RECENT DEVELOPMENTS:

SELECTED FEDERAL AND ILLINOIS CASES, RULINGS AND STATUTES

Chicago Estate Planning Council

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FEDERAL STATUTES, REGULATIONS, AND ADMINISTRATIVE MATTERS

A. **Rev. Proc. 2020-45 (October 26, 2020)** sets forth the inflation-adjusted figures for exclusions, deductions, and credits for 2021. In the estate and gift tax area the figures contained in Rev. Proc. 2020-45 are the following:

• Applicable Exclusion Amount:	Increases to $11,700,000
• Annual Exclusion:	Stays at $15,000
• Foreign Spouse Annual Exclusion:	Increases to $159,000
• §2032A Aggregate Decrease Limit:	Increases to $1,190,000
• §6601(j) 2% Amount:	Increases to $1,590,000
• §6039F Gifts From Foreign Persons:	Increases to $16,815
• 37% Bracket for Trusts and Estates:	Income over $13,250 (up $300)

B. **Follow Up On Tax Cuts and Jobs Act**

1. **Excess Deductions or Losses at Termination of Estate or Trust**. (**Executor or Trustee Fees and Other Miscellaneous Estate or Trust Expenses.) Notice 2018-61, 2018-31 I.R.B. 278 (July 13, 2018); Proposed Regulations, REG-113295-18, May 11, 2020; Final Regulations, TD9918, RIN 1545-BO87, September 21, 2020**

The Tax Cuts and Jobs Act introduced new § 67(g), which states that "[n]otwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026." Section 642(h)(2) provides that on the termination of an estate or trust, any deductions for the last taxable year of the estate or trust (other than the deduction in lieu of personal exemptions and other than the charitable deduction) in excess of gross income for the year shall be allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust. These deductions for individual beneficiaries are miscellaneous itemized deductions, and therefore their deduction seemed to be not allowed for 2018-2025 under new §67(g).

However, in Notice 2018-61 (July 13, 2018), entitled "Clarification Concerning the Effect of Section 67(g) on Trusts and Estates," the IRS wrote:

> The Treasury Department and the IRS are studying whether section 67(e) deductions, as well as other deductions that would not be subject to the limitations imposed by sections 67(a) and (g) in the hands of the trust or estate, should continue to be treated as miscellaneous itemized deductions when they are included as a section 642(h)(2) excess deduction.

Then, on May 11, 2020, the Treasury issued proposed regulations on excess deductions for an estate or trust. Under the proposed regulations, an excess deduction on termination of an estate or trust allowed in arriving at adjusted gross income (i.e., a § 67(e) deduction) is reported as an adjustment to income on Forms 1040, 1040-SR, and 1040-NR. Non-

miscellaneous itemized deductions are reported, as applicable, on Schedule A (Form 1040 or 1040-SR) or Schedule A (Form 1040-NR); and miscellaneous itemized deductions are not deductible.

For tax year 2019, an excess deduction for IRC § 67(e) expenses is reported as a write-in on Schedule 1 (Form 1040 or 1040-SR), Part II, line 22, or Form 1040-NR, line 34. On the dotted line next to line 22 or line 34 (depending on which form is filed), enter the amount of the adjustment and identify it using the code "ED67(e)". Include the amount of the adjustment in the total amount reported on line 22 or line 34.

For tax year 2018, an excess deduction for IRC § 67(e) expenses is reported as a write-in on Schedule 1 (Form 1040), line 36, or Form 1040-NR, line 34. On the dotted line next to line 36 or line 34, (depending on which form is filed), enter the amount of the adjustment and identify it using the code "ED67(e)". Include the amount of the adjustment in the total amount reported on line 36 or line 34.

On September 21, 2020, the Treasury issued final regulations, which adopt the proposed regulations with few changes. The final regulations clarify that certain expenses incurred by, and certain excess deductions upon the termination of, an estate or nongrantor trust are not affected by the suspension of miscellaneous itemized deductions for tax years 2018 through 2025. The following deductions are allowable in figuring adjusted gross income and are not miscellaneous itemized deductions:

- Deductions for costs paid or incurred in connection with the administration of the estate or trust which would not have been incurred if the property were not held in such estate or non-grantor trust.
- The deduction concerning the personal exemption of an estate or non-grantor trust.
- The distribution deductions for trusts distributing current income.
- The distribution deductions for trusts accumulating income.

The final regulations also provide guidance on determining the character and amount of, as well as the manner for allocating, excess deductions that beneficiaries succeeding to the property of a terminated estate or non-grantor trust may claim on their individual income tax returns. These provisions remain unchanged from the proposed regulations, and require the division of final year deductions into three categories: (1) amounts allowed in arriving at AGI (i.e., above-the-line deductions), (2) non-miscellaneous itemized deductions that are not subject to the 2% limitation (e.g., state and local taxes), and (3) miscellaneous itemized deductions.

Fiduciaries will be required to categorize the excess deductions into one of those three categories. The character and amount of the excess deductions is determined by allocating the deductions among the trust or estate's income as provided under IRC §652. Those regulations provide that all deductible expenses directly attributed to a certain class of income are allocated to that class of income, and that deductions which are not directly attributable to one class of income may be allocated to any item of income at the trustee's

discretion provided that a proportionate amount of the deduction is allocated to tax-exempt income, as applicable.

The instructions for the 2019 Form 1041 now provide:

> **Excess deductions on termination.** If the estate or trust has for its final year deductions (excluding the charitable deduction and exemption) in excess of its gross income, the excess is allowed as an itemized deduction to the beneficiaries succeeding to the property of the estate or trust. In general, an unused NOL carryover that is allowed to beneficiaries (as explained above) can't also be treated as an excess deduction. However, if the final year of the estate or trust is also the last year of the NOL carryover period, the NOL carryover not absorbed in that tax year by the estate or trust is included as an excess deduction. See the instructions for Schedule K-1 (Form 1041), box 11, code A, later.
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> **Special rules.** In the final year of an estate or trust, deductions in excess of income may be reported to the beneficiary on Schedule K-1, box 11. These deductions may also be deductible by the beneficiary for NIIT purposes. In this situation, the terminating estate or trust should provide the beneficiary information regarding whether the amounts reported in box 11, codes A through D, include any amounts that are deductible for NIIT purposes. See Regulations section 1.1411-4(g)(4).

2. Carried Interest Regulations. Proposed Regulations, REG-107213 (July 31, 2020); Final Regulations, (January 7, 2021).

The enactment of § 1061 as part of the Tax Cuts and Jobs Act changed the treatment of carried interests. After issuing proposed regulations last July, the Treasury issue final regulations under § 1061 on January 7, 2021. Section 1061 is generally intended to limit long-term capital gain treatment attributable to “carried interest” arrangements issued to owners and employees of private fund sponsors by imposing a three-year holding period requirement in lieu of a one-year holding period requirement.

The three-year holding period requirement applies to “applicable partnership interests” (“API”), which are generally defined as any interest in a partnership that, directly or indirectly, is transferred to (or held by) a taxpayer in connection with the performance of substantial services by the taxpayer, or a related person, in an “applicable trade or business.” An “applicable trade or business” is generally a trade or business that consists, in whole or in part, of raising or returning capital, and either investing in (or disposing of) certain investment assets—such as securities, commodities and real estate. Section 1061 provides for several exclusions from the definition of an API, including for capital interests in partnerships that are commensurate with contributed capital (Capital Interest Exception) and for partnership interests that are held by corporations (Corporate Holder Exception).

The basic definition of API under the Final Regulations remains broad. As expected, APIs include "carried interest" or "incentive allocations" used in typical private investment fund arrangements, as well as profits interests issued in connection with management fee waiver arrangements. Given how broadly an applicable trade or business is defined and the presumption that services are substantial, APIs may also include many other carried interest and profits interest arrangements granted to other persons, such as managers or developers who provide services to multiple asset-specific joint ventures that own specified assets.

The final regulations broaden the application of the Capital Interest Exception. Whereas the proposed regulations provided that the Capital Interest Exception only applied to the extent gain was allocated in proportion to the relative value of the holder's capital account balance (as determined under Section 704(b)), the final regulations look to whether allocations are made in a "reasonably consistent" with the allocation and distribution rights that apply to the capital invested by unrelated nonservice providers (such as third-party investors in a fund) who hold at least 5% of the capital contributed to the partnership. The final regulations also provide that typical differences between a general partner's capital interest and a fund investor's capital interest (such as a general partner's right to tax distributions and the general partner not being subject to certain expenses, such as charges for management fees) will not cause a general partner's capital interest to fail to qualify for the Capital Interest Exception.

The final regulations loosen the restrictions on the acquisition of capital interests with loan proceeds. Under the proposed regulations, capital interests financed by loans from the partnership, another partner or related person could not qualify for the Capital Interest Exception—thereby severely restricting the ability of individual members of the general partner from borrowing in order to fund a capital interest. The final regulations allow a capital interest that is financed with a loan from a partner or related person (but not the partnership) to qualify for the Capital Interest Exception if (1) the loan is fully recourse to the individual service provider, (2) the service provider has no right to reimbursement from another person and (3) the loan is not guaranteed by another person.

Under a special "look-through" rule in the Final Regulations, a sale of an API that has been held for more than three years may still be subject to recharacterization under Section 1061 based on the holding period of the underlying partnership assets. This look-through rule applies if either (1) the taxpayer's holding period in the API would be three years or less if it did not include any period before the date on which any unrelated non-service partners were required to commit substantial amounts of money or property to the partnership, or (2) a series of transactions has taken place with a principal purpose of avoiding the recharacterization rules of Section 1061. The look-through rule is intended to prevent sponsors from setting up a dormant carry vehicle in advance of raising capital in order to claim a longer holding period in the interests issued by the vehicle. This is a more limited application of the look-through rule contained in the proposed regulations, which applied a "substantially all" test.

The final regulations limit the acceleration of gain on certain transfers of APIs to related persons. Under the proposed regulations, recognition of gain would be accelerated upon all transfers of an API, even non-taxable transfers (including gifts). The final regulations narrow

the application of the acceleration rule so that it generally only applies to a taxable transfer of an API.

The final regulations maintain some features as they were contained in the proposed regulations. The final regulations confirm that the three-year holding period under Section 1061 applies only to gains that are characterized as either long-term or short-term under Section 1222 and do not apply to gain determined under Sections 1231 (gain on the sale of property used in an active trade or business) and 1256 (mark-to-market gains from futures and options contracts).

The final regulations, consistent with the proposed regulations, provide that partnership interests held by subchapter S corporations or PFICs with QEF elections do not qualify under the Corporate Holder Exception.

The final regulations retain the additional reporting requirements on taxpayers who directly or indirectly hold APIs, as well as partnerships that issue APIs, that were imposed by the proposed regulations. Failure to adhere to these reporting requirements can result in penalties and recharacterization of gain recognized with respect to an API. The final regulations also continue to require that capital interest allocations be clearly identified under the partnership agreement and in the partnership's books and records (reflected contemporaneously) as separate and apart from allocations made to holders of APIs.

Consistent with Section 1061 and the Proposed Regulations, the Final Regulations adopt the exception for interests transferred to a person who is only providing services for an entity that is not engaged in an applicable trade or business. This rule may permit profits interests granted to employees of portfolio companies that conduct typical operating businesses to avoid the application of the three-year holding period requirement.

