Subject: Notes from the 58th Heckerling Institute on Estate Planning – Part 4

The **58th Heckerling Institute on Estate Planning** was held January 8 through January 12, at Marriott World Center in Orlando, Florida. Members should click this link to review the meeting agenda:

The Heckerling Institute on Estate Planning covers a range of topics for estate planning professionals, including practical pointers that will assist practitioners whether their clients are high net worth individuals or more moderate net worth clients.

Mary E. Vandenack, Joy Matak and Martin Shenkman attended the Heckerling Institute on Estate Planning and agreed to share their notes. Because of the length of the proceedings and the detailed notes, the notes are being separated into four parts and will be published as a series.

Mary E. Vandenack, J.D., ACTEC, CAP®, COLPM®, Accredited Estate Planner (Distinguished) is a partner in the Omaha office of **DUGGAN BERTSCH, LLC**. Mary is a highly regarded practitioner in the areas of tax, trusts and estates, private wealth planning, asset protection planning, business exit and succession planning, and philanthropic strategies. Mary's practice serves businesses and business owners, executives, real estate developers and investors, health care providers, companies in the financial industry, and tax-exempt organizations. Mary is a member of Entrepreneurs Organization. Mary is a member of the American Bar Association Real Property Trust and Estate Section where she serves on Council. Mary is a member of the American Bar Association Law Practice Division where she currently serves as Chair. Mary has been named to ABA LTRC Distinguished Women of Legal Tech, received the James Keane Award for e-lawyering, and serves on ABA Standing Committee on Information and Technology Systems. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning topics as well as on practice management topics including improving the delivery of legal services, technology in the practice of law and process automation. Mary hosts a podcast called Legal Visionaries.
https://maryvandenack.com/podcast/

Martin M. Shenkman, CPA, MBA, PFS, AEP, JD is an attorney in private practice in New York City who concentrates on estate planning. He is the

author of 42 books and more than 1,200 articles. He is a member of the NAEPC Board of Directors (Emeritus), served on the Board of the American Brain Foundation, the American Cancer Society's National Professional Advisor Network, Weill Cornell Medicine Professional Advisory Council, and is active in other charitable organizations.

Joy Matak, JD, LLM is a **Partner** at **Avelino Law.** She has more than 20 years of diversified experience as a wealth transfer strategist with an extensive background in recommending and implementing advantageous tax strategies for multi-generational wealth families, owners of closely-held businesses, and high-net-worth individuals including complex trust and estate planning. Joy provides clients with wealth transfer strategy planning to accomplish estate and business succession goals. She also performs tax compliance including gift tax, estate tax, and income tax returns for trusts and estates as well as consulting services related to generation skipping including transfer tax planning, asset protection, life insurance structuring, and post-mortem planning. Joy presents at numerous events on topics relevant to wealth transfer strategists including engagements for the ABA Real Property, Trust and Estate Law Section; Wealth Management Magazine; the Estate Planning Council of Northern New Jersey; and the Society of Financial Service Professionals. Joy has authored and co-authored articles for the Tax Management Estates, Gifts and Trusts (BNA) Journal; Leimberg Information Services, Inc. (LISI); and Estate Planning Review The CCH Journal, among others, on a variety of topics including wealth transfer strategies, income taxation of trusts and estates, and business succession planning. Joy recently co-authored a book on the new tax reform law.

Table of Contents

PLANNING FOR MODEST ESTATES: PRACTICAL TOOLS 10
General Considerations 10
Spend Time on Client Motivations and Objectives 10
Using Revocable Trusts 10
Annual Gifts Pros/Cons 11
Charitable Giving 11
Portability – Trusts Compared to Direct Giving 11
Spousal Lifetime Access Trusts (“SLATs”) 13
Upstream Planning 14
Other Techniques 15
Testamentary Trust Plan/Options 16
RECENT DEVELOPMENTS 2023 17
Corporate Transparency Act 17
CCA Number 202352018 19
Adequate Disclosure 20
Connelly v. United States, 2021 WL 4281288 (E.D. Mo. 2021). 22
Tax Affecting: Estate of Cecil v. Commissioner 24
Assignment of Income Rule: Charities and Charitable Contributions 24
Decanting a QTIP Trust: Estate of Horvitz 25
Basis of Assets in Grantor Trust 26
Relief From Nonrecourse debt upon sale of property is not COD Income 27
Liability of Successor Trustees and Beneficiaries: Paulson 27
Proposed Regulations for Donor Advised Funds: REG-142338-07 28
Mortality Tables 32
Charitable Remainder Trusts 32
Definition of Standard of Living 33

Principal and Income Act ... 33
Conflict of Laws for Trust Administration ... 34
No Contest In Terrorem Clauses ... 34
Preservation of GST Tax Exemption ... 35
Residency ... 36
Moore Case ... 36
Valuation ... 36
PRACTICAL PARTNERSHIP PANACEAS TO COMMON CLIENT CIRCUMSTANCES ... 37
Investment Company Rules Sec. 721 ... 37
Eliminating Partnership Valuation Discounts ... 38
Divorce After Creation of Non-Reciprocal SLATs – Partnership Solution 39
Sale to Grantor Trust for Note – Improving Tax Results ... 40
Maximizing Basis Under 1014 ... 41
Staggering Distributions With No Section 754 Elections ... 42
Eliminating Valuation Discounts on Pre-Existing Partnerships ... 45
Tax Free Exchanges of Property ... 45
Marketable Securities, Private Equity, Venture Capital ... 50
Avoiding Gain Upon the Death of Grantor ... 51
MODERN ESTATE ADMINISTRATION ... 53
General Estate Administration Tips ... 53
Does Asset Use or Loans Carry Out DNI? ... 54
Trust Tax Distributions ... 54
Basis Consistency ... 54
Alternate Valuation Date ... 56
Debts of Estate – 2053 Proposed Regs ... 56
QTIP Planning – General ... 57
QTIP Planning – Aggregation Issue ... 58
Funding Marital Bequests ... 58

Funding Marital Bequests – Discounted Assets 59
2519 and QTIP 59
Bypass Trust Not Funded 60
Portability 61
Transferee Liability for Estate Tax 61
DRAFTING FLEXIBLE GRATS 62
GRATs 62
Basics 62
GRAT Requirements 62
Qualified Interest 63
Requirements for a Qualified Annuity 63
Required Trust Terms 64
Using Hard to Value Assets 64
Goal of Using a GRAT 65
Recent Issues with GRATs 65
Drafting Remedies to Resolve Potential Issues 68
GRAT Planning Considerations 69
Proposals to Kill GRATs 69
Effect of Anti-Grantor Trust Rules 69
Using Formulas 70
What is the Benefit of Using a Formula? 70
What About Timely Payments? 70
How To Qualify for A Marital Deduction 71
Benefits of Drafting Transferable Annuity Payments 71
Benefits of Drafting a Vested Remainder Interest 71
Myths About GRATs 72
GRATs Can Fail Even If Average Performance Exceeds the Section 7520 Rate 72
Inconsistent Performance Is Also a Problem 72

Steeply Declining GRATs May Work Better ... 72
Can You Use Debt with a GRAT? ... 73
Structuring GRATs to Improve Performance ... 74
Using a Substitution Power ... 74
Rolling GRATs and Asset Splitting GRATs ... 74
99 Year GRAT ... 75
Leveraged GRATs ... 75
Split Purchase Annuity Trust ... 76
ESG = ENVIRONMENTAL, SOCIAL AND GOVERNANCE ... 76
ESG ... 76
ESG and Trustee Duties ... 77
CURRENT ISSUES IN ESTATE AND GIFT TAX AUDITS AND LITIGATION ... 79
Prepare for the Audit ... 79
Relevant Valuation Decisions ... 79
Formula Transfers ... 80
Preferred Techniques ... 81
Potential Donees of the Excess Amount Under Petter Style Formula Clause ... 81
QTIP Termination ... 81
Statute of Limitations – Adequate Disclosure ... 82
Sales Audits ... 82
Promissory Notes ... 83
Installment Sales to IDGT ... 83
GRATs ... 83
Section 2036 ... 83
Section 2036(a)(2) ... 84
CYBERSECURITY, PRIVACY, ETHICS ... 85
Statistics On Data Breach ... 86

Technical Competence ... 86
Confidentiality Compared To Privilege ... 87
The Beginning of a Client Relationship ... 87
Identifying Conflicts of Interest ... 88
Safeguarding Client Information ... 90
Duty To Notify Clients of Data Breaches ... 91
Steps to Take ... 92
50 WAYS TO LEAVE YOUR LEGACY: THAT LIFE INSURANCE POLICY MAY BE WORTH MORE OR LESS THAN WHAT YOU THINK ... 92
Basic Life Insurance Concepts ... 92
Permanent Policy Types ... 93
Valuing Life Insurance Policies ... 94
THE NEW WORLD OF SOCIAL PHILANTHROPY and 501(c)(4) and some created strategies for 501(c)(3) ... 95
Historical Vehicles for Philanthropy ... 95
Social Welfare Organizations ... 95
What Activities are Social Welfare Activities? ... 97
Activities Exempt Under 501(c)(4) but not 501(c)(3) ... 99
Tax Considerations ... 100
Primary Benefits of 501(c)(4) ... 100
Downsides of 501(c)(4) ... 101
Estate Planning Examples ... 101
Estate Tax Considerations of Using a 501(c)(4) ... 101
Considerations re Social Welfare Organizations ... 102
Creative Strategies within 501(c)(3) Vehicles ... 102
Other Non-501(c)(3) Structures ... 103
CORPORATE TRANSPARENCY ACT: TRUSTEES, FAMILY OFFICES, PRIVATE TRUST COMPANIES ... 105
History and Purpose of the Corporate Transparency Act ... 105

CTA Basics 105
Exemptions from CTA 106
Beneficial Owners 109
Who Is a Company Applicant? 110
What Must Be Reported? 110
Filing Deadlines 111
Correcting Reporting Errors 111
Keeping BOI Reports and Applications Up to Date 112
Applying the Corporate Transparency Act to Trusts and Trustees 112
Trust as a Beneficial Owner 113
Responsibility for Reporting 114
Protection, Use and Disclosure of Beneficial Ownership Information 114
Applying the CTA to Trusts and Trustees 115
The Impact of the CTA on Family Offices and Private Trust Companies 119
Ethical Issues on CTA Compliance 120
Take-a-Ways 120
SLICING AND DICING FIDUCIARY DUTIES TO DIRECTED TRUSTS 121
What Is a Directed Trust? 121
What Is the Statutory Framework? 121
Liability and Standard of Care 123
Estate Planning Uses of Directed Trusts 124
Fiduciary vs. Non-Fiduciary Capacity of Direction Advisor 126
FIDUCIARY CASES 126
Trust Accountings 127
Trustee Making Gifts 127
Shortened Period of Liability 127
Distributions 128
SECURE ACT IS NOT A TODDLER ANYMORE 128

RMD Rules 128
Charitable Giving in Trusts 130
Separate Accounts 130
Separate Accounts for Retirement Account Through a Trust 131
Dealing With Surviving Spouse 132

NOTES:

PLANNING FOR MODEST ESTATES: PRACTICAL TOOLS

Presenters: Mickey R. Davis; Melissa J. Willms. Mickey is a partner in the law firm of Davis & Willms, PLLC in Houston, Texas. Melissa J. Willms is a partner in the law firm of Davis & Willms, PLLC in Houston, Texas.

General Considerations

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

Spend Time on Client Motivations and Objectives

- What is total net worth? Asset mix.
- What are client spending habits/growth expectations?
- What are client key concerns?
- Consider age of client and capacity.
- Consider and discuss marital history and agreements. If family is blended, spend time discussing where any wealth has been accumulated and desires about how it is to be allocated during life of both, survivor, and after both pass away.
- What are client occupations and exposure to litigation?
- Are clients philanthropic?
- Are there out of state beneficiaries? Foreign beneficiaries? Foreign assets?
- How much control is desired by clients?

Using Revocable Trusts

- Consider avoiding probate. In some states, failure to avoid probate has become close to being considered malpractice.

- Revocable trusts cover incapacity planning and replace need for conservatorship and possibly guardianship.
- Fund revocable trusts and be sure there are no conflicting TODs, PODs.
- IRAs and qualified plans do pass by beneficiary designation. Consideration should specifically be given to whether trust should be beneficiary rather than individuals. SECURE Act 2.0 and state laws regarding protection of inherited IRAs have changed the landscape. Discuss asset protection vs. tax savings and determine which objectives prevail.

Annual Gifts Pros/Cons

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

Charitable Giving

- Cash gifts are easy.
- Consider substantiation rules for non-cash giving. More substantiation is required for non-cash gifts in excess of $250.00.
- Donor advised funds have become popular charitable giving tools for those of modest wealth. Donors can take a charitable contribution for gits to donor advised fund.
- Some clients like private foundations. Gifts are limited to a smaller percentage of adjusted gross income and 5% annual distributions are required.
- New rules regarding donor advised funds do encourage looking more closely at private foundation options.

Portability – Trusts Compared to Direct Giving

- Portability allows surviving spouse to inherit (“port”) unused exemption of first deceased spouse and use in surviving spouse estate.
- One issue is that the deceased spouse unused exclusion (DSUE) does not inflate. If Spouse 1 dies and $10m of assets pass directly to surviving spouse and value doubles before Spouse 2 dies, Spouse 2 is limited to the DSUE. If those same assets had been placed in a credit shelter trust, the entire amount would be excluded from estate tax at death of Spouse 2.
- When surviving spouse dies, DSUE of predeceased spouse applies first. Portability only applies to last deceased spouse.
- Note that a non-citizen, non-resident spouse cannot use DSUE but they may still want to preserve the DSUE in the event that the non-resident spouse becomes a US citizen.
- Tax apportionment language is extremely important in the context of DSUE. Consider where transmission expenses might be applied and whether there is a benefit to using them to reduce the marital deduction in order to get an income tax benefit.
- DSUE can be elected with 5 years of first spouse’s death if below threshold by filing a pure portability return. Rev. Proc. 2022-32.
- Portability compared to trust planning should be specifically discussed with clients:
    - Direct transfers to spouse do not have asset protection for surviving spouse and there is no assurance to first deceased spouse regarding ultimate disposition. (Surviving spouse can pass all assets to new spouse and disinherit children from earlier marriage.)
    - DSUE can be lost on remarriage.
    - There is no portability of GST exemption.
    - Do note that DSUE should be considered even if trust planning is used.
- Some assets don’t work well with trust planning: S corporations; some other pass-through entities; Qualified Plan Accounts. In an estate consisting entirely of these assets, an approach other than trusts may make sense; however, there are trusts that work for these assets. Thus, revisit objectives, pros and cons.

Spousal Lifetime Access Trusts ("SLATs")

- The idea is to use up the excess or bonus exemption above what ½ the exemption will be in 2026. While client would be uncomfortable gifting away large amount but may get indirect benefit from the trust.
    - Comment: Premature death (and divorce which is discussed below) should all be considered. Life insurance may be used to protect the settlor spouse from premature death. Financial forecasts should be used to illustrate potential outcomes, tax burn, etc. Caution should be exercised in what types and amounts of "indirect" benefit the settlor spouse may obtain. Practitioners should be cautious about what the put in writing in regards to benefits the settlor spouse may obtain. Consider naming a trustee in a DAPT jurisdiction and qualifying the trust as a DAPT to provide a backstop if the indirect benefits are challenged by a creditor or the IRS.
- Consider who you represent. Most practitioners usually represent both spouses.
- Divorce. Settlor may lose access and under grantor trust rules repeal of Sec. 682 in 2017 Tax Act the settlor will remain taxable on SLAT income. Consider the impact on each spouse if they get divorced the next day. If the clients are worried about divorce, why are they doing a plan?
- Comment: Wealthy clients and/or well-educated clients may face a divorce rate that is perhaps about half of that of other clients. On the other hand, the only cohort of people for which divorce rates continue to rise are seniors, the so-called gray divorce issue. Since much of estate planning focuses on clients over 50-60 those may well be the clients most likely to divorce.
- Do not use gift splitting if spouse is beneficiary of the trust.
- Reciprocal SLATs. *Estate of Grace*. Trusts should not be identical But rather substantively different. There are no bright line rules. Economics should be materially different between the trusts. Some try to do a SLAT and a dynasty trust without spouse as beneficiary, but they acknowledge that moderate wealth clients are not comfortable doing that.
- Step transaction doctrine under the *Smaldino* Case. What should you do if starting with separate property funds, e.g. inherited funds. What

if assets are gifted from moneyed spouse to the non-moneyed spouse who then funds a trust. *Smaldino* was not a SLAT case but alerts us to those step-transaction issues.

  - Comment: *Smaldino* was also a bad facts case but looking at step-transaction doctrine is critical and speakers are right to point this at as so much focus is given to the reciprocal trust doctrine and not the step transaction doctrine. In Smaldino the husband transferred entity interests to the wife who then made a gift to a trust the next day that only benefited the husband's children from a prior marriage. The operating agreement for the LLC given was never updated to reflect the wife as owner. The Form 1065 forms K-1 were never issued to the wife for the day she supposedly owned and interest. The list of foot faults in Smaldino is quite long. Just as with the reciprocal trust doctrine as noted above, there are no bright line rules. This will become more of an issue the closer we get to 2026.

Upstream Planning

- Consider the possibility that a parent or senior generation has an exemption that client might want to capture. A general power of appointment can be given to the parent in a trust. Contrast the GPOA approach to giving an asset outright to a parent, in which case, the asset would be included in the estate of the parent and if parent lives for 1 year + 1 day, Sec. 1014(e) is avoided and a basis adjustment is available. However, the child donor has no control. Instead, the child sets up a grantor trust to benefit child's descendants and gives a general power of appointment in the trust to the parent. The GPOA can be narrow. For example, the GPOA could allow the parent to appoint assets to a creditor with the consent of another person up to her remaining exemption. There is no need to inform the parent of the existence of GPOA. But note that parent could exercise the GPOA.
  - Comment: Consider the following as possible steps to enhance or differentiate a GPOA plan.
  - Consider corroborating that the intended powerholder has legal capacity when the grant of the GPOA is made, although this appears to be unnecessary based on several of the cases on GPOAs. Nonetheless, several authorities relied on for GPOA planning results have fact patterns where the decedent had capacity when the power was granted. If the powerholder does

not have capacity, perhaps the GPOA could expressly state that an agent under a power of attorney or guardian for the powerholder could exercise the GPOA on behalf of the powerholder, if the donor were comfortable with that.

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

Other Techniques

- GRAT. The benefit of a grantor retained annuity trust for moderate wealth clients is the annuity or return of funds plus the 7520 rate. A GRAT for moderate wealth clients might serve as a type of estate freeze.
- QCD - qualified charitable distribution. This is permitted at age 70.5 not 72. The distribution to charity never shows as AGI, which can have many tax benefits for a client, even one of modest means. A couple gets $30,700 standard deduction so may never get a

charitable contribution deduction. Instead of taking RMD, such client can make a qualified charitable distribution to a client by having the IRA custodian send the money directly to charity. Absent this strategy, the RMD would have been income and the client may not receive full benefit of the charitable deduction. In addition, by keeping the AGI lower, a client with medical expenses may be able to get a deduction for medical expenses that is greater than they would have gotten otherwise. In addition, a lower AGI may save clients money on Medicare premiums.

Testamentary Trust Plan/Options

- Bypass Trusts may still make sense for some of the following reasons:
  - A credit shelter trust provides asset protection.
  - You can have beneficiary as trustee and still have creditor protection also protection from divorce from a future spouse.
  - Consider implications of surviving spouse remarrying.
  - Income shifting benefits of bypass trust as can sprinkle income to surviving spouse, children and grandchildren (whoever is named as a beneficiary of the CST) many or even all of whom may be in lower income tax brackets then the trust.
  - For special needs beneficiaries trusts can protect assets to protect government benefits by incorporating a supplemental needs trust.
  - Loans can be made instead of a distribution to retain assets in the trust. This can be done as a teaching tool for heirs. Loan heirs money and see how they react.
  - Trusts get unlimited charitable income tax deductions so a bypass trust may be a valuable tool for charitable planning but must include charity in the original document to meet the governing instrument rules.
- QTIP
  - All income must pass to surviving spouse. This requirement applies to fiduciary accounting income (“FAI”), not taxable income. There could be a mismatch between the two.
  - Assets held in a QTIP receive a basis step up on second death.

  - Reverse QTIP election can be made to preserve GST exemption.
  - The use of deceased spouse unused exclusion may create ability for surviving spouse to avoid estate tax on surviving spouse's.
  - You cannot sprinkle income in a QTIP as you can in a bypass trust and cannot have charitable beneficiaries.
- CLAYTON QTIP
  - The CLAYTON QTIP gives the executor the ability to decide whether the trust should be a bypass or QTIP after the first death.
  - To the extent the executor makes a QTIP election, those assets pass to QTIP and to the extent the executor does not make a QTIP election the assets pass to the bypass trust.
  - Surviving spouse should not be the person with the power to exercise the QTIP election of this type. If state law permits, you can have a special executor. If not, name a special trustee in a revocable trust and have surviving spouse be a successor trustee for everything other than the Clayton QTIP election.
  - If you make a QTIP election, estate tax is postponed. The portability election preserves exemption. It is important to address who will pay tax on QTIP assets. Those QTIP assets will be stacked on top of the surviving spouse's estate and the QTIP may pass to children from another marriage. The marginal estate tax rate is paid by the QTIP unless the documents provide otherwise. This can be negotiated.

RECENT DEVELOPMENTS 2023

Presenters: Turney Berry, Carlyn McCaffrey and Ronald D. Aucutt.
Turney is a partner at Wyant, Tarrant & Combs LLP. Carlyn is a partner at McDermott Will & Emery LLP. Ronald Aucutt is Senior Fiduciary Counsel at Bessmer Trust Company, N.A.

Corporate Transparency Act

- Practitioners may want to get FinCEN Identification Number.

