. 2015), considered whether the annuity "safe harbor" requires that the annuity have a minimum term or a positive rate of investment return, and effectively challenged whether the particular annuities were purchased with the intent to circumvent the Medicaid qualification rules. The rub was that the annuities were for 12 and 14 months and yielded a miniscule 5% return on the investment (which actually was negative after considering a "start-up" fee paid to brokers in each case). The state Medicaid authority asserted that these annuities were not exempt because they were not actuarially sound, because their terms were so short. Regulations mandate a maximum annuity term that may not exceed the annuitant's life expectancy (which precludes postmortem payments that benefit the annuitant's beneficiaries while sheltering wealth in the annuity safe harbor). But those regulations do not mandate a minimum term. Because Medicaid qualification is subject to annual review, a short-term annuity may return sufficient resources to the annuitant that, on review, the individual's net worth is too great to qualify. The short-term annuity tactic may be viable anyway if the annuity payments finance the individual's care while waiting out a period of ineligibility to qualify, or if costs of living consume the periodic annuity payments and, in the interim, the individual is able to qualify for Medicaid earlier than otherwise would be possible.

Annuities and insurance are functional opposites (annuities insure against living too long, and insurance protects against dying too soon). Although each relies on mortality predictions, there is no Medicaid spenddown exemption for life insurance. Instead, the asset spenddown standard is whether the purchase of an insurance policy constitutes a §1396p(c)(1)(A) disposition of assets for less than fair market value. ***Moore v. Illinois Dep't Human Serv.***, 74 N.E.3d 1173 (Ill. Ct. App. 2017), held that the purchase of an insurance policy was a disqualifying disposition because the applicant was not the beneficiary of the policy and the cash surrender value of the policy was not equal to the amount paid for it.

If life insurance has a cash value that approximates the premium paid, then the transfer of cash for the policy would be a transfer for adequate and full consideration and not a disqualifying disposition. But then it likely would do little good for spend down purposes, because the value of the policy would be a countable asset the same as any cash used to purchase the policy. So the tactic employed in *Moore* was to purchase a policy with little cash value, that named the applicant's estate as beneficiary of a larger death benefit. Similar to the logic behind the annuity exception, the conversion of wealth from one form into another is not a concern if the asset purchased replaces the assets transferred, which does not reduce the applicant's net worth. But *Moore* held that the insurance ploy was a disqualifying disposition, because whatever value was received in the transaction did not benefit the applicant inter vivos.

Dwelling Exception for Medicaid Qualification. The unremarkable conclusion in ***Daley v. Secretary of Health and Human Services***, 74 N.E.3d 1269 (Mass. 2017), is that the dwelling exception for Medicaid qualification is not lost if a personal residence is transferred into an irrevocable trust with retained lifetime enjoyment, nor if a remainder interest in such a dwelling is transferred with a retained life estate. The Director of the Massachusetts Office of Medicaid determined that the applicants' retention of a right to live in their homes made the equity in those dwellings a countable asset, which the court rejected because retention of the dwellings themselves would not constitute a countable asset.

Under Age 65 Requirement. There is uncertainty and significant debate regarding whether a pooled trust variety of special needs trust, authorized under §1396p(d)(4)(C), must be created before the beneficiary is age 65, as unquestionably is true for a §1396p(d)(4)(A) trust. The age 65 element is specifically included in §1396p(d)(4)(A), it is conspicuously absent from §1396p(d)(4)(C), but it appears to be required as to both by §1396p(c)(2)(B)(iv). The position advocated by the Centers for Medicare & Medicaid Services is that it applies to both, but this position is not universally followed among the states that administer Medicaid. The debate was rehearsed in *Center for Special Needs Trust Administration, Inc. v. Olson*, 676 F.3d 688 (8th Cir. 2012), and followed in

Hutson v. Mosier, 2017 WL 3942586 (Ks. Ct. App.), which sided with the position that a penalty applies if a (d)(4)(C) trust is created when the beneficiary is over age 64. The most unfortunate aspect of *Hutson* is that the trust corpus consisted largely of the proceeds from the sale of a dwelling that itself would have been an exempt asset. But the applicant was in need of care and couldn't live independently any longer. At the age of 72, she had a life expectancy of 13 years but was estimated to exhaust her funds, even if held in a special needs trust, in four to six years. Because the court applied the penalty provision in §1396p(c)(2), a transfer penalty of 313 days was imposed. The court doesn't mention the cost of her care, but the total amount transferred was under $60,000.

J. Wills

Is It a Will?. The classic definition of a will is that it is both revocable and ambulatory. The revocable prong informs the notion that a "contract to make a will" is an agreement that may allow for an action for breach of contract if the decedent had a compliant will and later revoked (or altered) it (or if the agreement anticipated that the decedent would execute a compliant will and instead died without). But the contract is no substitute for the will itself, and any will subject to the contract always can be changed or revoked. The ambulatory prong means that the document does nothing prior to the death of the maker.

In this light, consider a lease that contains a provision stating that "in the event of the death of the Lessor, this agreement shall not terminate. Rather, the rights and obligations of the Lessor shall immediately be transferred to X." Is that clause testamentary, making the lease (or that provision within the lease) a will, requiring that it be executed with all the formalities of a will?

Estate of Greer v. Ball, 218 So.3d 1136 (Miss. 2017), incorrectly holds that the lease was valid but the particular provision within it *is* testamentary, and therefore that this provision is not enforceable, because the lease was not signed with the requisite formalities under state law. The question was relevant because the Lessor had "another" will that benefitted someone other than X, who claimed the rental payments from the lease agreement. One possible interpretation was that this residuary beneficiary took the leasehold property, as an asset of the estate, subject to all of the provisions of the lease, meaning that this beneficiary would not receive the rental payments. The conclusion reached by the court was that the residuary beneficiary took the leasehold property subject to a lease agreement but that X could not benefit because the assignment of rental payments was an invalidly executed testamentary provision.