Both the Proposed Regulations and the Final Regulations reserve guidance on the application of Section 1061(b), which authorizes Treasury to establish an exception to the application of Section 1061 for gain attributable to any assets not held for portfolio investment on behalf of third-party investors (the “Family Office Exception”).

C. Coronavirus Aid, Relief and Economic Security Act (“CARES Act”) (March 27, 2020)

On March 27, 2020, President Donald Trump signed into law the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act). This outline discusses some provisions of particular importance to tax and estate planning (not PPP, not unemployment insurance provisions, not direct payments, etc.).

1. Retirement Plan Changes

The CARES Act makes two important changes with respect to retirement plans:

a. Waiver of Required Minimum Distribution Rules.

The Act waives required minimum distributions from defined contribution plans (such as 401(k) plans) and Individual Retirement Accounts (IRA's). This includes distributions that would have been required by April 1, 2020, due to the account owner having reached age 70 ½ in 2019.

b. "Coronavirus-related Distributions"

The ten percent penalty for early distributions from defined contribution plans and IRA's is waived for distributions made between January 1, 2020 and December 31, 2020 if certain requirements are met. The penalty-free distributions cannot exceed $100,000. They are limited to individuals who himself or herself or whose family is infected with the Coronavirus or who is economically harmed by the Coronavirus. The taxable income from the distributions is spread out over three years (unless the recipient opts out of the three year spread). If certain guidelines are met, the penalty-free distributions may recontributed to the plan or IRA during that same three-taxable-year period without regard to the typical limits on rollovers and plan contributions.

2. Tax and Debt Provisions

a. Delays in payment of employer payroll taxes. Allows employers to defer payment of the employer share of the Social Security tax with respect to their employees. The provision requires that the deferred employment tax be paid over the following two years.

b. Modifications for net operating loss. Provision provides that a loss from 2018, 2019, or 2020 can be carried back five years and temporarily removes the taxable income limitation to allow an NOL to fully offset income.

c. Modification of limitation on business interest. Temporarily increases the amount of interest expense businesses are allowed to deduct on their tax returns, by increasing the 30-percent limitation to 50 percent of the taxable income (with adjustments) for 2019 and 2020.

d. Fixes treatment of qualified improvement property. Enables businesses, especially in the hospitality industry, to write off immediately costs associated with improving facilities instead of having to depreciate those improvements over the 39-year life of the building.

e. Modification to the AMT. The provision accelerates the ability of companies to recover those AMT credits.

f. Temporary Relief from Troubled Debt Restructurings. Financial institution or federally-insured credit union may elect to suspend requirements under U.S. Generally Accepted Accounting Principles for loan modifications related to the coronavirus pandemic.

g. Creates a refundable payroll tax credit for 50 percent of wages paid by employers to employees during the COVID-19 crisis. The credit is available to employers whose (1) operations were fully or partially suspended, due to a COVID-19-related shut-down order, or (2) gross receipts declined by more than 50 percent when compared to the same quarter in the prior year. The credit is available for up to the first $10,000 of compensation, with a maximum credit of $5000 per employee.

- For employers with more than 100 full-time employees, credit is for employees that were not providing services during the shut-down. For employers with less than 100 full-time employees, all employees' wages qualify for the credit whether they were open or shut-down during the outbreak.

h. Employers can provide a student loan repayment program on a tax-free basis. Employer may contribute up to $5,250 annually toward employee student loan and such a payment is not taxed.

3. Provisions for Charitable Contributions

a. Expanded Qualified Charitable Contributions.

New §62(a)(22) provides that for 2020 only, up to $300 in "qualified charitable contributions" made by an "eligible individual" may be deducted in computing adjusted gross income. Under prior law, all charitable contributions were "below-the-line," itemized deductions; a taxpayer could only deduct charitable contributions by foregoing the standard deduction. Now, up to $300 in donations may be taken "above the line" in determining adjusted gross income, meaning a taxpayer can claim both the standard deduction and up to $300 in charitable contributions for 2020. However, the $300 limit applies to the tax-filing unit. Thus, married taxpayers who file a joint return are allowed a total of $300 in qualified charitable contributions.

New §62(f)(2) defines a qualified charitable contribution as one made in *cash* in 2020 to a public charity and not to a supporting organization or donor advised fund. It does not include carryover deduction amounts from donations made in prior years. Importantly, a qualified charitable contribution does not require any connection between the coronavirus and either the charity or the use to which the donation is put. And new §62(f)(1) defined an eligible individual as "any individual who does not elect to itemize deductions." So, if the taxpayer itemizes, the entire donation is taken below the line as an itemized deduction.

b. Increased Contribution Base.

Under prior law, the total itemized deduction a taxpayer could claim for cash contributions in any one taxable year was limited to 60 percent of the taxpayer's "contribution base, generally defined to mean the taxpayer's adjusted gross income with some modifications. For 2020 only, this limitation on cash contributions does not apply at all to "qualified charitable contributions," meaning an individual who itemizes may deduct qualified charitable contributions up to 100 percent of the taxpayer's contribution base.

Prior law also limited the total charitable contribution deduction for corporations generally to 10 percent of the corporation's modified taxable income. For qualifying contributions made in 2020, the limit is raised to 25 percent of the corporation's modified taxable income. No connection between the contributions and COVID-19 activities is required.

D. 2020-21 Priority Guidance Plan.

On November 17, 2020, Treasury and the Internal Revenue Service released their joint priority guidance plan for July 2020 – June 2021 ("Plan"). The Plan is again broken into six Parts, liked last year's Plan (up from four Parts in the 2018-19 Plan). but there are six Parts in this year's plan, up from four Parts last year. Part 1 is "Implementation of the Tax Cuts and Jobs Act (TCJA)". Part 2 is "Identifying and Reducing Regulatory Burdens" – has been in the priority guidance plan since 2017-18, and originally focused on the eight regulations from 2016 that were identified pursuant to Executive Order 13789 (regarding identifying and reducing regulatory burdens) and intended actions with respect to those regulations. It is now down from the original eight projects to three (there were four last year). Part 3 is "Burden Reduction." Part 4 "Taxpayer First Act Guidance." Part 5 is entitled "Bipartisan Budget Act of 2015 – Partnership Audit Regulations." What is now Part 6, in line with past years' plans and the Service's long-standing commitment to transparency in the process, provides "General Guidance."

1. Implementation of the 2017 Tax Act

Part 1 of the 2018-2019 Plan, titled "Implementation of Tax Cuts and Jobs Act (TCJA)," contains 38 items, compared to 52 items last year and 62 in the 2018-19 plan.

Trust and Estate Administration Expenses. Item 4 of Part 1 is described as "Regulations clarifying the deductibility of certain expenses described in §67(b) and (e) that are incurred by estates and non-grantor trusts." These final regulations were released September 21, 2020 (discussed above).

Qualified Business Income. Item 18 of Part 1 is entitled "Regulations and other guidance under §199A for cooperatives and their patrons." The Plan notes that proposed regulations were published on June 19, 2019 and that Notice 2019-27 (methods for calculating W-2 wages) was published on July 29, 2019.

Carried Interests. Item 30 of Part 1 is entitled "Regulations addressing partnership interests held in connection with the performance of services under §1061." The Plan notes that proposed regulations were published on August 14, 2020. These are discussed above, along with the final regulations published in January, 2021.

2. Identifying and Reducing Regulatory Burdens

Part 2 of the Plan, titled "Identifying and Reducing Regulatory Burdens," was Treasury's response to Executive Order 13789 of April 21, 2017, and is down to three projects. This was the part of the plan pursuant to which the regulations under Section 2704, that had been published in August 2016, were withdrawn, and that item has not appeared since the 2018-19 Plan.

3. Burden Reduction

Part 3 of the Plan, "Burden Reduction," is back up to 25 projects, after having been reduced from 20 to 14 projects in last year's plan. Some projects that may be of special interest to estate planners:

10. Final regulations streamlining the § 754 election statement. Proposed regulations were published on October 12, 2017.
14. Final regulations under §§1014(f) and 6035 regarding basis consistency between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016.
18. Final regulations under §2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption.

These Items have been in the Plan for years (and not yet completed). To fulfill the "burden reduction" promise, the final regulations for Items 14 and 18 should provide some relief – for example, relief from harsh rules like the 30-day due date in the consistent basis regulations and some relief from the requirements for affidavits in the 2642(g) regulations.

4. Taypayer First Act Guidance

5. Bipartisan Budget Act of 2015 – Partnership Audit Regulations

6. General Guidance

Part 6 is entitled "General Guidance" and is divided into traditional subject areas. Five items appear under the heading of "Gifts and Estates and Trusts":

1. Guidance on basis of grantor trust assets at death under § 1014.
2. Guidance on user fee for estate tax closing letters under § 2001.

3. Regulations under § 2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period. Proposed regulations were published on November 18, 2011. (The word "Final" has been removed from the beginning of this item).
4. Regulations under § 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
5. Regulations under § 7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests.

Items 1, 3, and 4 have been in the priority guidance plan for several years now. Although Item 1 is intriguing, any good news it may offer is likely to be limited to trusts created by non-U.S. persons. It is described only as "guidance," not "regulations," suggesting that this project may produce only, for example, a revenue ruling. That in turn implies that the guidance will not radically extend the step-up in the basis of appreciated assets as we know it. Treasury would presumably use a regulation for that.

Items 3 and 4 both reflect Treasury's responses to public criticism of previously proposed regulations. Item 3 – referred to as "anti-*Kohler*" regulations, addresses regulations under Section 2032(a) that were proposed in 2008 and then reproposed in 2011 to take a new approach to distributions and other transactions within six months after death that might affect estate tax value.

Regulations under Section 2053 were proposed in 2007 and then finalized in 2009 with §20.2053-1(d)(6) reserved to eventually address present value concepts differently from the 2007 proposed regulations. Both new approaches were prompted by criticism of the original proposed regulations in the public comments.

Item 5 was new in the 2018-2019 Plan. The current mortality tables, based on 2000 census data, became effective May 1, 2009, and Section 7520(c)(2) mandates revision of the tables at least once every ten years. New actuarial tables were proposed in November, 2019 (see 84 FR 60812, November 8, 2019), and will likely take effect in 2021. A comment period closed on January 7, 2020 and a public hearing took place on January 23, 2020. The explanation of revisions in the proposed rulemaking provides as follows:

> The life expectancy tables and applicable distribution period tables in the proposed regulations reflect longer life expectancies than the tables in the existing regulations that are generally between one and two years longer than under the existing regulations.

FEDERAL TRANSFER TAX CASES AND RULINGS

A. Valuation

1. *Grieve v. Commissioner*, T.C. Memo. 2020-28 (March 2, 2020)

Tax Court repudiates IRS valuations that assumed the voting interest would also be acquired in the same transaction.

In 2013 the taxpayer made two gift transfers. The first was a transfer of a 99.8-percent nonvoting interest in Rabbit LLC, an entity that owned just over $9.1 million in cash and marketable securities, to a two-year grantor-retained annuity trust (GRAT). The second was a transfer of a 99.8-percent nonvoting interest in Angus LLC, a different entity that owned over $31.9 million in cash and marketable securities, to an irrevocable trust in exchange for private annuity worth just over $8 million.