- CTA creates a national registry for entities. Any domestic entity created by filing a document with a Secretary of State and any foreign entity to do business in the US.
- When do entities need to report?
  - Entities formed in 2024 must report within 90 days of formation.
  - Entities in existence prior to 2024 have until the year end to file. If information changes, entities have 30 days to update.
- Which entities need to report?
  - Reporting Companies: Reporting companies are domestic entities formed by filing with Secretary of State. Common law trusts and general partnerships are formed by private agreements and without filings and they do not have to report. But if the partnership owns entities it will have to report and its Beneficial Owners will have to report. There are exceptions for entities subject to government supervision, large companies with 20+ employees, $5M of revenue and physical presence in the US, and banks. Private trust companies that are regulated should also be exempt.
  - Foreign entities not registered to do business in the US are not required to report.
  - There are 23 exceptions that apply to entities.
    - Banks and other companies like banks, already subject to federal regulation.
    - Tax exempt entities under 501(c)(3).
    - Publicly traded entities.
- Who is required to report?
  - Reporting Companies must report for Beneficial Owners and Applicants.
  - Beneficial Owners – This term is defined to include “any individual who directly or through any arrangement exercises substantial control or owns 25%”. This includes a senior officer, the power to direct the firing of officers, etc.
  - Applicants – For a newly formed entity, this is often the attorney and support staff that filed the formation documents with the Secretary of State.
- What information is required to be reported for Beneficial Owners?
  - Legal Name.

    - Date of Birth.
    - Residential address. Applicants only have to submit their business address.
    - Unique Identifying number. Scanned copies of identification information must be provided. As an alternate, individuals can obtain a FINCEN identifier.
    - Entities can also obtain a FINCEN identifier.
    - Company has to provide legal name, tradename, jurisdiction of formation, and federal identification number. Company can also obtain a FINCEN identifier.
- What are the penalties for not reporting?
    - CTA includes possibility of imprisonment for failure to comply.

CCA Number 202352018

- **Rev. Rul. 2004-64** specified that when a grantor pays income tax, doing so is not a gift to the trust. If the trustee is **required** to reimburse the grantor, there is a retained interest that will cause inclusion in grantor's estate. If trustee **only has discretion** to reimburse that alone does not cause inclusion in the settlor's estate; however, other factors added to that could result in estate inclusion (e.g., implied agreement
- In a 2016 letter ruling, the IRS said that modification of the trust to include a tax reimbursement clause was permissible under Rev. Rul. 2004-64, 2004-2 C.B. 7.
- In **CCA 202352018**, the trust at issue was an irrevocable discretionary trust that provided for distribution of income to child during the child's life and to child's issue per stirpes upon the child's death. Grantor retained a power to make the trust a grantor trust. Neither the trust or state law authorized reimbursement. Pursuant to state law the grantor's child and that child's issue consented to a modification to add a tax reimbursement clause. IRS concluded that as a result of the modification, there was a gift to the grantor.
- A footnote in CCA 202352018 specifically noted that *PLR 201647001* no longer reflects the position of the IRS.
- The CCA did not address how to value the gift. Numerous questions are left open. How do you estimate income? How do you estimate tax to be paid? How can you determine whether a discretionary power

will be exercised? How do you apportion the value among the various current and future beneficiaries.

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

Adequate Disclosure

- Adequate Disclosure is critical to tolling the statute of limitations when filing a gift or estate tax return.
- *Schlapfer v. Commissioner*, T. C. Memo. 2023-65. 6501(c)(9) states that the statute of limitations does not begin to run if no gift tax return is filed, or if the gift is not adequately disclosed on or with the gift tax return. Adequate disclosure of a completed gift on a gift tax return will commence the running of the period of limitations for assessment of gift tax on the transfer even if the transfer is ultimately determined to be an incomplete gift.

- The regulations regarding adequate disclosure specify that a gift will be adequately disclosed if you disclose a description of the transferred property and any consideration received by the transferor; the identity of and relationship between the transferor and each transferee; if the transfer is in trust, you have to disclose the trust's Tax ID No. and a brief description of the terms of the trust, or you can attach the entire trust; you have to have a detailed description of the method used to determine fair market value or you can attach a qualified appraisal; and you need to include a statement describing any position that's contrary to any proposed, temporary or final IRS regulation or revenue rulings that are published at the time of the transfer.
- Historically, these regulations were interpreted strictly by the IRS but that was not the situation in the Schlapfer case.
- In this case, taxpayer filed a 2006 gift tax return. IRS requested information on the Panamanian company which he provided. The brokerage statement showed the portfolio valuation. Two years later, IRS assessed deficiency and the taxpayer took the position that statute of limitations had run. Court said Regulation is a safe harbor and the requirements are just the requirements to satisfy the safe harbor. Requirements can be satisfied by substantial compliance.
- Schlapfer's transfer was a life insurance policy that was funded by a company that was owned by him. Court also addressed whether life insurance policy or stock was transferred. The court concluded that adequate disclosure requirements were satisfied whether the gift was in 2006 or 2007 as disclosure identified enough details to alert the IRS to the nature of the transaction.
- It is worthy of note in this case that issue arose in 2014 during a review of Schlapfer's participation in an offshore voluntary disclosure program.
- One requirement of adequate disclosure is description of property. Court noted that Schlapfer provided enough information to satisfy the requirement by providing information that described the underlying nature of the property. Court accepted "substantial compliance."

- Another aspect of adequate disclosure is identity of transferees and their relationships. Again, the court allowed substantial compliance because the donor's mother was named.
- Adequate disclosure also requires identification of the method used to determine the value of the gift. Donor provided detailed financial information identified in the instructions for Form 706. The court concluded the information provided was sufficient to show the IRS how the insurance was valued.
- Author's Note: Although this case was favorable to the taxpayer and allowed "substantial compliance", practitioners should generally not rely on substantial compliance. Strict compliance with the regulations is the right practice; however, in the event of an audit of a client under the disclosure rules, this case can be used to support a client who is in substantial compliance.

Connelly v. United States, 2021 WL 4281288 (E.D. Mo. 2021).

- Connelly v. United States, 131 AFTR 2d 2023-1902 (8th Cir. June 2, 2023), aff'g 128 AFTR 2d 2021-5955 (E.D. Mo. 2021), petition for cert. filed (U.S. No. 23-146, Aug. 16, 2023).
- The Connelly brothers entered into a Stock Agreement for the purpose of ensuring continued family ownership of Crown Co. The agreement provided that the survivor had the right to buy the deceased brother's shares and that the company would buy the shares if the surviving brother did not. The company bought $3.5 million insurance policies on each brother for the purpose of having insurance to fund a redemption upon death.
- Michael died and the surviving brother chose not to purchase the shares so the company redeemed the shares. The surviving brother was also the personal representative of Michael's estate. He entered into an agreement with Michael's son to redeem the shares for $3 million. The shares were valued at the agreed upon $3 million on the estate tax return filed for Michael's estate.
- The Court concluded that the life insurance proceeds received by the company had to be included in the value of Crown Co. despite the fact there was a redemption obligation. Court noted that value of underlying equity of company was not reduced by the obligation because the life insurance funded the obligation.

- By way of example, consider a company that has a value of $6,000,000. One owner dies. The company receives $3,000,000 of life insurance proceeds. At that point, the company is worth $9,000,000 (the position of the Connelly court). The company pays out $3,000,000 to the estate of the deceased owner. After such payment, the surviving owner has a company worth $6,000,000.
- The court in the Connelly case concluded that the buy-sell agreement did not satisfy the requirements of section 2703. The court noted that to the extent a process to determine valuation was part of the agreement, the process was not followed. The agreement provided for a certificate of value; however, no certificate of value was never completed. The agreement provided for an appraisal to value the company if no certificate of value was completed but no appraisal was completed.
- Note that this case was an Eighth Circuit case that concluded differently from an 11th Circuit case, *Blount v. Commissioner*. The US Supreme Court has accepted cert on the *Connelly* case.
- Many practitioners think the Connelly case is wrong. This author is among those who believe the Connelly conclusion is correct. Ultimately, whether owners use a cross purchase or redemption, in a scenario such as above, the surviving owner receives the benefit of the life insurance and has an increased estate as a result. Consider a cross purchase. Shareholder X owns a policy on Y. Y dies. Company is worth $6 million. X receives $3 million in life insurance proceeds and buys Y's stock from his estate. Y's estate receives $3 million. X has a company worth $6 million. The difference between the redemption and the cross purchase is that by virtue of including the life insurance in the value of the company at the time of the shareholder's death, the value is included in the shareholder's estate at the time of his death. In the event of a cross purchase, the surviving shareholder receives the benefit and has a larger estate but the increase in estate value is not immediately reportable because the shareholder is still alive.
- An important point in all of this for practitioners is to ensure that owners understand the economics of these transactions and are making a conscious decision. Additionally, work with clients to implement documents rather than just having them prepared. If using

a certificate of value approach, consider having an appraiser design a valuation methodology.

Tax Affecting: Estate of Cecil v. Commissioner

- T.C.M. 2023-24 (Feb. 28, 2023).
- This case dealt with the valuation of The Biltmore Company ("TBC") which owns the Biltmore Estate in Asheville, North Carolina. The taxpayers/donors were William (Bill) and his wife, Mary. In 2010, Mary gifted one Class A share to each of her children, Bill and Dini; William gifted Class B shares to separate trusts for the benefit of each of his five grandchildren. The Cecils reported those gifts on a gift tax return and the IRS challenged the valuation. There were two appraisal issues at trial: (1) whether the appraiser could use tax affecting to determine the fair market value of TBC shares; and (2) which valuation approach to apply for a privately held operating company. TBC was an S corporation so in comparing it to C corporations the appraisers adjusted the earnings for the different tax treatment. All the appraisers agreed on that approach.
    - Tax affecting is appropriate in this case for valuation purposes. Discount was 17.6%. "Tax affecting" refers to the step in the valuatin of a closely-held business that seeks to adjust for differences between passthrough entities and C corporations.
    - Net asset value approach was determined to be inappropriate for valuation purposes because the company is not a real estate holding company but is an operating business. Income approach must be used for this operating business.
    - Substantial discounts were allowed for lack of control, lack of voting rights and lack of marketability.
    - Practitioners should keep in mind that while valuation discounts can work well for our clients in some situations, the IRS can also use them to work against our clients.

Assignment of Income Rule: Charities and Charitable Contributions

- Hoensheid v. Commissioner, T.C. Memo. 2023-34 (March 15, 2023)
- Facts. Donor gives stock to a DAF. Donor clearly did not want stock to be given to charity until the donor was 99% sure that the company would be sold. Donor kept telling this to other people when he gave the stock to the DAF. DAF refused to sign documents pertaining to

the sale until they actually got the gift. Sale occurred immediately thereafter.

- The Tax Court applied the anticipatory assignment of income doctrine and denied a charitable deduction for a gift to charity quickly followed by a sale. *Hoensheid v. Commissioner*, T.C. Memo, 2023-34 (March 15, 2023). In this case, the owner didn't want to donate the shares until it was likely that a sale would go through because the owner didn't want to have the sale fall through and end up in a minority interest with respect to his partners. At the time the gift was made, a purchase agreement had not been signed but was going to be signed contemporaneously with closing. The only provision remaining for discussion was a non-substantive provision.
- The anticipatory assignment of income doctrine has two prongs.
    - The first is that the donor must give away the property absolutely.
    - The second is that the property must be given away prior to the property giving rise to income by way of a sale.
- For planners working with clients making gifts prior to a business sale, it is important to determine whether the seller is legally obligated to sell. In the *Hoensheid* case, the purchase agreement was going to be signed contemporaneously with closing and no substantive issues remained that were likely to kill the deal. It is more common that a purchase agreement is signed followed by a period of due diligence. It is not untypical for a deal to fall through at the final hour. The planner should both discuss and document the status of a possible sale. If the CEO indicates that a particular substantive provision could still kill the deal, document the same and make the gift before that is resolved.

Decanting a QTIP Trust: Estate of Horvitz

- The Tax Court respects decanting of QTIP trusts that permitted distributions to charity at the spouse's death. In this case, Horvitz had survived her spouse and had various trusts. One of the trusts was decanted and in the decanting process, Horvitz was given a broader power of appointment. Horvitz exercised the power of appointment to make bequests to Charity.

- The governing Ohio decanting statute allows decanting to another trust if the agreement gives the trustee absolute authority to make principal distributions, which is defined as distributions not subject to an ascertainable standard.
- A decanted trust can include a broadened power of appointment that includes additional appointees.
- The IRS was reluctant to allow an estate tax charitable deduction for charitable contributions that were made under the broadened power of appointment that resulted from the decanting transaction.
- The case was settled to allow a full estate tax charitable deduction that passed to charities pursuant to exercise of the broadened power of appointment.

Basis of Assets in Grantor Trust

- **Rev Rul 2023-**2 – Assets held in an irrevocable grantor trust do not get a step up in basis at the death of the grantor.
    - Facts of the Ruling: In Year 1, A, an individual, established irrevocable trust, T, and funded T with assets in a transfer that was a completed gift for gift tax purposes. A retained a power over T that causes A to be treated as the owner of T for income tax purposes under subpart E of part I of subchapter J of chapter 1 (subpart E). A did not hold a power over T that would result in the inclusion of T's assets in A's gross estate under the provisions of chapter 11. By the time of A's death in Year 7, the fair market value (FMV) of Asset had appreciated. At A's death, the liabilities of T did not exceed the basis of the assets in T, and neither T nor A held a note on which the other was the obligor.
    - Ruling Analysis: For property to receive a basis adjustment under § 1014(a), the property must be acquired or passed from a decedent. For property to be acquired or passed from a decedent for purposes of § 1014(a), it must fall within one of the seven types of property listed in § 1014(b). Asset does not fall within any of the seven types of property listed in § 1014(b).
- What Can Be Done?
    - Swap assets out so that asset on which step-up is desired is in estate.

- Ruling does not address trust's basis in case of sale to grantor trust.

Relief From Nonrecourse debt upon sale of property is not COD Income

- In P*arker v. Commissioner* (T.C. Memo 2023-104), the Tax Court concluded that income from cancellation of nonrecourse debt is includible in the amount realized from an S corporation's sale of real property subject to that debt. The court rejected the taxpayer's argument that it was COD income that could be excluded to the extent of the corporation's insolvency.
- In the case, Taxpayer owned an S corporation, which has various solely owned subsidiaries. One held real estate which had debt which had been personally guaranteed by Taxpayer. The buyers agreed to assume the personal guarantee obligation. The seller treated the COD as income that could be excluded under the insolvency exemption.
- The Tax Court concluded that the property was encumbered by nonrecourse debt and the outstanding debt was to be included in taxpayer's gross income includes from selling the property.

Liability of Successor Trustees and Beneficiaries: Paulson

- United States v. Paulson, 68 F.4th 528, 131 AFTR 2d 2023-1743 (9th Cir. May 17, 2023).
- Facts. Decedent died in 2000 with an estate worth $188m. IRC Sec. 6166 election made to defer estate tax. Periodically made payments of tax. Over the years trustees changed, distributions were made, various people are beneficiaries. Long before estate tax was fully paid, they stopped paying the estate tax. In 2015, IRS sues the family for tax due. The people included widow, grandchild, daughter in law and two sons. People were all co-trustees or beneficiaries of decedent's revocable trust, which held the bulk of Mr. Paulson's assets.
- IRS asserted personal liability under 6324(a)(2) as "transferee liability."
- Law. "If the estate tax imposed by chapter 11 is not paid when due, then the spouse, transferee, trustee…surviving tenant, person in possession of the property by reason of the exercise, non-exercise, or release of a power of appointment, or beneficiary, who receives, or

has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax."

- The Court of Appeals for the Ninth Circuit held that the successor trustee and the beneficiaries of a revocable trust, who received trust assets and trust distributions after the decedent's death, were personally liable for unpaid estate taxes. United States v. Paulson, 68 F.4th 528, 131 AFTR 2d 2023-1743 (9th Cir. May 17, 2023).
- This may not be the final word. A petition has been filed with the Supreme Court.
- **Comment**: When handling any estate administration, no successor trustee should assume that role without first ascertaining the status of tax due or other liabilities. Likely no professional or institutional trustee would be so cavalier. Beneficiaries similarly should consider some due diligence to assure that they are not receiving a liability. This is no different then refusing to accept title to real property without due diligence like a title search and perhaps some measure of environmental investigation.

Proposed Regulations for Donor Advised Funds: REG-142338-07

- Proposed Reg. §§53.4966-1 through -6, REG-142338-07, 88.
- On November 13, 2023, the Department of the Treasury and IRS released the first installment of long-awaited Proposed Regulations (REG-142338-07) providing guidance on certain tax rules relating to donor advised funds ("DAFs"). A DAF is an account that is maintained by a charitable organization (the "sponsoring organization") and funded by contributions from donors who retain advisory privileges with respect to the distribution or investment of amounts in the fund. Because DAFs are sponsored by public charities, they have historically been able to offer many of the same benefits as private foundations without being subject to the restrictive private foundation rules.
- To guard against perceived potential for abuse, Congress, as part of the Pension Protection Act of 2006 ("PPA"), added special rules enforced via excise taxes that (1) govern transactions with and benefits received by donors, donor-advisors, and certain other

persons, and (2) address distributions from DAFs, including “taxable distributions.”

- The Proposed Regulations expand upon interim IRS notices to provide guidance on the interpretation of key definitional terms of the PPA. The regulations clarify the scope of accounts treated as DAFs and the distributions constituting taxable distributions. The regs will necessarily impact the application of other rules for DAFs. Future guidance is expected to address additional rules relating to DAFs, including when distributions from a DAF provide a more than incidental benefit to a donor or donor-advisor (“prohibited benefits”) and whether a distribution from a DAF can be used to satisfy a personal pledge to make a charitable contribution by a donor (an issue addressed in IRS Notice 2017-73, which remains in effect).
- The proposed regulations expand limitations on donor advised funds (“DAFs”). Making payments for services to a donor or person who is an agent of a donor is subject to taxation of 25% on excess benefit. There is a 20% tax on any distribution to an individual if the distribution is made for a non-charitable purpose. There is a 125% excise tax on anything more than an incidental benefit to the donor, donor’s family as a result of any advice given by any of them and accepted by donor. An investment advisor who advices the donor of a DAF and also provides investment advice to the donor on personal investments is subject to excise tax (when DAFT is at a different investment firm).
- Although the Proposed Regulations are not yet effective, they provide guidance that will likely affect the operations of sponsoring organizations and their DAFs that have been operating in a near-regulatory vacuum for the past 17 years.
- The Proposed Regulations clarify that a fund or account satisfies the first prong of the statutory definition of a DAF if the sponsoring organization maintains a formal record of contributions to the fund or account relating to a donor or donors. In the absence of a formal record, whether the first prong is met depends upon all of the facts and circumstances, including, among other factors, whether the fund or account is named after the donor and whether one or more donors or donor-advisors regularly receive a fund or account statement from the sponsoring organization.

- Considerations and Takeaways:
    - Multiple-Donor Funds: A multiple-donor fund or account will not be a DAF if no donor or donor-advisor has, or reasonably expects to have, “advisory privileges”.
    - Single Identified Organization: An account that is established to make distributions solely to a single public charity or to a governmental entity for public purposes is not considered a DAF.
    - Scholarship Funds: In addition to a statutory exception for certain scholarship funds, under the Proposed Regulations, scholarship funds established by a broad-based section 501(c)(4) social welfare membership organization, such as a Rotary Club, are not DAFs if certain requirements are met.
    - Disaster Relief Funds: Consistent with earlier guidance in Notice 2006-109, the Proposed Regulations establish that disaster relief funds (within and outside of the employment context) are not DAFs.
    - Disaster Relief Funds: Consistent with earlier guidance in Notice 2006-109, the Proposed Regulations establish that disaster relief funds (within and outside of the employment context) are not DAFs.Advisory
    - Committees: The Proposed Regulations provide two safe harbors under which a donor’s service on an advisory committee or recommendation of an individual to serve on an advisory committee would not give rise to advisory privileges. Charities that do not think of themselves as sponsoring organizations may need to be careful to avoid inadvertently creating a DAF when permitting a donor to participate even informally in a committee that provides advice regarding the investments and/or distributions of a fund, particularly where the distributions would constitute taxable distributions, as discussed below, if the fund were considered a DAF.
    - Restricted Gifts: The preamble to the Proposed Regulations notes that a donor does not have advisory privileges for purposes of the DAF rules if a gift is given with a restriction but the gift does not provide for subsequent discretion with respect to the restrictions.

- Compensation of Investment Advisors: Many sponsoring organizations compensate outside investment advisors who manage the asset in a DAF. Since the Proposed Regulations provide that such advisors will be donor-advisors if they also provide advice with respect to the donor's personal assets, the payment of compensation using DAF assets to such personal investment advisors who serve in this dual role would constitute a distribution that would generally be a taxable distribution (and could also be a prohibited benefit).
- Purchase of Goods and Services by a DAF: A sponsoring organization that permits a DAF to purchase goods and services from non-charitable vendors for charitable programs or fundraising purposes would need to exercise expenditure responsibility with respect to such payments.
- Grants for Lobbying: Because lobbying is a non-charitable activity, a distribution used for lobbying would be a taxable distribution even though public charities are permitted to engage in a limited amount of lobbying.
- Grants to Intermediary Organizations: The Proposed Regulations set forth an anti-abuse rule providing that a planned series of distributions to intermediary recipients that would be considered a taxable distribution if made directly to the final recipient will be treated as a single taxable distribution.
- Distributions to Foreign Charities: Distributions made to qualifying foreign organizations are not considered taxable distributions. The Proposed Regulations clarify that for purposes of determining whether a foreign organization is the equivalent of a U.S. public charity, DAFs may rely on the same procedures private foundations use to make "equivalency determinations" with respect to foreign grantees.
- Binding Decision Not Required: A fund manager is deemed to agree to a distribution through any manifestation of approval of the distribution that constitutes an exercise of the fund manager's authority to approve the distribution, regardless of whether the approval is a final or decisive act on behalf of the sponsoring organization.

Mortality Tables

- The new mortality tables are available on the IRS website. https://www.irs.gov/retirement-plans/actuarial-tables.
- The tables are based on 2010 census data and reflect significantly lengthened longevity.
- This results in higher values for life interests and significantly lower values for remainder interests following life interests.
- A higher charitable deduction is achieved in a CLAT but smaller for CRATs.
- These tables came out in 2019. Consider any possible changes to strategies in place in 2019.