Over a strong (and correct) dissent, the court's error was in regarding the provision for X in the lease as conveying no interest to X prior to the Lessor's death, and therefore that it was a testamentary provision in the otherwise valid lease. That conclusion was based on the fact that the interest in X was revocable by the Lessor and Lessee, who could have altered the lease. Both rationales turn the definition of a will on its head, first because a will (or, here, the testamentary provision within the lease) must be revocable by the testator alone (not in conjunction with some other party – such as the lessee in this case). Second, because this lease was immediately effective as between the Lessor and the Lessee, meaning that it was not ambulatory. Indeed, the particular provision likely was not ambulatory, even on its own, because it is possible that the lease contained this provision because the Lessee wanted an assurance that it would deal with X after the death of the original Lessor, and not with whomever took the residue of the Lessor's estate. That assurance being an immediately effective and enforceable entitlement distinguishes the lease and this provision in it from a will.

These cases do not often arise, yet ***Bonvillain v. O'Bryan***, 2017 WL 2705667 (Ky. Ct. App.), involved a royalty agreement with an assignment of postmortem payments in which the same issue existed. The court correctly held that the beneficiary designation pursuant to that royalty agreement was not an invalid testamentary disposition because the agreement "took effect and created binding and enforceable obligations upon the parties immediately upon its execution." Meaning that it was not ambulatory and therefore could not be a will.

These cases are a good reminder that clients have other agreements and documents that can affect the ultimate disposition of their estates. And that it therefore usually is prudent to obtain copies of documents like deeds, leases, covenants, easements, beneficiary designations, and the like to verify title and both the rights and obligations to which the decedent is entitled or subject. The Greer lease, for example, likely could affect the value of the underlying property and, if it was not at arm's length, it also could constitute a gratuitous transfer with gift tax implications (depending on the identity of the lessee).

Harmless Error. State law formalities for execution of a will vary. Some states permit holographs (wills written entirely in the testator's hand and signed but not witnessed) or nuncupative (oral) wills, which deviate from the most basic requirements that a will be written and signed. Over forty years ago Yale Professor Langbein began a conversation about relaxing will execution formalities when it is clear that a testator intended a document to be a will and failure to comply with the formalities for proper execution did not indicate wrongdoing. *See* Langbein, Substantial Compliance With the Wills Act, 88 Harv. L. Rev. 489 (1975); Langbein & Waggoner, Reformation of Wills on the Ground of Mistake: Change of Direction in American Law, 130 U. Pa. L. Rev. 521 (1982); and Langbein, Excusing Harmless Errors in the Execution of Wills: A Report on Australia's Tranquil Revolution in Probate Law, 87 Colum. L. Rev. 1 (1987). Over the years Langbein and Waggoner, as the primary authors of both the UPC and the Restatement (Third) of Property: Wills and Other Donative Transfers, have engineered changes in the law to embrace the concept that insubstantial noncompliance with will execution formalities – so-called harmless error – should not invalidate an otherwise valid will. Today, for example, the latest version of UPC §2-503 reflects this development by providing that a will is valid if the proponent of the will proves by clear and convincing evidence that the decedent intended the document to be the decedent's valid will.

This relaxation of the traditional will execution formalities had been adopted in fewer than 25% of American jurisdictions, which confirms that this concept is controversial and that change occurs slowly in the law of wills. Furthermore, even in states that have embraced the concept, case law reaches inconsistent results. For example, *In re Estate of Ehrlich*, 47 A.3d 12 (N.J. Super. Ct. 2012), admitted to probate under a harmless error statute an *unsigned* copy of decedent's will, found with a marginal note that the original was in the possession of the named executor, who was deceased and the executed will was not found, and *In re Will of Ranney*, 589 A.2d 1339 (N.J. 1991), adopted the substantial compliance doctrine in a situation in which witnesses signed the self-proving affidavit but failed to execute the attestation provision, the court granting relief because the decedent's intent was clear and there were no abuses sought to be prevented by strict adherence to execution formalities. But *In re Alleged Will of Ferree*, 848 A.2d 81 (N.J. Super. 2004), refused to extend substantial compliance to a holograph, saying that unwitnessed wills already represent a relaxation of the traditional execution requisites, such that additional relaxation of the execution requisites was inappropriate. Elsewhere, *Dalk v. Allen*, 774 So. 2d 787 (Fla. Dist. Ct. App. 2000), denied probate to a will because, in the confusion of eight different estate planning documents circulating for execution in a single proceeding, the will was properly attested and notarized but not signed by the decedent. The court refused to overlook the error. And *Norton v. Hinson*, 989 S.W.2d 535 (Ark. 1999), refused to apply the substantial compliance doctrine to overcome invalidity due to one witness being underage, in that case under circumstances suggesting impropriety – the 99-year-old decedent's caregiver proposing a will benefiting the caregiver, witnessed by the caregiver's child and grandchild.

Most recently, ***In re Estate of Malsberger***, 2017 WL 2991773 (N.J. Super.), admitted an otherwise unsigned holograph, holding that the decedent's name, written in the first line of that document, was intended to serve as a signature and that a signature is not necessarily required under the harmless error doctrine. The *Malsberger* document provided: "I'm Alice Malsberger …. I wish my estate be sold … and 1/3 granted to [each of three named individuals].… I intend to see a lawyer & to validate everything." This handwritten document was regarded as a valid holograph, the written name in the first line was deemed to be intended to be the testator's signature, and the last sentence was not deemed to indicate that the document lacked testamentary intent.