On his 2013 federal gift tax return, the taxpayer reported a taxable gift of zero for the transfer of Rabbit units and a taxable gift of nearly $10 million for the transfer of Angus units. These numbers were based on appraisals that valued the nonvoting units in Rabbit at just over $5.9 million and the nonvoting interests in Angus at nearly $20.9 million. But the Service determined that the nonvoting interests in Rabbit were worth just over $9 million and the nonvoting interests in Angus were worth nearly $31.9 million.

The valuation adjustment for the Rabbit units was no big deal since the Service agreed that no gift tax would be due if the size of the annuity payments from the GRAT is adjusted to reflect the higher valuation. But the valuation adjustment to the Angus units changed the value of the net gift from nearly $10 million to about $17.8 million.

The taxpayer challenged this determination in the United States Tax Court. Both sides came equipped with new and improved appraisals at their sides. The taxpayer's expert conclude the value of the transferred Rabbit interest was in fact only $5.88 million and the value of the transferred Angus interest was $19.85 million. But the Service's expert claimed the value of the transferred Rabbit interest was $8.9 million and the value of the transferred Angus interest was just over $31.4 million. It was thus up to the court to figure out the "true" values.

The Tax Court did not like the reasoning of the Service's expert that a willing buyer of a 99.8-percent nonvoting interest would necessarily also purchase the 0.2-percent voting interest in order to protect the investment in the large nonvoting interest. The court believed testimony from the taxpayer's daughter, the sole shareholder and manager of the corporation that owned the voting interests in each entity, that she has no plan to sell her interest and that if she ever did she would demand a substantial premium. She also testified that if the nonvoting interests were ever sold outside the family, she would demand a fee for managing the entities. The court held it was thus improper to factor in the value of the 0.2-percent voting interest. It went on to find that the taxpayer's expert used an appropriate valuation method that had been approved in prior cases and that the discount ranges used by the

taxpayer's expert were also in line with those used by the court in earlier cases. It thus adopted the valuations reported by the taxpayer's expert.

B. Inclusion in Gross Estate

1. *Badgley v. United States*, 957 F.3d 969 (Ninth Circuit, April 28, 2020).

Full value of GRAT assets included in estate of grantor who died during the GRAT term.

The *Badgley* case is also a case previously reported on in these materials. The Northern District of California decision was issued May 17, 2018.

On February 1, 1998, Patricia Yoeder created a grantor retained annuity trust. She was to receive annual annuity payments for the lesser of 15 years or her prior death in the amount of 12.5% of the date of gift value of the property transferred to the GRAT. The GRAT was to pay her an annual annuity of $302,259 in quarterly installments. Upon the end of the annuity term, the property was to pass to Patricia's two living daughters. The GRAT also stated that, if the trustor failed to survive the trust term, the trustee was to pay all the remaining annuity amounts and the portion of the trust included in the trustor's estate to the survivor's trust created under Patricia's revocable trust.

Patricia died on November 2, 2012, three months before the end of the 15-year annuity term. The last payment she had received from the GRAT was a quarterly payment on September 30, 2012, in the amount of $75,564.75.

The federal estate tax return reported a gross estate of $36,829,057, including the value of the assets held in the GRAT. The estate paid federal estate taxes of $11,187,457. On May 16, 2016, the estate filed a claim for refund seeking $3,810,004 in estate tax overpaid by the estate as a result of the inclusion of the full value of the GRAT. The case was before the court on cross-motions for summary judgment from the Government and the estate.

Pursuant to Section 2036(a)(1), the Government asserted that the grantor retained "the right to the income from" the property she transferred to the GRAT because of her right to the annuity payments. The Government also asserted that the grantor retained the "possession or enjoyment of" the property she transferred to the GRAT under Section 2036(a)(1) because of her control over the activities of the partnership.

The Estate asserted that there is no statutory or judicial authority for the proposition that a fixed-term annuity payable out of transferred property constitutes the possession, enjoyment or right to income under Section 2036(a)(1). The Estate believed that this annuity interest is not the same as a "right to income" under Section 2036(a)(1) and that therefore the grantor's interest in the GRAT was not within the scope of the statute.

Although the District Court (Judge Gilliam) agreed that no authority equates a fixed-term annuity with a "right to income" or "possession or enjoyment" under Section 2036(a)(1), it stated that "the U.S. Supreme Court has adopted a substance-over-form approach that favors a finding that Patricia's annuity comprises some possession, enjoyment, or right to income from the transferred property," citing *Helvering v. Hallock*, 309 U.S. 106 (1940); *Commissioner v. Church's Estate*, 355 U.S. 632 (1949); *Spiegel's Estate v. Commissioner*, 335 U.S. 701 (1949). The court explained that the language of the statute has been broadly interpreted, and that technical distinctions based on property law are not dispositive of whether the statute applies. The court also stated that Section 2036 was enacted to prevent taxpayers from avoiding estate tax through lifetime transfers that were testamentary in nature, and that concluding that an annuity right is not covered by Section 2036(a)(1) would circumvent that intent. The court therefore found that an annuity right and a right to income were not distinct for purposes of Section 2036. The court further concluded that the grantor's access to income from the partnership constituted the retained "possession or enjoyment" of the transferred property.

The Estate also argued that Treas. Reg. 20.2036-1(c)(2) was overly broad and invalid to the extent it applies to the GRAT. Although Section 2036 does not expressly refer to an annuity right, the regulations under this section interpret this section as causing an annuity right to trigger inclusion in the gross estate. Reg. §20.2036-1(c)(2)(i) states that it "applies to a grantor's retained use of an asset held in trust or a retained annuity … including without limitation … a grantor retained annuity trust (GRAT) paying out a qualified annuity interest within the meaning of §25.2702-3(b) …." The District Court stated that the primary issue to resolve was whether the regulation was "arbitrary or capricious in substance, or manifestly contrary to the statute." *Mayo Found. For Med. Educ. & Research v. United States*, 562 U.S. 44 (2011). The court reviewed the Treasury Decision promulgating this regulation and concluded that it was a reasonable interpretation of Section 2036 and therefore valid.

The Ninth Circuit affirmed the district court's granting of summary judgment to the IRS, starting its opinion by noting that "thanks to Benjamin Franklin, death and taxes are inextricably linked in most American minds as the only two things in the world that are certain." It then explained that Section 2036(a) was the response of Congress to the attempts of taxpayers to avoid the estate tax by using a variety of legal mechanisms to transfer property during their lifetimes while holding onto the fruits of that property. The presence of one or more of three strings -- possession, enjoyment, or the right to income – would cause estate inclusion. The issue for the Ninth Circuit was whether Patricia's annuity interest in the GRAT was a sufficient string to cause the inclusion of the GRAT in Patricia's estate.

The Ninth Circuit first addressed the estate's argument that because Section 2036(a)(1) does not contain the term "annuity," that section does not unambiguously apply to annuities. The Ninth Circuit disagreed. Congress instead instructed courts to look at the results – possession, enjoyment, or the right to income – rather than the form those strings took. Citing *Commissioner v. Church's Estate*, 335 U.S. 632 (1939), the Ninth Circuit rejected the estate's argument that because Section 2036(a)(1) does not mention annuities, the full value of Patricia's annuity could not be included in Patricia's estate.

The Ninth Circuit then moved to main issue of whether the annuity flowing from a GRAT fell within the class of will substitutes to which Section 2036(a)(1) applies. The estate argued that a "fixed-term annuity" was not the same as a right to income or some other form of possession or enjoyment as required by Section 2036(a)(1). The Ninth Circuit concluded that deriving a substantial economic benefit from property is sufficient for the application of Section 2036(a)(1). In turn, Patricia's annuity from the GRAT was a substantial economic benefit.

The Ninth Circuit that rejected the estate's attempt to say that the Supreme Court disavowed a "substance over form" argument in *United States v. Byrum*, 408 U.S. (1972), by noting that *Byrum* stated that enjoyment connoted a substantial economic benefit. Moreover, its interpretation of Section 2036(a)(1) was within the meaning of the text of that section. The Ninth Circuit then quotes various commentators with respect to the manner in which GRATs work, suggesting that these commentators understand the mortality risk associated with GRATs.

Regarding the estate's challenge to the part of Treas. Reg. 20.2036-1(c)(2) that provides the formula for the calculation of the property includable under Section 2036(a), the Ninth Circuit noted that the argument on this issue was limited to two sentences and two footnotes. The cursory manner in which the argument was made waived the argument under the Federal Rules of Appellate Procedure 28(a)(8)(A). Even if the argument was not waived, it would not apply to this case. Badgley argued that the formula was flawed because it assumes that the annuity payment will come entirely from the GRAT's income, rather than contemplating the amortization of principal. But, according to the court, "she does not argue that the Decedent's annuity contemplated the amortization of principal." Badgley also contended that formula might be arbitrary if it was applied to a short-term GRAT that contemplates the amortization of principal, which was not the case here.

COMMENT: In *Badgley*, the court relied on the language of section 2036 and cases interpreting that section, and the provision in Treas. Reg. 20.2036-1(c)(2)(i) providing that if "a decedent transferred property into a [GRAT] and retained or reserved the right to use such property, or the right to an annuity, unitrust, or other interest in such trust with respect to the property decedent so transferred for decedent's life…, then the decedent's right to … the retained annuity, unitrust, or other interest (whether payable from income and/or principal) constitutes the possession or enjoyment of, or the right to the income from, the property for purposes of section 2036," in holding that the entire value of the GRAT was included in Ms. Yoeder's estate. There is no indication that the court attempted to calculate the result of the formula contained in the remaining portion of Treas. Reg. 20.2026-1(c)(2)(i).

The taxpayer's summary argument regarding the validity of the part of Treas. Reg. 20.2036-1(c)(2)(i) that provides the formula for determining the portion of a GRAT included in a decedent's estate is interesting, particularly as it relates to a ***non-zeroed out*** **GRAT**, in which case it appears the result would often be inclusion of the entire trust principal in the estate of the grantor, even if a portion of the grantor's transfer to the GRAT was treated as a taxable gift. See the example below of a 2-year GRAT, in which the grantor dies after year one. Because the regulations do not, in fact, consider the amortization of principal, a $1,000,000

transfer to a GRAT for a 2-year term, would result in the entire value of the GRAT up to the sum of $75,675,000 being included in the grantor's estate.

Example GRAT Calculation:

Transfer Date:	2/2021
§7520 Rate:	0.60%
Term:	2 years
Payment Period:	Annual
FMV:	$1,000,000
Percentage Payout:	45.405000%
Income Earned by Trust:	3.00%
Annual Growth of Principal:	4.00%

Annual Annuity Payout:	$454,050.00
Value of Grantor's Retained Annuity Interest:	$899,972.51
Taxable Gift (Based on Term Interest):	$100,027.49

Economic Schedule

Year	**Beginning Principal**	**4.00% Growth**	**3.00% Annual Income**	**Required Payments**	**Remainder**
1	$1,000,000.00	$40,000.00	$30,600.00	$454,050.00	$616,550.00
2	$616,550.00	$24,662.00	$18,866.43	$454,050.00	$206,028.43
Summary	$1,000,000.00	$64,662.00	$49,466.43	$908,100.00	$206,028.43

Inclusion in Gross Estate; Death After Year 1:

§7520 Rate:	0.60%	0.60%
Trust Value at Death:	$616,550	$75,680,000
Total Annual Payments:	$454,050	$454,050
Payment Period:	Annual	Annual
Adjusted Annuity Amount:	$454,050	$454,050
Value of Amount Includible at Death:	$616,550	$75,675,000
Value of Amount Excludable at Death:	$0	$5,000

C. Marital Deduction.

1. PLR 202021003 (May 22, 2020)

Estate granted extension of time to make QTIP election.