Charitable Remainder Trusts

- *Estate of Block v. Commissioner* – Estate was denied an estate tax charitable deduction for a transfer to a trust that failed to qualify as a CRAT and was not judicially reformed.
- *United States v. Eckhoff,* No. 2:22-CV-04027 (W.D. Mo. May 23, 2023). Promoters are liable for damages and permanently enjoined from promoting scheme.
- CCM 202233014 - A CRT was determined not to generate either a marital or charitable deduction where the trustee was required to distribute 1.25% to the surviving spouse but could distribute the remaining 3.75% between spouse and charity. There's no charitable deduction for the 75% because charity may not receive it. There's no marital deduction for the 75% because how much, if any, of the 75% will pass to the spouse is uncertain.
- *Furrer v. Commissioner*, T.C. Memo. 2022-100. Taxpayer transferred crops to two CRATs. The crops were corn and soybeans. The taxpayers were worse off after they went to appeals court than before. Court noted that petitioners were engaged in the farming business, and the corn and soybeans grown on their farm constituted ordinary income property. Thus, any charitable contribution deduction would be limited to their cost or adjusted basis in the crops. That basis was zero.
- *Gladys L. Gerhardt v. Commissioner*, 160 TC. No. 9 (April 20, 2023) – The Tax Court found that a CRAT scheme that purportedly avoided income tax on the sale of appreciated property is invalid. The

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

Definition of Standard of Living

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

Principal and Income Act

- *In re Sunderland Irrevocable Trust,* 2022 WL 17827275 (Nev.).

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

Conflict of Laws for Trust Administration

- *In re Dille Family Trust*, 2023 WL 6121850 (Pa. Super. Ct.) – The Court determined that Pennsylvania law applied to appointment of a successor trustee. Although the governing law provision of the trust specified California law, the court concluded that Pennsylvania law applied because California law was only applicable to questions of interpretation of the trust instrument. The trust was silent on questions of administration.
    - The trust situs had been moved from California, to Illinois and then to Pennsylvania. The court stated that trust administration of movables determined the state most substantially related to trust's situs.
- For planning purposes, consider specifying the law to govern administration questions.

No Contest In Terrorem Clauses

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

Preservation of GST Tax Exemption

- Letter Ruling 202301001 – IRS ruled that a proposed transfer of trust assets to a successor trust, even when those assets will remain in trust for the benefit of beneficiaries beyond the period of outright distribution under the original trust, will not cause either trust to lose its tax exempt status for GST tax purposes.
- Letter Rulings 202317001 and 202318010 involved a trust with a future per stirpes

Residency

- *Acklie v. Nebraska Department of Revenue*, 982 N.W.2d 228 (Ne. 2022). The issue was whether Duane (and Phyllis) Acklie had changed domicile to Florida from Nebraska. Burden of proof of establishing that you are no longer a resident is on the taxpayer. In this case, taxpayer still had a house, club membership, and vehicles registered in Nebraska. In addition, taxpayer made political contributions reflecting a Nebraska address. It is worthy of note that taxpayer had established significant contacts in Florida.
  - When working with a client who is trying to change residency, it is important to look at all factors that courts consider for the state from which they are trying to move.

Moore Case

- The issue in this case is the mandatory repatriation tax.
- This tax was part of the 2017 Tax Act's conversion from a "worldwide" system to a "source-based" system of corporate taxation. It is a one-time tax on US persons owing at least 10 percent of the stock of a CFC in 2017 on the CFC's undistributed post-1986 earnings and profits.
- The Moore's owned 11 percent of KisanKraft, a CFC that supplied tools to farmers in rural India. All profits were reinvested and the Moore's had never received a distribution from the company. Because they owned more than 10% of the company, they paid a tax of $14,729 and filed a refund claim. The Moore's argued that the tax was a retroactive tax on past earnings and thus violated the Due Process Clause of the Fifth Amendment. The retroactive argument was dropped on appeal to the Supreme Court but taxpayers have claimed that the MRT violates the apportionment clause. The claim is that the MRT is an un-apportioned direct tax and therefore unconstitutional.
- The federal income tax is an un-apportioned tax but protected by the 16th Amendment. To avoid 16th amendment protection, the Moore's have asserted that the MRT is not an income tax because it is taxing amounts not yet received as income. That is, the Moore's argued that the income has not been realized.

Valuation

- *Buck v. United States*, 2021 WL 4391091 (Dist. Ct. Conn. 2021). Each year from 2010 to 2013, the plaintiff reported and paid gift tax on these transfers as two separate gifts to his sons, each representing the gifted 48% interest in given tracts. The plaintiff valued the gifts using discounts meant to account for the possibility that the interests were less valuable to hypothetical buyers than they might be otherwise. While the combined purchase price of the properties was $82,853,050, the plaintiff declared the discounted value of each 48% fractional interest to be $18,496,249, a total of $36,992,498 for the two sons. This represented a 55% discount from the total purchase price. The Internal Revenue Service ultimately challenged the plaintiff's valuations and assessed deficiencies in the plaintiff's gift tax returns. The plaintiff paid this amount in full and filed claims for refunds before bringing this action. Presenter noted that court ignored Revenue Ruling 93-12 which states: Rev. Rul. 81-253, 1981-1 C.B. 187, holds that, ordinarily, no minority shareholder discount is allowed with respect to transfers of shares of stock between family members if, based upon a composite of the family members' interests at the time of the transfer, control (either majority voting control or de facto control through family relationships) of the corporation exists in the family unit. The ruling also states that the Service will not follow the decision of the Fifth Circuit in Estate of Bright v. United States, 658 F.2d 999 (5th Cir. 1981).
- *Estate of David G. Massad v. Commissioner* (Docket No. 5019-23)(T.Ct. 2023), is the valuation of 11.6% of the shares of a publicly traded company. Management Planning, Inc. appraised the shares with a 15% discount for lack of liquidity and marketability. The IRS engineer offered a 1.7% discount. Significant dollars are at issue.

PRACTICAL PARTNERSHIP PANACEAS TO COMMON CLIENT CIRCUMSTANCES

Presenter: Paul Lee. Paul is the Chief Tax Strategist at Northern Trust Company.

Investment Company Rules Sec. 721

- Watch funding of partnerships with marketable securities. The partners may need to have identical securities positions to avoid

investment company rules. If they fail the mechanical tests so that the partnership portfolio is deemed to be a diversification, deferred gain could be triggered.

Eliminating Partnership Valuation Discounts

- Most taxpayers never face an estate tax. Valuation discounts may thus prove detrimental. Example: Negative basis property worth $20M in a limited partnership owned by 4 children. Discounts will limit the basis step up each of them will realize on death. IRS may even argue for valuation discounts to limit basis adjustment at death.
- State default rules often provide that any restriction in LP agreement is permissible under state law. States did not change GP statute. GP law provides that a GP can leave the partnership at anytime and receive the greater of their liquidation value or the FMV of their interest. So, if you can convert the LP to a GP each individuals would own a GP interest. But a GP has no limited liability, all GPs are liable for entity debts and claims. But the partners will want limited liability. That might be achieved by each GP contributing his interests into a wholly owned disregarded LLC and converting the LP into GP and thereby eliminating valuation discounts. Each former member owns a single member disregarded LLC. and the 4 LLCs in turn own the GP. That structure, it is suggested may eliminate discounts.
- **Comment**: There are different views as to whether the language in the governing instrument might be used to support the elimination of discounts. Some suggest that approach might trigger some type of gift based on theory of CCA 202353018. Others disagree. See Steve Akers outline from this year at page 50: "have a shareholder agreement that will eliminate the discount (by giving the marital legatee the right to liquidate the company or otherwise have control)."
- **Comment**: Research state law to be certain that under applicable state law each single member disregarded LLC will have charging order and asset protection benefits similar to that provided by a multi-member partnership. If not, have the client weigh the possible benefit of reducing or eliminating discounts versus the potential reduction in, or loss of, liability protection.
- **Comment**: Evaluate depending on the nature of the assets of the entity whether there will, even with the structural change, remain

valuation discounts. For example, for real estate there may still be a material partition discount. For example, in the Estate of LeFrak (1993) the court held that the determination of a fractional interest discount must consider the cost, uncertainty and delays attendant upon partition proceedings as the basis to allow a fractional interest discount. The Court in LeFrak found a 30% valuation discount.

Divorce After Creation of Non-Reciprocal SLATs – Partnership Solution

- It is common for married couples to create non-reciprocal spousal lifetime access trusts (SLATs). Assume that each SLAT is funded with different assets and that one SLAT is worth $10M and the second SLAT $14M, so that the larger SLAT has $4M more than the other at the time of divorce. Might a partnership plan overlay help negotiate a divorce settlement?
- After SLAT funding husband and wife divorce. There is a different value in each as well as different assets. Perhaps different tax profile. How can this be addressed? During the negotiations the trustee of the larger SLAT modifies and divides that SLAT into two SLATs (by decanting, trustee action, etc.) so that there is the resulting SLATs one has $4M and the other two SLATs have an equal $10M each, identical asset values, although the assets still remain different.
- Effectively the larger SLAT was divided to slice off the excess value into a separate new SLAT. Then the spouse could renounce his or her interests in that SLAT so that it will only benefit say children or other heirs.
  - **Comment**: This presumes that spouse will be willing on the verge of divorce to give up rights to the potential benefits of those assets. Also, will the IRS argue a gift by the renouncing spouse under CCA 202353018?
- So far, we have equalized the value of the two SLATs. But the assets and tax profiles are still different. That will be addressed next.
- In conjunction with the divorce do an exchange. Exchange $10M value of all the SLAT property so that each SLAT will own ½ of each asset. Both SLATs must be grantor trust as to all income and principal, e.g., by a swap power. Then you end up with each SLAT

having a 50% interest in each asset. Then you have each SLAT put the assets it then has into a partnership.

- For 704(c) purposes each spouse is deemed to have put in exactly ½ of each asset. So, since 50/50 partnership, the income tax results will be identical to each SLAT and spouse. Provide for tax distributions each year to each spouse.
    - **Comment**: Combining both SLAT assets into a partnership can address the equalization of income and rates of return. However, will this require more coordination and involvement of the soon to be ex-spouses? Is that a problem?
    - **Comment**: This plan does not address the likely fundamental and economically significant differences of each SLAT from the other. In order to make the trusts distinguishable for purposes of the reciprocal trust doctrine practitioners often build in an array of differences. One SLAT may provide the spouse/beneficiary a 5/5 power and a HEMS standard for distribution during lifetime. The other spouse's SLAT may have neither. The result might be that even if the assets are identical the ability of each spouse to reach and benefit from the SLAT's assets and income may be very different.
- Grantor trust status. Each SLAT (created for the other spouse) is by definition a grantor trust as to the settlor spouse. That means post divorce the settlor spouse will remain liable on the income earned by the SLAT that they may not be a beneficiary of and which income may be paid to their ex-spouse.
- One solution is to structure or modify the trusts so that the income distributions of the SLAT to the spouse/beneficiary is subject to approval by an adverse party. That will make the SLAT a spousal lifetime access non-grantor trust or (SLANT) so that this income tax issue will be avoided. Some believe that there is some risk in this approach, in part because of the difficulties in defining who constitutes an "adverse party."
    - Comment: Many practitioners frequently use the adverse party technique and believe that there is reasonable support for that position despite the uncertainties that must be acknowledged.

Sale to Grantor Trust for Note – Improving Tax Results

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

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

Maximizing Basis Under 1014

- When an interest in a partnership is included in the gross estate of a decedent, the partnership will often make a section 754 election (or already have one in place) and rely upon the inside basis adjustment under section 743(b) to “step-up” the basis of the assets inside the partnership. There are reasons to do so; however, the inside basis adjustment and the how it is allocated to each of the partnership

assets under section 755 of the Code is formulaic and there are other strategies that may be more tax efficient.

- The proposed alternative strategy works best with marketable securities.
  - A distribution of marketable securities is generally treated as a distribution of cash (rather than property).
  - Unless an exception applies, a distribution of marketable securities results in gain to the distributee partner, the gain is the excess of the value of the marketable securities over the partner's outside basis.
  - The amount of marketable securities treated as cash is reduced (and the potential recognized gain is reduced) by, according to the section 731(c)(3)(B) of the Code:
    - such partner's distributive share of the net gain which would be recognized if all of the marketable securities of the same class and issuer as the distributed securities held by the partnership were sold (immediately before the transaction to which the distribution relates) by the partnership for fair market value, over (ii) such partner's distributive share of the net gain which is attributable to the marketable securities of the same class and issuer as the distributed securities held by the partnership immediately after the transaction, determined by using the same fair market value as used under clause (i)

Staggering Distributions With No Section 754 Elections

- When a decedent's partnership interest is included in the gross estate, the estate will often claim a valuation discount for lack of marketability and control. This is often the case with estates when estate tax is payable (i.e., the gross estate exceeds the decedent's Applicable Exclusion Amount and there is no ability to "zero-out" the estate tax with the marital deduction because there is no surviving spouse). The valuation discount represents a 40% Federal estate tax savings, which is typically greater than the income tax savings from a basis adjustment under section 1014 of the Code (i.e., 20% for capital assets and 37% for ordinary income assets). As a result, the "step-up" in basis to the partnership interest. Interest is reduced by the

valuation discount, which in turn, reduces the inside basis adjustment under section 743(b), if the partnership has a section 754 election in place.

- Example:
  - A and B form AB Partnership. A contributes shares of a publicly-traded company Z (Stock Z), which have a fair market value of $10 million and an adjusted basis of zero, in exchange for a 50% interest in AB Partnership. B contributes Stock Z shares, which have a fair market value of $10 million and an adjusted basis of $4 million, in exchange for a 50% interest in AB Partnership. Although AB Partnership would be considered an "investment company" under sections 721(b) and 351(e), the contributions to the partnership does not result in diversification. Thus, the contribution does not result in gain recognition and under section 721(a), A receives a partnership interest that has an outside basis of zero and a capital account of $10 million. B receives a partnership interest that has an outside basis of $4 million and a capital account of $10 million.
  - Soon thereafter, A passes away. On date of death, the value of Stock Z has not changed. The fair market value of A's partnerships interest is appraised at $7 million, due to a 30% valuation discount. The partnership makes a section 754 election to make a corresponding inside basis adjustment under section 743(b) to the assets in the partnership.
    - Under section 743(b)(1), A's estate (the transferee) is entitled to an increase in partnership inside basis equal to the "excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property." The estate's basis in the partnership interest, under section 1014, is "the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent." As a result, since there are no

liabilities or IRD in this example, the estate's basis in the partnership interest is $7 million.

- A transferee partner's proportionate share of the basis of the partnership property is the sum of the partner's previously taxed capital, plus the partner's share of partnership liabilities. There are no partnership liabilities. The partner's previously taxed capital, in this example, is the amount of cash the partner would receive upon a hypothetical sale of all of the partnership assets (immediately after the transfer or death, as the case may be) in a fully taxable transaction for cash equal to the fair market value of the assets, decreased by the amount of tax gain that would be allocated to the partner on the hypothetical transaction. The amount the estate would receive in the hypothetical sale, in this example, is $10 million (A's capital account balance at death), and the amount of gain that would be allocated to the estate is $10 million. The latter is due to the fact that A contributed shares of Stock Z when it was (and still is) worth $10 million, and under section 704(c), all of that gain must be allocated to A's estate, as transferee. The hypothetical gain attributable to the other assets (the shares of Stock Z contributed by B) in the partnership are allocated to B under section 704(c). As a result, the estate's previously taxed capital (and proportionate share of the adjusted basis of the partnership property) is zero ($10 million minus $10 million). The excess of the basis to the estate (the transferee) is $7 million ($7 million minus zero), As a result, under section 743(b)(1), the increase in inside basis is equal to $7 million.
- The positive $7 million inside basis adjustment under section 743(b) will be allocated to the partnership assets according to section 755. All of the assets in this example are capital assets, so the entire basis adjustment is allocated to that class. In this simple example, only the property contributed by A would result in gain to the estate (transferee) due to the section 704(c) rules. As a result,

the entire $7 million inside basis adjustment would be applied to the Stock Z contributed by A, and none would be applied to the Stock Z contributed by B. As a result, the Stock Z contributed by A has an inside basis of $7 million and a fair market value of $10 million.

Eliminating Valuation Discounts on Pre-Existing Partnerships

- A common "free-base" situation occurs when the first spouse passes away, and assets are transferred to or for the benefit of the spouse in a transfer that qualifies for the marital deduction under section 2056. In community property states, as mentioned above, the "step-up" in basis will also apply to the assets held by the surviving spouse. Clearly, for income tax purposes, a higher valuation is preferable to a lower valuation. As such, consideration should be given to when valuation discounts should be created and when they should be removed. For example, when both spouses are alive, it is sensible to avoid valuation discounts, and if the assets that would be includible in the surviving spouse's estate are significantly above the Basic Exclusion Amount (including any ported amount), then valuation discounts will likely save more in estate taxes than the income tax savings from the subsequent "step-up" at the surviving spouse's estate. If a quick succession of deaths is a worry, practitioners should be prepared to layer valuation discounts immediately after the first death, so post-mortem estate planning might include the estate creating family limited partnerships prior to the complete settlement of the estate.
- Where assets have been divided among generations to create discounts, consideration should be given to undoing those arrangements if the effect is to depress the value of an estate below the amount of BEA in order to increase the income tax basis of the assets under section 1014.
- Family limited partnerships or other entities that create valuation discounts could be dissolved or restated to allow the parties to the entity to withdraw for fair value or to remove restrictions on transferability.

Tax Free Exchanges of Property

- As discussed in these materials, contributions of property in exchange for an interest in a partnership are generally non-recognition events. In addition, distributions of partnership property to partners are also generally nontaxable. Before the “anti-mixing bowl” rules were enacted, taxpayers would use partnerships as a vehicle to exchange assets and property interests without recognizing any gain. Of course, taxpayers can gift property to each other with little to no income tax consequences, but the transfers may carry gift tax consequences and the IRS might recast related transfers as recognition events.
- Partnerships are one of the only vehicles in the Code that will allow taxpayers to exchange property interests in a tax free manner.248 However, that requires taxpayers to have patience because the “anti-mixing bowl” rules have a 7-year holding period in order avoid recognition caused by the distribution of partnership property to a contributing partner or to a non-contributing partner. For this reason, it is often recommended that taxpayers fund partnerships as soon as possible to start the holding period for “mixing bowl” purposes and to keep the assets in the partnership unless there is a compelling tax reason to distribute the property.
- **Avoiding the Mixing Bowl Rules – example.** Partners A, B, and C form ABC Partnerships. Under section 721, the partners make the following contributions of non-depreciable capital assets, at three different times but in the same year: (i) Partner A contributes Asset A, which has an adjusted basis of $0x and fair market value of $100x; (ii) Partner B contributes Asset B, which has an adjusted 248 Exchanges between grantor’s and IDGTs are income tax free, so are most transfers from non-grantor trusts to beneficiaries. These vehicles, however, often involve transfers that are taxable gifts or have the same effect of a taxable gift like an installment sale to an IDGT (which transfer appreciation out of the grantor’s gross estate). 3-51 basis of $20x and fair market value of $100x; and (iii) Partner C contributes Asset C, which has an adjusted basis of $50x and fair market value of $100x. More than seven years after the last contribution, the ABC Partnership liquidates and makes the following liquidating distributions: (i) Asset C to Partner A; (ii) Asset A to Partner C; and (iii) Asset B to Partner C. Because the liquidating distributions

occur more than seven years after the last contribution of the partners, there is no "mixing bowl" transaction and the distributions are tax free. In addition, the adjusted bases of the assets held by the former partners are as follows: (i) Asset C held by A has an adjusted basis of $0x; (ii) Asset A held by B has an adjusted basis of $20x; and (iii) Asset B held by C has an adjusted basis of $50x. As a result, A, B, and C have accomplished a tax free exchange properties, and the tax basis that each had with their original property is now reflected in the property that they received.

- **Swapping Interests in Different Properties – Example**. After the death of their parents, siblings, A, B, and C. find themselves equal partners in three different partnerships that own rental real estate in different parts of the United States, as follows: (i) Partnership 1 holds rental property in California (CA Property) with a fair market value of $300x and an adjusted basis of zero. Each of the siblings has a 1/3 interest in Partnership 1, and each of their partnership interests have an outside basis of zero and a capital account of $100x. The parents contributed the CA Property to the partnership 10 years ago. (ii) Partnership 2 holds rental property in New York (NY Property) with a fair market value of $330x and an adjusted basis of zero. Each of the siblings has a 1/3 interest in Partnership 2, and each of their partnership interests have an outside basis of zero and a capital account of $110x. The parents contributed the NY Property to the partnership 15 years ago. (iii) Partnership 3 holds rental property in Florida (FL Property) with a fair market value of $300x and an adjusted basis of zero. Each of the siblings has a 1/3 interest in Partnership 3, and each of their partnership interests have an outside basis of zero and a capital account of $100x. The parents contributed the FL Property to the partnership 5 years ago. Each year, all three of the partnerships distribute 100% of the net rental income to the partners. Partner A is a resident of California, but Partner A must file and pay income taxes in A's resident state of California and also New York. Partner B is a resident of New York, but Partner B must file and pay income taxes in B's resident state of New York and also California. Partner C is a resident of Florida, but Partner C, a resident of a state that has no state income tax, must file and pay income taxes in both California and New York. Partners A, B, and C wish to

exchange their 1/3 interests in each of the rental properties in a manner that results in the following: (i) Partner A will own 100% of the CA Property; (ii) Partner B will own 100% of the NY Property; and (iii) Partner C will own 100% of the FL Property. They wish to accomplish the foregoing in an income tax free manner (or in the most tax efficient way) and without making (or being deemed to have made) taxable gifts to each other.

- **Common Mistake – example**. Under section 721: (i) Partnership 1 contributes the CA Property to newly-created Partnership 4 in a tax free exchange for a partnership interest in Partnership 4; (ii) Partnership 2 contributes the NY Property to newly-created Partnership 4 in a tax free exchange for a partnership interest in Partnership 4; and (iii) Partnership 1 contributes the FL Property to newly-created Partnership 4 in a tax free exchange for a partnership interest in Partnership 4. Partnership 4 owns all of the rental real estate. The net effect, even if Partnerships 1, 2, and 3 remain in existence or liquidate (distributing partnership interests in Partnership 4 to the partners), is Partners A, B, and C will own a 1/3 interest in each of the rental properties. Unfortunately, the contribution to a newly-created Partnership 4 (whether or not Partnership 1, 2, and 3 remaining in existence) will restart the holding period for "mixing bowl" purposes. This means the partners will need to wait an additional 7 years before the properties can be exchanged in a tax free manner, notwithstanding the fact that the properties have been held in a partnership for a minimum of 5 years.
  - A better solution is to merge the partnerships and their respective properties into one partnership that is deemed to be a continuation of all of the partnerships. The Code provides a methodology to merge partnerships, the challenge is to ensure that the merger is a nontaxable event and does not restart the holding period of any of the properties for "mixing bowl" purposes. Use Assets-Over Merger into Existing Partnership.
  - With an assets-over merger, the merged partnership's contribution of 704(c) property to the resulting partnership in exchange for an interest in the resulting partnership under section 721 and the liquidating distribution of the resulting partnership interest to the partners of the merged partnership

will not trigger section 704(c)(1)(B). However, a subsequent distribution of the section 704(c) property by the resulting partnership will however be subject to section 704(c)(1)(B).