That last issue – lack of testamentary intent – arises in cases that typically involve a letter written to an attorney asking for a will to be prepared, but the decedent died before the requested will could be executed. Courts that deny probate to the letter say that it cannot qualify as a will, because the letter lacks testamentary intent. Instead, it reflects the intent that a separate document be created, which document would then be the will requested in the letter. *Malsberger* held that this case differed because the last sentence was only meant to indicate that the testator would verify with an attorney that everything was in order.

The result in *Malsberger* is not particularly surprising, given that New Jersey has held that a document need not be signed at all to constitute a valid will, yet *Ferree* suggests that a particular result is not predictable. No knowledgeable planner would fail to perform an execution that complies with all of the technical execution requirements of state law, but these cases confirm that proponents of a will should not assume that a will is inadmissible merely because it lacks a particular formality. The courts are simply rendering unpredictable conclusions in these situations.

Elective Share of Deceased Surviving Spouse. It is somewhat disconcerting to think of the rights of a surviving spouse (S) who already is deceased. But it happens – a married couple who die in relatively rapid succession. As a surviving spouse, S may have a state-law right to reject the estate plan of the first spouse to die (D) and assert an elective share in D's estate. Having died, however, S's executor must pursue S's elective share entitlement. Oddly, however, state laws don't always guarantee whether, or the extent to which, S (or S's estate) is entitled to share in D's estate under these circumstances.

For example, the latest version of UPC §2-212(a) provides that S must be alive at the time the right of election is exercised. So, being just a surviving spouse isn't good enough. Further, §2-212(b) provides that, if S survives but is incapacitated, then the share provided by the UPC is held in a trust that, upon S's death, is distributable to the estate or beneficiaries of D, not S. Effectively the elective share is converted into a life estate only.

The UPC elective share of a surviving spouse who lives and is competent is a fee simple entitlement that essentially is a community property surrogate, reflecting an economic partnership theory of the elective share. But it differs for a surviving spouse who is incapacitated. It is treated as if the elective share was based on a support theory. Further, if S is unable to elect prior to dying, then the elective share is totally lost, which makes sense in the context of a support theory but is inconsistent with an elective share that is meant to be a community property surrogate. In this sense the UPC is conflicted and probably reflects a compromise between the two theories of the elective share – one being the economic partnership and the other being a modern substitute for dower.

In re Estate of Scherr, 2017 Il. App. (2d) 160889, addressed the argument made by the heirs of D that S's renunciation of D's will in favor of the Illinois elective share "abated" when S died during administration of D's estate. Billed as a case of first impression in Illinois, the court rejected their argument, saying that filing the renunciation and making claim to the elective share was the only operative requirement. The court did not address whether a failure or inability to file before the death of S would generate a different result. Citing authority from other jurisdictions, the impression given is that Illinois regards the right of election as a modern version of dower, which has a support theory underpinning, rather than an economic partnership rationale. That disparity accurately reflects the uncertain status of the right of election in America in general. The UPC being out front in its advocacy of the economic partnership theory – the community-property surrogate as applied in disguise in non-community property jurisdictions – as opposed to a support theory meant to protect against impoverished survivors.

K. Trusts

Funding Inter Vivos Trusts. *Carne v. Worthington*, 246 Cal. App. 4th 548 (2016), reported at ¶904.1 of last year's materials, involved realty that was regarded as an asset of a revocable inter vivos trust, notwithstanding that there was no deed of transfer to the trust. The settlor merely stated in the trust itself that "I transfer to my Trustee the property listed in Schedule A," identified only one asset – the real estate in question. According to the court, a valid trust was created and the real estate effectively was transferred to it, relying on Restatement (Third) of Trusts §16 cmt. b:

> Good practice certainly calls for the use of additional formalities and the taking of appropriate further steps, such as changes of registration, or the execution and recordation of deeds to land. Nevertheless, a writing signed by the settlor, or a trust agreement signed by the settlor and trustee, manifesting the settlor's present intention thereby to transfer property (such as all property listed on an attached schedule) is sufficient to create a trust.

The *Carne* trust was created by the settlor's execution of the trust document and then funding with the realty, which effectively was transferred to the trust merely by listing it on the trust's schedule of assets. According to California law, the only formalities required to transfer the realty being (1) a written instrument, (2) naming the transferor and transferee, and (3) delivery to and acceptance by the transferee.

As alluded to by the quoted comment, however, this result says nothing about the validity of the transfer vis-à-vis third parties. Recordation of the transfer would be required to be effective as to strangers to the transfer, such as creditors of the transferor. But as a donative device, the transfer was effective to remove the property from the transferor's estate (or, in *Carne*, from another trust of which the transferor was the settlor and trustee) and place it in the transferee trust. Meaning that it would pass as provided in the transferee trust and not as a part of the settlor's estate (or under the terms of the transferor trust).

As a point of distinction, compare ***In re Griffith***, 2017 WL 193162 (Md. Ct. Special App.). The decedent executed a self-trusteed declaration of trust just over one month before dying, and declared that, among other assets, the trust corpus consisted of "all accounts" held at various banks. The account in question was a joint tenancy account (which previously had been a POD account) naming one of the decedent's five children as joint tenant. That same child was designated as successor trustee of the trust, and the question was whether the pre-existing joint account was a trust asset or belonged to the one child as the surviving joint tenant.