Husband and wife created a joint revocable trust, which upon the death of husband allocated his interest in community property and his separate property to a marital trust. The trust document provided that the marital trust property was to be treated as QTIP property for federal and state death tax purposes if the necessary election was made.

The surviving spouse, as the personal representative, retained an accountant to prepare the Form 706 (Estate Tax Return). The accountant prepared the Form 706 and timely filed it, but failed to prepare a Schedule M to include with the return. After the filing of the Form 706, new counsel was retained to advise the surviving spouse on her estate planning. During the review by the new counsel, the failure to file the Schedule M and make the QTIP election on the first spouse's return was discovered. As a result, the spouse requested an extension of time to make a QTIP election for the marital trust.

Treas. Reg. § 301.9100-1(c) gives IRS the discretion to grant a reasonable extension of time for a regulatory election, or statutory election (but no more than 6 months in the case of a taxpayer who is abroad). Under Treas. Reg. § 301.9100-3, a request for an extension of time will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make an election.

The IRS found that the requirements of Treas. Reg. § 301.9100-3 had been satisfied and granted an extension of time for the estate to make the QTIP election for the marital trust.

D. Gift Tax

1. *Estate of Bolles v. Commissioner*, T.C. Memo 2020-71 (June 1, 2020)

Lifetime loans became gifts when decedent converted them to advancements in her estate plan.

Mary Bolles died on November 19, 2010. Over many years, she made cash transfers of varying amounts to her five children, each time keeping records of the transfers as loans. However, there were no written promissory notes and no collateral for the loans, and there appeared to be no attempt to force repayment. It was Mary's practice each year to forgive each child's outstanding debt to the extent of the federal gift tax annual exclusion. The total cash transfers to her oldest son, Peter, were larger than those made to the other kids, totaling $1,063,333 from 1985 through 2007. Peter had not made any repayment after 1988.

When the decedent created a revocable living trust in 1989, she expressly excluded Peter from any distributions upon her death. In 1996, the decedent executed a new revocable living trust that included Peter as an equal beneficiary with his siblings, but only after accounting for "loans" made to him plus accrued interest. Peter signed an acknowledgment that the total outstanding debt owed to the decedent ($771,628 plus interest at the short-term AFR) "shall be taken into account for purposes of any and all calculations to be made" in determining his share of the trust upon the decedent's death. The acknowledgment provided that Peter " has neither the assets, nor the earning capacity, to repay all, or any part, of the amount previously loaned, directly or indirectly, to the undersigned by Mary Piper Bolles."

After Mary's son filed her estate tax return, the IRS argued that the entire $1,063,333, plus accrued interest of $1,165,778, was an asset of Mary's gross estate, resulting in an estate tax deficiency of $1,152,356. At trial, the IRS conceded its argument as to whether the estate had "undervalued Peter's debt," but argued that $1,063,333 was an adjusted taxable gift by Mary. The estate maintained that the amounts were at all times loans.

The court looked at *Miller v. Commissioner*, T.C. Memo 1996-3, aff'd 113 F.3d 1241 (9th Cir. 1997), for the traditional factors used to decide whether an advance is a loan or a gift. These factors include:

1. the existence of a promissory note or other evidence of indebtedness;
2. the charging of interest;
3. the use of security or collateral;
4. the present of a fixed maturity date;
5. the making of a demand for repayment;
6. any actual repayment;
7. the ability of the transferee to repay;
8. any records maintained by either the transferor or the transferee that reflect the transaction as a loan; and
9. the manner in which the transaction was reported for tax purposes.

Then the court reiterated, "[i]n the case of a family loan, it is a longstanding principle that an actual expectation of repayment and an intent to enforce the debt are critical to sustaining the tax characterization of the transaction as a loan," citing *Estate of Van Anda v. Commissioner*, 12 T.C. 1158 (1949), aff'd per curiam, 192 F.2d 391 (2d Cir. 1951).

The Tax Court took a middle ground, finding that the transfers made prior to the execution of the 1989 revocable trust were loans. Although there were no loan agreements or efforts to collect payments, the court concluded that the decedent initially expected Peter to repay the loans, and found that Mary had recorded the advances and kept track of interest. "We find [Mary] expected him to make a success of the practice as his father had, and she was slow to lose that expectation." But that changed by 1989 when her trust made no provision for Peter. At that time, "the 'loans' lost that characterization for tax purposes and became advancements against Peter's inheritance from Mary."

In conclusion, the court held that the advances to Peter were loans through 1989 but after that were gifts. With respect to the loans, the court found that Mary "did not forgive the loans but rather accepted they could not be repaid on the basis of Peter's financial distress." Indeed, the later acknowledgment Peter signed in 1996 confirms the conclusion that the amounts paid to Peter over the years were really advances on his inheritance.

The court's conclusion means that the estate lost over $1 million of applicable exclusion amount through the lifetime taxable gifts. The result would have been much worse had the IRS not conceded, but prevailed on, its argument that the debt, with accrued interest, was an asset of Mary's estate.

E. Generation-Skipping Tax

1. PLR 202013001 (March 27, 2020)

Modification of GST-grandfathered trust is not lost when testamentary general power of appointment creates vested interest.

Trust A was an irrevocable, GST-grandfathered trust, which provided for outright distribution to the beneficiaries upon the termination of Trust A and the Trust A Successor Trusts, 21 years after the death of Son. Under a proposed modification of the trust agreement, any share upon the termination of Trust A and the Trust A Successor Trusts distributable to a beneficiary who is under the age of b, will be held in a continuing trust for that continuing beneficiary. Each such beneficiary would have a testamentary general power of appointment with respect to the property in that Successor Trust.

The Service noted that under § 2041(a)(2), the continuing beneficiary's trust property will be includible in his or her estate at his or her death. Further, each continuing beneficiary will be treated as the transferor of the trust corpus for GST tax purposes under § 2652(a)(1). Therefore, the Service ruled that the proposed modification will not result in a shift of any beneficial interest in any beneficiary who occupies a generation lower than the persons holding the beneficial interests, and that the proposed modification in further trust will not extend the time for vesting of any beneficial interest in any trust. Therefore, the proposed modification will not cause Trust A or the Trust A Successor Trusts to lose their exemption from the generation-skipping tax.

While this ruling seems unremarkable, it is only the third such ruling – that a testamentary general power of appointment satisfies the "vesting" requirement in the GST-grandfathered regulations, Treas. Reg. 26.2601-1(b)(4)(i)(D)(1). The prior rulings were in 2019 (PLR 201947001) and earlier in 2020 (PLR 202011001 (which was a related ruling)).

F. Late Filing Penalties

1. *Estate of Skeba v. United States*, 2019 WL 4885697 (D. N.J. Oct. 3, 2019); Superseding Memorandum and Order, 2020 WL 70962, 432 F. Supp. 3d 461 (D. N.J. Jan. 7, 2020).

Late filing penalties held inapplicable when the tax was paid on time.

The prior opinion in *Skeba* was in last year's materials and starts below this paragraph. On a motion for reconsideration filed by the US. Government, the court issued a superseding opinion on January 7, 2020. The opinion was consistent with the court's prior opinion, granting summary judgment for the taxpayer and denying summary judgment for the government. The IRS's argument based on § 6151, which requires payment on the filing date "without regard to any extension of time for paying the tax" "misses the mark,"

according to the court. Section 6151 begins, "[e]xcept as otherwise provided in this subchapter…." Sections 6651(a)(1) and (2) "designate the specific day on which penalties will be assessed for both late filing and payment of the estate tax return," and both provide that the "date prescribed" is to "be determined *with* regard to any extension of time for" filing or payment. The specific statute controls over the more generic § 6151. The court also confirmed its prior finding that the taxpayer demonstrated reasonable cause and not willful neglect in allegedly failing to timely file its estate tax return.

Agnes R. Skeba died on June 10, 2013, so that her estate tax return was due on March 10, 2014. On or about March 6, 2014, the estate, through its attorney, filed IRS Form 4768 "Application for Extension of Time to File a Return and/or Pay U.S. Estate Taxes" together with an estate tax payment of $725,000 and a cover letter explaining that the estate was short of liquid assets, all of which were being used to pay state and federal estate taxes, and that it was in the process of attempting to raise liquid funds by mortgaging commercial property held by the estate. The application requested six-month extensions of the times to pay the tax and to file the return. The letter also noted that the loan had not yet been closed, because of "circumstances previously unknown and unavoidable by the Executor," and that it was expected to close within 14 days of the date of the letter. The loan did close and the estate paid another $2,745,000 eight days after the original payment due date. A few months later, the IRS approved the six-month application for an extension to file and stated that further extensions were "granted on a year by year basis only." A few weeks after that, the IRS approved the six-month extension of time to pay the estate tax and waived the requirement of a bond under Section 6165. In neither approval did the IRS mention the payments that had been made.

After the expiration of the six-month extension, the estate filed its federal estate tax return, reporting a $941,162 estate tax overpayment and requesting a refund. The IRS acknowledged the overpayment but assessed a $450,969.50 late filing penalty. The IRS stated that the late filing penalty was 25% of the "unpaid amount" of $1,803,838, which ignored the previous $2,745,000 payment. The estate's attorney requested abatement of the penalty based on the reasonable reasons that existed for the late filing, including litigation regarding the validity of the will, the process of which was delayed because of health problems of the executor and, later, of the estate's litigation counsel. The IRS responded with a one line statement that this letter did not "establish reasonable cause or show due diligence."

The District Court (Judge Sheridan) held that the estate owed no late filing penalties, despite the fact that the estate bears the burden to prove it has exercised ordinary business care and prudence in filing a late return. *United States v. Boyle*, 469 U.S. 241, 246 (1985). The court explained that the Section 6651(a)(1) late filing penalty is 5% of the estate tax per month, up to a total of 25% of the tax, and that the Section 6651(a)(2) penalty for late payment is 0.5% of the underpayment, up to a total of 25% of the tax. In each case, the estate tax base is reduced by any timely payments. The IRS argued that the payments taken into account in measuring the failure to file penalty include only those made before the initial filing date, determined without regard to extensions. The court disagreed, and found that both Sections 6651(a)(1) and 6651(a)(2) designate that the "date prescribed" for filing is determined after taking into account any extensions. In addition, the court held, the estate's failure to file in a

timely manner was based on reasonable cause and not willful neglect, finding the reasons given to be adequate and criticizing the IRS for its summary rejection of the statement of reasons.

This problem could have been resolved had the estate sought (and, presumably, received) additional extensions of the time for filing. There were reasons why the administration of the estate in this case was less than perfect, but estate advisors should make a point to obtain additional extensions when the initial six month extension is not sufficient.