- Example (cont.) - Instead of creating a newly-created partnership, Partnerships 1 and 3 contribute all of their assets (CA and FL Properties) and liabilities (none) to Partnership 2 under section 721, in exchange for interests in Partnership 2. Immediately thereafter, Partnerships 1 and 3 distribute their interests in Partnership 2 to A, B, and C, in full liquidation and termination of Partnerships 1 and 3. Partnership 2 now owns the CA, NY, and FL Properties, A, B, and C are equal partners, and each of them has a 1/3 interest in Partnership 2, each having $0x of outside basis and a capital account balance of $310x (the sum of all their capital account balances in all three of the partnerships before the merger). As discussed above, this is an “assets-over” merger of Partnerships 1 and 3 (the terminating or consolidating partnerships) into Partnership 2 (the resulting partnership). For “mixing bowl” purposes, the merger is nontaxable. For holding period purposes, Partnerships 1 and 3 are deemed to continue through Partnership 2. As a result, Properties A, B, and C are deemed to have been contributed to Partnership 2, ten, fifteen, and five years, respectively.
- (i) adjusted basis of zero); (ii) $2 million of growth equities with an adjusted basis of $1 million; (iii) $5 million of private equity investments with an adjusted basis of $5 million; and (iv) $2 million of high dividend paying equities with an adjusted basis of $1 million. For income tax purposes Spouse A is deemed to own all of the assets of SLAT B, and Spouse B is deemed to own all of the assets of SLAT A. As a result, this exchange of assets will not be a taxable event under section 1041, and the SLATs will have carryover basis. This exchange can happen prior to the divorce when A and B are still married or the transfers can occur “incident to the divorce” (within one year after the date on which the marriage ceases or related to the cessation of the marriage).

- Example (Continued): SLATs A and B contribute their respective one-half interest in the rental real estate, growth equities, private equity investments, and high dividend paying equities to a newly-created partnership in a tax free exchange under section 721. Both SLAT A and SLAT B hold a 50% interest in the partnership. Because SLAT A and SLAT B have contributed exactly one-half of each asset in the partnership, all of the income, gain, loss, profit, and other tax items will be allocated equally, under sections 704(c) and 704(b). In addition, the partnership agreement should include a tax distribution provision mandating an annual distribution of cash, distributed equally to each SLAT, in an amount equal to two times the Federal and state income tax liability (attributable to the partnership allocations) of either Spouse A or Spouse B, whichever is greater for that taxable year. Each SLAT can then distribute the tax distribution to Spouse A and Spouse B, so that each of them can pay the income taxes attributable to the assets in their grantor trusts.

Marketable Securities, Private Equity, Venture Capital

- Never make these investments individually but always do it through a partnership. Make the investment into the partnership with cash. The primary reason is that if the partnership is only funded with cash and there are no property contributions, then no “mixing bowl” transaction can occur. This gives the partnership freedom to distribute partnership property without having to worry about a 7-year holding period and provides significant leeway to make disproportionate distributions of property.
- The reason for doing this is so that you can do basis shifting.
  - Example: ABC Partnership owns two assets and has a section 754 election in place. Asset A has an inside basis of $0x and a fair market value of $100x. Asset B has an inside basis of $100x and a fair market value of $100x. Assets A and B are capital assets. ABC Partnership has three partners, A, B, and C, who are not equal partners (but their proportionate ownership interest is unimportant). The outside basis of C’s partnership interest is $0x and a capital account of $100x. ABC

Partnership distributes Asset B (the high basis asset) to C in liquidation of C's partnership interest. As discussed in these materials, Asset B will have its basis reduced to the outside basis of C's partnership interest, which is $0x. This is sometimes referred to as the "basis strip." C owns Asset B outside of the partnership with an outside basis of $0x and a fair market value of $100x. It should be noted that if this was a non-liquidating "current" distribution (e.g., C's capital account was $150x), you would have the same result and C would still be a partner. Because ABC Partnership has a section 754 election in place, under section 734(b), the adjusted basis of partnership property (the only asset remaining in the ABC Partnership is Asset A) is increased by the amount of basis what was stripped from Asset B upon the distribution to C. As a result, Asset A (as the only asset remaining in the partnership) will have its inside basis increased to $100x. This is sometimes referred to as the "basis shift." The end result is the tax basis that was on Asset B has been "shifted" to Asset A.

Avoiding Gain Upon the Death of Grantor

- Making the Debt Disappear
    - As mentioned above, the conversion from grantor to non-grantor trust (e.g., death of the grantor) is treated as a transfer by the grantor of the underlying property in the trust. Often, the original transfer of the property is pursuant to an installment sale to an IDGT, with the purchase effectuated by a promissory note from the IDGT to the grantor and the IDGT's debt obligations collateralized by the transferred property. If the promissory note is outstanding at the time of conversion from grantor to nongrantor trust, gain will be recognized to the extent that the debt encumbering the property is in excess of its tax basis.
    - Grantors and their IDGTs may be able to use disregarded entities to eliminate the potential gain and provide for a step-up in basis on the underlying assets upon the death of the grantor. To illustrate how this might be accomplished, consider an IDGT that holds an asset worth $100x and an adjusted basis of $0,

but the asset is encumbered by a $50x liability of the IDGT to the grantor, as evidenced by an installment note (e.g., paying interest annually and with an outstanding principal amount of $50x) held by the grantor. If the grantor dies, (i) the promissory note would be includable in the grantor's estate and get a "step-up" in basis, (ii) the asset in the IDGT would be out of the grantor's estate but would not get a "step-up" in basis, and (iii) $50x of gain would have to be recognized by the estate because of the liability in excess of tax basis.

- To avoid this result, the grantor and the IDGT could simultaneously contribute their respective interests in the property and the debt to a newly formed LLC. IDGT would contribute the asset, along with its $50x liability to grantor, to the LLC. Grantor would contribute the installment note with a principal amount of $50x. Assuming, the net value of the asset and the promissory note were both equal to $50x, IDGT and grantor would be equal (each 50% owners) members in the LLC, but the LLC would continue to be a disregarded entity because they are considered the same taxpayer. As such, the contribution of the asset (subject to the debt) and the promissory note should not have any tax ramifications.
- The LLC, as a separate legal entity, now owns an asset with a gross value of $100x, has a debt liability of $50x, and it owns the right to receive the $50x debt. In other words, if a person has a debt but also owns the right to be paid on the debt, the debt should by law be extinguished. Further, because the LLC is disregarded and the members of the LLC are the same taxpayer due to the grantor trust rules, the extinguishment of the debt should have no tax ramifications. This leaves the LLC simply holding an asset worth $100x (and no liabilities) with the IDGT and grantor each owning 50% of the LLC.
- Upon the death of the grantor, there is a deemed transfer of 50% of the LLC to the trust (no longer a grantor trust) which converts the disregarded entity to a partnership for tax purposes under situation 1 of Revenue Ruling 99-5. As discussed above, such a conversion is treated as an acquisition of the LLC assets by the members and a contribution of those

assets to a new partnership. Significantly, if the conversion is treated this way, then for step-up in basis purposes, the estate does not own a 50% interest in a partnership, rather the estate is deemed to own 50% of the assets which are simultaneously contributed to a partnership at death. As such, the estate should be entitled to claim a step-up in basis under section 1014(a) of the Code for 50% of the value of the asset in the LLC without risk of losing basis due to valuation discounts.

- Under sections 722 and 723 of the Code, the estate should have an outside basis in the LLC of $50x, and the LLC should have an inside basis of $50x on the asset which is worth $100x. Practitioners taking this position will likely want to report the inclusion of 50% LLC asset in the estate of the grantor, rather than a 50% interest in the LLC, and out of an abundance of caution, ensure that the LLC makes a section 754 election, entitling it to an inside basis adjustment under section 743(b), in case there is a question as to whether the LLC has $50x of inside basis on the asset.

MODERN ESTATE ADMINISTRATION

Presenter: Steve Akers is a managing director at Bessemer Trust.

General Estate Administration Tips

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

Does Asset Use or Loans Carry Out DNI?

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

Trust Tax Distributions

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

Basis Consistency

- Before change 1014 said basis adjustment is to FMV and estate value is presumptively the value but the beneficiaries could argue a different position. But that rule was changed in the pothole bill in 2015.
- Code. Sec. 1014(f) says basis will not exceed estate tax final value. The change also added companion Code. Sec. 6035 reporting requirements.

- If the estate does not owe estate tax, e.g., due to either the marital and/or charitable deduction then Code Sec. 1014(f) does not apply. So, beneficiaries of those estates may take a different position then the estate did as to basis.
- Exceptions from 6035 Reporting requirements.
    - If don't have to file Form 706 there is no Sec. 6035 reporting.
    - If estate files solely to allocate GST or portability it will not have to go through information reporting for basis consistency.
- Non-Recourse debt.
    - Assets in estate subject to non-recourse debt. Sec. 2053 provides that the net value of asset, i.e., the gross value less non-recourse debt, is reported. The basis consistency Regs provide that basis is gross value of the asset even though it is only the net reported on the return.
- Omitted Assets.
    - If an asset discovered later and was not reported on the original return, and if the return is not amended before statute runs, the basis is zero. Presumably, this would even apply to cash.
    - Once you are past the statute of limitations period there is no way to cure this.
    - ACTEC pointed out that there is no legislative authority for the above proposed Reg above.
- Schedule A.
    - Executor must give schedule A to each beneficiary indicating the property they might receive. This is very confusing. And executor may not want to disclose all this information to each beneficiary.
    - The disclosure may create problems with the beneficiaries if eventually a particular beneficiary gets different property, or that one beneficiary sees what others might receive.
    - ACTEC suggested just give dollars not assets and then file an amended report.
- Subsequent transfers.
    - Initial recipient who receives assets and thereafter makes a gift or other transfer, must give a report to the new transferor.
    - This seems to go on forever and there is no statutory authority for this.

Alternate Valuation Date

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

Debts of Estate – 2053 Proposed Regs

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

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

- Rev. Proc. 64-19 makes sure that there is language that describes how the pecuniary marital bequest is determined.
  - Use date of distribution values. There is gain recognition under 1.1014-4(a)(3).
  - Use estate tax values with a "minimum worth" requirement- no taxable gain and the executor may shift maximum value or appreciation to bypass trust by allocating the most highly appreciated assets to the residuary trust.
  - Consider funding decisions very carefully in a hostile family situation.
  - Use estate tax values with a "fairly representative" funding requirement. There is not taxable gain and funding process is more flexible than with a strict fractional share bequest. Administrative difficulties might still be encountered in determining which assets are fairly representative.
- These Regs are a problem once finalized.

QTIP Planning – General

- Qualified Terminable Interest Property (QTIP) Trust. Spouse as only beneficiary.

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

QTIP Planning – Aggregation Issue

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

Funding Marital Bequests

- Watch out to avoid unintentional triggering of gain issues. Rev Proc. 64-19. Use date of distribution values. To use estate values, must have fairly representative clause. Fund pecuniary bequest based on

estate tax value, gain will be realized for income tax purposes if the distribution value of an asset exceeds its estate tax value.

- Consider fractionalization discount.
  - Case with gift split to two charities and IRS successfully argued valuation discounts must be applied to value each of the two separate charitable bequests thereby reducing the charitable contribution deduction (but note that the full undiscounted value was included in the gross estate as a control position).
- If you don't consider discounts in what you fund to spouse/marital deduction then you are underfunding the marital bequest. That might lead to an overfunding of the bypass trust and that might trigger gain. Might that make the surviving spouse a partial transferor to the bypass trust for GST purposes? Does that raise 2036 issues if surviving spouse is deemed a contributor to the bypass trust and is also a beneficiary?

Funding Marital Bequests – Discounted Assets

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

2519 and QTIP

- Planning consideration when funding marital bequests with discounted assets.

- If you fund the marital bequest with lack of control assets must consider discounts. Could underfund marital bequest because of discount.
  - Alternative, consider funding the marital bequest with note that encumbers the remaining assets. Those remaining assets, subject to and reduced in value by, the note, would pass to the remainder beneficiaries. That could assure the full funding of the marital bequest without any reduction by discounts.
  - Distribute full assets to marital bequest to avoid fractionalization and have the marital bequest give a note back to the estate for the difference and the estate funds the bypass trust with the note. As this is paid off in future years. Might pay off in kind with discounted interests.
  - Use defined value clauses in funding.
- Kite case held distribution to spouse followed immediately by sale for a private annuity was treated as a 2519 transfer. Did not decrease gift value by the value of the asset received on the sale.
- McDougall v. Commissioner, and CCA20211800. Reciprocal gifts should be netted out. Distinguished Kite case. IRS seeks to tax the same property multiple times which is ridiculous.
- Planning with distributions, e.g. distribute assets from QTIP to surviving spouse for gift planning. But are the distributions authorized by the governing instrument? Unauthorized distributions from a trust were not given effect for tax purposes.

Bypass Trust Not Funded

- What if bypass trust not funded? E.g., 15 years after first spouse dies discover bypass was not funded.
  - Comment: This is a common situation especially with high exemptions and clients that DIY probate.
- IRS didn't negate marital trust qualification for marital deduction because of failure to fund. Deemed funding to have happened at a reasonable time and allocated later appreciation between marital and non-marital bequests. May impute interest on late funding. TAM 8746003.
- How much is in CST at the surviving spouse's death when wasn't funded? Estate of Olsen v. Commr, T.C. Memo. 2014-58.

- Approaches to unfunded CST treat property that should have been transferred to CST as being held in a "constructive trust" by surviving spouse for CST and then funding. Stansbury v. United States, 543 F. Supp. 154 (N.D. Ill. 1982), aff'd, 735 F.2d 1367 (7th Cir. 1984). Or treat property as having been misappropriated by surviving spouse creating a debt to CST. Bailey v. Commissioner, 741 F.2d 801 (5th Cir. 1984). Davis, Funding Unfunded Testamentary Trusts, 48TH ANN. HECKERLING INST. ON EST. PL, ch. 8 (2014).

Portability

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

Transferee Liability for Estate Tax

- Code Sec. 6901 governs transferee liability. Courts limit to value of assets received.
- But personal liability under Code. Sec. 6324(a)(2) is not clearly limited to the value of assets received.
- Cases not consistent as to whether limiting liability to value of property at decedent's death applies to interest and unpaid tax.

- Personal liability under Code Sec. 6324(a)(2) extends to successor trustees and trust beneficiaries who are appointed or receive property even years after decedent's death. Beneficiaries facing liability include trust beneficiaries and beneficiaries of insurance and annuities.

DRAFTING FLEXIBLE GRATS

Presenters: Diana Zeydel; Jonathan Blattmachr. Diana S.C. Zeydel is a shareholder and Global Chair of the Private Wealth Services practice of the law firm of Greenberg Traurig, P.A. Diana presented an early session on GRATs solo and a follow-up session with Jonathan Blattmachr. Jonathan is the founder of Interactive Legal and a principal at Pioneer Wealth Partners. The below notes consolidate the two sessions.

GRATs

Basics

- The general rule of 2702(a) applies to a transfer, the value of any interest retained by the transferor or an applicable family member is zero for purposes of determining whether the transfer is a gift and, if so, the value of the gift. However, if the transferor's retained interest is a "qualified interest" the value of the retained interest is determined under 7520.

GRAT Requirements

- Transfer in trust.
- Trust can be informal trust or life estate.
- For family members.
- Value of interest retained by transferor and applicable family member.
- Value is -0- if not a qualified interest.
- If you cannot subtract it then entire transfer to the trust is a gift.
- If you have a qualified retained interest value it under 7520.
- Right to received fixed payments not less than annually is a qualified payment.
- Can increase annuity payments 20% each year.
- Need to have valuation certainty so no contingencies.

- You cannot make payments to anyone other than annuitant during GRAT term. Substitutions, reimbursements, etc. may raise issues.
- No commutation. You cannot accelerate the annuity interest by paying to grantor actuarial value of annuity interest.
- You cannot issue debt to make annuity payment.
- Prohibition on additional contributions.
    - Most forms say if there is an additional contribution you cannot add to initial GRAT but rather you have to create a new GRAT on same terms.
    - If all assets funded on same day should not be an issue.
    - But if you are concerned contribute all assets to single member LLC then when LLC is fully funded assign LLC to GRAT.
    - Or make GRAT revocable so it is an incomplete gift not subject to 2702. When trust is fully funded revoke the power of revocation.

Qualified Interest

- Any interest which consists of the right to receive fixed amounts payable not less frequently than annually,
- Any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and
- Any noncontingent remainder interest if all of the other interests in the trust consists of interests described in paragraph (1) or (2).
- The term qualified interest includes a qualified annuity interest, a qualified unitrust interest, and a qualified remainder interest. The term qualified interest also includes the retention of a power to revoke a qualified interest.

Requirements for a Qualified Annuity

- Fixed amount or percentage of the initial trust assets payable at least annually.
- Payable for a fixed term and not subject to any contingencies other than holder's survival.
- May retain the power to revoke a qualified interest of a spouse.
- No payments to anyone but annuitant.

- Annuity must be fixed and ascertainable at creation of the trust.
- No commutation.
- Debt instrument may not be used to satisfy the annuity.
- Programs designed for calculating annuity often assume that start date is January 1 so it may be useful to have an actuary do the calculation so that your calculation is accurate even if the GRAT starts on a date is other than January 1.

Required Trust Terms

- Qualified Annuity. See above.
- Payment of Excess Income. It is permissible to pay income in excess of the annuity amount; however doing do dilutes the transfer tax benefits of the GRAT.
- Incorrect Valuations. If annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of Treas. Regs. 1.664-2(a)(1)(iii).
- Annuity must be payable upon anniversary date of the creation of the trust or the taxable year of the trust and may be paid more frequently than annually.
- If the annuity amount is based on anniversary date of creation of trust, it must be paid no later than 105 days after the anniversary date.
- Treas. Reg. 25.2702-3(b)(5) prohibits additional contributions to be made to the GRAT.
- The term of the annuity must be fixed and ascertainable at the creation of the GRAT. The term may be for the life of the annuitant, for a specified term of years or for the shorter of the two.
- Governing instrument must prohibit commutation of the annuity interest.
- Issuance of a note in satisfaction of the annuity amount does not constitute payment of that annuity amount. Treas. Reg. 25.2702-3(b)(1)(i).

Using Hard to Value Assets

- A GRAT may be ideal for contributions of hard to value assets because the use of a formula to determine the annuity amount based

upon the initial fair market value of the property transferred to the trust "as finally determined for federal tax purposes" is expressly authorized.

- This does make accurate and timely payment of the annuity amount more challenging.
- When funding a GRAT with hard to value assets, consider also funding with cash and marketable securities to ensure coverage of at least two to three years of annuity payments.

Goal of Using a GRAT

- The goal of using a GRAT is to transfer assets out of the grantor's estate for federal estate tax purposes using none or little of the grantor's gift tax exemption.
- This is achieved by the grantor retaining an annuity interest that is large as a percentage of the assets transferred. This results in the remainder interest being very small or equal to zero (the zeroed out GRAT).
- A GRAT will achieve its goals when the growth of the assets exceed the 7520 rate.
- Early losses or inconsistent performance may cause a GRAT to fail.

Recent Issues with GRATs

- In CCA 201939002, the IRS took the position that in valuing a gift of publicly traded stock transferred to a GRAT at the time when the company was involved in merger discussions, a taxpayer could not simply rely on the high-low-mean valuation approach required by Treas. Reg. §25.2512-1.
    - In the CCA, the IRS considered a situation in which the co-founder and chairman of a company whose stock was traded on the New York Stock Exchange (NYSE) contributed shares of the company's common stock to a two-year zeroed-out GRAT. The donor's gift tax return valued the shares based on the mean between the high and low NYSE prices on the date of contribution. These prices did not take into account ongoing merger negotiations. The merger occurred seven months later.
    - The IRS's position was that the stock should have been valued roughly 50% higher than what was reported on the gift tax

return, and that the difference should be considered a taxable gift regardless of the fact that the GRAT trust instrument contained standard provisions for a formula revaluation of the annuity amount based on values as finally determined for federal gift tax purposes.

  - The matter was litigated in the Tax Court in *Baty v. Commissioner*. The taxpayer's argument was **(**1) that no tax deficiency existed; (2) that the publicly traded price should control; (3) that the stock was valued without considering transfer restrictions imposed by the federal securities laws; (4) that the GRAT valuation adjustment clause applies to prevent any gift tax; and **(5)** that penalties should not be imposed. With respect to the willing-buyer willing-seller analysis that applies to determine fair market value for federal gift tax purposes, the IRS provided no explanation of how the hypothetical buyer might learn of closely guarded merger negotiations; nor did the IRS address the fact that to trade on non-public information received from insiders would be illegal.
  - The IRS ultimately conceded, and a stipulated decision was entered in the *Baty* case.
- In CCA 202152018, the IRS applied Atkinson type analysis to entirely disqualify a GRAT. In the CCA, the donor was the founder of a very successful company that solicited offers for merger and received multiple offers. Three days after receiving the various offers for merger, the donor created a two-year GRAT, the terms of which satisfied Code section 2702 and the accompanying Treasury Regulations.
  - The donor funded the GRAT with shares of the company. The value of the shares was determined based on an appraisal that was approximately seven months prior to the transfer to the GRAT trust. The appraisal, which was obtained in order to satisfy the reporting requirements for nonqualified deferred compensation plans under Code section 409A, valued the shares at a price well below the merger price.
  - The donor subsequently gifted Company shares to a separate charitable remainder trust and valued those shares (for charitable deduction purposes) at a subsequent tender offer

price that was approximately three times greater than the section 409A appraisal from the prior year that was used to establish the value for the GRAT. When asked to explain the use of the outdated appraisal to value the transfer to the GRAT, as well as the use of a new appraisal to value the transfers to charity, the company that conducted the appraisal stated only that "the appraisal used for the GRAT transfer was only 6 months old and business operations had not materially changed during the 6-month period. For the charitable gifts, under the rules for Form 8283, in order to substantiate a charitable deduction greater than $5,000, a qualified appraisal must be completed. Because of this requirement an appraisal was completed for the donations of Company stock to various charities."