Under the rationale in *Carne* it might appear that merely listing the account on the trust schedule of assets caused it to become a trust asset. And state law might provide that a completed gift of a jointly held financial account such as this does not occur if the decedent contributed all of the funds in the account. That issue was not addressed in *Griffith*. Instead, the court simply noted that "ownership of the joint checking account was not transferred to the [trust] merely by virtue of its being listed in Schedule A as trust property." In partial explanation, the court also held that a state law "presumption of equal ownership of funds among parties to a multiple-party account" was not rebutted.

The real difference, however, may have been that the decedent didn't own the joint account unilaterally – he was a joint owner with the child. According to the court the decedent could have withdrawn all of the funds in the joint account and opened a new account in the name of the trust. That would be consistent with the traditional state law that the depositor to a joint account may withdraw his or her contributions at will. As the Restatement comment quoted above indicates, however, more may be required under state law to create trust ownership of an asset vis-à-vis third parties, such as the surviving joint owner of that account.

L. Powers to Appoint

Avoiding General Power Treatment. A question that has arisen numerous times involves a power to appoint held by a descendant of the trust's settlor, as to which the permissible appointees of the power are descendants of the settlor. The question is whether the powerholder, who is a descendant, can appoint in favor of the powerholder. An interpretative issue thus arises if the power was not meant to be a general power, meaning that Section 2041 inclusion in the powerholder's estate was not the settlor's intent.

Multiple authorities have established that, if the power is not exercisable inter vivos, then the powerholder cannot appoint to the powerholder personally. This is because the powerholder will be deceased when the power becomes exercisable. *See*, *e.g.*, PLRs 201436036, 201427008 and -010 to -015 (all respecting state court orders providing that testamentary powers, in most cases granted to grandchildren to appoint among issue of their parents, did not permit exercise to the powerholder, the powerholder's estate, or creditors of either and therefore that the powers were not Section 2041 general powers), 201006005 (nontaxable reformation of a testamentary power to expressly preclude a powerholding child from appointing to the child, notwithstanding that the power was exercisable in favor of the settlor's "issue'"), 201446001 through -011 and 201444002 through -006 (all testamentary powers granted to grandchildren to appoint to the settlor's issue), 9826010, 9826008, 9826007, and 9826006 (powers were deemed to be nongeneral notwithstanding that grandchildren as powerholders could appoint to grandchildren of the settlor, with no specific exclusion of the powerholder grandchild from the class of permissible appointees), and *Hillman v. Hillman*, 744 N.E.2d 1078 (Mass. 2001) (a trust reformation case, brought to preclude a child's exercise of inter vivos power to appoint corpus to the settlor's "issue" from including the child personally and thereby constituting a general power of appointment). The facts of PLR 199938024 were so similar that it may well have been the *Hillman* case. PLR 200152026 involved a very similar issue and holding, the government concluding that the power was not general because it was titled "limited power." PLRs 200832015 and 200210038 similarly reached a taxpayer favorable result involving testamentary powers allowing the powerholders – the settlor's grandchild and child, respectively – to appoint among the settlors' descendants, which was deemed not to include the powerholders because the powers could not be exercised inter vivos and were viewed as not specifically including the estates of descendants, and PLRs 201229005 and 201231007 (apparently involving the same situation, for two different children, each of whom had a testamentary power to appoint among the "Settlors' issue"), which concluded that neither child could exercise their power in favor of their own estate or creditors of their estate, and because the powers were testamentary and therefore could not be exercised in their own favor or to their creditors while the children were living.

See also Borron, Simes & Smith The Law of Future Interests §917 (3d ed. 2011) (stating a presumption that "a donor who did not permit the [powerholder] to make an effective appointment until the [powerholder's] death intended … an appointment only to persons who survived [the powerholder]" and, thus, a powerholder cannot appoint to a deceased permissible appointee unless the power specifically authorizes appointment to a decedent's estate, meaning that a testamentary power to appoint among a class including the powerholder could not be exercised in favor of the powerholder unless exercise to the powerholder's estate expressly was permitted). *Accord*, *MacBryde v. Burnett*, 45 F. Supp. 451 (D. Md. 1942); *Dow v. Atwood*, 260 A.2d 437 (Me. 1969); *In re Newlin Estate*, 72 Pa. D. & C. 446 (1950); *In re Sears' Estate*, 215 N.Y.S.2d 859 (Surr. Ct. 1961). Restatement (Third) of Property: Wills and Other Donative Transfers §19.12(a). Note that Uniform Powers of Appointment Act §306(b) provides that a holder of a nongeneral power may exercise in favor of descendants of a deceased permissible appointee – which is contrary to the position stated in Borron – but this surrogate antilapse rule does not alter the result in the cited cases and rulings; instead, it confirms the rule in §306(a) that appointment to a deceased permissible appointee is not effective.

Brozman v. Brozman, 2016 WL 7163618 (Cal. Ct. App.), misconstrues drafting that was intended to avoid the issue involved in these developments. The power to appoint was testamentary, allowing a child to "appoint … for the benefit of one or more of any of my lineal descendants and their spouses (excluding from said class, however, such beneficiary and such beneficiary's creditors, estate, and creditors of such beneficiary's estate)." The court held that "the most reasonable construction of 'lineal descendants and their spouses' is that the appointment *must* be exercised in favor of a lineal descendant and *may* also include the lineal descendant's spouse …." (emphasis in original). Which is to say that appointment to the spouse of a descendant alone was regarded as invalid. Testimony of the drafter that "and" should be read as "or" was rejected, not because the disjunctive is the exact opposite of the conjunctive but, instead, because the document was "not ambiguous" (which is bizarre, given the construction the court established).

If a drafter was intent on making clear that such a power is not general, perhaps it would better avoid confusion if the power stated that it is a "nongeneral power to appoint among a class consisting of any one or more of my descendants (specifically excluding the powerholder) and spouses of my descendants (not excluding the powerholder's spouse)."