G. FLP, LLC, 2036, 2038

1. *Estate of Moore v. Commissioner*, T.C. Memo 2020-40 (March 2, 2020).

Assets in family limited partnership taxed in decedent's estate at their full fair market value.

This is another FLP case involving terrible facts – a "bad facts make bad law" case. The first two paragraphs of the case read as follows:

> Howard Moore was born into rural poverty but over a long life built a thriving and very lucrative farm in Arizona. In September 2004 he began negotiating its sale, but his health went bad. He was released from the hospital and entered hospice care by the end of that year.
>
> Then he began to plan his estate.

Moore's lawyer developed a complex plan consisting of five trusts and a partnership. The plan required Moore to contribute most of his farm to the partnership. Moore's stated reason was to protect the farm from various business risks and to bring his sometimes fractious family together to run and manage the business without him. However, five days after the partnership received part ownership of the farm, Moore sold it. Even after the sale, Moore remained on the farm and directed its operations until his death.

The court noted that the key question before it was whether Moore's complex estate plan reduced the size of his taxable estate. The court also had to determine whether Moore's efforts to reduce the size of his taxable estate resulted in taxable gifts.

Moore was born in poverty and had a difficult upbringing. His formal education ended in the eighth grade. Through hard work Moore was able to acquire more than a thousand acres in the Dome Valley near Yuma, Arizona. Moore was quite rough on his four children and often played his three Sons against each other to motivate them. He also had one daughter. Moore also suffered from a long battle of alcoholism before going to a rehab facility for help.

Moore began to think about selling the farm and in 2004, when he was 89, Moore became more focused on selling the farm. Moore had begun negotiations to sell Moore Farms to a

neighbor, Mellon Farms, but before the sale was completed Moore had congestive heart failure, a heart attack, heat stroke, and was unable to breathe on his own. He insisted on returning home and was put on hospice care because he was given less than six months to live. Moore continued to work and a priority was to put his affairs in order.

At the end of December 2004, Moore called Bradley Hahn, an estate planning attorney with fifteen years of specialization in estate planning. Hahn had previously worked on Mrs. Moore's estate plan.

Moore compiled a list of written estate planning goals during the "design phase" with his attorney, which included: "I wish to maintain control of my assets during my lifetime;" and "It is of importance that the plan reduce or eliminate federal estate taxes, if possible." Other goals included the maintenance of his customary lifestyle, providing adequate liquidity for emergencies and investment opportunities, sufficient cash flow to make annual gifts to his children, the equal treatment of his children (although his son, Virgil, was to get his residence, his son, Ronnie was to get ½ of his interest in RRCH Moore Custom Farming and all of his interest in Yuma Speedway, LLC, and his grandson, Chet, was to get ½ of his interest in RRCH Moore Custom Farming), creditor protection, and the reduction of income, and estate taxes.

In order to accomplish his goals, Moore, with Hahn's help, four days after being discharged from the hospital, on December 20, 2004 created the following trusts:

1. Howard V. Moore Living Trust
2. Howard V. Moore Charitable Lead Annuity Trust
3. Howard V. Moore Children's Trust
4. Howard V. Moore Family Management Trust
5. Howard V. Moore Irrevocable Trust

Moore also created the Howard V. Moore Family Limited Partnership.

Moore was trustee of the Living Trust with his Son, Virgil, and his daughter, Lynda. Moore transferred all of his real and intangible personal property to the Living Trust, including his farm, which went under the name "Moore Farms." Upon his death, the remaining trust property was divided between the charitable lead annuity trust (referred to in the opinion as the "Charitable Trust") and the Children's Trust.

The Charitable Trust was to make distributions to the Howard V. Moore Foundation, which would then contribute money to the Community Foundation for Southern Arizona where the distribution would be distributed among several charities as determined by the boards of the Moore Foundation and the Community Foundation. The purpose of the Charitable Trust was to provide a vehicle through which the four children could remain on speaking terms.

The amount to be distributed by the Living Trust to the Charitable Trust was defined as a fraction of the full estate that would result in the least possible federal estate tax being paid as a result of Moore's death taking into account the applicable exclusion amounts. The

Charitable Trust at the time of the trial, had donated a total of $2.5 million to the Community Foundation. However, Hahn testified that the purpose of the trust was to provide a vehicle through which Moore's children would keep on speaking terms.

The remainder of the Living Trust property was to be distributed at Moore's death to the Children's Trust which, in turn, provided for the distribution of the remaining trust property to each of the four children in equal shares. The Children's Trust also contained the gifts of the specific assets that Moore including the gift of the residence to Virgil and the gift of Moore's ½ interest in RCCH Moore Custom Farming and Moore's 100 percent interest in Yuma Speedway, LLC.

The only purpose of the Management Trust was to be a partner in the Family Limited Partnership. Its only asset was a one percent interest in the Family Limited Partnership. The initial trustees were Virgil and Lynda and its designated beneficiary was Moore. Upon Moore's death, the remaining assets in the Management Trust were to be transferred to each of the four children through the Living Trust.

The Irrevocable Trust was initially funded with $10.00 with Virgil as its trustee and Moore's children as the beneficiaries. Subsequently, interests in the Family Limited Partnership were sold to it. The Irrevocable Trust provided for discretionary distribution of income and principal to the children. It also contained a provision for the transfer to the Living Trust of the amount of any asset included in Moore's estate. Following Moore's death, the Irrevocable Trust transferred large sums to the Charitable Trust. For example, from 2007 to 2009, the Charitable Trust made three payments to the Foundation of $790,000, $433,818, and $433,818 respectively.

In addition to the five trusts, Moore also set up the Family Limited Partnership on December 20, 2004. The Tax Court referred to the Family Limited Partnership as the "keystone" of Moore's estate plan. The Management Trust, the Living Trust, and the four children each made a total initial contribution of $10,000. These transfers gave each contributor a one percent interest. In addition, one Son, Ronnie, contributed his partial interest in another farm, (called Doval Farm) to the Family Limited Partnership in what the court described as a roundabout way. First Ronnie and Moore deeded their separate interest in Doval Farm to the Living Trust. The Living Trust then contributed Doval Farms to the Family Limited Partnership along with 4/5ths of Moore's farm. In return, the Living Trust received a 94 percent interest (and then had 95 percent of the interests in total).

During trial, Moore's Son maintained that the purpose of the Family Limited Partnership was to protect against liabilities, creditors, and bad marriage and to help bring the family together. Under the family limited partnership agreement, no single partner could transfer or sell any interest without the unanimous consent of the remainder of the family. The limited partners had no right to participate in the business or management decisions. In Moore's last months, he completed negotiations for the sale of Moore Farms. Moore Farms was under contract with Mellon Farms for $16,512,000 within five days after Moore contributed Moore Farms to the Living Trust. The court noted that even though the Family Limited Partnership held 4/5ths of the interests in the Moore Farms, the decision to sell was made solely by Moore.

Moore continued to live on the property until his death (which was not unusual in the Dome Valley when a long held family farm was sold).

After the creation and funding of the trusts and the Family Limited Partnership, Moore had other items to complete.

The first was the payment of attorneys' fees to Hahn for the estate planning which totaled $320,000. Part of the payment came from the Family Limited Partnership shares and proceeds from the sale of the farm, and part came out of the Living Trust.

Moore also had the Family Limited Partnership issue a check for $500,000 to each of his four children. Moore required each child to sign a promissory note for the money, which was to be paid back on or before February 2020 at a stated rate of interest. None of Moore's children made payments of principal and interest and the Family Limited Partnership made no effort to collect. Moore's grandson, Chet, also received a $500,000 check which was actually a gift. The Family Limited Partnership then paid $2,000,000 to the Living Trust to be used to cover expenses of the land sale, various miscellaneous items, and income taxes owed on the sale of the farms.

Subsequently, about February 25, 2005, Moore appears to have engaged in a sale to a defective grantor trust transaction. First, Moore's Living Trust transferred $500,000 to the Irrevocable Trust. This transfer was reported on Moore's 2005 gift tax return as a gift of $125,000 to each of the four children. Two weeks later, the Living Trust transferred its entire interest in the Family Limited Partnership to the Irrevocable Trust for $500,000 in cash and a note for $4.8 million. Moore died shortly thereafter at the end of March 2005. After his death, the Living Trust covered many of his final expenses including a flat fee to Bradley Hahn of $475,000 for the administration of the estate (in addition to Hahn's fees of $320,000 for designing the estate plan).

Moore's 2005 gift tax return reported the $500,000 gift to Chet and the four separate $125,000 gifts to each of Moore's children resulting from the transfer of $500,000 from the Living Trust to the Irrevocable Trust.

The Internal Revenue Service reviewed Moore's estate tax return and determined an estate tax deficiency of $6.4 million.

It also determined a gift tax liability of more than $1.3 million in 2005.

At trial, The Tax Court examined four issues.

1. Would the underlying value of the farm be taxed in Moore's estate under Section 2036 despite its sale through the Family Limited Partnership?
2. If some value of the farm was included in the estate, did the subsequent transfer of the Living Trust's Family Limited Partnership interest to the Irrevocable Trust remove that value?

3. Could Moore's estate deduct a $2 million debt payable to the Family Limited Partnership, future charitable contribution deductions through the Charitable Trust, and $475,000 in attorney fees?
4. Whether Moore's transfers of $500,000 to each of his children were gifts or loans?

In the Tax Court proceedings, the IRS viewed Moore's estate plan as "nothing more than a last minute, last ditch effort to avoid paying tax." It argued that Section 2036 should apply because the transfer of 4/5ths of the farm to the Family Limited Partnership was not a bona fide sale for full and adequate consideration since Moore lacked legitimate non-tax reasons for forming the Family Limited Partnership and because Moore kept possession and enjoyment of the farm even after its sale. Thus, Moore had a retained use and enjoyment of the property under Section 2036(a)(1). The IRS also argued that Moore's retention of control over the Family Limited Partnership was a power to control the use and enjoyment of the property by others under Section 2036(a)(2). As a backup argument, the IRS argued that the subsequent sale of the Living Trust's interests in the Family Limited Partnership to the Irrevocable Trust was not a bona fide sale for full and adequate consideration but a deemed gift. This should also cause the value of the underlying assets in the Family Limited Partnership to added back into the estate.

The IRS disputed the availability of the estate tax charitable deduction for amounts transferred to Charitable Trust because the amounts passing to charity cannot be determined as of the date of Moore's death and were contingent on the IRS's examination of the estate tax return. The IRS argued against the deduction of the attorneys' fees either because they were not incurred in the administration of the estate or they were unreasonably high.
Finally, the IRS argued that the $500,000 cash payments to the four children were gifts and not loans.

The court first looked at the applicability of Section 2036. Using the test in *Estate of Bongard v. IRS*, 124 T.C. 95 (2005), a transfer will not be respected if:

1. The decedent made an inter vivos transfer of property;
2. The decedent's transfer was not a bona fide sale for adequate and full consideration; and
3. The decedent retained an interest or right in the transfer property.

The court noted that whether a transfer was for adequate and full consideration is a question of value. Whether a transfer of property was bona fide turns on motive. The court then noted that under *Bongard*, the sale is bona fide only if there is a legitimate and significant non-tax reason for creation of the Family Limited Partnership. Moore's estate asserted that the principal reason for the formation of the Family Limited Partnership and transferring the interest in Moore Farms to the Family Limited Partnership was to bring the family together so they could learn how to manage the business without Moore. However, the court noted that after the sale of the farm, the only assets left in the Family Limited Partnership were liquid and an investment advisor managed them, not the family members. At trial, the Sons maintained the Family Limited Partnership also provided protection from creditors. The court said that protection from creditors can be considered a legitimate, but not significant, non-tax

reason to form a family limited partnership. Moreover, no credible evidence had been introduced that any of the children had a legitimate concern with possible creditors' claims. The court also found other factors supporting a finding that the transfer was not bona fide. One was Moore's significant health problems and his desire to save millions of dollars of taxes. The second was his creation of a complex and extensive estate plan four days after being discharged from a hospital in critical condition and placed in the care of hospice. Finally, Moore's unilateral decision making and control of the entire process contradicted any assertion of a bona fide sale.

The court then reviewed as an "alternate holding," whether Moore retained possession or enjoyment of the transferred interest after the transfer. This would be based on retaining a substantial present economic benefit. The court found that Moore continued to live on the property and continued to operate the farms as his own up until the date of his death. Even after the sale of the farm, Moore used the now liquid assets of the Family Limited Partnership to pay his expenses even though he kept sufficient assets of his own. This pattern was evidence of an implied agreement to retain the use of the property. Essentially Moore's relationship to assets in the assets of the Family Limited Partnership remained unchanged before and after the transfer. Consequently, because Moore retained possession or enjoyment of the assets in the Family Limited Partnership and because his transfer of part of the ownership of the Family Limited Partnership lacked a substantial non-tax purpose, the value of Moore Farms was to be included in the value of the estate under Section 2036 (a)(1).

Because the court concluded that Section 2036(a)(1) applied, it did not address the 2036(a)(2) or deemed gift arguments advanced by the IRS.

The court then discussed the impact of the full Tax Court decision in *Estate of Powell v. IRS*, 148 T.C. 392 (2017) which analyzed, for the first time, the application of Section 2043(a) of the Code as it applied to family limited partnerships. In *Powell*, the court held that where Section 2036 compelled inclusion of the assets in a family limited partnership at the fair market value, Section 2033 also compelled inclusion of the partnership interests in the estate at the discounted value.

Before, it had always been an "either or" analysis. Now, one must look at Section 2043(a). Section 2043(a) allows the estate to subtract the value of consideration received from the transferor from the full value of the partnership assets included under Section 2036 to avoid double taxation. The facts made the application of Section 2043 easy in *Powell* because the date of death was shortly after the date of the transfer of assets to the Family Limited Partnership.

The facts did not make the application of Section 2043 in *Moore* easy, because any increase or decrease in the value of the underlying assets in the Family Limited Partnership and the Family Limited Partnership interests themselves between the date of the transfer and the date of death must had to be taken into account. This causes a more complicated set of calculations.

The court then presented an equation to address the needed calculations, which read:

$$V_{included} = C_d + FMV_d - C_t.$$

$V_{included}$ = the value that must be added to the gross estate;

C_d = the date of death value of the consideration received by the decedent from the transaction that remains in his estate (Section 2033);

FMV_d = fair market value at the date of death of property transferred by the decedent whose value is included in the gross estate under Section 2036; and

C_t = consideration received by the decedent at the time of the transfer, which has to be subtracted under Section 2043(a).

The court then went through five examples of how this formula would work and noted that depending upon the facts, some of the examples must seem odd; however, the court had to apply the Code as it was written and interpreted and the full decision of the Tax Court in Powell. The five examples were:

Example 1: Constant Values
Example 2: Inflating Values
Example 3: Declining Values
Example 4: Discounted Interest, But Simple
Example 5: Discounted Interest, But Not Simple

The court then noted that the C_d variable was not limited by tracing rules. Essentially, whatever is left of the original consideration in the estate is included but so also are the proceeds from a later sale because Section 2033 includes all property that the decedent owns in his gross estate on the date of death. As a result, property that leaves an estate after a transfer governed by Section 2036 but before the decedent's death is generally not included in decedent's gross estate. The court then went through an extensive analysis of the facts in this case and it noted that determining the value of four-fifths of the farm that went from the Living Trust to the Family Limited Partnership in exchange for an interest in the FLP was difficult. The estate valued Moore's interest in the Family Limited Partnership at about $5.3 million. The IRS argued that it was worth $8.5 million.

After determining what the formula should be, but not the values that should be applied, the court then turned to the remaining issues.

The court also determined that the $500,000 "loans" by Moore to his children were" more likely than not" gifts. Some of the factors in making this determination were:

1. The notes had no fixed payment schedule;
2. The children paid no interest on the notes;
3. The children lacked the resources to pay off the notes;
4. The notes were not secured; and

5. The children did not set aside funds to repay the notes.

The court then disallowed the deduction of the $475,000 of attorney's fees for the administration of the estate (over and above the $320,000 in fees for the estate planning), because there was no evidence that the fees were reasonably incurred in the administration of the estate or if they were, why the fees were so high. It noted that while New York courts might at least consider the reasonableness of fees based on a percentage of the gross estate, Arizona law required a court to look at other evidence, including billable hours and the type of work performed and use good judgment to decide the weight to give to each factor.

Although the estate tax return reported the estate as owing $2,000,000 to the partnership as the result of the "loan" of $2,000,000 from the FLP to the Living trust, the court found no evidence that the transfer was a loan and disallowed the deduction for that debt. There was no promissory note, no interest charged or paid, no collateral, no maturity date, no payments made, and no demand for payments.

With respect to the availability of the estate tax charitable deduction for the distributions from the Irrevocable Trust to the charitable lead annuity trust (through the Living Trust), the court held, based upon its review of the language, that the estate tax charitable deduction should be denied because the language of the Irrevocable Trust referred to "an amount equal to the value of any asset *of this trust* which is includible in my gross estate." The court also distinguished other formula clause cases, in that it was not the *amount* of a gift that might be transferred to the CLAT that was determined by formula, but *whether anything at all* would be transferred to the CLAT. Because only after an audit that resulted in additional property being included in the gross estate would amounts from the Irrevocable Trust be transferred to the CLAT, the charitable deduction was not ascertainable at the decedent's date of death.

In closing, the court noted that the computations under the equation that it had presented would be difficult.

H. Defined Value Clauses

1. *Nelson v. Commissioner*, T.C. Memo 2020-81 (June 10, 2020)

Formula clauses referenced only appraisals, not final gift tax values; additional gift tax imposed.

To start, **the *Nelson* case is NOT a big deal when it comes to defined value clauses**.

Mrs. Nelson's father had organized Warren Equipment Co. ("WEC") in 1990, which served as a holding company owning 100% of six subsidiaries that were operating businesses and two other subsidiaries providing administrative services and holding real estate. Mrs. Nelson transferred her shares in WEC (about 27% of the stock), to an FLP called Longspar Partners, Ltd. on October 1, 2008. The stock was 98% of the FLP's assets. At the outset, Mrs. Nelson and her husband owned the 1% general partner interest, and Mrs. Nelson owned 93.88% of

the limited partner interests, with the remaining LP interests held by family trusts and custodial accounts.

About three months later, on December 31, 2008, Mrs. Nelson made a gift of FLP interests to a trust for her husband and children, of which her husband was the trustee ("Descendants Trust"). The Memorandum of Gift and Assignment of Limited Partner Interest (gift assignment) provided:

> [Mrs. Nelson] desires to make a gift and to assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 * * *, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment.

Then, on January 2, 2009, Mrs. Nelson entered into a sale transaction for additional FLP interests, and the memorandum of sale provided:

> [Mrs. Nelson] desires to sell and assign to * * * [the Trust] her right, title, and interest in a limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009 * * *, as determined by a qualified appraiser within one hundred eighty (180) days of the effective date of this Assignment * * *.

Neither the gift assignment nor the memorandum of sale contained any reference to final gift tax values, any clause defining "fair market value," or any clause subjecting the limited partner interests to reallocation after the valuation date.

Mr. and Mrs. Nelson retained a qualified appraiser to value the Longspar limited partnership interests in connection with both the 2008 gift and the 2009 sale. The appraiser concluded that as of the dates of the gift and the sale, the value of a one percent limited partnership interest in Longspar was $341,000. As a result, the appraiser calculated that Mrs. Nelson gave 6.14 percent of her Longspar limited partnership interests (value of $2,093,740) to the trust on December 31, 2008 and sold 58.65 percent of her Longspar limited partnership interests (value of $19,999,650) on January 2, 2009. Thus, a total of 64.79 percent of Mrs. Nelson's Longspar limited partnership interests were given or sold to the Descendants Trust.

On their 2008 federal gift tax returns, the taxpayers split Mrs. Nelson's gift, meaning each had gifted $1,048,000, an amount that utilized (but did not exceed) four annual exclusions and the applicable exclusion amount. In 2013, the Service determined that the value of each gift was $1,761,009, not $1,048,000. The Service also determined that the property transferred in the $20 million sale was really worth just over $33.6 million, meaning each taxpayer had made a 2009 gift of just over $6.8 million.

Mr. and Mrs. Nelson argued that the transfer documents showed that Mrs. Nelson transferred specific dollar amounts of Longspar limited partnership interests and not fixed percentages

citing *Wandry v. Commissioner*, T.C. Memo 2012-88; *Hendrix v. Commissioner*, T.C. Memo 2011-133; *Estate of Petter v. Commissioner*, T.C. Memo 2009-280; and *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006).

The Tax Court disagreed. The court observed that the gifted and sold interests “are expressed in the transfer instruments as an interest having a fair market value of a specified amount as determined by an appraiser within a fixed period. The clauses hang on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes.” So, because the transfers were based on the value as determined by the appraisal and not on the finally determined gift tax value, the taxpayers were stuck with the percentage interests reflected on the gift tax return.

The court then primarily addressed two issues regarding the valuation of WEC. Although the separate values of the subsidiaries reflected “at least some elements of control,” “home discount should apply in valuing a minority interest in WEC common stock.” The court reduced the lack of control discount from 20% to 15%. The second issue was the taxpayer’s appraiser’s use of the income approach ($335.1 million) and market approach ($269.8 million) to valuing WEC, and the weight given to each approach. The taxpayer’s appraiser concluded the value of WEC was $309.0 million. The court found that there was not sufficient evidence to support the use of the market approach.

On the valuation of the FLP interests, the taxpayer’s and IRS’s appraisers agreed on a 30% lack of marketability discount; however, the court reduced that to 28%. The court reduced the taxpayer’s lack of control discount from 15% to 5%. At the end of its analysis, the court concluded that the taxpayers made combined gifts of about $2.5 million in 2008 and about $4.1 million in 2009, for gift tax deficiencies of about $2,000,000. This was only about 30% of what the IRS had assessed, so somewhat a taxpayer victory, but if the formula clause had been properly drafted there would have been no gift tax liability.

Some have called this a mistake in the drafting of the formula clause, some have argued that this worked out well for the taxpayers. In the course of the audit, a proposed settlement was negotiated that would have reduced the percentage interest in the partnership owned by the Trust by 26.24% (from 64.79% to 38.55%). Given the net asset value of the partnership’s assets, the undiscounted value of 26.24% of the partnership would have been $15,900,000, which would have been back in the donor’s estate, along with income and appreciation on that amount. The settlement was never completed, the case went to court, and the result was a $2,000,000 gift tax deficiency (and all 64.79% of the partnership interests remaining in the trust). The taxpayers have appealed the decision to the Fifth Circuit.

I. Income Tax

1. PLR 202022002 (May 29, 2020)

No recognition of gain on sale of LLC interests from one grantor trust to another when sale of interests triggers withdrawal right.

In PLR 202022002, Grantors created an irrevocable trust – Trust 1 – for the benefit of their children and grandchildren. Grantors transferred Shares to Trust 1. Trust 1 prohibited the distribution of the Shares, but allowed the distribution of the proceeds from the sale of the shares.

Subsequently, Trust 1 contributed all of its Shares to LLC in exchange for a membership interest, and the same restriction applied to the LLC interests that applied to the Shares. Then, Trust 1 transferred LLC interests to Subtrust.

"A" was the sole beneficiary of Subtrust and could withdraw all of Subtrust's assets (upon reaching age 40, which presumably had occurred) except the LLC interests. A's right of withdrawal caused Subtrust to be a grantor trust as to the portion of Subtrust that could be withdrawn. On "Date 4," A withdrew all of the assets of Subtrust other than the LLC interests.

The trustees of Subtrust agreed to sell a portion of the LLC interests held in Subtrust to Trust 2 in exchange for cash and a promissory note. Trust 2 was a grantor trust as to A. Trust 1 represented that A had the authority to withdraw the cash and promissory note from Subtrust after the proposed sale (which would make Subtrust a grantor trust under section 678). The question for the Service in the ruling request was whether gain is recognized on the sale of the LLC interest from Subtrust to Trust 2.

The Service discussed Revenue Ruling 85-13, 1985-1 C.B. 184. This was the ruling in which the Service held that "the owner of a grantor trust is not merely taxable on a trust's income, but is treated as the owner of the trust's assets for federal income tax purposes," and that the transfer of corporate shares to the trust in exchange for a promissory note was not recognized as a sale for federal tax purposes because A was both the maker and the owner of the promissory note.

Here, even though the right of A to withdraw the assets of Subtrust did not arise until the LLC interests were purchased from Subtrust by Trust 2, the Service held that the transfer of the LLC interests to Trust 2 was not recognized as a sale for federal income tax purposes. This was because A had "a power exercisable by herself to vest the proceeds from the sale of Subtrust's LLC interest in herself and those proceeds are Subtrust's only asset," and was therefore treated as the owner of the Subtrust under section 678.

Note that in Rev. Rul. 85-13, like in this PLR, the trust was not always a grantor trust; rather, it was the exchange of the corporate shares in the trust for the grantor's promissory note that made it a grantor trust

2. *Kroner v. Commissioner*, T.C. Memo 2020-73 (June 1, 2020)

Transfers from foreign business associate were not excludible from income as "gifts."

During the tax years 2005, 2006, and 2007, Burt Kroner received wire transfers from a business associate, David Haring, who was a foreign citizen, or entities associated with Haring in the aggregate amounts of $4,425,000, $15,350,000, and $5,000,000, respectively. Kroner's lawyer, who was also Haring's lawyer, advised that the transfers were excludable from income under Section 102 which states that gross income does not include the value of property acquired by gift, bequest, devise or inheritance. The lawyer also advised Kroner of the requirement to file the Form 3520, Annual Return to Report Transaction with Foreign Trusts and Receipt of Certain Foreign Gifts, for each year that Kroner received a transfer from Haring into an account in his name. The Internal Revenue Service argued that the transfers were not gifts and subject to income tax under Section 102(a) and imposed a penalty for substantial understatement under Section 6662(a).

The Tax Court, noting that the intention with which Haring made the transfers was the most critical factor in determining whether the transfers were gifts, found Kroner's gifts story unconvincing and the testimony provided by Kroner and his lawyer to be unreliable. None of the testimony was supported by credible documented evidence. The lawyer represented both Kroner and Haring and was thus an interested party, and Haring, a foreign citizen, did not testify. As a result, Kroner was unable to prove that the transfers were made with disinterested generosity which is the basic requirement for a transfer to be treated as a gift.

The court also noted the lawyer was evasive in his answer and in his selective invocation of the attorney-client privilege with respect to the legal advice provided to Haring about the transfers. Instead, the timing of the transfers, especially with respect to liquidity events in investments in which Kroner could not invest because of non-compete agreement, showed that Haring acted as the nominee for Kroner in those investments. The court could not find facts that showed that Haring and Kroner had the type of relationship from which there would be disinterested generosity and that would result in the substantial "gifts" which were made. Instead, Kroner and Haring had only a business relationship. As a result, the transfers were subject to income tax.

ILLINOIS CASES

1. *Baillie v. Raoul*, 2019 IL App (4th) 180655 (October 16, 2019).

Illinois state court denies fractional interest discount.

In *Baillie*, the Illinois Appellate Court in the Fourth District rejected the guidance of a Treasury Regulation and failed to respect the position of the IRS on the estate tax valuation question involved.

The case involves the valuation of John Baillie's one-half interest in three parcels of farmland that were owned by John and his wife, Glenda, as joint tenants with right of survivorship, which would be Section 2040(b) qualified joint interests. As a qualified joint tenancy, 50% of the value of that farmland would be includible in John's estate for federal estate tax purposes, and Illinois' estate tax piggybacks on the federal inclusion. However, John's one-half interests were the subject of a timely Section 2518 qualified disclaimer by Glenda, and John's one-half interests were included on the federal estate tax return under Section 2033, not 2040(b).

Under principles of state law, embraced at the federal level, Glenda's disclaimer related back to the time of John's death, it worked to convert the joint tenancy into a tenancy in common, and it caused John's half of each parcel to pass to their children through John's probate estate. Glenda was John's executor. The question litigated was the proper valuation of John's half interests for *Illinois estate tax purposes.*

The estate's valuation of the survivorship portion on the federal estate tax return reflected a 20% fractional interest discount, which was not challenged by the IRS. (The opinion does not reveal whether the estate was taxable at the federal level; John died in 2015 and the federal return may have been filed solely to elect portability.) Despite its acceptance of the federal return, the State of Illinois asserted that Internal Revenue Code Section 2040(b) was applicable notwithstanding the disclaimer, that the interest includible in John's estate was therefore valued under Section 2040(b)(1), meaning that an undiscounted 50% of the fair market value of the joint tenancy property owned by John and Glenda at the moment of John's death was the proper amount includible in John's estate for Illinois estate tax purposes.

That valuation conclusion is inconsistent with Reg. §25.2518-2(c)(5), Examples 12 and 14, the important crux of which is a timing rule. A Section 2518 qualified disclaimer is deemed to relate back to the moment of death, which effectively treats Glenda and John as having severed their joint tenancy before John died, causing the property interest owned by John to pass through John's estate as if it were a tenant in common interest. These regulatory examples do not expressly articulate the valuation that applies to John's interest in the former joint tenancy, but they do state that the value of John's interest is, by virtue of the disclaimer, includible in John's gross estate under Section 2033, and not under Section 2040(b) as a qualified joint tenancy interest. That position was reached by the federal government after years of litigation regarding the effect of a surviving joint tenant's qualified disclaimer.

Estate planners properly rely on the fully-litigated position, articulated by the regulations for federal estate tax purposes.

Because of these Treasury Regulations, the valuation of John's interest would naturally reflect the claimed fractional interest discount, as if the property was owned by John and Glenda as tenants in common. Glenda obtained appraisals of the farmland for purposes of filing John's estate tax return, which applied a 20% discount to the one-half interests included in John's estate. Glenda filed the federal return on that basis, and filed the Illinois return on that basis as well because the Illinois estate tax piggybacks on the federal estate tax return.

Indeed, the *Baillie* court expressly stated that "Illinois determines gross value the same way the federal government does. '[T]he gross value of transferred property … shall be its value as finally determined for purposes of the federal transfer tax.' 35 ILCS 405/5(c)." Nevertheless, the *Baillie* court concluded that the position reached for federal estate tax purposes, and the regulation examples upon which Glenda relied, are not entitled to judicial deference in this case.

The court cited Section 2033, which provides that "[t]he value of the gross estate shall include the value of all property to the extent of the *interest therein of the decedent at the time of his death.*" (emphasis added). The court then described the nature of joint tenancy in Illinois, and found that "the phrase 'at the time of his death' is a hole in the net of federal estate taxation." This is because a surviving joint tenant is left as the sole owner of the land, and "it is impossible for the deceased spouse (or his or her estate) to own any interest in a joint tenancy estate." Until a joint tenancy is severed, "the title and interest are not divided into fractional shares." Further, because there is no *transfer* of a joint tenancy interest at death, but the survivor automatically owns the whole, according to the court, no federal estate tax would be imposed on a decedent's extinguished joint tenancy interest but for the enactment of Section 2040. This analysis by the court ignores the relation-back in time theory associated with qualified disclaimers under Section 2518, and the federal law that has developed thereunder as expressed in the regulations.

The court acknowledged that the Treasury Regulations cited by Glenda were adopted by the Treasury in response to Seventh and Eighth Circuit Court of Appeals cases, *Kennedy v. Commissioner*, 804 F.2d 1332; and *McDonald v. Commissioner*, 853 F.2d 1494. The court also conceded that Glenda's disclaimer was a qualified disclaimer under Section 2518.

However, the court wrote that deference to regulations is "conditional: '[C]ourts will give substantial weight and deference to an interpretation of an *ambiguous* statute by the agency charged with the administration and enforcement of the statute." (citing *Illinois Consolidated Telephone Co. v. Illinois Commerce Comm'n*, 95 Ill. 2d 142 (1983)) (emphasis in original). The Illinois Appellate Court concluded, *de novo*, that Section 2518 is unambiguous. The Court likewise found section 2040(b) to be unambiguous.

Thus, because the joint tenancy owned by John and Glenda at the moment of death was a qualified joint tenancy, subject to Section 2040(b), the court's conclusion is that John's 50%

is includible in John’s gross estate, with no discount. “It is that simple” the court said. “Disclaiming the survivorship interest after the decedent’s death cannot change how the property was held until the decedent’s death.” Rather, “[a]ll disclaiming a survivorship interest does is cause a distribution of the survivorship interest to some else at the decedent’s death (see 755 ILCS 5/2-7(d) (West 2014)); it does not change how the property was held before the decedent’s death.

Baillie is irrelevant for federal estate tax purposes. The Illinois court’s denial of deference to the Treasury Regulation does nothing to diminish the effect of the regulation for federal estate tax purposes. But it is conceivable that other states may embrace the result in *Baillie*, and in any event Illinois planners may need to consider the best planning response to it. In Illinois (and perhaps elsewhere), spouses might prefer to sever their joint tenancies during life rather than rely on a qualified disclaimer by the surviving spouse postmortem. As an undivided tenancy in common, the probate avoidance attraction of joint tenancy would be lost, but probate could be avoided by holding a one-half tenant in common interest in trust.

One other implication of the disclaimer is avoidance of inclusion of both halves in the estate of the survivor, which is important only if the property will appreciate during the remaining life of the surviving spouse. In the final analysis, the basis of the disclaimed half in the first estate is smaller by virtue of the valuation discount applicable to an undivided tenancy in common versus a qualified joint tenancy. And the basis following the survivor’s death is smaller because of the same valuation discount, and by avoiding inclusion in the survivor’s estate of any appreciation in the predeceased spouse’s half. As in much of estate planning today, these basis consequences may be the most meaningful consequences to consider.

2. *Raoul v. Dunston*, 2020 IL App (5th) 190017 (February 20, 2020)

Disclaimer does not have to be federal qualified disclaimer for purposes of Illinois-only QTIP election.

James R. Dunston passed away on May 2, 2014, with an estate plan that had he executed in 2007. James’s surviving spouse and children were the successor co-trustees of his revocable trust, under which a Marital Trust and a Family Trust were created. James’s revocable trust funded the Family Trust with the maximum amount that would result in no (or the least possible) federal estate tax, a provision which had not been changed since the decoupling of the federal and Illinois estate tax exemptions. The court noted, “*[a]s with many estate documents drafted before the changes in the law*, the Trust was not modified or amended after the law changed and before James's death.”

The Family Trust created under James’s revocable trust gave to Judy a lifetime power to appoint the assets of the trust among James’s children and their spouses. Judy’s lifetime power of appointment would disqualify the Family Trust from qualifying for a QTIP election under section 2056(b)(7) of the Internal Revenue Code.

James's spouse, Judy, as executor, filed an Illinois estate tax return for James's estate. Notwithstanding Judy's lifetime power of appointment over the Family Trust, James's Illinois estate tax return reported a tentative taxable estate of $5,050,687.84 and made an Illinois QTIP election in the amount of $1,050,687.84.

The Attorney General determined that the Family Trust did not qualify for a QTIP election and assessed unpaid Illinois estate tax as of February 2, 2015. Over three years later, on June 20, 2018, the AG filed a complaint against Judy and the two children, individually and as co-trustees, claiming personal liability for estate tax and accrued interest of $398,516.

On July 19, 2018, more than four years after James's death and after the Attorney General's complaint was filed, Judy executed a written disclaimer of her lifetime power of appointment over the Family Trust pursuant to section 2-7 of the Probate Act, 755 ILCS 5/2-7. The disclaimer was effective retroactive to May 2, 2014, the date of James's death. Eight days later, on July 27, 2018, the defendants filed a motion to dismiss the Attorney General's complaint, on the basis that the Judy's disclaimer brought the Family Trust into compliance with Illinois QTIP requirements.

Unlike the Code, Illinois law does not provide a time limit for a disclaimer to be "qualified." A disclaimer under Illinois state law is barred by (1) a judicial sale of the property, part or interest before the disclaimer is effected; (2) an assignment, conveyance, encumbrance, pledge, sale or other transfer of the property, part or interest, or a contract therefor, by the disclaimant or his representative; (3) a written waiver of the right to disclaim; or (4) an acceptance of the property, part or interest by the disclaimant or his representative.

The circuit court dismissed the complaint, finding that the Judy's disclaimer was effective under Illinois law for estate tax purposes, and not governed by the timeliness provisions of section 2518 of the Code, and the Attorney General appealed.

The Fifth District Appellate Court affirmed the circuit court, framing the "sole issue" as "whether the circuit court correctly found that Judy's Disclaimer was not subject to the timeliness requirements set forth in section 2518 of the Federal Code (26 U.S.C. § 2518 (2018)), resulting in the Disclaimer being valid and the Illinois QTIP election being effective under Illinois law."

The Attorney General first argued that the estate failed to make a valid Illinois QTIP election by timely designating compliant property on its Illinois estate tax return because when it attempted to make the election on the Illinois return, the property was not federally QTIP eligible because Judy's lifetime power of appointment violated section 2056(b)(7)(B)(ii) of the Federal Code. The appellate disagreed and, since the circuit court had found that the disclaimer was effective retroactively under state law, considered any issue regarding the validity of the QTIP election in the absence of the disclaimer to be moot.

The Attorney General then argued that the circuit court erred in finding section 2518 of the Code inapplicable to Judy's disclaimer for purposes of determining the validity of an Illinois QTIP election. The court acknowledged that "the provision of the Illinois Estate Act that

allows an Illinois QTIP election defines the election as one "under Section 2056(b)(7) of the [Federal Code]" and that Illinois QTIP elections are valid only to the extent that they are taken pursuant to that section." However, that same section (section 2(b-1)) of the Illinois Estate Tax Act also makes clear that an Illinois QTIP election is "separate and independent" from a federal QTIP election. The court wrote:

> The Attorney General aptly observes that the Illinois Estate Act adopted the Federal Code's definition of QTIP but then attempts to expand that to subject Illinois QTIP elections to the mandates of other sections of the Federal Code—particularly section 2518, which contains federal disclaimer limitations that govern federal QTIP elections. In essence, the Attorney General argues that, because section 2(b-1) of the Illinois Estate Act adopted the Federal Code's section 2056(b)(7) definition of QTIP, the federal disclaimer restrictions governing federal QTIP elections under section 2518 of the Federal Code are also applicable to Illinois QTIP elections, notwithstanding the "separate and independent" language in section 2(b-1) of the Illinois Estate Act and notwithstanding the fact that section 2(b-1) does not reference section 2518 of the Federal Code.

According to the court, although Illinois adopted the Code's definition of QTIP, it did not adopt the Code's provisions on disclaimers.

The Attorney General argued that, as a practical matter, taxpayers could generate a windfall through "inadvertent mistakes" in estate planning by waiting until after an audit to disclaim and noncompliant QTIP power. Had James's estate not been audited, "Judy would have been free to exercise the lifetime power to transfer the QTIP property out of her estate, perhaps avoiding Illinois estate tax at the time of her death or greatly complicating its collection." The court responded to this by saying that the lifetime power of appointment was not an "inadvertent mistake" *at the time the trust was drafted in 2007*. Moreover, Judy never exercised her power before disclaiming it, and Judy would have been barred from disclaiming the power if she had exercised it. Query, in the AG's example, wouldn't the exercise of Judy's lifetime power of appointment be a taxable gift or invoke section 2519 of the Code? What would have happened upon Judy's death had she never been audited, never executed the disclaimer, and died with an Illinois QTIP election in place for a trust that never qualified for it?

Finally, the Attorney General cited *Baillie* to support its argument that the Illinois disclaimer statute does not operate to treat the offending lifetime power of appointment as if it never existed. The court distinguished *Baillie*, first, because *Baillie* did not involve a question about the timeliness of a disclaimer. Further, the *Baillie* court relied heavily on the state law of joint tenancy, and the "only period of time when a joint tenancy can be severed" is before the other joint tenant dies. *Baillie*, 2019 IL App (4th) 180655, ¶ 37. Further, while *Baillie* involved a joint tenancy, this power in this case was transferred to the surviving spouse upon the decedent's death.

The court noted that "[m]aking funds available for a surviving spouse to live on and estate tax being deferred during the lifetime of the surviving spouse is a long standing public policy in Illinois," as indicated by the legislative history relating to the statute allowing the Illinois-only QTIP election. The court found its resolution in harmony with this "longstanding spirit of Illinois estate law."

3. *Carroll v. Raoul*, 2020 IL App (3d) 180550 (March 13, 2020)

Prior transfer credit does not reduce Illinois estate tax.

Carroll involved an estate's claim of a prior transfer credit to reduce Illinois estate tax. Carroll was executor of the estate of Sharon Maloney, who died on May 21, 2015 with an estate of about $6,570,000. Her mother and father both died within ten years prior to her death. Her mother's estate paid federal estate taxes of $66,993 and state estate taxes of $62,947; and her father's estate paid federal estate taxes in the amount of $1,866,945 and Illinois estate taxes in the amount of $1,091,417.

The executor filed federal and state estate tax returns for Sharon's estate, claiming a credit on the Illinois return of $181,348.23 for prior estate taxes paid on the property transferred from her parents' estates. Section 2013 of the Internal Revenue Code allows a credit against federal estate tax for estate taxes paid on transfers of property to the (current) decedent by or from a person who died within 10 years before or 2 years after the decedent's death.

The Attorney General conducted an audit and determined that a prior transfer credit does not exist under the Illinois Estate Tax Act, and that the federal tax credit for prior transfers has no impact on the amount of Illinois estate tax due.

The estate paid $193,942 in taxes, penalties, and interest under the Protest Monies Act and then filed a complaint for declaratory and injunctive relief against the Attorney General and State Treasurer. The Attorney General moved to dismiss the complaint, and the trial court granted that motion, holding that the Estate Tax Act did not authorize use of the prior transfer credit to calculate the amount due for state tax purposes. The estate appealed.

The estate argued that a plain reading of the Illinois statute and federal tax code leads to an interpretation of the Estate Tax Act that allows for a prior transfer credit for state estate taxes. The estate also argued that the Attorney General's interpretation of the Estate Tax Act runs counter to prior representations and violates due process, and the denial of the prior transfer credit for state estate taxes violates the uniformity clause of the Illinois Constitution.

Looking first at the Illinois Estate Tax Act, the court concluded that the plain language of that act calculates the Illinois estate tax as the federal "state tax credit" as it existed in 2001 – as the "full credit calculable under section 2011 … of the Internal Revenue Code as the credit would have been computed and allowed under the Internal Revenue Code as in effect on December 31, 2001… but recognizing the exclusion amount of only … $4,000,000 for persons dying on or after January 1, 2013…." 35 ILCS 405/2(b) (West 2016).

Section 2011 of the IRC, as of December 31, 2001, provided as follows:

> The tax imposed *** shall be credited with the amount of any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia, in respect of any property included in the gross estate (*not including any such taxes paid with respect to the estate of a person other than the decedent*).

26 U.S.C. § 2011(a) (2000) (emphasis added).

The appellate court reasoned that there is no reference to section 2013 in section 2011 of the IRC. To the contrary, section 2011(a) specifically states that the credit for state death taxes does not include "any such taxes paid with respect to the estate of a person other than the decedent." The court noted that the payment of a state estate tax for the prior transfer of the same property by a parent's estate is a "tax[ ] paid with respect to the estate of a person other than the decedent." Thus, under federal law, a credit for prior transfers is not (or, was not as of 2001) permitted in the calculation of the state tax credit.

The estate also argued that the Attorney General's position is a change from a prior rule that violates due process. This was based on the estate's assertion that:

> the Attorney General told the Plaintiff that, in the case of a situation in which the estate was required to file an Illinois estate tax return but was not required to file a federal tax return, the State of Illinois would honor any election or credit that would be available on the federal return if the federal exemption were $4 million.

The court held, however, that the policy plaintiff was trying to enforce conflicts with the agency's enabling statutes, 35 ILCS 405/2(b), 3 (2016) and IRC § 2011 (2000). Even if the Attorney General had issued a regulation to allow a prior transfer credit, the Estate Tax Act would preclude the application of a prior transfer credit against the Illinois estate tax. The court also held that the Attorney General's denial of the prior transfer credit does not violate the Uniformity Clause of the Illinois constitution, since all estates are subject to a tax defined by the former federal state tax credit.