- In the CCA, the IRS addressed a "qualified annuity interest" in a GRAT for purposes of Treas. Reg. § 25.2702, and noted that § 25.2702-3(d)(1) provides that, to be a qualified annuity interest, the interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust. The IRS cited the case of *Atkinson v. Commissioner*, 115 T.C. 26, 32 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002), for purposes of taking the position that, in the parallel context of a charitable remainder trust, the failure of the trust to function as a charitable remainder trust in its administration caused the trust to be disqualified as a charitable remainder trust. In *Atkinson*, the donor created a charitable remainder annuity trust, but no payments were actually made from the trust to the donor during the two-year period between the creation of the trust and the donor's death. The IRS argued that this caused the charitable remainder trust in *Atkinson* to be an invalid charitable remainder trust from its creation, and the court agreed because the trust failed to operate in accordance with its terms.
- The IRS applied *Atkinson* to the facts at hand and found the case to be analogous. The IRS disqualified the GRAT due to the trust's perceived failure to function as a GRAT. The IRS made references to taxpayer's failure to consider the pending merger in valuing the corporate shares that were transferred to

the GRAT. The GRAT trust instrument included a built-in re-valuation clause to re-value the qualified annuity interest in the event of the IRS adjustment but the IRS position was that "[t]he operational effect of *deliberately* using an undervalued appraisal is to artificially depress the required annual annuity. Thus, in the present case, the artificial annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars. The cascading effect produced a windfall to the remaindermen. Accordingly, because of this operational failure, Donor did not retain a qualified annuity interest under § 2702. See *Atkinson*."

- The IRS disqualified the GRAT altogether, finding that the taxpayer deliberately used an undervalued appraisal, and thus, in essence, never intended to retain a qualified annuity.

Drafting Remedies to Resolve Potential Issues

- You can establish the annuity amount by a word formula.
- Sample Language:
  - For purposes of this Article:
    - The Annuity Amount shall be determined as follows:
      - In the first year of each GRAT, the Annuity Amount shall be the Fixed Percentage of the Gift Tax Value of the assets contributed to the GRAT on its Funding Date: and
      - In each subsequent year of each GRAT during the fixed term of that GRAT, the Annuity Amount shall be 120% of the Annuity Amount payable in the preceding year.
    - The "Fixed Percentage" shall be that percentage that will cause the Gift Tax Value of the taxable gift to the GRAT (taking into account the increase in the Annuity Amount as provided for in clause (ii) of subparagraph (a) of this paragraph and taking into account the determination of the Fixed Term as provided in subparagraph (c) of this paragraph to equal the greater of:

  - 1% of the Gift Tax Value of the assets contributed to the GRAT on its Funding Date rounded up to the nearest whole dollar;
  - And the smallest amount such that the Annuity Amount will constitute a qualified annuity interest within the meaning of section 25.2702-3(b) of the Treasury Regulations.

GRAT Planning Considerations

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

Proposals to Kill GRATs

- There are a variety of proposals to kill GRATs.

Effect of Anti-Grantor Trust Rules

- Proposed New Section 2901
  - If the grantor is the deemed owner of a trust, the value of the gross estate includes the assets attributable to that portion of the trust.
  - A distribution during life is subject to gift tax.
- BUT does not apply to a trust that is otherwise estate tax includible (does not say in whole or in part).
  - In other words, a GRAT, during the GRAT term.

- There is a reduction for the value of any transfer by gift.
    - But apparently only in absolute dollars at the time of the gift.
- Tax is payable by the trust.
- Applies to a trust created before the date of enactment if a contribution is made on or after such date.
    - Meaning of contribution is unclear.
    - Applies to an existing trust that does a Rev. Rul. 85-13 transaction.

Using Formulas

- Using a formula to set the annuity amount.
- Suppose you create a 5-year GRAT.
- Suppose your formula states that the first-year annuity payment must be the amount which, if it increases by 20% annually, causes the remainder to be worth .01% of the FMV of the initial contribution.
- Is that a percentage of the initial FMV?

What is the Benefit of Using a Formula?

- Formula controls the remainder to be .01% of whatever the FMV of the contribution turns out to be.
- The formula also says if the remainder interest is required to be greater – the proposed legislation appears to concede there is no such requirement – formula would reset based upon the minimum required remainder.
- Also, the formula would reset if there is a minimum required term for a GRAT.
- And in each case, the amounts due are percentages of the FMV that will be determinable at the outset.

What About Timely Payments?

- If GRAT payments are required to be made annually, but in no event later than 105 days beyond the due date, can you draft to protect against a failure to comply?
    - It seems that you can.
    - Create a formula that shifts the responsibility of the trustee with respect to the annuity payment on the last permissible payment date to one of a nominee who holds the assets required to satisfy the annuity amount for the grantor.

- Similar to the concept of a "dry trust."

How To Qualify for A Marital Deduction

- If the grantor dies within the GRAT term, it is likely the entire trust will be estate tax includible.
- Yet annuity payments must continue to the grantor's estate.
- Considering the GRAT property as a whole, both the assets remaining in the GRAT and the annuity payments made to the estate must qualify for a marital deduction.
- How to solve?
  - You must pay the entire income on the GRAT and the assets distributed from the GRAT to the surviving spouse, and no other person may receive any distributions.
  - Thus, if the grantor dies within the term, the GRAT must distribute the greater of the annuity and the income from the GRAT.
  - The income from the GRAT must be paid to the surviving spouse.
  - The excess annuity payment, if any, must go to a marital deduction trust.
  - During the GRAT period, the surviving spouse must receive all the income on both trusts.
  - After the GRAT term, the GRAT must become a marital deduction trust.

Benefits of Drafting Transferable Annuity Payments

- Example 5 in the Regulations permits a term GRAT with the annuity payments payable to the grantor or the grantor's estate.
- Payments to a revocable trust are not permitted
- Commutation is not permitted
- But nothing prohibits the GRAT from alleviating spendthrift protection so the grantor can transfer the annuity payments to the grantor and to the grantor's estate.
- If interest rates rise, the annuity becomes less valuable
- Avoid Section 2036 inclusion.

Benefits of Drafting a Vested Remainder Interest

- Suppose you make a separate trust the remainder beneficiary of the GRAT.
- Suppose that separate trust owns the remainder interest vested absolute.
- Then the remainder interest should be transferable.
- Can you transfer to a GST exempt trust?

Myths About GRATs

- GRATs only work when interest rates are low.
- GRATs always work if the average return exceeds the Section 7520 rate.
- 20% increasing annuity payments are always best.
- You cannot use debt with a GRAT.

GRATs Can Fail Even If Average Performance Exceeds the Section 7520 Rate

- Suppose the grantor creates a 2-year GRAT with $1 million.
- Suppose the annuity payments are $530,000 annually.
- At the end of year 1, the assets drop to $750,000.
    - $530,000 is paid to the grantor leaving $220,000 in the GRAT.
- At the end of year 2, the original assets grow to $1,250,000.
    - The remaining assets in the GRAT are worth only $366,666.
- Thus, all the property has been returned to the grantor, and the GRAT fails.

Inconsistent Performance Is Also a Problem

- Grantor funds a 2-year GRAT with $1 million when the Section 7520 rate is 5%.
- In the first year the GRAT earns 2% and grows to $1,020,000.
    - $537,000 must be paid to the grantor leaving $483,000 in the GRAT.
- In the second year the GRAT earns 10%.
    - The GRAT has $531,300, but the annuity is $537,000 and the GRAT fails.
- Average performance is 6% but the GRAT fails.

Steeply Declining GRATs May Work Better

- GRATs are about capturing volatility.

- Suppose a $1 million GRAT is funded when the Section 7520 rate is 5%.
- The first annuity payment is $954,836 and the second annuity payment is $100,000.
- Suppose the assets increase by 25% in the first year to $1,250,000, but decrease in the second year by 10%.
  - After the first annuity payment, the GRAT has $295,164.
  - At the end of year 2, the GRAT is worth $265,648, but the annuity payment due is only $100,000, leaving $165,648 in the GRAT.

- Suppose instead the grantor creates the GRAT with 20% increasing annuity payments.
  - At the end of year 1 the GRAT is worth $1,250,000, and the annuity due is $490,003, leaving $759,997 in the GRAT.
  - At the end of year 2, the GRAT is worth $683,997 and the annuity due is $588,004, leaving only $95,993 in the GRAT, instead of $165,648 in the prior example.
- A steeply declining GRAT will also be better if performance is poor in the first year because it will accelerate the opportunity to re-GRAT.

Can You Use Debt with a GRAT?

- Treas. Reg. § 25.2702-3(b)(1)(i) states that the issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount.
  - Prohibition appears only to cover a trustee issuing debt.
  - However, the preamble to the regulations signals the possible application of the so-called “step transaction doctrine” to a situation where the trustee borrows money from a bank and the bank agrees to make the loan only if the grantor deposits funds with the bank equal to the amount of the loan.
  - It seems that because the grantor has in effect provided security for the trustee’s borrowing, the transaction is treated as if the grantor is the borrower from the bank, and the trustee has merely issued a debt obligation to the grantor.

- But what if the grantor issues debt to the GRAT as part of a substitution?And subsequently repays the debt to the extent required to permit the trustee to make the annuity payment?
    - The trustee is not issuing a debt instrument in violation of the prohibition.
    - Nor is the grantor securing the trustee's debt.
- Would it be a violation if the trustee distributed a portion of the grantor's note to pay the annuity?

Structuring GRATs to Improve Performance

- Swapping Assets
- Rolling GRATs
- Asset Splitting GRATs
- 99-Year GRAT
- Leveraged GRATs
- Split Purchase GRATs

Using a Substitution Power

- Gift tax valuation principles control.
- Draft in the past tense so that the trustee cannot block the substitution.
- Cases have held that issuing debt is a valid substitution.
- Be careful how you draft:
    - Avoid Section 2036(b)
    - Avoid Section 2042

Rolling GRATs and Asset Splitting GRATs

- In 2007, we worked with a financial institution to compare GRATs to installment sales to grantor trusts.*
- We looked at a couple with $30 million in total wealth contributing $9 million to a GRAT and $1 million to a Dynasty Trust.
- We compared the median result after 25 years in terms of wealth transferred to the children, including through the estates.
    - 2-year rolling GRATs produced a result that was 11% better than a 9-year term GRAT.
    - 2-year rolling asset-splitting GRATs improved the results another nearly 2%.

    - Total wealth in the children's trust for 2-year asset-splitting rolling GRATs is 250% of the wealth transferred using a 9-year GRAT.

99 Year GRAT

- What's the Deal?
    - It's a numbers game.
    - Included property of a GRAT is a function of dividing the amount of the annuity by the Section 7520 rate.
    - The higher the rate, the lower the inclusion.
- So, the bet is that interest rates will go up.
- Contribute $1 million to a 99-year GRAT when the Section 7520 rate is 5.6%
    - Annuity is $56,256 to zero out.
    - If 7520 rate goes to 7%, and the GRAT is still worth $1 million:
        - More than 20% escapes estate tax
        - $56,256/.07=$803,657
- If the assets also appreciate at the rate of 7% at the end of 30 years the GRAT will be worth $2.3 million.
    - In that case 65% escapes estate tax

Leveraged GRATs

- Purpose:
    - More valuation protection than with a traditional installment sale.
- Method:
    - Perform the sale with an entity that is owned by the seller or a wholly grantor trust owned by the seller for income tax purposes that is an incomplete gift trust.
- Contribute $1 million to a 99-year GRAT when the Section 7520 rate is 5.6%
    - Annuity is $56,256 to zero out.
    - If 7520 rate goes to 7%, and the GRAT is still worth $1 million:
- More than 20% escapes estate tax
- $56,256/.07=$803,657
    - If the assets also appreciate at the rate of 7% at the end of 30 years the GRAT will be worth $2.3 million.
    - In that case 65% escapes estate tax

- Form LLC and fund.
  - Rule of Thumb is 10%
- Form FLP and fund.
  - Perform an installment sale using the LP interest in the FLP with the LLC.
- Contribute the leveraged LLC to a GRAT.
  - The LLC will hold FLP interest and Note obligation.
- Valuation protection from the GRAT.
  - Annuity will self-adjust if the value of the LLC is challenged.
  - Annuity payment will be relatively small.
  - Superior to funding a GRAT directly with the FLP interest.
- Negative (as with all GRATs):
  - GST planning is difficult.

Split Purchase Annuity Trust

- Goal is to avoid estate tax inclusion if death occurs within the term.
- The annuitant buys the annuity, the remainder beneficiary buys the remainder interest.
- If the remainder beneficiary is a GST exempt trust, the wealth transfer benefits are greatly improved.
- Could a BDIT be the perfect remainder beneficiary?
- Potential issue under Section 1014 if the annuity continues beyond the lifetime of the annuitant.

ESG = ENVIRONMENTAL, SOCIAL AND GOVERNANCE

Presenters: Lauren J. Wolven; Jennifer B. Goode, Amy E. Szostak. Lauren Wolven is a partner in the Trusts & Estates Group of Levenfeld Pearlstein, LLC in Chicago. Jennifer B. Goode is a Director of the Institute on Trusts and Estates with Bernstein Private Wealth Management's Washington, D.C. office. Amy Szostak is a Senior Vice President and the Director of Family Education and Governance.

ESG

- ESG investing is here to stay so engage settlor to discuss. Also, to what extent does the settlor wish to have the beneficiaries involved in trust administration? Want a flexible means to allow for these matters.
- Some people view ESG as giving up return to accomplish social goals.

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

ESG and Trustee Duties

- Duty of loyalty.

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

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

CURRENT ISSUES IN ESTATE AND GIFT TAX AUDITS AND LITIGATION

Presenter: John Porter is a partner at Baker Botts, Houston, Texas.

Prepare for the Audit

- IRS is staffing up and much of additional funding is being put into estate and gift tax. Number of appeals officers has increased.
- Anticipate your potential audience at the planning stage.
- Anticipate broad IRS requests.
- Understand and preserve all privileges.
- Remember that your files can be subpoenaed. This includes emails. Really think about what you stated in your email before you click send.
  - Email correspondence is subject to discovery. There may be privilege issues but be really aware of the possibility that the email gets read.
- You might have to testify about reasons for creating the entity. It may be desirable for you to waive privilege.
- **Support your client by creating a file that supports the non-tax reasons for creating an entity or entering into a transaction. Some of best evidence comes from contemporaneous correspondence**.
- It is okay to discuss tax attributes but also discuss the non-tax attributes.

Relevant Valuation Decisions

- Decisions are all over the board on valuations and discounts.
- Often, the result turns on a qualified appraiser who accurately values the interest. Use a good appraiser familiar with the subject matter of the appraisal.
- Cecil case
  - Interest valued had no control and court adopted income approach not on a net asset basis because they could not control realization of net asset value.
  - The net asset value was worth more than the value as an operating business. The IRS adopted the operating value

("income") approach. The reason for the conclusion was that the interest being valued was a non-controlling interest.
  - Both experts in this case tax affected.

Formula Transfers

- Using formula transfers creates the ability to transfer hard to value assets.
- Types of formula clauses
  - Defined value clause based on values
  - Reversion clauses don't work.
  - Consideration adjustment clause
- Formula language really matters.
  - Wandry – "I hereby transfer to X that number of shares of the Company with a fair market value as finally determined for federal gift tax purposes equal to $X." Wandry is based on Petter. Using a Wandry clause will be subject to scrutiny. IRS is "hostile" towards it.
  - Petter – "I hereby transfer 100 shares to Company to taxable transferee and charity to be allocated between the transferees as follows (1) that number off shares with a fairt market value as finally determined for federal gift tax purposes equal to X and (2) the remainder to charity.
  - Price Adjustment Clause - King "I hereby sell 100 shares of Company in exchange for a promissory note with a principal amount of X (which the parties believe to be equal to fair market value of shares). The term of promissory note shall be $X. If the fair market value of the shares as finally determined for estate tax purposes is greater than $X, the principal amount of note shall be adjusted to the finally determined value effective as.. The parties intend for the sale to be at fair market value so no gift results.
  - Nelson. "X desires to make a gift and assign to trust her right title and interest in a limited partnership interest having fair market value of $2m as of DATE as determined by qualified appraiser within 90 days of effective date of agreement.
  - Reversion clauses don't work – Proctor. You can't undo a transfer.

Preferred Techniques

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

Potential Donees of the Excess Amount Under Petter Style Formula Clause

- Public Charity/Donor Advised Fund
    - Independent Fiduciary Obligation
    - Subject to private inurement and excess benefit rules
    - McCord, Hendrix, petter
- Private Foundation
    - Self dealing,excess business holdings and other rules make this approach more difficult.
- LifetimeQTIP
- GRAT
- None? Wandry
- Consideration Adjustment? King

QTIP Termination

- CCA 202118008 - The IRS Office of Chief Counsel issued advice regarding the commutation of a qualified terminable interest property (QTIP) trust, finding that a surviving spouse's commutation of her QTIP was a disposition of her qualifying income interest in the trust that was subject to Sec. 2519 and, further, that the commutation and

the distribution of the trust's property to the surviving spouse were separate gift transfers by separate donors, the surviving spouse and the remainder beneficiaries, and therefore not offsetting reciprocal gifts.

- Treas. Reg. 25.2519(a)
- Rev. Rul. 98-8 – Surviving spouse's purchase of a remainder interest is a gift from surviving spouse to remainder beneficiaries.
- Treas. Reg 25.2519(e) – Exercies of powert to appoint QTIP to done spouse is not a disposition under 2519.

Statute of Limitations – Adequate Disclosure

- Treas. Reg. 301.6501(c)-1(f)(2)
  - A transfer reported on the gift tax return that is not adequately disclosed does not commence running of statute of limitations.
- *Schlapfer* TC Memo 2023-65
  - Adequate disclosure requires substantial compliance rather than strict compliance but taxpayers must comply with each requirement of the regulations not the regulations overall.
- Donee Liability
  - Donee liability for donor's gift tax may exist under IRC 6901 or 6324(b)
  - Consider this issue when advising whether to file adequate disclosure gift tax return for sale transaction to start statute of limitations running.
  - There is a split among circuitss on whether done liability is limited to value of gifts.

Sales Audits

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

Promissory Notes

- 7872
  - IRS has taken position that lack of security is a non-commercial provision takes case outside the safe harbor.
- Bona Fide Gift or Loan
  - Is there a reasonable expectation of repayment.
  - Factors examined include note, interest, repayment schedule, collateral, demand for repayment, records reflecting debt, actual repayment and borrow solvency.

Installment Sales to IDGT

- Gift Tax Issues
  - FMV of interest sold.
  - Consider step transaction issue.
  - FMV of consideration received. Valuation of a note – Is 7872 a safe harbor?
- Estate Tax issues
  - 2036/2038 with respect to interest sold
  - Pierre issue (part gift/part sale)

GRATs

- Do terms comply with 2702 regs?
- Is GRAT operated in accordance with term
  - Substantiation of annuity payments
  - Atkinson analysis CCA 20125208
- Valuation
  - Initial transfer of assets
  - Exercise of power of substitution
  - Use of hard to value asset to pay annuity
  - Consider *Wandry* or *King* provisions for 2 and 3
- Baty v Comm'r
  - IRS position was that value of publicly traded stock should consider merger negotiations.
  - IRS also asserted that gross valuation error results in inability to adjust annuity or alternatively a non-qualified annuity.
  - IRS ultimately conceded case.

Section 2036

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

Section 2036(a)(2)

- Strangi, Turner, Cohen
- Investment powers not subject to 2036(a)(2). If senior family member is GP, have restrictions on distributions such as having a bifurcation of duties with someone else approving distributions.
- Powell case
- 2036(a)(2) applied because decedent in conjunction with others could dissolve partnership or control amount and timing of distributions.
    - The issue may change over time but should be dealt with at the planning stage.
    - Satisfy the bona fide sales test.

    - Create two classes of interest with one to vote on dissolution, distribution and amendment and a 2nd class that the donor gets that doesn't have these powers.
    - Have senior family member dispose of all interest more than 3-years before death.
    - Terminate the entity more than 3-years before death, but income tax may apply to the latter.
    - Powell could result in double taxation.
- How to Avoid Powell issue
    - Satisfy bona fide sale rules
    - Create two classes of interests
        - One with vote on dissolution and amendment
        - One without vote on dissolution/amendment
    - Have senior member dispose all interests at least three years before death.
    - You can also terminate entity at least three years before death but keep in mind that this approach poses tax issues.

Penalties

    - There is a reasonable cause exception.
    - Morrissette case

    - A trust is not a DB.
    - Four requirements can allow the trust to be a see-through trust. Trust provides that all plan distributions will be paid directly to or for the benefit of one or more specified beneficiaries.
- Accumulation Trust is anything that is not a conduit. Any beneficiary who can receive amounts from the plan may be a beneficiary except for those specifically excluded.
- Most common estate distribution issue is that IRA ends up in estate or trust rather than to spouse. Various revenue rulings allow spouse to get IRA out of estate or trust to spouse.

CYBERSECURITY, PRIVACY, ETHICS

Presenters: Jeff Chadwick is chair of the Wealth Preservation Practice Group with offices in Houston and The Woodlands. Kris Coleman is the

founder of Red Five, a family of companies which began as Red Five Security in 2004 to provide bespoke solutions for unique clientele. Lisa Vandesteeg is a partner in the Financial Services and Restructuring Group at Levenfeld Pearlstein LLC in Chicago, Illinois.

Statistics On Data Breach

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

Technical Competence

- Model Rule 1.1 – "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation.
- Comment 8 to Rule 1.1 provides: "To maintain the requisite knowledge and skill, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology [emphasis added], engage in continuing study and education and comply with all continuing legal education requirements to which the lawyer is subject."
- Currently, the reference to "technology" in Comment 8 is the only reference to technology in the Model Rules. Comments to the Model Rules are not a basis for discipline. The Preamble to the Model Rules

highlights that fact: “Comments do not add obligations to the Rules but provide guidance for practicing in compliance with the Rules.

- Technological competence means having basic skills and knowledge in the use of technology. Lawyers are expected to take reasonable steps to understand how technological advances may affect their practice. Technology competence also requires staying current on the risks and benefits of technology. A lawyer should be able to evaluate technology with respect to his or her practice. A lawyer should also be able to advise a client regarding options as they are impacted by technology.
- Areas of Technical Competence
  - Basic understanding of technology.
  - Timekeeping and billing.
  - Protecting sensitive documents.
  - Vetting vendors for security compliance.
  - Ensure vendors have insurance for cybersecurity breaches.