Blending Exercise of Power to Appoint. A "blending" exercise of a power to appoint occurs when the powerholder commingles appointive assets with other property, typically the powerholder's own assets, often under a single document or in a single trust. For example, in ***McDowell Revocable Trust v. Stockall***, 894 N.W.2d 810 (Neb. 2017), the powerholder exercised a nongeneral testamentary power in favor of the powerholder's revocable trust, from which the powerholder's debts, expenses, and taxes could be paid. This violated an express limitation in the power that precluded appointment in favor of the powerholder, the powerholder's estate, or creditors of either (a common provision that seeks to preclude making the power a taxable general power). This invalid exercise could have been avoided had there been a provision in the power, the exercise, or under state law that would segregate the appointive assets and selectively allocate them to permissible appointees. *See* Uniform Powers of Appointment Act §308, which is designed to salvage an exercise such as this.

Specific Reference Requirement. Well-drafted powers to appoint typically require the powerholder (historically known as the "donee" of the power) to make a specific reference to the power as a means of precluding an inadvertent exercise of the power. The most common case of an unintended exercise is "blanket exercise" language often found in wills that purport to dispose of "all the residue of my estate, *including any property over which I may have a power of appointment*." If asked, the typical client likely would respond affirmatively to the question: do you want to control any appointive assets? But when studied, the typical power benefits the same takers who will receive the powerholder's estate anyway, making a "blending exercise" of the power, meant to direct appointive assets to those same beneficiaries, unnecessary and potentially problematic.

For example, in states that still apply some version of the Rule Against Perpetuities, no new period under the Rule begins to run with exercise of a nongeneral power. Yet the powerholder often blends the appointive assets with their own and places them in a trust, with a perpetuities saving clause that is tied to the powerholder's death, rather than to when the period began to run with respect to the trust that gives the power that is being exercised. Which all means that the exercise may fail. Invalid appointment can occur in other respects as well (*e.g.*, because a beneficiary of the trust into which the exercise was made is not a permissible appointee under the power). The way to minimize these sorts of risks is to require the powerholder to inspect the power so as to comply with the specific reference requirement. Making specific reference often forces inspection of the document granting the power, to make an affirmative statement that establishes knowledge about the power and its parameters, and a positive intent to exercise. In the process, the theory is that invalid appointments are less likely.

In re Estate of Pierce, 394 P.3d 316 (Okla. Ct. Civ. App. 2017), illustrates these sorts of concerns, the powerholder having exercised a nongeneral testamentary power by directing the trust assets to a new trust granting a life estate to an individual (the powerholder's surviving spouse) who was not a permissible appointee (that class being limited to descendants of the powerholder). With a remainder to the powerholder's child, the court correctly held that the life estate aspect of the exercise was invalid, but the court failed to state what the effect of the invalid appointment will be – sequestration of the life estate for the default takers, or acceleration of the remainder. (Indeed, the court also failed to state who the default beneficiaries were).

More important to the case was whether the exercise was effective in any respect, because of the specific reference requirement. The court held that the exercise was effective, based on several theories. The first was that the exercise did not specifically refer to the power itself (as required by the express terms of the power) but it did identify the primary asset held in that trust, which the court took as adequate to satisfy what the court regarded as the primary goal of the specific reference requirement, which is to make clear the powerholder's intent to exercise. A second rationale for holding the exercise to be effective is an Oklahoma statute providing that "formalities in addition to those prescribed in this act be observed in the execution of the power … may be disregarded." The court held that the specific reference requirement was such a formality that could be ignored. And, finally, the court relied on an "equitable rule" articulated in Restatement (Third) of Property: Wills and Other Donative Transfers §19.10 cmt. d and Restatement (Second) of Property (Wills and Other Donative Transfers) §18.3, to the effect that the court may disregard the powerholder's failure to satisfy a formality required by the donor of the power. *See* Kingma, Using Equity to Aid the Exercise of a Power of Appointment that Fails to Specifically Refer to the Power, 51 Real Prop., Trust & Est. J. 457 (2017), which reveals that author Kingma was an expert witness in such a case. Without saying so, that case might have been *Pierce* (at least the timing is very fortuitous, the case and the article appearing in print at nearly the same time).

M. Powers of Attorney

Forged Power of Attorney. Son forged Mother's signature on a power of attorney. Nevertheless, Notary acknowledged Mother's signature on the document without Mother ever being present. Son then used the power of attorney to borrow from Lender, pledging

Mother's dwelling as collateral. Son defaulted on the loan, Lender foreclosed on the dwelling, and then sold it to Bona Fide Purchaser for value (BFP). Mother subsequently sued BFP to regain title to the dwelling.

A California statute provides that "[a] third person who acts in good faith reliance on a power of attorney is not liable to the principal or any other person if … (1) [t]he power of attorney is presented to the third person by the attorney-in-fact … (2) [t]he power of attorney appears on its face to be valid [and] (3) [t]he power of attorney includes a notary public's certificate of acknowledgement …." Intended to facilitate third party reliance on what appears to be a valid power of attorney, the statute was deemed *not* to protect BFP in ***Yi v. Oh***, 2017 WL 3393283 (Cal. Ct. App.), because the power was presented to Lender, not to BFP. In addition, the court noted the traditional common law notion that a forgery conveys no title, which meant that BFP obtained no title from Lender, who also obtained no title because the power of attorney was a forgery.