Confidentiality Compared To Privilege

- Model Rule 1.6 sets forth the general rule regarding a lawyer's duty to maintain client confidentiality. Absent certain exceptions, "[a] lawyer shall not reveal information relating to the representation of a client." Those exceptions include when the client gives informed consent, when disclosure is impliedly authorized to carry out the representation, and when the lawyer believes disclosure is reasonably necessary to prevent death, substantial bodily harm, or criminal activity.
- The duty of confidentiality is generally broader than the attorney-client privilege. All communications between a lawyer and client are confidential, but only a subset of those communications are protected by the attorney-client privilege.
- The attorney-client privilege is an evidentiary rule found in state statutes and common law. The privilege applies to communications made in confidence by a client or attorney for the purpose of seeking or providing legal advice.
- The duty of confidentiality is an ethical rule that is not limited to the laws of evidence.

The Beginning of a Client Relationship

- A person who consults with a lawyer about the possibility of forming a client-lawyer relationship with respect to a matter is a prospective client. Model Rule 1.8. A relationship may be formed at an initial meeting regardless of whether the client hires the attorney. Even if not hired, the lawyer is still bound by the duty of confidentiality and prohibited from using or revealing any information acquired from the prospective client.

Identifying Conflicts of Interest

- Model Rule 1.7 provides that a "concurrent" conflict of interest exists if: (i) the representation of one client will be directly adverse to another client; or (ii) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
- Estate Planning Conflicts of Interest:
    - Spouses – Many couples choose to engage in estate planning together. When working with spouses, it is important to remember that all marriages end; either the couple divorces or one or both spouses die. When (not if) the marriage ends, clients can sometimes have selective memories regarding the limitations of a joint representation and a lawyer's role in advising the couple as a single economic unit. It is in the best interests of the spouses and the lawyer to identify and address these potential conflicts of interest at the outset of the estate planning engagement, and to document the file throughout the course of the joint representation.
    - Family Members - Many professionals, including attorneys, CPAs, and financial advisors, represent multiple generations within a single family unit. Despite the benefits of representing multiple generations, individual family members can have disputes, which may result in litigation against each other and even litigation with their lawyer. Having a clear, well-documented engagement letter setting forth the appropriate ground rules should help implement the client's true objectives while also protecting the lawyer from future claims of

malpractice or tortious interference with an expected inheritance.

- Fiduciaries and Beneficiaries - Most estate planning attorneys will also represent clients serving as executors and trustees, guiding them through the estate and trust administration process. Attorneys should identify and explain potential conflicts to all affected clients.
- Businesses and Their Owners - It is common for an attorney to represent an individual client with respect to his or her estate planning matters, and for the same attorney or a colleague at the same law firm to also represent the business in other matters, such as negotiating a merger or acquisition, dealing with an employment dispute, or structuring a buy-sell agreement.
    - Model Rule 1.13 deals with the organization as a client. The Model Rule recognizes that the business and its owners are separate and distinct, but that practically the lawyer must work through the business's representatives, such as officers, directors, or employees.
    - The Model Rule also authorizes the dual representation of the business and any of its owners or employees, but requires the lawyer to "explain the identity of the client when the lawyer knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.
- Sharing Confidential Information Among Clients.
    - When a potential conflict of interest exists, it is important for the engagement letter to establish how confidential information will be shared with (or withheld from) other represented parties.
    - When communication is "closed," the lawyer cannot share information received from one client with another client without the client's consent.
    - When communication is "open," the lawyer is obligated to share all relevant information with all represented parties.
- Cover all issues in engagement letters.

Safeguarding Client Information

- Model Rule 1.6(a), establishes the basic rule that a lawyer "shall not reveal information relating to the representation of a client," subject to certain exceptions contained in Model Rule 1.6(b).
- Client Communications include those by e-mail, text, voice, instant messaging, shared calendars and task lists, white boards, collaboration platforms, and videoconferencing services. And, don't forget social media. Confidentiality applies at the level of communication as well as data security. Data security issues are covered in further detail later in this outline.
- When transmitting a communication that includes information relating to the representation of a client, the lawyer must take reasonable precautions to prevent the information from coming into the hands of unintended recipients.
- ABA Formal Opinion 477R
    - Client matters involving proprietary information in highly sensitive industries, such as health care, banking, and defense may present a higher risk of data theft.
    - An attorney should understand how their firm's electronic communications are created, where the client data resides, and what avenues exist to access that information.
    - Attorneys must protect against unauthorized disclosure in client communications by using appropriate electronic security measures including, for example, by: secure internet access methods to communicate, access, and store client information; unique complex passwords, changed periodically; firewalls and anti-malware, anti-spyware, and anti-virus software on all devices containing client confidential information; and all necessary security patches and updates to operational and communications software.
    - Different communications require different levels of protection. At the beginning of the attorney-client relationship, the attorney and client should discuss, and in cases involving sensitive communications agree, on appropriate levels of security for each electronic communication.
    - Attorneys should mark applicable communications as "privileged and confidential" to alert anyone to which the

communication is inadvertently disclosed that the attorney intended to protect the communication. Model Rule 4.4(b) obligates lawyers who know or reasonably should know that they have received an inadvertently sent communication relating to the opposing party to promptly notify the sending lawyer.

    - ABA Model Rule 1.15 requires attorneys to provide appropriate safeguards to any property they hold on a client's behalf. Comment 1 makes it clear that attorneys must hold all types of client property with the care required of a professional fiduciary. When law firms store client data in physical form, like paper documents, portable flash drives, or CDs or other media, attorneys must take steps to secure these physical items.
    - Lawyers must establish policies and procedures and periodically train employees, subordinates, and others assisting in the delivery of legal services, in the use of reasonably secure methods of electronic communications with clients.
    - ABA Model Rule 5.1 directs attorneys who have supervisory authority over other attorneys to make reasonable efforts to ensure the supervised attorneys conform with the Rules of Professional Conduct.
    - ABA Model Rule 5.3 requires attorneys with supervisory authority over non-attorneys inside and outside the firm to make reasonable efforts to ensure the non-lawyer's conduct comports with an attorney's professional obligations.

Duty To Notify Clients of Data Breaches

- ABA Formal Op. 483 imposes imposes an affirmative duty on attorneys to notify current clients of data breaches that materially compromise their confidential information.i; Data Breach Notification Obligations and State Bar of Cal. Standing Comm. on Prof'l Responsibility and Conduct, Formal Op. 2020-203 (2020) ("In all cases involving a data breach, disclosure to clients must be made as soon as reasonably possible so that the affected clients can take steps to ameliorate the harm."); State Bar of Cal. Standing Comm. on Prof'l Responsibility and Conduct, Formal Op. 2020-203 (2020) (discussing a lawyer's obligation to conduct a reasonable inquiry to

determine the extent and consequences of a breach and to notify any client whose interests have a reasonable possibility of being negatively impacted by the breach).
- Lawyers should remove or archive files related to former clients to avoid ever having to provide notice to a former client of a breach.

Steps to Take

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

50 WAYS TO LEAVE YOUR LEGACY: THAT LIFE INSURANCE POLICY MAY BE WORTH MORE OR LESS THAN WHAT YOU THINK

Presenters: Speakers: Donald O. Jansen; Lawrence Brody; Mary Ann Mancini. Donald O. Jansen is Associate General Counsel, University of Texas System Office of General Counsel. Lawrence Brody is Senior Counsel at Harrison LLP, resident in its St. Louis office and is a member of the Missouri bar. Mary Ann Mancini is at Loeb & Loeb LLP, Washington D.C.

Basic Life Insurance Concepts

- Investment risk in Permanent Policies
  - There is some level of investment risk in all permanent policies.
- Credit Risk in All Policies
  - There is also some level of credit risk associated with all life insurance policies.
- Cost of Insurance Risk in Universal Policies
  - In these types of policies, the insurer has the ability to increase costs of insurance, based on its mortality experience, on a policy class basis, with no notice.
- Premium Pricing and Policy Illustrations

  - Life insurance policies have traditionally been sold based on illustrations of projected future values, prepared by the issuing insurer, showing fixed premiums and constant, guaranteed returns on policy cash values.
  - The premium pricing of all permanent (i.e., non-term) life insurance products consists of three components: (1) a mortality charge, generally based on mortality tables which assume all insureds die by age 100 (2001 CSO mortality tables for policies issued in 2009 or later; 1980 CSO mortality tables are used for earlier policies; 1958 CSO mortality tables are used on older policies); (2) expense loading, including sales commissions, underwriting and administrative expenses; and (3) investment experience or return (on the savings element).
  - What clients should look for is a policy from a financially sound carrier, with reasonable illustrated results, taking into account investment return, expenses, and mortality charges, which, based on reasonable assumptions, is projected to last well past actuarial life expectancy (perhaps to age 110 or 120, recognizing that life expectancy is the point at which one-half of the insureds are alive, and the other half not-so-much).
  - Clients could consider hedging their bets, by choosing multiple carriers and multiple policy types (in large cases), both as a hedge against carrier insolvency and to diversify potential investment risks.
  - Clients should also look for a policy series that the carrier will continue to support in the future – one that is central to its sales strategy.

Permanent Policy Types

- When a client owns life insurance, regular reviews should be conducted. Far too often a client buys a policy only to later discover the policy is no longer serving its purpose. This should be part of an annual review process.
- Whole Life Insurance Policies
  - A whole (or ordinary) life policy has a fixed (non-increasing) premium, which is due each year over the contract life.
- Universal Life (Flexible Premium) Insurance Policies (UL Policies)

    - These are unitary policies, mostly issued by stock companies (some of which are subsidiaries of mutual companies), composed of two elements – a risk element (the death benefit) and an accumulation element (the cash value).
- Equity Indexed Universal Life Policies (EIUL or IUL Policies)
    - A number of insurers also offer equity indexed universal life policies, in which the crediting rate is determined not by interest earned by the carrier, but by reference to the performance of an equity index (perhaps the S&P 500, excluding, however, its dividend component), but with a minimum guaranteed crediting rate and a maximum crediting rate cap – a floor and a ceiling.
- Variable Universal Life Insurance Policies (VUL Policies)
    - Variable policies are generally built on a universal life chassis, a hybrid of universal and variable life insurance policies, combining – some would argue – the best features of both.

Valuing Life Insurance Policies

- The gift tax regulations give rules of thumb on how to value various types of life insurance policies.
    - For income tax purposes, the IRS has taken the position in a 1959 revenue ruling that income tax policy valuation rules are the same as the gift tax valuation rules.
    - There are numerous exceptions. In the case of many exceptions, the rule is that of fair market value with a safe harbor of the greater of interpolated terminal reserve and the product of PERC (premiums, earnings and reasonable charges) and applicable average surrender factor.
- Life insurance falls under “hard to value” asset.
    - Willing buyer/willing seller analysis applies.
    - There are typically few willing buyers.
    - The Federal gift tax valuation of a policy is in Reg. Sec. 25. 2512- 6(a). That reg relies on the cost of what it calls a “comparable” policy.
    - For a single premium or a paid-up policy, its gift tax value is its replacement cost. Example (3) of Reg. Sec. 25.2512-6(a).
    - For a new policy, its gift tax value would be the premium paid. Example (1) of Reg. Sec. 25.2512-6(a).

  - For a more usual policy on which further premiums are due and which has been in force for some time, since the Regulations conclude that the cost of a "comparable policy" would be hard to determine, the Regulations provide that its gift tax value may be approximated by the policy's interpolated terminal reserve (its "ITR" value), plus any prepaid premiums.
  - For annually renewable term, the gift value should only be the unearned premium for the year of the gift.

THE NEW WORLD OF SOCIAL PHILANTHROPY AND 501(C)(4) AND SOME CREATED STRATEGIES FOR 501(C)(3)

Presenters: Brad Bedingfield is a Partner and Chair of the Nonprofit Group at Hemenway & Barnes in Boston, Massachusetts. Meghan Biss joined Caplin & Drysdale's Exempt Organizations practice group as Of Counsel in January 2018 after more than a decade with the Internal Revenue Service. Michele McKinnon is a Partner in the Richmond, Virginia office of McGuireWoods LLP and is a member of its Private Wealth Services Group and head of its Nonprofit and Tax-Exempt Organizations group. These notes combine comments from an early presentation by Brad Bedingfield solo with a later presentation on

Historical Vehicles for Philanthropy

- Direct Gifts to Charities.
- Charitable Trusts.
- Distributions from Qualified Accounts.
- Donor Advised Funds. Donor advised funds are becoming less preferred than private foundations because of the strict manner by which the IRS is interpreting the rules related to donor advised funds.
- Private Foundations.

Social Welfare Organizations

- Resurgence of social welfare organizations are being driven in part by rules regarding gift tax.
  - In July 7, 2011, IRS issued Memorandum re "Guidance for SB/SE Estate and Gift Tax and TE/GE Exempt Organizations" in which the IRA acknowledged lack of clarity regarding application of gift tax to gifts to 501(c)(4) organizations.

- PATH Act 2501(10(6) has clarified that gift tax does not apply to social welfare organizations. We now know that a gift of any size can be made to a 501(c)(4) can be made without triggering gift tax.
- New proposed regulations are making private foundations more viable than donor advised funds but 501(c)(4) is an alternate to the private foundation.
- Social welfare organizations are covered under 501(c)(4).
    - Social welfare organizations are exempt from income tax.
    - Contributions to social welfare organizations do not result in a charitable deduction for donor.
    - Social welfare organizations must be operated “exclusively” for the promotion of social welfare”. Such an entity must be operated for the “common good and general welfare of the people of the community.”
        - Community movement to accomplish community “ends.”
        - Outward community focus rather than inward focus on private benefits.
        - Quantum of social welfare activity can be an issue.
        - Key is to benefit community as a whole and not private interests.
    - Lobby and political activity are permitted in 501(c)(4).
    - Split interest rules don’t apply to 501(c)(4).
    - *Erie Endowment v. United States*, 316 F.2d 151, 156 (3rd Cir. 1963) (Must be “a community movement designed to accomplish community ends.”)
    - IRS, Exempt Organizations – Technical Instruction Program for FY 2003, Social Welfare Organizations: “Although the Service has been making an effort to refine and clarify this area, IRC 501(c)(4) remains in some degree a catch-all for presumptively beneficial non-profit organizations that resist classification under the other exempting provisions of the Code. Unfortunately this condition exists because “social welfare” is inherently an abstruse concept that continues to defy precise definition.” Citing 1981 CPE text, Chapter G, “Social Welfare: What Does It Mean? How Much Private Benefit Is Permissible?”

    - There is no need to benefit a charitable class.
    - Some private benefit is permissible but too much can preclude exemption.
- 501(c)(4) is a member based organization.
    - Services to members benefit the community as a whole.
    - IRS Denials:
        - IRS Denial 202336028: Organization formed to own and operate a water supply system for members not exempt under 501(c)(4) because limited to lot owners, and membership does not serve a "community" which bears a reasonable recognizable relationship to an area ordinarily identified as governmental.
        - IRS Denial 202226014: Organization formed to maintain common areas of gated community constructed around country club golf course not exempt under 501(c)(4) – although golf course membership is open to the public, activities are primarily directed towards members 8-7 (homeowners of gated community), not general public.
    - If membership is open to entire community, it is more likely to indicate public benefit.

What Activities are Social Welfare Activities?

- Lobbying activities *can be* social welfare activities. Lobbying must be in service of public goal.
- Low and moderate income housing will fit within 501(c)(4). Moderate or mixed income housing projects involving government organizations and nonprofit organizations a 501(c)(4) permits this but in a 501(C)(3) moderate or mixed housing would likely not qualify.
- Addressing racial wealth gap, e.g., helping minorities start business. That is not a charitable class under existing case law so can do this in (c)(4) but not in a (c)(3).
- Lobbying activities can be social welfare under (c)(4). Not all lobbying counts. It must be in service of a public goal, not for private benefit.
- Outward community focus rather than inward focus on private benefits.
- Quantum of social welfare activity can be an issue.
- Key is to benefit community as a whole and not private interests

- Intervention in political campaigns is not a social welfare activity.
- Business Activities:
  - Carrying on a business for the public is not a social welfare activity.
  - Unrelated Business Tax (UBTI) – ok in 501(c)(3) but pay tax but could taint charity. Can put inside a C corporation. But does it solve question as to whether (c)(4) is pursuing too much business activity?
  - 501(c)(4) should not be just a wrapper around business activities but should be clearly engaged in social welfare activities.
  - Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii): "Nor is an organization operated primarily for the promotion of social welfare if its primary activity … is carrying on a business with the general public in a manner similar to organizations which are operated for profit."
  - See People's Educational Camp Society, Inc. V. Comm'r, 331 F.2d 923 (2d Cir 1964): Where social welfare activities supported by operation of commercial resort, which activities greatly outweighed social welfare activities, not entitled to 501(c)(4) status. Resort activities not themselves social welfare activities, and large portion of revenue reinvested in commercial operations.
  - Rev. Rul. 70-535: Organization managing low and moderate income housing projects for a fee not entitled to 501(c)(4) status where management services were primary activity and were carried out in a manner similar to for-profit organizations.
- Partnership Structures:
  - Rev. Rul. 98-15: "[T]he activities of an LLC treated as a partnership for federal income tax purposes are considered to be the activities of a nonprofit organization that is an owner of the LLC when evaluating whether the nonprofit organization is operated exclusively for exempt purposes within the meaning of section 501(c)(3)."
  - Rev. Rul. 2004-51: Otherwise potentially disqualifying activities via LLC joint venture for 501(c)(3) permissible where university.
- Personal Interests of Founder:

- PLR 201224034: Organization established, funded, and run (as sole member, Director and President) by single individual, a known local political figure, to promote solutions to particular state's problems through grassroots advocacy and publicity not exempt under 501(c)(4) because, based on all facts and circumstances, including connection with Founder's political interests, appears to be focused on primarily benefiting personal interests of Founder.
- Bring in some independence to board.

Activities Exempt Under 501(c)(4) but not 501(c)(3)

- Private Benefit
  - Rev. Rul. 75-286: Organization formed by residents of city block to preserve a beautify block qualifies under 501(c)(4) as primarily focused on improving community, but not exempt under 501(c)(3), given more than insubstantial private benefit.
  - *Columbia Park & Recreation Association v. Comm'r*, 88 TC 1 (1987): Planned community with more than 100,000 residents qualified as 501(c)(4) organization but not exempt under 501(c)(3), despite essentially operating as a municipality, because of more than incidental private benefit to residents of Columbia (vs. general public). Despite size, association was essentially "an aggregation of homeowners and tenants bound together in a structural unit formed as an integral part of a plan for the development of real estate" and not a "community at large" that might re-frame its activities as "charitable" – "The size of an organization is meaningless if it is not fully integrated with a public element. … To the extent that Columbia is owned and controlled by the homeowners and residents within its boundaries, free from any governmental or other outside influence, we find that it is an unusually large aggregation of private interests" and therefore more than insubstantially serving private purposes.
- Charitable Class
  - 501(c)(4)s need not tie purposes and activities into one or more of these categories (relief of the poor, etc.), so long as benefiting the public.

    - Rev. Rul. 55-439: Organization giving aid, counsel and advice in connection with location and construction of homes to be purchased by individuals in the low to moderate income groups and where no adequate housing exists may qualify under 501(c)(4).
- Economic Development Organization
    - Rev. Rul. 64-187: Corporation organized to aid and promote purposes of local redevelopment legislation by providing loans to purchase or develop lands and facilities to alleviate unemployment in designated redevelopment areas qualifies as 501(c)(4).
    - Rev. Rul. 67-294: Organization created to make loans to businesses as inducement to locate to economically depressed area to alleviate unemployment may qualify under 501(c)(4) because promotion of social welfare includes 8-13 efforts to relieve unemployment by inducing industry to locate in a community.

Tax Considerations.

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

Primary Benefits of 501(c)(4)

- No private foundation rules
- No public support test requirements
- Broader array of permissible activities (501(c)(4) vs. 501(c)(3))
- Gift Tax: Non-Applicability vs. Deduction.
- Distributions From Trusts IRC 642(c) vs. IRC 661.

Downsides of 501(c)(4)

- No income tax deduction.
- Public scrutiny.
- Lack of clarity about qualifying for 501(c)(4).

Estate Planning Examples

- Yvon Chouinard. The founder of Patagonia, Yvon Chouinard, gave the bulk of the economic value in Patagonia to a 501(c)(4) called the Holdfast Collective. The voting interests in Patagonia are held in a special purpose trust. The Holdfast Collective devotes the dividends paid out by Patagonia (all of which are free of income tax) to social welfare causes, in particular the environment. "Earth is now our only shareholder."
- Sergey Brin. Google co-founder Sergey Brin launched a 501(c)(4) social welfare organization focused on health and climate change, named Catalyst4, to which he contributed about $366 million in appreciated stock in Tesla. The 501(c)(4) pays no tax on the capital gains generated from sale of that stock, and can use the assets for charitable activities, as well as for broader social welfare activities (including lobbying and some political activities).

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

- Bequests to 501(c)(4) do not qualify for a charitable contribution deduction.
- If make lifetime gift to a (c)(4) but have strings it could be included in your estate. So do all the planning you do when you set up a family trust you don't want included in the client's estate. Don't have the client as a director of the (c)(4). Some clients, however, won't accept this exclusion.
- Should not have power to remove directors and insert yourself as a director. Consider a private trust company running the (c)(4)s to avoid this.

- Rev. Rul. 72-552 if you are a member, director or president alone or with others that might require inclusion in your estate. Unlike a 501(c)(3) you don't get a deduction so you could trigger estate tax.
- Planning strategies
  - Using money as you go. Put money in and use it. This is the most common use of a (c)(4). You don't build up assets, so you are not concerned about estate tax.
  - Create a temporary 501(c)(4) which is converted to 501(c)(3) on death for charitable deduction but gives them more flexibility during lifetime.

Considerations re Social Welfare Organizations

- Consider seeking an IRS determination as to whether an organizational purpose qualifies as social welfare.
- Plan for 2036 risk.
  - Ensure donor does not participate in control structure.
  - Include contingent charitable deduction provisions to cover the event that the property is included in donor's estate.

Creative Strategies within 501(c)(3) Vehicles

- Program Related Investments
  - A program-related investment (PRI) is a type of impact investment made by a foundation or nonprofit organization to support charitable activities. It involves providing funds to organizations or projects that align with the mission of the investing entity, with the expectation of both financial return and social impact. PRIs are often used to support initiatives that promote economic development, affordable housing, job creation, and other socially beneficial purposes. The term is defined in the tax laws under IRC 509(a).
  - The primary purpose must be to accomplish one or more 170(c)(2)(B) purposes.
  - Examples:
    - Low-interest loans to small businesses in deteriorated area owned by members of economically disadvantaged minority group.
    - Equity investments, guarantees, investments in foreign countries, investments with high rate of return.

    - To qualify as a program related investment, no significant purpose may be the production of income or appreciation of property.
    - No purpose of the investment may be lobbying or political activity.
- Mission Related Investing
    - Mission related investment is the use by a charity of investment in profit seeking ventures that align with its philanthropic mission.
    - Treas. Reg. § 53.4944-1(a)(2)(i) provides that an investment jeopardizes exempt purposes if it is determined that the foundation managers, in making the investment, failed to exercise ordinary business care and prudence in providing for the long-term and short-term financial needs of the foundation to carry out its exempt purposes.
    - A foundation may consider its charitable purposes as a factor in determining whether the foundation managers have exercised ordinary business care and prudence in making the investment.
        - The greater the mission-alignment, the more flexibility to do something that might otherwise be seen as imprudent or jeopardizing.
- Recoverable Grant
    - A recoverable grant is a type of grant that is provided to an organization or individual with an expectation that it will be repaid if certain conditions are not met. This type of grant allows a foundation to support projects and also ensure funds are being used responsibly.

Other Non-501(c)(3) Structures

- 501(c)(5) for labor, agricultural, or horticultural organizations. Gifts are exempt from gift tax under 2501(a)(6).
- 501(c)(6) for business leagues, chambers of commerce, real estate boards, boards of trade and professional football leagues. Gifts are exempt from gift tax under 2501(a)(6).
- 527 organizations for political organizations. Gifts are exempt from gift tax under 2501(a)(4).
- Complex Trusts

- Trusts may support both charitable and non-charitable interests.
- Where such trusts have flexibility to support both charitable and family interests at the same time, contributions to such trusts will be subject to gift tax and will not warrant income tax deductions on contribution.
- Permissible contributions to charity may generate either IRC § 170 deductions (when made from grantor trusts) or IRC § 642(c) deductions (when made from non-grantor trusts).
- Omnibus no tax non-grantor trust – Trust provides for family and charities.
  - Discretionary distributions to charity are eligible for income tax deduction.
  - Governing instrument must expressly permit distributions to charity.
  - Deduction amount is limited to gross income.
- A complex trust can avoid the excess business holdings issue. In PLR 201303021, a family created various trusts with mix of charitable and non-charitable beneficiaries to hold voting shares of family company. Foundation owned all the non-voting shares in family company. Family interests in the trusts were limited to income. Trusts were structured so that family interests, in the aggregate were less than 35% of the beneficial interest in each of the trusts. As a result, these trusts were not disqualified persons, the foundation was permitted to hold the nonvoting shares.

- Non-4947 Trusts
  - IRC 4947 was enacted to preclude the use of certain trusts to avoid being subject to the normal statutory taxation of exempt organizations, particularly the requirements and restrictions upon private foundations.
  - IRC § 4946(a)(1)(G) treats as a disqualified person a trust in which disqualified persons hold more than 35 percent of the beneficial interest.
  - IRC § 4946(a)(1)(H) treats, for purposes of the excess business holdings rules, as a disqualified person a private foundation which II-C-19 is effectively controlled by the same persons who

control the private foundation in question (or where substantially all of the funding came from the same people).
    - A non-4947 trust will not be a disqualified person. A family could transfer all voting shares to a non-4947 trust and the non-voting shares to a foundation.

CORPORATE TRANSPARENCY ACT: TRUSTEES, FAMILY OFFICES, PRIVATE TRUST COMPANIES

Presenters: Nancy G. Henderson is a founding partner of Henderson, Caverly & Pum LLP, San Diego, California. Jocelyn Margoline Borowsky is a partner with Duane Morris LLP in Wilmington, Delaware. Benetta Y. Park is the president of the family office, Johnson Keland Management, Inc., Racine, Wisconsin.

History and Purpose of the Corporate Transparency Act

- The Corporate Transparency Act was enacted as part of an international fight against money laundering. Generally, the United States has been behind in this fight.
- Legal entities in the United States are generally formed by filing documents with the Secretary of state in which the entity is formed. Typically, the filings do not require disclosure about the individuals who financially benefit from the entities. Other than filing an SS-4 and federal income tax returns, most entities don't have federal filing requirements. Those entities that are subject to federal regulation will have federal filing requirements.
- Various versions of the Corporate Transparency Act had been introduced but the current Act was enacted in 2020.
- FinCen is charged with administering and enforcing the CTA.
- CTA published a Small Business Compliance Guide in September 2023.

CTA Basics

- The principal objective of the CTA is to create a national database of information about he individuals who own, directly or indirectly, own or control a substantial interest in, or hold substantial control over (referred to in the CTA as "Beneficial Owners") certain types of domestic and foreign legal entities (referred to in the CTA as "Reporting Companies").

- For domestic Reporting Companies created on or after January 1, 2024, and foreign Reporting Companies first registering in the U.S. on or after January 1, 2024, information must be provided about certain persons who were involved in the legal formation or registration of the Reporting Company (referred to in the CTA as "Company Applicants").
- The information provided by the Reporting Companies about their Beneficial Owners and Company Applicants (Beneficial Ownership Information, or "BOI") will be maintained by FinCEN in a secure national database. Access to the information will only be available to certain law enforcement agencies, taxing authorities, and a limited number of other potential users for specified purposes upon request.
- The CTA applies to corporations, LLCs, and other legal entities created by the filing of a document with a Secretary of State or similar office pursuant to the law of the state in which filed. The CTA also applies to foreign legal entities that register to do business in the U.S.
    - General partnerships, sole proprietorships and trusts are usually not created by a filing with the Secretary of State.

Exemptions from CTA

- Large Operating Companies. Legal entities that have significant business operations in the United States (referred to in the CTA Final Regulations as "Large Operating II-B-7 Companies") are not subject to the CTA. To qualify as a Large Operating Company, a legal entity must meet all of the following requirements:
    - The legal entity must have an operating presence at a physical location in the United States. This cannot be a PO box. The locations must be owned or leased by the legal entity and distinct from the place of any unaffiliated entities. The location may be a personal residence.
    - The legal entity must have more than 20 full-time employees.
    - The legal entity must have at least $5 million of gross receipts or sales, in the aggregate, based on the income tax return for the prior year.
- A church, a charity, a nonprofit entity or other organization described in IRC § 501(c) that is exempt from income tax under IRC § 501(a).

Such a legal entity will remain a CTA-exempt entity for a period of 180 days following the loss of its tax-exempt status.
    - Note that the filing requirement is 90 days after formation for new entities. You may not have received confirmation of tax exempt status by that point in time so you may need to file.
- A charitable trust or charitable split interest trust described in IRC § 4947(a)(1) or (2).
- A public accounting firm registered with the Public Company Accounting Oversight Board's Registered Firm's list pursuant to the Sarbanes-Oxley Act of 2002.
- A legal entity that exercises governmental authority on behalf of the U.S., an Indian tribe, a state, or a political subdivision of a state if it is established under U.S. law, tribal law, the law of a state or a political subdivision of a state by a compact between 2 or more states.
- An FDIC insured bank, U.S. credit union, or deposit institution holding company.
- A securities exchange or clearing agency and other Securities Act of 1934 entities.
- A registered investment company and registered investment adviser.
- A venture capital fund adviser that is described in Section 203(1) of the Investment Advisors Act of 1940 and has filed Item 10, Schedule A as well as Schedule B of Part 1A of Form ADV with the SEC.
- An insurance company.
- An insurance producer if authorized by a state, and subject to supervision by the state insurance commissioner or similar state office, but only if the producer has an operating presence in a physical location in the United States.
- A Commodity Exchange Act registered entity, including a future commission merchant, introducing broker, commodity pool operator and commodity trading adviser that is registered with the Commodity Futures Trading Commission.
- A retail foreign exchange dealer registered with the Commodities Futures Trading Commission.
- A regulated public utility within the meaning of IRC § 7701(a)(33)(A) providing telecommunications, electrical power, natural gas, water or sewer services.

- A financial market utility designated by the Financial Stability Oversight Council.
- CTA Exempt Subsidiaries
  - A legal entity whose ownership interests are, directly or indirectly, controlled by, or wholly owned by, one or more of the specified exempt entities discussed paragraphs (a) and (b) immediately above is also a CTA-exempt entity under the so-called Subsidiary Exemption. Any ownership interest in a subsidiary, direct or indirect, by either an individual, a non-exempt entity or a CTA-exempt entity described in paragraph. below will cause the entity to lose its exempt subsidiary status.
  - There is no CTA exemption for a parent company or a holding company of a CTA-exempt entity.
- CTA Exempt Entities with No Subsidiary Exemption – The following entities are exempt but not considered "specified exempt entities" meaning that subsidiaries of any of these CTA exempt entities do not qualify for the subsidiary exemption discussed above.
  - A legal entity that operates exclusively to provide financial assistance to, or hold governance rights over, the CTA-exempt non-profit entities and trusts that are described in CTA § 5336(a)(11)(B)(xix).
  - Money transmitting businesses and money services businesses registered with FinCEN.
  - Pooled investment vehicles that are operated or advised by any of the following types of CTA-exempt legal entities: FDIC insured banks, U.S. credit unions and deposit institution holding companies; brokers or dealers in securities; registered investment II-B-12 companies and registered investment advisers; insurance companies; and public accounting firms.
  - Inactive legal entities that are not owned directly or indirectly, in whole or part, by any foreign persons. These are also sometimes referred to as "grandfathered" CTA-exempt legal entities. To be "grandfathered," the legal entity must (a) have been in existence on or before January 1, 2020; (b) not be engaged in an active business; (c) hold no assets (including an interest in another legal entity); (d) not had a change of ownership in the prior 12-month period; and (e) not received,

directly or through an affiliated entity, more than $1,000 in the prior 12- month period.

Beneficial Owners

- The definition of beneficial owner includes any individual who, directly or indirectly, (a) exercises “substantial control” over a Reporting Company (regardless of any actual “ownership” of the legal entity) or (b) owns or controls 25% or more of the “ownership interests” in the Reporting Company.
- Substantial Control:
    - Seniors officers of Reporting Company.
    - Any individual with the authority to appoint or remove any senior officer or a majority of the Board (or similar body) of a Reporting Company has substantial control.
    - Any individual who otherwise directs, determines or has “substantial influence” over “important decisions” is deemed to have substantial control of a Reporting Company.
    - An individual with “any other form of substantial control” over a Reporting Company is also a Beneficial Owner.
    - Substantial control can be exercised directly or indirectly, and it may be exercisable by a trustee of a trust or other similar arrangement.
- 25% Ownership
    - The definition of ownership is broadly defined an any instrument, contract, arrangement, understanding, relationship, or other mechanism used to establish ownership.
    - With respect to a trust that holds an ownership interest in a Reporting Company, multiple individuals could be deemed to own or control the same ownership interest.
        - An individual trustee of a trust (or similar arrangement), or other individual, with the power to dispose of trust assets, will be deemed to control or own the ownership interest in the Reporting Company held in the trust.
        - The reference to “other individual” in this context implies that individuals serving as investment directors, advisors, or committee members, such as trust protectors or persons holding veto powers over certain actions of the

trustee, could be deemed to be beneficial owners depending upon the circumstances.

    - A beneficiary of a trust who is the sole permissible recipient of income and principal of the trust, or who can withdraw substantially all of the assets from the trust, will be deemed to own the ownership interest in the Reporting Company held by the trust.
    - The grantor of any trust will be deemed to control or own the ownership interest in the Reporting Company held by the trust if the grantor has the right to revoke the trust or otherwise withdraw assets from the trust.
- Ownership and control is determined at the time of filing the report.

Who Is a Company Applicant?

- A "Company Applicant" is defined in the CTA Final Regulations as any individual who files the document with an Applicable Agency that creates a domestic Reporting Company or who first registers a foreign Reporting Company with an Applicable Agency. A Company Applicant is further defined as the individual, if any, who directs or controls the filing of such a document. As few as one, and no more than two individuals (the actual filer and the person directing the filer, or the person preparing the documents and the actual filer of the documents) will need to be identified as "Company Applicants."

What Must Be Reported?

- The following information must be provided:
    - Full legal name of reporting company as well as any tradename.
    - Street address of principal place of business, or the street address of primary location in the U.S. at which the company engages in business.
    - State, territory, possession, or tribal jurisdiction of domestic Reporting Company's registration.
    - TIN or EIN for all domestic reporting companies and that of foreign reporting entity with such a number, otherwise Reporting Company's identification number issued by foreign jurisdiction.

- Reporting Company must provide the following for each Beneficial Owners and Company Applicants:
    - Full legal name and Date of Birth.
    - Individual’s resident address. Individuals may notify FINCEN that doing so will create a safety risk and each such request will be reviewed.
    - If a Company Applicant works at an entity that regularly forms business, business address may be used.
    - Image of identifying document from which identifying number was obtained and individual’s photograph.
    - If an individual is a beneficial owner related to an exempt CTA entity, Reporting Company may simply provide information about the exempt entity.
    - Individuals and entities that are Beneficial Owners or Applicants will be able to obtain a FinCEN identifier.
    - A Reporting Company may also secure its own FinCEN Identifier but only after submitting its initial report to FinCen.

Filing Deadlines

- Reporting companies created or registered in the United States January 1, 2024 or later shall be required to file within 90 days of notice to the reporting company that it has been formed or the date the applicable agency first provides public notice of such creation.
- Note that entities formed January 1, 2025 or later will have 30 days to file.
- Reporting Companies created prior to January 1, 2024, must file initial reports no later than January 1, 2025.
- An entity that was exempt but loses its status for exemption from filing shall have 30 days from the date the entity no longer qualifies for any exemption from filing.

Correcting Reporting Errors

- If any information in a BOI Report filed with FinCEN contains information that is incorrect or inaccurate, the Reporting Company must file a corrected BOI Report within 30 calendar days from when it first becomes aware of, or has reason to know of, the mistake or inaccuracy.

- If an individual applies for a FinCEN Identifier and if the information in that application is incorrect or inaccurate, then that individual must file a corrected application within 30 calendar days from when he or she first becomes aware of, or has reason to know of, the mistake or inaccuracy.
    - If a Reporting Company has secured its own FinCEN Identifier, and if the information in its application is incorrect, the Reporting Company must file a corrected application within 30 calendar days from when it first becomes aware of, or has reason to know of, the mistake or inaccuracy.

Keeping BOI Reports and Applications Up to Date

- It is the responsibility of each Reporting Company to keep its BOI Report current with FinCEN. This is not an annual filing requirement but an "as needed" filing II-B-21 requirement, meaning the BOI Report must be updated by the Reporting Company within 30 calendar days of the following events:
    - Change in Information submitted about Reporting Company.
    - Change in identify of Beneficial Owners.
    - Any change in information previously submitted with regard to Beneficial Owners.
    - If a Reporting Company is using a FinCEN Identifier for a Beneficial Owner, the obligation to keep the information on that Beneficial Owner up to date falls on the Beneficial Owner and not the Reporting Company.

Applying the Corporate Transparency Act to Trusts and Trustees

- Trust and The Ownership Test.
    - Final Regulations provide a descriptive list of individuals who would be considered a Beneficial Owner under the ownership test when a trust owns or controls at least 25% of the ownership interests in a Reporting Company: (a) an individual trustee of the trust; (b) an individual with authority to dispose of trust assets; (c) a beneficiary who is the sole permissible recipient of income and principal from the trust; (d) a beneficiary who has the right to demand a distribution of or withdraw substantially all of the assets in the trust; (e) a grantor of the trust who has the right to revoke the trust; and (f) a grantor of

the trust who has the right to withdraw the assets of the trust. The foregoing provisions are not intended to be an exhaustive list of situations related to the ownership test with respect to a trust.

  - The ownership test further contemplates an “aggregation rule,” namely, that all of an individual’s ownership interests in a Reporting Company are to be taken into account to determine if the individual meets the 25% threshold, including interests that the individual owns or controls directly or indirectly. 31 CFR § 1010.380(d)(2)(iii) (“In determining whether an individual owns or controls at least 25% of the ownership interests of a reporting company, the total ownership interests that an individual owns or controls, directly or indirectly, shall be calculated as a percentage of the total outstanding ownership interests of the reporting company as follows…”)
  - There is no attribution of ownership among family members but the rules do contemplate attribution when an individual owns or controls interests through different vehicles.
  - Additionally, the rules may require that a trustee’s interest in a Reporting Company be aggregated for purposes of identifying the Beneficial Owner.

Trust as a Beneficial Owner

- 25% threshold must first be met for trust to be a Beneficial Owner (BO) but if trust controls the entity, e.g., 1% GP interests is in trust, then trust is a BO based on substantial control.
- Trustee who owns legal title is a reporting entity.
- Disposition is broad enough to cover distributions.
- Directed trust. Investment advisor has powers and would be a BO. What about person who can replace an investment adviser?
- Trust protector. Powers may make a Bo, but it depends on which powers granted.
- Beneficiary of income or principal is BO. Beneficiary who can withdraw substantially all the assets.
- Lifetime LPOA, not testamentary POA since that takes place in the future.

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

Responsibility for Reporting

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

Protection, Use and Disclosure of Beneficial Ownership Information

- Many professionals have expressed concern related to disclosure of highly sensitive information about owners and applicants. Information reported in a BOI Report or FinCEN Identifier application is confidential. Strict confidentiality, security, and access restrictions on the information are imposed. FinCEN has the responsibility to maintain Beneficial Ownership Information in a secure, nonpublic data base.
- Information can be requested by a federal agency for national security, intelligence or law enforcement purposes. Information can be requested by a state, local or tribal enforcement agency upon authorization by a court of competent jurisdiction in connection with a

civil or criminal case. A federal agency acting on behalf of a foreign prosecutor may request information.

- FinCen indicates that further regulations will be issued. Regardless of the attempts to assure practitioners about confidentiality and limited disclosure, the author does not think the uses for which information can be requested have been sufficiently defined in the narrow manner that would match the intended purposed of the CTA – to prevent money laundering.

Applying the CTA to Trusts and Trustees

- Trusts and the Ownership Test
  - Beneficial ownership when a trust owns or controls 25% of a Reporting Company includes:
    - An individual trustee of the trust;
    - An individual with authority to dispose of trust assets;
    - A beneficiary who is the sole permissible recipient of income and principal from the trust;
    - A beneficiary who has the right to demand a distribution of or withdraw substantially all of the assets in the trust;
    - A grantor of the trust who has the right to revoke the trust; and
    - A grantor of the trust who has the right to withdraw the assets of the trust.
  - The rules contemplate an aggregation rule where an individual's ownership interests in a Reporting Company may be taken into account with interests controlled directly or indirectly.
    - If an individual owns 10% of the stock of a Reporting Company and a trust for the individual's benefit owns 15% interest in the Reporting Company (and individual is sole beneficiary), such individual will be considered to own the threshold 25%.
    - The "aggregation rule" may require that all of a trustee's interests in the same Reporting Company be aggregated for purposes of identifying the Beneficial Owner. For example, if three separate trusts each own a 10% interest in a Reporting Company and have the same trustee, the

aggregation rule suggests that the trustee would own a 30% interest and therefore be a Beneficial Owner under the ownership test.

- Applying the Rules to Modern Trust Structures
  - Modern trusts often bifurcate trustee duties. Note that these Heckerling commentaries include detailed notes on such bifurcation in the coverage of Michael Gordon's presentation on directed trusts.
  - Any trustee, direction advisor, protector, designated representative or other individual acting on behalf of the trust (whether a fiduciary under state law or not) who meets the 25% threshold and has the power to dispose of trust assets to a beneficiary and the power to terminate a trust likely brings the individual within the definition of an individual with authority over these decisions.
  - Presenter pointed out the importance of reviewing the trust agreement to be clear about the specific role of each advisor as well as the governing agreements of any entities holding assets within the trust.
  - Other factors that result in sufficient authority include:
    - Voting power;
    - Substantial authority regarding important decisions such as reorganization, major expenditures, loans, compensation of senior officers, amending governing documents and decision-making authority over significant contracts;
    - The right to remove and replace a majority of the board of directors of the Reporting Company;
    - The right to remove senior officers of the Reporting Company;
    - Grantor with right to revoke trust;
    - Beneficiary who is sole permissible recipient of income and principal of the trust and beneficiary owns or controls at least 25% of ownership interests in Reporting Company;
    - A beneficiary who has the right to demand a distribution of or withdraw substantially all of the trust's assets when the

trust and beneficiary own or control at least 25%. This likely includes beneficiaries who have a present power of appointment and a beneficiary holding a Crummey power where the trust is not substantially funded (resulting in power applying to substantial portion of trust property).

- Trustee is not considered to actually own the ownership interest. The Trustee would achieve Beneficial Owner status based on “control” over the ownership interest. If the trustee does not have such control, then it is questionable whether the trustee is a Beneficial Owner at all. The Trustee might also fit within the intermediary exception.
- Beneficiaries
  - A sole current permissible beneficiary of income and principal is a Beneficial Owner if 25% ownership threshold is met. The regs are not clear on whether information must be reported when there are multiple current permissible beneficiaries but this situation likely results in falling within the inheritance exception (mere expectancy).
  - The regs do not address the situation where the beneficiary has only an income interest or only an interest in principal.
  - A beneficiary with a substantial withdrawal power will be a beneficial owner.
- Grantors
  - A grantor with the power to revoke the trust will be a beneficial owner.
  - A grantor who has the right to withdraw assets of the trust is a beneficial owner but it is unclear whether this applies to a grantor with the power to substitute assets.
- Silent Trusts
  - Trustee may have competing obligations.
  - Regs do not address whether a Designated Representative.
- Trusts rotate roles over time and changes may trigger the need to update (change of situs, change of address of trustee or advisor, beneficiary reaching age where beneficiary has power

to control or dispose trust assets, minor coming of age, death of beneficiary or grantor who was beneficial owner).

- Applicability of Exemptions
  - Consider a trust that has a single fiduciary, a bank acting as a trustee, and the trust wholly owns an LLC, which in turn, owns a portfolio of marketable securities and other assets. The LLC is member-managed by the sole member, the trust, by its bank-trustee. The trust itself is not a legal entity and cannot hold legal title to the LLC membership interest. Legal title to the LLC's membership interest is wholly owned by the bank-trustee for the trust. This example potentially illustrates a trust structure that complies with the Subsidiary Exemption.
  - Consider instead the same trust with a member managed LLC and bifurcated trustee duties with the settlor acting as an advisor with the right to sell or distribute the entity interest. Even though a non-exempt person has control, the bank-trustee still owns the entity ownership interest and the Subsidiary Exemption still applies.
  - If instead, the LLC is manager managed by the settlor who created the trust, the grantor would be a senior officer. Notwithstanding, if the LLC qualifies as a CTA-exempt entity under the Subsidiary Exemption based on its membership interest being wholly owned by the bank trustee, the beneficial owner definition is inapplicable because the LLC is not a Reporting Company. In other words, once the Subsidiary Exemption is satisfied, analysis of beneficial ownership is foreclosed.
  - The presenter suggested that it is unlikely that FinCEN intends an interpretation of the Subsidiary Exemption that treats a trust-owned subsidiary as a CTA exempt entity where a non-exempt person controls the ownership interest of the subsidiary. If the trust agreement vests control of investment or distribution decisions in the hands of a direction adviser (who is not a specified CTA-exempt entity) or if the trust agreement gives a non-exempt person the right to remove and replace the trustee, it seems unlikely that the Subsidiary Exemption would be upheld.