If the statute had applied, then Lender could rely on the power of attorney, and Lender's title would be immune to attack by Mother as rightful owner of the dwelling. And, if Lender had good title, due to reliance on the power and based on the statute, then BFP presumably would have obtained Lender's good title. But in *Yi* the common law notion meant that Lender obtained nothing, and so too BFP. The end result was that the court rejected BFP's demurrer to Mother's claim to recover the property.

As a practical matter, how would BFP know that Lender obtained title from Son, acting under Mother's forged power, and how could BFP ascertain whether that power was invalid because it was a forgery? And how will BFP recover its consideration paid to acquire the dwelling? Presumably BFP could sue Lender, based on the notion that Lender did not have marketable title. And the statute will not protect Lender, notwithstanding that it purports to protect Lender from both Mother and "any other person" – which would appear to include BFP. Perhaps either BFP or Lender also may sue Notary, whose acknowledgement facilitated Son's fraud. In some states Notary may be bonded but, if Notary is not (adequately) insured, then it would appear that both BFP and Lender must rely on any protection they obtained from having title insurance.

If allowed to stand, *Yi* defeats the intent of the statute, which is meant to facilitate use of and reliance upon powers of attorney. At least in this particular corner of fraud and abuse, maybe that's a good lesson to learn, in the sense that powers of attorney have spawned much abuse and litigation and, notwithstanding statutes of this nature, perhaps they should not be regarded as reliable.

As a matter of policy, who should bear the loss in any case involving abuse perpetrated by a power of attorney? In *Yi*, Son is judgment proof, having borrowed the money and defaulted on the loan. Should Mother – the subject of the original fraud – bear the loss? That frequently is the result in cases that involve abuse flowing from powers of attorney. That harsh result may confirm that powers of attorney are a source of evil, and perhaps estate planners should be less willing to encourage their use. And the statute, well-intentioned but (at least in this case) ineffective, may be wrong-minded to the extent that it discourages more caution.

IX. Uniform Laws: Summary from Uniform Law Commission

Ben Orzeske, the Legislative Counsel for the Uniform Law Commission, has provided the Heckerling Institute with the following summary of 2017 actions and the status of uniform laws of most interest to us:

Uniform Law Commission
NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS

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Uniform Trust and Estate Acts

Report to Heckerling Institute on Estate Planning
November 2017

Executive Summary:

Two new uniform trust and estate acts were approved at the Uniform Law Commission's 2017 Annual Meeting in San Diego: the Uniform Directed Trust Act, and the Uniform Guardianship, Conservator-ship, and Other Protective Arrangements Act. The committee revising the Uniform Principal and Income Act also read its draft for comments. The act will be renamed as the "Uniform Fiduciary Income and Principal Act" and the committee will meet twice more to consider further changes before reading its final draft for possible approval at the ULC's 2018 Annual Meeting. The Tribal Probate Code drafting committee continues its work with representatives from American Indian tribes to draft a simplified version of the Uniform Probate Code compatible with the federal American Indian Probate Reform Act.

Two new drafting committees are working on trust and estate projects:

- The Electronic Wills drafting committee met for the first time in October to consider the issues raised by electronic versions of wills and other estate planning documents. The Reporter will produce a draft act for consideration at the next committee meeting in the spring.
- A new committee on Management of Funds Raised through Crowdfunding Efforts was appointed and will meet for the first time in Spring 2018.

A study committee will consider the issue of economic rights for unmarried cohabitants. On the legislative front, seventeen more states enacted the Revised Uniform Fiduciary Access to Digital Assets Act in 2017, bringing the total number of jurisdictions to thirty-seven. Fourteen other bills to enact various uniform trust and estate acts were also enacted into law.

Detailed information on every Uniform Law Commission project is available from www.uniformlaws.org.

New Uniform Acts:

Uniform Directed Trust Act

Robert H. Sitkoff, Chair

Turney P. Berry, Vice-Chair

James P. Spica, ABA Advisor

John Morley, Reporter

The Uniform Directed Trust Act (UDTA) provides default rules to allocate liability among the trustee and other persons who are given powers by the terms of the trust. The act defines the term "trust director" as any non-trustee granted a "power of direction" over a trust, whether called a director, protector, advisor, or by any other title. A "power of direction" is defined, with certain exceptions, as a power granted to a non-trustee by the terms of a trust, including a power over the investment, management, or distribution of trust property, and over administrative matters. The exceptions include powers of appointment granted in a non-fiduciary capacity, a settlor's powers over a revocable trust, and powers granted to beneficiaries over their own beneficial interests.

By default, a trust director is a fiduciary under the UDTA and is responsible for actions or omissions within the scope of the power. A trust director's fiduciary duties may be waived by the terms of a trust to the same extent that a trustee's duties are waivable under state law. A trustee has a duty under the UDTA to take reasonable action to follow the direction of a trust director, unless by doing so the trustee would engage in willful misconduct. This is the same standard used under the current law of Delaware.

By adopting the willful misconduct standard, the UDTA ensures beneficiaries will receive the same or greater legal protections under a directed trust as they would under a trust that vested all powers in a single trustee. The fiduciary duties owed to beneficiaries may be allocated among trustees and trust directors according to their assigned roles, but may not be reduced in the aggregate. Furthermore, the trustee under a directed trust has the additional duty to refrain from willful misconduct when following directions. The net effect is an increase in the total fiduciary duties owed to the beneficiaries, with the trustee serving as an additional safeguard to prevent misconduct on the part of a trust director.

In addition to allocating liability, the UDTA includes innovative provisions not addressed in most current state statutes.

- Under the UDTA, trustees and trust directors have a duty to cooperate and share relevant information to the extent required for each person to effectively carry out assigned duties, but also expressly provides that trustees and trust directors have no default duty to monitor, inform, or advise each other with respect to each other's individual areas of responsibility.
- To promote settlor autonomy and ensure the law applies to all parties equally regardless of the titles used in the terms of the trust, the UDTA overrides the traditional common law rule for liability of co-trustees and allows a trust to relieve co-trustees of fiduciary duties to the same extent relief is allowable for trustees and trust directors.
- The UDTA adopts the enacting state's current law governing trustees with respect to appointment, resignation, filling of vacancies, compensation, personal jurisdiction, and statutes of limitation, and applies those provisions equally to trust directors.

Uniform Guardianship, Conservatorship, and Other Protective Arrangements Act

David M. English, Chair

Catherine Anne Seal, ABA Advisor

Nina A. Kohn, Reporter

The Uniform Guardianship, Conservatorship, and Other Protective Arrangements Act (UGCOPAA) is a comprehensive revision of the Uniform Guardianship and Protective Proceedings Act, last revised in 1997. The act implements recommendations from the Third National Guardianship Summit, which took place in Salt Lake City in 2011.

UGCOPAA is a modern statute that respects the legal rights of persons who need protection. It requires courts to implement the least-restrictive orders appropriate under the circumstances, and requires guardians and conservators to create and file a detailed, individualized, legally enforceable plan within 60 days of appointment. The act includes a new Article 5 expressly authorizing courts to issue protective orders instead of guardianship or conservatorship that preserve the legal independence of the respondent to the greatest extent possible. Alternative protective arrangements include single transactions, such as purchasing an annuity for income or ordering a move to an assisted living facility, technological assistance, and supported decision-making.

Although most state statutes already allow limited guardianships and conservatorships, in practice courts still issue plenary orders more often than not. UGCOPAA provides sample court forms that require a petitioner to detail the respondent's alleged needs and explain why less-restrictive alternatives to guardianship or conservatorship would be insufficient. It also requires regular monitoring for compliance with the individual's plan, and authorizes the court to name any person who has demonstrated appropriate concern to receive notice of certain actions, and thereby serve as additional eyes and ears of the court to help prevent abuse.

The revised act provides a clear decision-making standard that respects the autonomy of adults subject to a court order. Rather than use substituted judgment, UGCOPAA requires a guardian to make the decision that the guardian reasonably believes the adult would make if able, unless doing so would unreasonably harm or endanger the welfare or interests of the adult. To determine the decision the adult would make, the guardian is required to consult with the adult, or if that is not possible, to consider the adult's prior directions, preferences, opinions, values, and actions to the extent known or reasonably ascertainable.

The new act will also help to prevent isolation of persons subject to guardianship. Under UGCOPAA, one element of the guardianship plan is to list family members and friends and any plan to facilitate visits with those people. A guardian may not restrict the ability of an adult to communicate or visit family members and friends without court approval, unless the guardian has good cause to believe interaction poses a risk of significant harm. In that case, the adult can only be denied access to family members and friends for a maximum of seven days, and all other persons for 60 days, without a court order.

Current Drafting Projects:

Electronic Wills Drafting Committee

Suzanne Brown Walsh, Chair

Turney P. Berry, Vice-Chair

John T. Rogers, ABA Advisor

Susan N. Gary, Reporter

The committee met for the first time in October to consider issues raised by the prospect of electronically creating and filing wills and other estate-planning documents. There was a spate of vendor-driven legislation to allow e-wills in 2017, including one bill in Nevada that was enacted into law and another in Florida that passed the legislature but was vetoed by the governor. This committee will attempt to draft a new uniform act that authorizes e-wills subject to certain restrictions based on public policy.

At the first drafting meeting, the committee worked through a preliminary list of issues including necessary definitions, process of creating an e-will, execution, storage, amendment, and revocation. The Chair reported a productive discussion which will influence the first draft to be discussed at the committee's next meeting in the spring.

Uniform Fiduciary Income and Principal Drafting Committee

Turney P. Berry, Chair

David J. Clark, Vice-Chair

William P. LaPiana, ABA Advisor

Ronald D. Aucutt, Reporter

This committee is revising the Uniform Principal and Income Act, and has recommended renaming the act to the Uniform Fiduciary Income and Principal Act (UFIPA). The draft act was read for comment at the ULC's 2017 annual meeting.

The current draft includes an innovative unitrust conversion provision that is much more flexible than the non-uniform provisions contained in existing statutes. The draft act was also reorganized for clarity and readability. The committee continues to review the act's many default rules and is soliciting input from corporate trustees and from specialists in the various types of alternative investments covered by the act.

Management of Funds Raised Through Crowdfunding Efforts Drafting Committee

Terry Care, Chair

Karen Boxx, Reporter

The ULC Executive Committee appointed a new drafting committee to produce a uniform or model act governing the management of funds raised through crowdfunding efforts. The committee will determine whether the scope of the act should be limited to charitable fundraising or should also include funds raised for business ventures. Topics to be discussed include transparency (including the identity of the fund sponsor and the purpose of the fund), application of excess funds and of funds that do not meet the minimum target amount, and remedies for misapplication of funds.

The committee will meet for the first time in the Spring of 2018.

Drafting Committee on a Tribal Probate Code

Timothy Berg, Chair

David English and Kathleen Guzman, Co-Reporters

Nancy Appleby, ABA Advisor

This committee will produce a model probate code for use by American Indian tribes, consistent with the federal American Indian Probate Reform Act (AIPRA). This is the ULC's second project involving tribal law, following the successful drafting and promulgation of the Model Tribal Secured Transactions Act.

The committee will draft a simplified version of the UPC for enactment by tribes, and also address issues unique to Indian country, including the fractionated ownership of land that resulted from the Dawes Act of 1887 and the disposition of culturally significant personal property.

The committee met last spring in conjunction with the Federal Bar's 2017 Indian Law Conference to gather input from tribal members and lawyers as to the contents of a tribal probate code. Efforts are ongoing to finish the draft act and create an implementation guide for use by the tribes.

Studies:

Study Committee on Economic Rights of Unmarried Cohabitants

Gail Hagerty, Chair

Barbara Ann Atwood, Vice-Chair

Naomi Cahn, Reporter

The ULC Executive Committee approved a joint recommendation from the Joint Editorial Board on Uniform Trust and Estate Acts (JEB-UTEA) and the Joint Editorial Board on Uniform Family Laws (JEB-UFL) to appoint a committee to study the economic rights of unmarried cohabitants.

The rate of marriage in the United States has been in decline, while the number of long-term cohabitating couples is rising. This gives rise to more frequent legal disputes in the event of one partner's death or the dissolution of the partnership. The committee will study case law and current state statutes to determine if a more uniform law would be helpful and feasible.

JEB UTEA Activity:

The Joint Editorial Board for Uniform Trust and Estate Acts
(JEB-UTEA) met in December 2016 and May 2017. Board actions included:

- The election of Bruce Stone, an ACTEC appointee, as the Chair, replacing Malcolm Moore.
- Review of all current trust and estate drafting projects, with a period for questions and advice to the drafting committee chair.
- Drafting an amendment to the Official Comment to Uniform Trust Code Section 413 that addresses the appropriate application of the cy pres doctrine to charities organized as corporations and to charitable gifts held in trust or in another form.
- Appointment of a subcommittee to consider amendments to the Uniform Probate Code in light of the recently approved revision of the Uniform Parentage Act.

The next meeting of the JEB-UTEA is scheduled for December 1, 2017 in Chicago, Illinois.

Legislative Report:

The following report shows legislative activity for all current uniform trust and estate acts in this format:

Name of Act (Year Approved) (Total Enactments)

2017 Activity: State – Action

Revised Uniform Fiduciary Access to Digital Assets Act (2015) (37 Enactments)

2017 Activity:
Alabama – ENACTED
Alaska – ENACTED
Arkansas – ENACTED
District of Columbia – Introduced, pending
Georgia – Died in committee, reintroduction expected
Iowa – ENACTED
Kansas – ENACTED
Maine – Carried over to 2018
Mississippi – ENACTED
Missouri – Vetoed on other grounds
Montana – ENACTED
Nevada – ENACTED
New Hampshire – Passed Senate, Died in House
New Jersey – ENACTED
New Mexico – ENACTED
North Dakota – ENACTED
Ohio – ENACTED

Pennsylvania – Introduced, pending
Rhode Island – Died in committee
South Dakota – ENACTED
Texas – ENACTED
Utah – ENACTED
Vermont – ENACTED
Virginia – ENACTED
West Virginia – Passed Senate, Died in House Judiciary

Uniform Trust Decanting Act (2015) (5 Enactments)
2017 Activity: Illinois Died in House Rules
Nevada – Died in Assembly Judiciary
North Carolina – ENACTED
Virginia – ENACTED
Washington – ENACTED

Uniform Recognition of Substitute Decision-Making Documents (2014) (3 Enactments)
2017 Activity: Connecticut – ENACTED

Uniform Powers of Appointment Act (2013) (8 Enactments)
2017 Activity: Illinois – Died in House Rules
Kentucky – Died in House Judiciary
Nevada – ENACTED
Utah – ENACTED

Uniform Real Property Transfer on Death Act (2009) (14 Enactments, + 13 Non-Uniform Statutes)
(UPC Article 6 Part 4)
2017 Activity: Connecticut – Died in Joint Judiciary
Iowa – Died in Senate Judiciary
Kentucky – Died in House Judiciary
Maine – Carried over to 2018
Utah – Died in House Rules

Uniform Probate Code (Last Amended 2008) (18 Enactments)
2017 Activity: Maine Carried over to 2018

Uniform Principal and Income Act (Last Amended 2008) (47 Enactments)
2017 Activity: Ohio – 2008 Amendments ENACTED

Uniform Adult Guardianship and Protective Proceedings Jurisdiction Act (2007) (48 Enactments)
(UPC Article 5A)
2017 Activity: US Virgin Islands – ENACTED

Uniform Guardianship and Protective Proceedings Act (1997) (5 Enactments)
(UPC Article 5)
2017 Activity: US Virgin Islands – ENACTED

Uniform Prudent Management of Institutional Funds Act (2006) (51 Enactments)
2017 Activity: None

Uniform Power of Attorney Act (2006) (25 Enactments)
(UPC Article 5B)
2017 Activity: District of Columbia – Introduced, pending
Georgia – Passed with non-uniform amendments
Mississippi – Died in Committee
New Hampshire – ENACTED
North Carolina – ENACTED
Texas – ENACTED
Wyoming – ENACTED

Uniform Trust Code (2000) (32 Enactments)
2017 Activity: Illinois – Died in House Rules
West Virginia – ENACTED 2010 insurable interest amendments

Uniform Prudent Investor Act (1994) (43 Enactments)
2017 Activity: None

Uniform Multiple-Person Accounts Act (8 Enactments)
(UPC Article 6 Part 2)
2017 Activity: None

Uniform TOD Securities Registration Act (1989) (51 Enactments)
(UPC Article 6 Part 3)
2017 Activity: None

Uniform Custodial Trust Act (1987) (17 Enactments)
2017 Activity: None

Uniform Transfers to Minors Act (Last Amended 1986) (49 Enactments)
2017 Activity: None