The Impact of the CTA on Family Offices and Private Trust Companies

- The definition of family office varies based on who is providing the definition.
- As a generality, a family office is created by a family or families to provide various services such as tax, fiduciary, and compliance needs; investment management, risk management, estate planning, and trust administration; philanthropic advisement, financial education programs for family members; and family governance and wealth transfer planning. The presenter cited Kirby Rosplock, PhD, <u>The Complete Family Office Handbook</u>, (Bloomberg Press 2014) as a resource.
- Family Office Structures
  - Embedded Family Office. This is a family office within a family owned business.
  - Separate Entity. Such entity is funded by service fees paid by family member clients or entities that are being served by the family office entity.
  - Private Trust Company. Certain states allow for the creation of a private family trust company, which can serve as a trustee for trusts and/or as a family office, directly or through a subsidiary.
  - Many family offices are being structured to have the family office take a profits interest in entities holding investments. This structure is based on the results of *Lender Mgmt, LLC v. Comm'r*, T.C. Memo 2017-246 (the "Lender case").
- CTA Implications on Family Office Structures
  - Embedded Family Office. When the family office is embedded in an operating business, the entity to assess for CTA purposes is the operating business. The question is whether the operating business is a Reporting Company, and if so, who are the Beneficial Owners.
  - Separate LLC/Corporation. The standard CTA analysis applies. The family office is likely a reporting company absent applicability of an exemption. Consider the Large Operating Company as a possible exemption. Those rules are discussed earlier in this summary.
  - Private Trust Company. A regulated private family trust company may fall within the bank exemption. An unregulated

private family trust company likely will not. If the bank exemption does not apply, consider other possible exemptions.
    - Lender structure. In this structure, the family office is the management company. Exemptions to consider include the large operating company exemption and the subsidiary exemption (if the entity is a subsidiary of a regulated private family trust company). An additional exemption to consider is that of the pooled investment vehicle.

Ethical Issues on CTA Compliance

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

Take-a-Ways

- Think about CTA compliance before forming entity. Who are Beneficial Owners and how will you get information?
- FinCEN Identification Numbers is key. Require everyone to get them. This way you avoid Reporting Company having to update information. Note that there is no way to terminate or surrender a FinCEN identification number.
- Update governing documents for Reporting Companies regarding transfer of ownership interests. Before you can transfer you must file Beneficial Ownership information or its not a permitted transfer.
- Have processes in place for CTA compliance. Penalties require willful failure so being able to show you had a procedure and that you did your best may help deflect penalties.
- Watch out for Minor becoming adult.
- When in doubt file. There is no penalty for over reporting.

- Applicant who must file. Attorney who directs filing of creation document is a company applicant along with whoever physically files it. You can only have two company applicants. The person who sent it to secretary of state must be one of them.

SLICING AND DICING FIDUCIARY DUTIES TO DIRECTED TRUSTS

Presenter: Michael M. Gordon is a Director at the Wilmington law firm of Gordon, Fournaris & Mammarella, P.A

What Is a Directed Trust?

- A directed trust is a trust that removes one or more powers or discretions traditionally held by the trustee and vests that power or discretion in a person who is either a special trustee or not a trustee at all. The power or discretion can relate to investment decisions, management decisions, distribution decisions and any other decision affecting the administration of the trust. It is important to consider the statutory framework of the state for which the trust is being drafted although it is also important to consider the possibility of a change of situs.
- In a traditional trust structure, the trustee is vested with three trust functions:
    - investment decisions,
    - distribution decisions, and
    - administration (recordkeeping, tax reporting, etc.).
    - A directed trust takes one of these traditional powers and gives it to another trustee.

What Is the Statutory Framework?

- Uniform Trust Code - Section 808(b): "If the terms of a trust confer upon a person other than the trustee of a revocable trust power to direct certain actions of the trustee, the trustee shall act in accordance with an exercise of the power unless the attempted exercise is manifestly contrary to the terms of the trust or the trustee knows the attempted exercise would constitute a serious breach of a fiduciary duty that the person holding the power owes to the beneficiaries of the trust."
- Third Restatement - Section 75 of the Third Restatement of Trusts states: ...[I]f the terms of a trust reserve to the settlor or confer upon

another a power to direct or otherwise control certain conduct of the trustee, the trustee has a duty to act in accordance with the requirements of the trust provision reserving or conferring the power and to comply with any exercise of that power, unless the attempted exercise is contrary to the terms of the trust or power or the trustee knows or has reason to believe that the attempted exercise violates a fiduciary duty that the power holder owes to the beneficiaries.

- Uniform Directed Trust Act - The UDTA has been adopted in 15 states.
    - Section 6 of the UDTA recognizes, that subject to Section 7, (a) the terms of a trust may grant a power of direction to a trust director, and (b) unless the terms of a trust provide otherwise: (1) a trust director may exercise any further power appropriate to the exercise or non-exercise of a power of direction granted to the director; and (2) trust directors with joint powers must act by majority decision.
- The Delaware Model uses the UDTA but has adopted a more detailed version than most states.
- Types of Advisors:
    - Investment Direction Advisor - An Investment Direction Adviser has the ability to direct the trustee with respect to the investment of the trust assets. This is commonly used when a trust is going to hold a concentrated position.
    - Special Holdings Direction Advisor – The use of this type of advisor is typically when there will be a bifurcation of duties with respect to the assets held in trust. This advisor has the ability to direct the trustee as to the special assets while at the same time allowing the trustee to be responsible for the investment and management of the marketable securities held in the trust.
    - Distribution Advisor - A Distribution Adviser who has the ability to direct the trustee when and how the beneficiaries will receive distributions from the trust based on the standards contained in the trust instrument.
    - Trust Protector - The Trust Protector is vested with key powers that will allow the trust instrument to remain flexible as circumstances change over time. Typical duties include the ability to amend the trust for certain purposes, to change the

situs and governing law of the trust, the power to remove, appoint and replace advisors, the ability to convert a trust from grantor trust status to non-grantor trust status, and the power to expand the class of beneficiaries.
    - Author notes that another common advisor is a Charitable Advisor for clients who want to allow for charitable distributions from the trust. This may be designed with a Charitable Advisor (as part of a Distribution Committee) with fiduciary duty and a Charitable Director without fiduciary duty.

Liability and Standard of Care

- Directed Trustees and Direction Advisers
    - UDTA 9(a) - Subject to subsection (b), a directed trustee shall take reasonable action to comply with a trust director's exercise or nonexercise of a power of direction or further power under Section 6(b)(1), and the trustee is not liable for the action. -
    - UDTA 9(b) - A directed trustee must not comply with the trust director's exercise or non-exercise of a power of direction or further power under Section 6(b)(1) to the extent that by complying the Trustee would engage in willful misconduct.
    - UDTA 11(a) - Unless the terms of a trust provide otherwise, a trustee does not have a duty to monitor a trust director; or inform or give advice to a settlor, beneficiary, trustee, or trust director concerning an instance in which the trustee might have acted differently than the director.
- Liability of Direction Advisor
    - UDTA 8(a) - A trust director has the same fiduciary duty and liability in the exercise or nonexercise of the power (A) if the power is held individually, as a sole trustee in a like position and under similar circumstances; or (B) if the power is held jointly with a trustee or another trust director, as a co-trustee in a like position and under similar circumstances; and (2) the terms of the trust may vary the director's duty or liability to the same extent the terms of the trust could vary the duty or liability of a trustee in a like position and under similar circumstances.
    - UDTA 11(b) - Unless the terms of the trust provide otherwise, a trust director does not have a duty to monitor a trustee or

another trust director; or inform or give advice to a settlor, beneficiary, trustee, or another trust director concerning an instance in which the director might have acted differently than a trustee or another trust director.
    - Section 5(a)5 - One issue that often arises is whether a powerholder directing a trustee as to a particular function is serving in a fiduciary or nonfiduciary capacity. The UDTA recognizes the need to permit a trust director to serve in a nonfiduciary capacity but only for federal (not state) tax purposes. Section 5(a)(5) of the UDTA permits the terms of a Trust to provide that a power may be held in a non-fiduciary capacity but 10-8 only when the “power must be held in a non-fiduciary capacity to achieve the settlor’s tax objective under the United States Internal Revenue Code of 1986.
- Delaware Model
    - Liability of Trustee:
        - When a trustee acts in accordance with the directions of a trust direction adviser, the trustee will only be liable for its “willful misconduct”.
    - Liability of Direction Advisor:
        - Absent express language in the governing instrument such adviser is deemed to serve in a fiduciary capacity and will be held to the prudent person standard. However, Delaware law permits a trust agreement to exculpate and indemnify a fiduciary (including an adviser) for all acts other than those committed with willful misconduct.

Estate Planning Uses of Directed Trusts

- The Springing Completed Gift Asset Protection Trust
    - The client will create the trust in a jurisdiction permitting self-settled asset protection trusts.
    - The client will create the trust for the benefit of other beneficiaries (i.e., descendants and possibly spouse).
    - The client will have no retained discretionary beneficial interest in the trust and instead an independent powerholder, such as a Trust Protector, will have the ability to add to the class of

beneficiaries during the client's lifetime which would include the power to add the client as a discretionary beneficiary.

  - Under the "Springing" approach the client would never be added as a beneficiary of the trust if life plays out the way the client anticipates. If unforeseen circumstances arise the Trust Protector could exercise the authority conferred upon the Trust Protector pursuant to the terms of the trust to add the client as a discretionary beneficiary.
  - Presenter's view is that this structure will avoid the risk of inclusion in the grantor's estate.
  - In order for the "Springing" concept to work, the trust not only needs to be created in a jurisdiction allowing for self-settled asset protection trusts but the trust also should be created in a jurisdiction that allows for directed trusts and permits the direction adviser to serve in a non-fiduciary capacity. The power to expand the class of beneficiaries during the client's lifetime should not be held by the trustee as a trustee serves in a fiduciary capacity. Instead, the power should be held by an independent power holder, such as a Trust Protector, serving in a non-fiduciary capacity so as to create the possibility of the power actually being exercised in the future.

- The Incomplete Gift Non-Grantor Trust ("ING")
  - A grantor can establish a trust in a jurisdiction that allows for the creation of self-settled asset protection trusts, retain a beneficial interest in the trust and have the trust treated as a non-grantor trust for income tax purposes. The trust will typically be an incomplete gift for transfer tax purposes.
- Avoiding the Reciprocal Trust Doctrine Through Directed Trusts
  - The reciprocal trust doctrine is a judicially created doctrine developed in response to perceived tax-avoidance strategies where two parties, commonly spouses, create trusts for each other which, practically speaking, allows each lifetime enjoyment over their property while avoiding it being in their gross estate. Under the reciprocal trust doctrine the beneficiary of the trust at issue is deemed to be the transferor of funds into the trust thereby typically negating any tax benefit. For example, if husband and wife were each to create and fund an

identical trust for one another the reciprocal trust doctrine could apply so as to treat husband as being both the grantor and beneficiary of the trust he established and wife as being both the grantor and beneficiary of the trust she established.

- Establishing Differences with Directed Trusts
    - Create different fiduciary and non-fiduciary positions with different duties.
    - Use a springing feature in one of the trusts.
    - Author Note: There are numerous other strategies such as differences in beneficiaries, establishing trusts in different jurisdictions, allowing lapse of time between creation of trusts.

Fiduciary vs. Non-Fiduciary Capacity of Direction Advisor

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

FIDUCIARY CASES

Presenter: Dana C. Fitzsimons, Jr. Mr. Fitzsimons is Managing Director and Senior Fiduciary Counsel at Bessemer Trust.

Trust Accountings

- Salce v. Cardello, 348 Conn. 90 (2023).
    - Trust Accounting required.
    - In terrorem clause. Will said any action removes claimant as a beneficiary.
    - Lawyer made errors on death tax return and refused to fix them.
    - Kids also sued each other.
    - Would violate public policy if beneficiary raises fiduciary errors. The In Terrorem is not enforceable where it would interfere with administration of trust. If brought in bad faith it would be disallowed.
- Estate of Sarah Graham Kenan, 2023 NYLJ LEXIS 962 (Surrogate's Court of New York, New York County 2023).
    - No trust accounting required.
    - Court refused to compel a trust accounting for the time period that was subject to a release agreement signed by beneficiary that included disclosure of the same information that would have been included in the trust accounting.
    - The accounting didn't include a Shareholders' agreement, but beneficiary had negotiated it for five years. This was the same information that would have been included in the trust accounting.
    - Court held it was not in best interests of trust.

Trustee Making Gifts

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

Shortened Period of Liability

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

Distributions

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

SECURE ACT IS NOT A TODDLER ANYMORE

Presenter: Natalie B. Choate. Natalie Choate is an estate planning lawyer, writer, and speaker specializing exclusively in the tax and estate planning treatment of IRAs and other qualified retirement plan accounts.

RMD Rules

- Is death before or after the RBD? This matters a LOT.
- Though SECURE seemed to reduce the differences between the RMD rules for "death before the RBD" and "death after the RBD," the Treasury regulations continue and even increase that difference—with a vengeance. For example, the EDB of a participant who died before his RBD can elect to use the 10-year rule instead of the life expectancy payout. SECURE did not require or even suggest that wrinkle. The EDB of a participant who died after his RBD can't elect the 10-year rule (sorry). A designated beneficiary who is subject to the 10-year rule does not have to take any annual RMDs in years 1-9,

just a 100% distribution in Year10...unless the participant died on or after the RBD, in which case such beneficiary DOES have to take annual RMDs in years 1-9.

- Step one in determining RMDs to the beneficiary of an inherited retirement account is determining whether the participant died before or after his “Required Beginning Date” (RBD).
- Unfortunately, the RBD is a moving target and is different for different types of retirement accounts. Not only is the “Applicable Age” different for people born in different years, an individual can have different “RBDs” for his various retirement accounts—one for his traditional IRA (strictly age-based), another for his Roth IRA (there is no RBD for Roth IRAs), another for his 401(k) plan (where he is still working past the “Applicable Age” and does not own more than 5% of the employer)! Starting in 2024, it will be possible for one individual to have different RBDs for different accounts in the same retirement plan thanks to SECURE 2.0.
    - In 2023, the RBD for a “traditional” [i.e., non-Roth] IRA is April 1 of the year after the year the IRA owner turns age 73 [or 70½ if the participant was born before 7/1/1949, or 72 if born between 7/1/49 and 12/31/1950]. Scheduled to increase to 75 in 2033. Because the age for starting RMDs is now a moving target, the official RBD is now April 1 of the year after the year the participant reaches the Applicable Age (70½, 72, 73, etc.).
    - For a qualified retirement plan (such as a 401(k) plan) the RBD is the same as for an IRA if the participant owns more than 5% of the employer (“5% owner”). For a non-5%-owner, it is April 1 following the later of the year the employee retires from the employer that sponsors the plan or the year the employee attains age 73 [or 70½ if born before 7/1/1949 or 72 if born between 7/1/49 and 12/31/1950].
    - Roth IRAs have no RMDs during the account owner’s life so death is always before the RBD regardless of age. As of 2023, this does not apply to “designated Roth accounts” (DRACs) in a qualified retirement plan, which are subject to the lifetime RMD rules applicable to qualified plans. However, as a result of SECURE 2.0, it will also be true for DRACs starting in 2024, which will create some anomalous results.

Charitable Giving in Trusts

- Traditional retirement benefits are a good asset to leave to charity. Other heirs will have to pay income taxes when they withdraw money from an inherited retirement plan, but a charity, being income tax exempt, collects the full account tax-free.
- The best way to leave a retirement account to charity is to name the charity as beneficiary on your beneficiary designation form. This account goes directly to charity.
- Include language that says: “This gift shall be funded to the maximum extent possible with my IRA or the proceeds thereof.”
- Avoid language referring to “income in respect of a decedent. ”IRD might be considered a class of income and an instruction to fund a charitable bequest with a class of income will not be respected for fiduciary income tax deduction purposes unless it has independent income tax effect.
- The IRS’s position is that transferring the IRA in fulfillment of a pecuniary bequest is treated as a sale of the IRA (which would generate equivalent income at the trust level) and of course there is no DNI deduction for a distribution to charity and no charitable deduction either since these bequests do not meet the requirements of § 642. This IRS position appears to directly violate the Code’s rules for “income in respect of a decedent”; see ¶ 4.6,03 of Life and Death Planning for Retirement Benefits. However, the trustee can shift IRA income to the residuary charitable beneficiary by transferring a $3 million inherited IRA to the charity intact. See FIT Fact # 7 [Appendix A]. Transfer of an IRA to a residuary beneficiary does not trigger realization of income at the trust level. The charity takes over the IRA and cashes it out tax-free because the charity is income tax-exempt.
- SECURE ACT 2.0 – You can have a charity as a remainder beneficiary of a Type 2 AMBT. A Type 2 AMBT is a trust that provides for a beneficiary who is disabled or chronically ill (designated eligible beneficiary).

Separate Accounts

- You need to know prior December 31 account balance.
- You then need to know the factor to use to calculate the RMD.

- All is clear if an IRA is left to one human being as a "designated beneficiary." But what if the retirement account is left to multiple beneficiaries?
    - The IRS has six different rules for determining type of beneficiary (six for dying before RBD and six for dying after RBD).
- To get separate accounts treatment is to divide the account into separate IRAs by the SAD (separate accounts determination date.) The SAD is December 31 after the year in which the account owner died. You have to divide the account equally by the SAD.

Separate Accounts for Retirement Account Through a Trust

- Since 2002, regulations have provided that "...the separate account rules under A-2 of §1.401(a)(9)-8 are not available to beneficiaries of a trust with respect to the trust's interest in the employee's benefit." Reg. § 1.401(a)(9)-4, A-5(c). In other words, "separate accounts" treatment cannot be allowed for multiple subtrusts (or even separate shares distributed outright to different beneficiaries) created under a single trust (called the "funding trust" in this Outline) unless the subtrusts (or shares) were named directly as beneficiaries of the retirement plan. Since SECURE essentially "overruled" this regulation as it would apply to an Applicable Multi-Beneficiary Trust (AMBT), there was some hope that the Treasury would repeal the regulation altogether. The Proposed Regulations did not do so.
- In the case of a trust that qualifies as a designated beneficiary, and that is named as beneficiary, and that "isto be divided immediately upon the death of the employee into separate trustsfor each beneficiary," each subtrust shall be treated as a separate beneficiary if at least one beneficiary of the funding trust is a D/CI individual.
- This section provides that, except as provided for funding trusts where at least one beneficiary is D/CI, "section 401(a)(9) may not be applied separately to the separate interests of each of the beneficiaries of a" See-through Trust.
- Planning tip: Name subtrusts on the beneficiary designation form. The "solution" for this problem is (as before the proposed regulations) for the participant to name, directly as beneficiaries of his retirement account, the separate sub-trusts or beneficiaries intended to wind up

owning the benefits. For example, instead of naming as beneficiary "The Mary Doe Revocable Trust," which immediately upon Mary's death is to split up into three subtrusts, name the subtrusts directly ("I name as my beneficiary the separate trusts established for my children and issue under Article 3 of the Mary Doe Revocable Trust, in the proportions indicated in said Article 3 which is hereby incorporated herein by reference"). If the separate shares or subtrusts are named directly as beneficiary on the beneficiary designation form, then they are entitled to separate accounts treatment, provided the accounting requirements (Prop. Reg. § 1.401(a)(9)-8(a)(2)) and deadline requirement (Prop. Reg. § 1.401(a)(9)-8(a)(1)(ii)) are met.

Dealing With Surviving Spouse

- Although the general rule is that a beneficiary who is required to take life-expectancy-based RMDs must commence such RMDs the year after the year of the participant's death, there is a special rule for the surviving spouse. If the participant died before his first "distribution year" (the age for starting RMDs) the spouse is not required to commence distributions until the later of the year after his death or the year in which he would have reached the "Applicable Age". § 401(a)(9)(B)(iv); Prop. Reg. § 1.401(a)(9)-3(d).
- Unlike other EDBs, the surviving spouse's life expectancy is recalculated annually. The effect of this is to extend the life expectancy, since the life expectancy is not reduced by one year each year; life expectancy extends as the individual lives longer (ask your neighborhood actuary how this works). Because the S/S's life expectancy is recalculated annually, the S/S (while living) will not be required to withdraw 100% of the inherited account until she reaches age 120, when the life expectancy finally drops to one year or less. Thus, unlike other EDBs, the S/S cannot outlive her own life expectancy—unless she lives to age 120.
- The surviving spouse's right to roll over retirement benefits payable to her from an inherited plan or IRA was not changed by SECURE. Briefly, as a reminder, the spousal rollover is not a "minimum distribution" rule; it is a totally separate Code section and concept, so it is not subject to various limitations that can arise under the minimum distribution rules.

- Also, there is no requirement that the spousal rollover occur within a certain time after the participant's death. It could occur one, five, or 10 years after his death or even later.
- Suppose the surviving spouse is approaching or past age 72. If the participant-spouse died before his RBD, and the S/S elects the 10-Year Rule [see #4(C) in this PART 3], then the S/S could effectively delay RMDs for about nine years, then in year 9 of the 10-year payout roll over the inherited account to the S/S's own IRA, thus sidestepping several years of RMDs. Prop. Reg. § 1.402(c)-2(j)(3)(iii) blocks this maneuver: A S/S's rollover, if it occurs in any year after the year she turns age 71, must be reduced by a deemed RMD amount—the cumulative total of what would have been RMDs if the account had belonged to her during the delayed rollover period.
- What if surviving spouse does not roll over an inherited IRA?
- Old Rule: RMDs based on life expectancy based on deceased spouse's age and no RMDs required until decedent would have turned 73.
- New Rule: Spouse subject to same requirement to take distributions in year after decedent's death unless spouse rolls over into inherited IRA.
- **HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!**

- Mary Vandenack
- Martin Shenkman
- Joy Matak

CITE AS: