RECENT DEVELOPMENTS:

SELECTED FEDERAL AND ILLINOIS CASES, RULINGS AND STATUTES

Chicago Estate Planning Council

February 20, 2020

Ryan A. Walsh
Hamilton Thies & Lorch LLP
200 South Wacker Drive, Suite 3800
Chicago, Illinois 60606
(312) 650-8650
walsh@htl-law.com

FEDERAL STATUTES, REGULATIONS, AND ADMINISTRATIVE MATTERS

A. **Rev. Proc. 2019-44**, **2019-47 I.R.B. 1093 (November 18, 2019)** sets forth the inflation-adjusted figures for exclusions, deductions, and credits for 2019. In the estate and gift tax area the figures contained in Rev. Proc. 2018-57 are the following:

- Applicable Exclusion Amount: Increases to $11,580,000
- Annual Exclusion: Stays at $15,000
- Foreign Spouse Annual Exclusion: Increases to $157,000
- §2032A Aggregate Decrease Limit: Increases to $1,180,000
- §6601(j) 2% Amount: Increases to $1,570,000
- §6039F Gifts From Foreign Persons: Increases to $16,649
- 37% Bracket for Trusts and Estates: Income over $12,950 (up $200)

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

1. **Final Anti-Clawback Regulations: T.D. 9884 (Nov. 22, 2019), 84 Fed. Reg. 64995 (Nov. 26, 2019). Proposed Reg. §20.2010-1(c) and (e)(3), REG-106706-18, 83 FED. REG. 59343 (Nov. 23, 2018).**

The Tax Cuts and Jobs Act amended §2001(g) to add a new §2001(g)(2) directing the Treasury to prescribe regulations as may be necessary or appropriate to address any difference in the basic exclusion amount at the time of a gift and at the time of death. This is to deal with the possibility of a "clawback" – i.e., a prior gift that was covered by the gift tax exclusion at the time of the gift might result in estate tax if the estate tax basic exclusion amount has decreased by the time of donor's death, thus resulting in a "clawback" of the gift for *estate* tax purposes. The Treasury issued proposed regulations on November 23, 2018.

New Section 2010(g)(2) provides:

> (2) MODIFICATIONS TO ESTATE TAX PAYABLE TO REFLECT DIFFERENT BASIC EXCLUSION AMOUNTS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—
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> (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and
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> (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.

The clawback concern is this: If a large gift in 2019 is entirely or partly exempt from gift tax because of the nearly doubled basic exclusion amount under the 2017 Tax Act and the donor dies after 2025 when the doubling has "sunsetted," will part of the gift in effect be taxed

anyway (clawed back) in the estate tax calculation? The statutory mandate of Section 2001(g)(2) appears to provide (perhaps even without regulations) that the answer is no – there will be no such clawback.

Proposed regulations were issued in November, 2018, which were finalized in November, 2019.

Confirmation in the Final Regulations. The final regulations, published almost exactly on the anniversary of the notice of proposed rulemaking, confirm the promise of what the preamble to the final regulations calls the "special rule" set forth in the proposed regulations. In fact, Proposed Reg. §20.2010-1(c)(1), although divided into a few more subdivisions (Reg. §20.2010-1(c) and (c)(1)(i)(A) & (B)), is finalized without any change at all (except that "year" is replaced by "calendar period" and "period" in the two places it was used). And the only substantive change to the example in Proposed Reg. §20.2010- 1(c)(2) – now Reg. §20.2010-1(c)(2)(i), Example 1 – is to use more realistic (though not as simple) hypothetically inflation-adjusted BEAs of $11.4 million and $6.8 million rather than the unindexed $10 million and $5 million in the proposed regulations.

The final regulations add Reg. §20.2010-1(c)(1)(ii) and (iii) to clarify some of the calculations required to translate exclusions to credits, and they add three more examples. These additions help to answer some of the questions that had been raised about the proposed regulations, although many of those questions are specifically addressed only in the preamble and perhaps only illustrated in the examples.

Cost of Living Adjustments. The preamble to the final regulations acknowledges expressions of concern that the proposed regulations did not explicitly state that they applied to the BEA as indexed for inflation. Noting in the preamble that "by definition, the term BEA refers to the amount of that exclusion as adjusted for inflation," and that "inflation adjustments were not included in that example for purposes of more simply illustrating the special rule," Treasury and the IRS nevertheless relented and included hypothetically inflation-adjusted numbers in the examples.

Portability. The preamble to the final regulations states:

> Several commenters asked for confirmation that, even if the amount of BEA that is allowable under section 2010(c)(3) of the Code decreases after 2025, a DSUE amount elected during the increased BEA period will not be reduced as a result of the sunset of the increased BEA. Section 2010(c)(4) defines the DSUE amount as the lesser of the BEA or the unused portion of the deceased spouse's applicable exclusion amount (AEA) at death. The regulations in §§20.2010-1(d)(4) and 20.2010-2(c)(1) confirm that the reference to BEA is to the BEA in effect at the time of the deceased spouse's death, rather than the BEA in effect at the death of the surviving spouse.

Examples 3 and 4 in Reg. §20.2010-1(c)(2)(iii) and (iv) both illustrate the durability of a $11.4 million DSUE amount resulting from a portability election after 2017 and before 2026.

Use of Exclusion "Off the Top" Repudiated. There had been speculation (or hope?) that the regulations might address the option of making, for example, a $5 million gift during the 2018-2025 period (assuming no previous taxable gifts) and treating that gift as using only the temporary "bonus" exclusion resulting from the 2017 Tax Act, which is sometimes described as using the exclusion "off the top," still leaving the exclusion of $5 million (indexed) to generate a credit to be used against the estate tax after 2025. But, as many expected, the preamble to the final regulations states bluntly that "the increased BEA as adjusted for inflation is a "use or lose" benefit and is available to a decedent who survives the increased BEA period only to the extent the decedent "used" it by making gifts during the increased BEA period." Example 2 in Reg. §20.2010-1(c)(2)(ii) confirms that.

GST Exemption. The preamble to the final regulations reports that "[s]everal commenters asked for confirmation that, during the increased BEA period, donors may make late allocations of the increase in GST exemption to inter vivos trusts created prior to 2018." The preamble viewed that request as "beyond the scope of this rulemaking." Nevertheless, in a footnote, the preamble cited without reservation the Joint Committee on Taxation's Bluebook for the proposition "that a late allocation of GST exemption (increased by the increase in the BEA) may be made during the increased BEA period."

Similarly, the preamble to the final regulations notes that a "commenter requested confirmation and examples showing that allocations of the increased GST exemption made during the increased BEA period (whether to transfers made before or during that period) will not be reduced as a result of the sunset of the increased BEA." The preamble also found that "this request is beyond the scope of this project," but not before observing that "[t]here is nothing in the statute that would indicate that the sunset of the increased BEA would have any impact on allocations of the GST exemption available during the increased BEA period."

2. 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)

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 seems to be not allowed for 2018-2025 under new §67(g).

However, in Notice 2018-61 (July 13, 2018), entitled, 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.

Despite no further official guidance from the Service, the instructions for Form 1041 now provide:

> 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.
>
> * * *
>
> If this is the final return of the estate or trust, and there are excess deductions on termination (see the instructions for line 22), enter the beneficiary's share of the excess deductions in box 11 [Final year deductions], using code A. Figure the deductions on a separate sheet and attach it to the return.

3. Life Insurance Death Benefits: REG-103084-18 (March 25, 2019); T.D. 9879 (Oct. 15, 2019), 84 Fed. Reg. 58460 (Oct. 31, 2019); 2019-47 I.R.B. 1052 (Nov. 18, 2019).

Last year, in Notice 2018-41, the IRS stated its intent to propose regulations under Sections 6050Y and 101(a) respecting the changes made by the 2017 Tax act to the taxation of life insurance policies. The 2017 Tax Act added a new paragraph (3) to Section 101(a), entitled "Exception to Valuable Consideration Rules for Commercial Transfers," to deny exceptions to the "transfer for value rule" in the case of "reportable policy sales." Those exemptions had exempted the sale or exchange or other transfer of a life insurance policy from income tax if the transferee succeeds in whole or in part to the transferor's basis in the policy, or if the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer.

In 2019 Treasury and the IRS both proposed and finalized regulations under Sections 101 and 6050Y, regarding "reportable policy sales," "reportable death benefits," and the 2017 changes in the transfer for value rules. A reportable policy sale is defined as any direct or indirect acquisition of an interest in a life insurance contract, if at the time of the acquisition the acquirer has no substantial family, business, or financial relationship with the insured, apart from the acquirer's interest in the insurance contract. Treas. Reg. §1.101-1(c)(1).

Under Reg. §1.101-1(c)(2), the following are expressly not reportable policy sales:

(i) A transfer of an interest in a life insurance contract between entities with the same beneficial owners, if the ownership interest of each beneficial owner in the transferor entity does not vary by more than a 20% ownership interest.

(ii) A transfer between corporations that are members of an affiliated group (see Section 1504(a)) that files a consolidated return for the taxable year in which the transfer occurs.

(iii) The indirect acquisition of an interest in a life insurance contract if

(A) a partnership, trust, or other entity in which an ownership interest is being acquired directly or indirectly holds the interest in the life insurance contract and acquired that interest before January 1, 2019, or acquired that interest in a reportable policy sale reported in compliance with Section 6050Y(a); or

(B) immediately before the acquisition, no more than 50% of the gross value of the assets of the partnership, trust, or other entity that directly or indirectly holds the interest in the life insurance contract consists of life insurance contracts, and after the acquisition, with respect to that partnership, trust, or other entity, the person indirectly acquiring the interest in the life insurance contract and his or her family members own, in the aggregate, (1) for an S corporation, stock possessing 5% or less of the total combined voting power of all classes of stock entitled to vote and 5% or less of the total value of shares of all classes of stock of the S corporation, (2) with respect to a trust or estate, 5% or less of the corpus and 5% or less of the annual income, or (3) with respect to a partnership or other entity that is not a corporation or a trust, 5% or less of the capital interest and 5% or less of the profits interest.

(iv) The acquisition of a life insurance contract by an insurance company that issues a life insurance contract in a Section 1035 exchange.

(v) The acquisition of a life insurance contract by a policyholder in a Section 1035 exchange, if the policyholder has a substantial family, business, or financial relationship with the insured, apart from its interest in the life insurance contract, at the time of the exchange.

C. 2019-20 Priority Guidance Plan.

On October 8, 2019 Treasury and the Internal Revenue Service released their joint priority guidance plan for July 2019 – June 2020 (“Plan”). The Plan is again broken into Parts, but there are six Parts in this year’s plan, up from four Parts last year. Part 1 of this year’s Plan is now titled, “Implementation of the Tax Cuts and Jobs Act (TCJA)”. Part 2 of this year’s plan – “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 eight project to four. Part 3 of this year's Plan is entitled "Burden Reduction." Part 4 is entitled "Taxpayer First Act Guidance," and lists seven projects for implementation of the Taxpayer First Act, enacted July 1, 2019. Part 5 of this year's Plan is entitled "Bipartisan Budget Act of 2015 – Partnership Audit Regulations," and brings back regulatory guidance regarding partnership audits, which had been in the 2017-18 plan but was not included in the 2018-19 plan. 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 52 items, compared to 62 in the 2018-19 plan.

Trust and Estate Administration Expenses. Item 6 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." The Plan references Notice 2018-61, published on July 30, 2018, and suggests that regulations are forthcoming.

Qualified Business Income Deduction. Item 17 of Part 1 is entitled "Guidance on computational, definitional, and anti-avoidance rules under §199A and §643(f)." The Plan notes that final and proposed regulations were published on February 8, 2019, Notice 2019-07 was published on February 25, 2019, and Rev. Proc. 2019-38 (rental real estate safe harbor) was published on October 15, 2019.

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.

Clawback. Item 26 of Part 1 is entitled "Final regulations under §2010 addressing the computation of the estate tax in the event of a difference between the basic exclusion amount applicable to gifts and that applicable at the donor's date of death." The proposed regulations were published on November 23, 2018 and the final regulations were released on November 26, 2019 (discussed above).

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 four 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 did not appear in last year's 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:

9. Final regulations streamlining the § 754 election statement. Proposed regulations were published on October 12, 2017.

12 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.

17. Final regulations under §2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption.

To fulfill the "burden reduction" promise, the final regulations for items 12 and 17 above 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 Budgest Act of 2015 – Partnership Audit Regulations

6. General Guidance

Part 6 of this year's Plan (Part 4 of last year's plan) is titled "General Guidance" and is divided into traditional subject areas. Four items appear under the heading of "Gifts and Estates and Trusts":

1. Guidance on basis of grantor trust assets at death under §1014.
2. 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).
3. 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.
4. Regulations under §7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests.

These four items 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 2 and 3 both reflect Treasury's responses to public criticism of previously proposed regulations. Item 2 – 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 4 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. This will give individuals with affected retirement plans the option to withdraw slightly smaller amounts from their plans each year, giving individuals and beneficiaries the option to leave amounts in tax-favored retirement accounts for a slightly longer period of time, to account for the possibility that they may live longer.

D. SECURE Act

The "Setting Every Community Up for Retirement Enhancement" division (Division O) of the Further Consolidated Appropriations Act, 2020 was signed into law on December 20, 2019, effective January 1, 2020. The "SECURE Act" includes a revenue provision, which adds new subparagraph (H) to § 401(a)(9) and adds new definitions in § 401(a)(9)(E). These provisions replace the life expectancy payout with a 10-year payout rule for all but a new category of beneficiaries now defined as "eligible designated beneficiaries."

1. In General (Non-beneficiary-related significant changes).

- The Required Beginning Date (RBD) is changed from 70½ to 72 (April 1 of the year following the year the owner turns 72).

- The age limitation of 70½ for deductible (non-rollover) contributions to a traditional IRA is repealed. However, the amount excluded from income as a result of a qualified charitable distribution is reduced by the amount of any post-age 70½ deductible contribution, to the extent the distribution did not reduce a prior year's charitable distribution exclusion.

- There is a new allowance of a $5000 penalty-free withdrawal upon birth or adoption of child.

- **Notice 2020-6 (January 27, 2020)**

  Notice 2020-6 clarifies that IRA owners who attain age 70½ in 2020 will not have a required beginning date of April 1, 2021. Rather, their required beginning date will be April 1 of the year after the year in which they turn 72. For individuals who attained age 70½ in 2019, the required beginning date is April 1, 2020, and they must take their 2019 required minimum distributions by that date.

2. Rules Regarding Distribution of Plan After Death.

SEC. 401. MODIFICATION OF REQUIRED DISTRIBUTION RULES FOR DESIGNATED BENEFICIARIES

(a) MODIFICATION OF RULES WHERE EMPLOYEE DIES BEFORE ENTIRE DISTRIBUTION.—

(1) IN GENERAL.—Section 401(a)(9) of the Internal Revenue Code of 1986 is amended by adding at the end the following new subparagraph:

''(H) SPECIAL RULES FOR CERTAIN DEFINED CONTRIBUTION PLANS.—In the case of a defined contribution plan, if an employee dies before the distribution of the employee's entire interest—

''(i) IN GENERAL.—Except in the case of a beneficiary who is not a designated beneficiary, subparagraph (B)(ii)—

''(I) shall be applied by substituting '10 years' for '5 years', and

''(II) shall apply whether or not distributions of the employee's interests have begun in accordance with subparagraph (A).

''(ii) EXCEPTION FOR ELIGIBLE DESIGNATED BENEFICIARIES.—Subparagraph (B)(iii) shall apply only in the case of an eligible designated beneficiary.

''(iii) RULES UPON DEATH OF ELIGIBLE DESIGNATED BENEFICIARY.—If an eligible designated beneficiary dies before the portion of the employee's interest to which this subparagraph applies is entirely distributed, the exception under clause (ii) shall not apply to any beneficiary of such eligible designated beneficiary and the remainder of such portion shall be distributed within 10 years after the death of such eligible designated beneficiary.

''(iv) SPECIAL RULE IN CASE OF CERTAIN TRUSTS FOR DISABLED OR CHRONICALLY ILL BENEFICIARIES.— In the case of an applicable multi-beneficiary trust, if under the terms of the trust—

''(I) it is to be divided immediately upon the death of the employee into separate trusts for each beneficiary, or

''(II) no individual (other than a eligible designated beneficiary described in subclause (III) or (IV) of subparagraph (E)(ii)) has any right to the employee's interest in the plan until the death of all such eligible designated beneficiaries with respect to the trust,

for purposes of a trust described in subclause (I), clause (ii) shall be applied separately with respect to the portion of the employee's interest that is payable to any eligible designated beneficiary described in subclause (III) or (IV) of subparagraph (E)(ii); and, for purposes of a trust described in subclause (II), subparagraph (B)(iii) shall apply to the distribution of the employee's interest and any beneficiary who is not such an eligible designated beneficiary shall be treated as a beneficiary of the eligible designated beneficiary upon the death of such eligible designated beneficiary.

''(v) APPLICABLE MULTI-BENEFICIARY TRUST.—For purposes of this subparagraph, the term 'applicable multi-beneficiary trust' means a trust—

''(I) which has more than one beneficiary,

‘‘(II) all of the beneficiaries of which are treated as designated beneficiaries for purposes of determining the distribution period pursuant to this paragraph, and

‘‘(III) at least one of the beneficiaries of which is an eligible designated beneficiary described in subclause (III) or (IV) of subparagraph (E)(ii).

‘‘(vi) APPLICATION TO CERTAIN ELIGIBLE RETIREMENT PLANS.—For purposes of applying the provisions of this subparagraph in determining amounts required to be distributed pursuant to this paragraph, all eligible retirement plans (as defined in section 402(c)(8)(B), other than a defined benefit plan described in clause (iv) or (v) thereof or a qualified trust which is a part of a defined benefit plan) shall be treated as a defined contribution plan.’’.

(2) DEFINITION OF ELIGIBLE DESIGNATED BENEFICIARY.— Section 401(a)(9)(E) of such Code is amended to read as follows:

‘‘(E) DEFINITIONS AND RULES RELATING TO DESIGNATED BENEFICIARIES.—For purposes of this paragraph—

‘‘(i) DESIGNATED BENEFICIARY.—The term ‘designated beneficiary’ means any individual designated as a beneficiary by the employee.

‘’(ii) ELIGIBLE DESIGNATED BENEFICIARY.—The term ‘eligible designated beneficiary’ means, with respect to any employee, any designated beneficiary who is—

‘‘(I) the surviving spouse of the employee,

‘‘(II) subject to clause (iii), a child of the employee who has not reached majority (within the meaning of subparagraph (F)),

‘‘(III) disabled (within the meaning of section 72(m)(7)),

‘‘(IV) a chronically ill individual (within the meaning of section 7702B(c)(2), except that the requirements of subparagraph (A)(i) thereof shall only be treated as met if there is a certification that, as of such date, the period of inability described in such subparagraph with respect to the individual is an indefinite one which is reasonably expected to be lengthy in nature), or

‘‘(V) an individual not described in any of the preceding subclauses who is not more than 10 years younger than the employee. The determination of whether a designated beneficiary is an eligible designated beneficiary shall be made as of the date of death of the employee.

‘‘(iii) SPECIAL RULE FOR CHILDREN.—Subject to subparagraph (F), an individual described in clause (ii)(II) shall cease to be an eligible designated beneficiary as of the date the individual reaches majority and any remainder of the portion of the individual’s interest to which subparagraph (H)(ii) applies shall be distributed within 10 years after such date.”.

(b) EFFECTIVE DATES.—

(1) IN GENERAL.—Except as provided in this subsection, the amendments made by this section shall apply to distributions with respect to employees who die after December 31, 2019.

(2) COLLECTIVE BARGAINING EXCEPTION.— * * *

(3) GOVERNMENTAL PLANS.— * * *

(4) EXCEPTION FOR CERTAIN EXISTING ANNUITY CONTRACTS.—

(A) IN GENERAL.—The amendments made by this section shall not apply to a qualified annuity which is a binding annuity contract in effect on the date of enactment of this Act and at all times thereafter.

(B) QUALIFIED ANNUITY.—For purposes of this paragraph, the term ''qualified annuity'' means, with respect to an employee, an annuity—

(i) which is a commercial annuity (as defined in section 3405(e)(6) of the Internal Revenue Code of 1986);

(ii) under which the annuity payments are made over the life of the employee or over the joint lives of such employee and a designated beneficiary (or over a period not extending beyond the life expectancy of such employee or the joint life expectancy of such employee and a designated beneficiary) in accordance with the regulations described in section 401(a)(9)(A)(ii) of such Code (as in effect before such amendments) and which meets the other requirements of section 401(a)(9) of such Code (as so in effect) with respect to such payments; and

(iii) with respect to which—

(I) annuity payments to the employee have begun before the date of enactment of this Act, and the employee has made an irrevocable election before such date as to the method and amount of the annuity payments to the employee or any designated beneficiaries; or

(II) if subclause (I) does not apply, the employee has made an irrevocable election before the date of enactment of this Act as to the method and amount of the annuity payments to the employee or any designated beneficiaries.

(5) EXCEPTION FOR CERTAIN BENEFICIARIES.—

(A) IN GENERAL.—If an employee dies before the effective date, then, in applying the amendments made by this section to such employee's designated beneficiary who dies after such date—

(i) such amendments shall apply to any beneficiary of such designated beneficiary; and

(ii) the designated beneficiary shall be treated as an eligible designated beneficiary for purposes of applying section 401(a)(9)(H)(ii) of the Internal Revenue Code of 1986 (as in effect after such amendments).

(B) EFFECTIVE DATE.—For purposes of this paragraph, the term ''effective date'' means the first day of the first calendar year to which the amendments made by this section apply to a plan with respect to employees dying on or after such date.

PRE-SECURE ACT

	Death Before RBD	Death After RBD
Designated Beneficiary	Life Expectancy of Designated Beneficiary	Longer of: 1) Life Expectancy of Designated Beneficiary 2) Remaining Life Expectancy of Plan Owner
Non-Designated Beneficiary	Five-Year Rule	Remaining Life Expectancy of Plan Owner

POST-SECURE ACT

	Death Before RBD	Death After RBD
Eligible Designated Beneficiary	Life Expectancy of Eligible Designated Beneficiary	Life Expectancy of Eligible Designated Beneficiary (Longer of?)
Designated Beneficiary	Ten-Year Rule	Ten-Year Rule
Non-Designated Beneficiary	Five-Year Rule	Remaining Life Expectancy of Plan Owner

"Designated Beneficiary" means any (living) individual designated as a beneficiary by the employee. Note, a trust is *never* a "designated beneficiary." Some trusts, such as conduit trusts and accumulation, qualify as "see-through" trusts so that the individual beneficiaries of the trust are considered the designated beneficiaries. Non-designated beneficiaries are an estate, one or more charities, or a trust that does not qualify as a see-through trust.

"Eligible Designated Beneficiary" means only one of the following (IRC § 401(a)(9)(E)(ii)):

- Surviving spouse.
- Minor child ***of the plan participant or owner*.**
  - Ten-year rule applies upon child reaching age of majority (within the meaning of § 401(a)(9)(F)), or completing a "specified course of education" (up to age 26) (see Treas. Reg. § 1.401(a)(9)-6, Q&A 15).
- Disabled individual (within the meaning of Code § 72(m)(7).
- Chronically Ill individual (within the meaning of Code § 7702B(c)(2)).
- Individual not more than ten years younger than the participant or owner.

Upon the death of any eligible designated beneficiary, the 10-year rule applies. When a minor child of the participant reaches the age of majority, the 10-year rule applies.

Special rules continue to apply to surviving spouses as designated beneficiaries, if the benefits are not rolled over (whether named outright or as a conduit beneficiary): required minimum distributions do not have to begin until the end of the year in which the deceased participant would have reached age 72; and the spouse's life expectancy is recalculated annually.

Under the 10-year rule, all benefits must be withdrawn by December 31 of the year containing the 10th anniversary of the death of the participant (or the death of the prior eligible designated beneficiary). However, no amounts are required to be withdrawn in any given year during that period, so long as all the funds are withdrawn by the deadline.

3. What Has Not Changed.

The definition of "designated beneficiary" has not changed. The rules governing which trusts will be treated as "see-through" trusts for purposes of treating the beneficiaries of the trust as designated beneficiaries have not changed. The payout rules for a plan or IRA with no designated beneficiary have not changed. The rule allowing spouses, only, to roll over inherited benefits to his or her own IRA has not changed. The options for removing or paying out beneficiaries by the "beneficiary determination date" (September 30 of the year following the death of the participant/owner) have not changed.

4. Conduit Trusts and Accumulation Trusts.

Under the rules that have not changed, two types of trusts could qualify as see-through trusts – "conduit trusts" and accumulation trusts. Under a conduit trust, all distributions made from the retirement plan to the trust during the lifetime of the conduit beneficiary must be distributed to that beneficiary. This allows the conduit beneficiary to be the designated beneficiary of the plan, regardless of the identity of the remainder beneficiaries. A conduit trust would still work, but unless the conduit beneficiary is an eligible designated beneficiary, the 10-year rule will apply.

With an accumulation trust, the trustee can accumulate withdrawals from the retirement plan for possible distribution to one or more trust beneficiaries, currently or in the future. However, all beneficiaries who could ever possibly receive the plan benefits (including through the exercise of powers of appointment) are counted as beneficiaries for purposes of determining how to apply the minimum distribution rules, except that beneficiaries who are considered "mere potential successor" beneficiaries are disregarded. To be a see-through trust, all countable beneficiaries must be identifiable individuals. Under SECURE, a see-through accumulation trust will be subject to the 10-year rule, except for certain trusts for disabled or chronically ill individuals.

One exception to the 10-year rule for accumulation trusts is provided in the SECURE Act for trusts for the benefit of disabled or chronically ill individuals. New § 401(a)(9)(H)(iv) provides a special rule in the case of trusts for disable or chronically ill beneficiaries. So long as no individual other than an eligible designated beneficiary who is disabled or chronically ill has any right to the employee's interest in the plan until the death of such eligible designated beneficiary, the trust will qualify for a life expectancy payout based on the life of that eligible designated beneficiary. Upon the death of that eligible designated beneficiary, the other beneficiaries of the trust are treated as beneficiaries of the deceased eligible designated beneficiary. However, the trust must still qualify as a see-through trust, i.e., all beneficiaries must be identifiable individuals. A remainder to the eligible designated beneficiary's estate or to one or more charities would disqualify the trust from see-through treatment.

5. Beware of Existing Conduit Trusts.

Conduit trusts designed to take advantage of life expectancy rules should be reviewed. Any conduit trust with a beneficiary who is not an eligible designated beneficiary will not get a life expectancy payout, but will instead have to withdraw the entire plan balance under the ten-year rule. This means that the entire plan balance must be distributed out of the trust to the conduit beneficiary by the end of the tenth year after the owner's death.

6. Rules for Death Before 2020; Existing Inherited IRAs.

New rules in the SECURE Act relating to post-death distributions generally apply to deaths of plan participants, IRA owners, and designated beneficiaries after 2019. For any deceased participant (or IRA owner) prior to 2020, the amendments made by the SECURE Act apply

to such participant's beneficiaries, and an existing designated beneficiary is treated as an "eligible designated beneficiary." This means that the remaining balance of a plan or IRA, with respect to pre-2020 decedent participant or owner, must be distributed within 10 years of the death of the designated beneficiary. If a designated beneficiary died before 2020, the subsequent beneficiaries remain under the old rule – having to withdraw the IRA within the remaining period of the original designated beneficiary's life expectancy – but upon the death of such subsequent beneficiary, the benefits must be withdrawn with 10 years.

7. Questions and Answers.

Do the ages of trust beneficiaries who are treated as designated beneficiaries matter anymore?

No. Unless the trust is a conduit trust and the conduit beneficiary is an eligible designated beneficiary, the benefits must be withdrawn by the trustee with 10 years after the participant's death (expect for a special rule for disabled or chronically ill beneficiaries).

Can a trust for a minor "flip" from a conduit trust to an accumulation trust?

No, under current rules, once a conduit trust always a conduit trust. Absent further regulatory guidance that would allow such a "flip," a conduit trust for a minor beneficiary may use the minor's life expectancy until the beneficiary reaches the age of majority (and must distribute those plan withdrawals to such beneficiary), but that conduit trust must also distribute the entirety of the plan to the beneficiary within 10 years after the beneficiary reaches majority.

Does a disable/chronically ill beneficiary have to be the oldest beneficiary of the trust?

No. Under SECURE, if a trust qualifies as an accumulation see-through trust, the ages of the beneficiaries are irrelevant, and the 10-year rule applies, except in the case of a disabled or chronically ill beneficiary. In the case of such a beneficiary, so long as all beneficiaries of the trust are identifiable individuals, and no other beneficiary has an interest in the plan benefits during the lifetime of the disabled or chronically ill beneficiary, the trust will qualify for the special rule and the trustee will use that beneficiary's life expectancy for retirement plan withdrawals.

What happens upon the death of one of multiple designated beneficiaries of an existing trust treated as see-through trust?

Who knows? Under rules prior to SECURE, a trust with multiple beneficiaries could be treated as a see-through accumulation trust so long as all the beneficiaries were identifiable individuals. In such a case, the life expectancy of the oldest beneficiary was used in determining required minimum distributions. SECURE now provides that an

existing designated beneficiary (i.e. of a plan benefit from a pre-2020 death) is treated as an "eligible designated beneficiary," and that after the death of such beneficiary the 10-year rule applies. How will this rule apply to an accumulation trust with multiple designated beneficiaries? Does the 10-year rule apply only on the death of the oldest beneficiary, whose life expectancy was used for minimum required distributions? Regulations should answer this question.

8. Planning Considerations

• Roth Conversions

- No required minimum distributions
- Tax-free distributions, pre- or post- death
- Tax bracket now vs. later
- Use of outside funds to pay income tax liability
- Unused carryovers (i.e, NOL, charitable); current year ordinary losses
- Ten-year post death tax-free growth
- Taxable estate?

• Charitable Remainder Trusts

- Donor receives income tax deduction for present value of remainder (must be at least 10% of the value of contributed assets)
- Annual payments for life or a term of years
- Remainder to charity

FEDERAL TRANSFER TAX CASES AND RULINGS

A. Valuation

1. *Kress v. United States*, 372 F. Supp. 3d 731 (E.D. Wis. March 26, 2019).

District Court values family-owned S corporation stock to determine a refund of overpaid gift tax.

This case involves Green Bay Packaging, Inc. (GBP), a vertically integrated manufacturer of corrugated packaging, folding cartons, coated labels, and related products, founded in 1933 by George Kress and headquartered in Green Bay, Wisconsin. By 1988 GBP had elected to be an S corporation, and by 2016 when this case was filed it had about 3,400 employees in 14 states. The Kress family owned approximately 90% of GBP's shares of common stock, and GBP's employees and directors owned the remaining 10%.

There was an established price of 120% of book value for the sale and purchase of GBP shares by employees and directors. A right-of-first-refusal restriction in GBP's bylaws required that an employee or director shareholder give GBP written notice of intent to sell and offer to sell the shares to GBP before selling to others. There was no price established for shares transferred to members of the Kress family, but the following Family Transfer Restriction in the bylaws limited the transfer of shares by family members:

> Transfer of shares of the Corporation by shareholders who are members of the Kress Family … is hereby restricted to transfers by gift, bequest or private sale to a member or members of the Kress family, provided, however, that the children of George and Marguerite Kress may transfer shares of the Corporation by gift to such child's spouse or trust therefor and further provided that in the event of any such transfer as above provided to issue and descendants or spouse of a child or trust therefor of George and Marguerite Kress, that all of the restrictions set forth herein shall continue to be applicable to the shares of common stock then held by such issue and descendants or spouse or trust therefor as transferee.

James Kress (George and Marguerite Kress's son) and his wife Julie Kress made gifts of minority-interest shares of GBP stock to their children and grandchildren in 2006, 2007, and 2008 and filed gift tax returns for those years reporting the fair market value of the shares as $28.00 per share for 2007, $25.90 per share for 2008, and $21.60 per share for 2009. The IRS challenged the amounts reported on the gift tax returns, asserting that the gift tax value of the stock was the price used for actual share transactions between GBP and its employees, which was $45.97 per share for 2007, $47.63 per share for 2008, and $50.85 per share for 2009. The Kresses paid $1.8 million in gift tax deficiencies and filed amended gift tax returns seeking refunds for the additional taxes and interest they paid.

The sole issue in the case was the fair market value of the GBP stock the Kresses gave to their children and grandchildren in 2007, 2008, and 2009. The Government abandoned its

initial valuations and requested the court to adopt its expert's conclusions of fair market value of $38.40 per share for 2007, $27.81 per share for 2008, and $40.05 per share for 2009.

The District Court (Chief Judge Griesbach) determined that the Government's expert had overvalued the shares because he had failed to consider appropriate comparable companies under the market approach and the impact of the economic recession in 2008 and 2009, improperly treated non-operating assets, and applied a low lack-of-marketability discount.

Tax-Affecting. Both the Kresses' and the Government's experts tax-affected the earnings of the S corporation to apply a C corporation level tax to effectively compare the S corporation being valued to other C corporations that were used as comparables. For example, the Government's appraiser used a market approach (deriving multiples of enterprise value to earnings *before* interest, *tax*, depreciation, and amortization (EBITDA) and price to earnings of selected comparable companies and applying "the multiples to relevant GBP financial data") and also used an income approach by completing a capitalized cash flow analysis in which "[h]e applied an effective tax rate to GBP as if it were a C-corporation and then applied an adjustment to reflect the value of GBP as an S corporation"

The Government's expert also applied an S corporation premium because of advantages associated with being an S corporation, but the court found the subchapter S status to be a neutral consideration because there were also disadvantages of S corporation status ("including the limited ability to reinvest in the company and the limited access to credit markets"), and it was "unclear if a minority shareholder enjoys those benefits."

The Kresses offered the analysis of two valuation experts, and the court determined that one of the expert's valuations was the most reliable. That expert's valuation of the stock was $28.00 per share for 2007, $25.90 per share for 2008, and $21.60 per share for 2009.

Section 2703. The expert's valuation had attributed a 3% discount to the Family Transfer Restriction in GBP's bylaws. The Government asserted that the restriction must be disregarded under Section 2703. The Kresses argued that the restriction met each of the following three requirements of the exception in Section 2703(b):

> (1) It is a bona fide business arrangement.
>
> (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth.
>
> (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.

The court found the first requirement to be met, stating:

> GBP … is unmistakably an operating business. GBP is a family-owned S corporation, and there is no dispute that the Family Transfer Restriction was incorporated into GBP's Bylaws to ensure that the Kress family retains

> control of the company, to minimize the risk of disruption by a dissident shareholder, to ensure confidentiality of GBP's affairs, and to ensure that all sales of GBP minority stock are to qualified subchapter S shareholders.
>
> The Government argues that the Restriction does not constitute a bona fide business arrangement because it does not prevent a dissident Kress family shareholder from causing management discontinuity by failing to maintain confidentiality or by starting a competing business. But the fact that the objectives of the Restriction are not fail-proof does not mean that the Restriction is not a bona fide business arrangement. The family transfer restriction significantly reduces the risk of these things occurring.

The Government cited the paraphrase of Section 2703(b)(2) in Reg. §25.2703-1(b)(1)(ii) ("The right or restriction is not a device to transfer property to *the natural objects of the transferor's bounty* for less than full and adequate consideration in money or money's worth" (emphasis added)) for the proposition that the second requirement applies to gifts as well as to transfers at death. But, citing *Chevron, U.S.A., Inc. v. Nat'l Res. Def. Council Inc.*, 467 U.S. 837, 842 (1984), the court found the word "decedent's" in Section 2703(b)(2) to be unambiguous. As to the second requirement, then, the Kress court concluded:

> Because Plaintiffs gifted their shares to their family members as living persons, they are, by definition, not decedents. Therefore, § 2703(b)(2) is satisfied. But even were I to conclude that § 2703(b)(2) does apply to inter vivos transfers, this would not change the result. For as noted above, the family transfer restrictions serve the bona fide purpose of maintaining family ownership and control of the business, and were not intended as a tax avoidance device.

But after all that, the court found that the third requirement of Section 2703(b) was not satisfied, because the Kresses had "not produced any evidence that unrelated parties dealing at arms' length would agree to such an arrangement." So the court reduced the Kresses' expert discount by the 3% he had attributed to the Family Transfer Restriction. Accordingly, the court concluded the fair market value of the stock to be $29.20 per share for 2007, $27.01 per share for 2008, and $22.50 per share for 2009.

2. *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101 (Aug. 19, 2019).

Tax Court approves valuation of timberland by an income approach rather than net asset value and approves tax-affecting for valuing interests in an S corporation and a limited partnership.

Synopsis. In May 2009, Aaron Jones made gifts to his three daughters, and to trusts for their benefit, of voting and nonvoting interests in an S corporation and limited partnership that together operated a lumber and timber business that he had originally founded in 1954. He reported the gifts on his gift tax return with a total value of about $21 million, but the IRS

notice of deficiency asserted a value of about $120 million and a gift tax deficiency of about $45 million. The Tax Court (Judge Pugh) agreed with the taxpayer's appraiser that the value was about $24 million, and the resulting gift tax owed will apparently be less than $2 million.

The most significant issue from a monetary standpoint was that the timber was valued under the income method rather than the net asset value method where there is an ongoing business operation and the facts were clear that the timber will not be liquidated and the transferee would have no ability to force the liquidation. In addition, the Tax Court concluded that "tax-affecting" the earnings of the S corporation and limited partnership was appropriate in determining the valuations of the entities under the income method. The Tax Court has appeared reluctant to accept tax-affecting following its decision 20 years ago in *Gross v. Commissioner,* T.C. Memo. 1999-254, aff'd, 272 F.3d 333 (6th Cir. 2001).

Basic Facts.

(1) Background. The core business involved in the 2009 gifts was Seneca Sawmill Co. (SSC) of Eugene, Oregon. Mr. Jones founded SSC in 1954 as a lumber manufacturing business; in 1986 it elected to be an S corporation. The Tax Court opinion describes the significant growth of the business since 1954 and includes considerable detail about the operation and business environment of the lumber business. At the time of the gifts in 2009, SJTC (introduced and described in the next paragraph) held approximately 1.45 billion board feet of timber over 165,000 acres in western Oregon.

Originally relying on timber from federal lands, SSC began purchasing its own land in 1989 when environmental regulations had reduced the access to federal lands. In 1992 Mr. Jones formed Seneca Jones Timber Co. (SJTC), an Oregon limited partnership, to hold timberlands intended to be SSC's inventory and to obtain debt financing secured by the timberlands. SSC was the 10% general partner of SJTC and contributed to SJTC the timberland it had recently acquired. SSC and SJTC share a management team and share their headquarters in Eugene, which was built in 1996.

SSC's shareholders could not sell, give away, or otherwise transfer their SSC stock, except in compliance with a Buy-Sell Agreement. Any sale of SSC stock that caused SSC to cease to be an S corporation would be null and void under the Buy-Sell Agreement, unless SSC and the holders of a majority of its outstanding shares consented. If an SSC shareholder intended to sell, give away, or otherwise transfer SSC stock to a person other than a family member, the shareholder had to notify SSC, which had a right of first refusal to purchase those shares. If SSC declined to purchase the shares, the other shareholders were given the option to purchase them. If either SSC or other shareholders exercised their option to purchase shares, the purchase price was the fair market value of the shares, which was to be mutually agreed upon or, if the parties could not agree, determined by an appraisal. Under the Buy-Sell Agreement, the reasonably anticipated cash distributions allocable to the shares had to be considered and discounts for lack of marketability, lack of control, and lack of voting rights had to be applied in determining the fair market value.

Under SJTC's partnership agreement, no transfer of SJTC partnership units was valid if it would terminate the partnership for federal or state tax purposes. The consent of all partners was required for the substitution of a transferee of SJTC partnership units as a limited partner. A transferee who was not substituted as a limited partner would be merely an assignee. Limited partners were also subject to a Buy-Sell Agreement, which mirrored SSC's Buy-Sell Agreement: Any transfers that would terminate SJTC's partnership status for tax purposes were void; SJTC and then the other limited partners were granted a right of first refusal before a limited partner could transfer units; and a determination of fair market value had to take into account lack of marketability, lack of control, lack of voting rights of an assignee, and the reasonably anticipated cash distributions allocable to the units.

(2) 2009 Gifts. On May 28, 2009, pursuant to succession planning that began in 1996, Mr. Jones formed seven family trusts, made gifts to those trusts of SSC voting and nonvoting stock, and made gifts to his three daughters of SJTC limited partner interests.

(3) Gift Tax Valuation Dispute. Mr. Jones timely filed a 2009 gift tax return, reporting values based on accompanying appraisals that had determined values of $325 per share of SSC voting stock, $315 per share of SSC nonvoting stock, and $350 per SJTC limited partner unit, resulting in total gifts of about $20,895,000.

The IRS's notice of deficiency asserted that the corresponding values should have been $1,395 per share of SSC voting stock, $1,325 per share of SSC nonvoting stock, and $2,511 per SJTC limited partner unit, resulting in total gifts of about $119,987,000 and a gift tax deficiency (including other much smaller items which were not disputed in the Tax Court) of $44,986,416.

Mr. Jones filed a petition in the Tax Court in November 2013. He died on September 14, 2014, and was replaced in the Tax Court proceeding by his estate and his executors. The estate engaged another appraiser, Robert Reilly of Willamette Management Associates, whose appraisal, employing a discounted cashflow (DCF) method, determined values of $390 per share of SSC voting stock, $380 per share of SSC nonvoting stock, and also $380 per SJTC limited partner unit, somewhat higher than the values reported on Mr. Jones's gift tax return but far smaller than the values asserted by the IRS.

An appraiser engaged by the IRS, using a net asset value (NAV) approach, determined the value of an SJTC limited partner unit to be $2,530, slightly higher than the notice of deficiency. (The court explained that "Respondent did not submit a valuation of SSC and largely accepted the valuation methods and inputs Mr. Reilly used in his valuation of SSC." The IRS apparently had engaged a valuation expert with respect to the value of SSC shares, but used that expert only for rebuttal.)

Opinion. A four-day trial was held in Portland, Oregon, in November 2017, and Judge Pugh's opinion in *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101, was issued August 19, 2019, accepting all the values determined by Mr. Reilly.

In the view of the court:

> The primary dispute between the parties is whether SJTC should be valued using an income approach or an asset-based approach. The parties have several other points of dispute: (1) the reliability of the 2009 revised projections, (2) the propriety of "tax-affecting", (3) the proper treatment of intercompany loans from SSC to SJTC, (4) the proper treatment of SSC's 10% general partner interest in SJTC, and (5) the appropriate discount for lack of marketability.

(1) Income or Asset-Based Approach for SJTC. Whether an income or asset-based approach is used for valuing the timberland in SJTC makes an enormous dollar difference. Mr. Reilly agreed with a valuation submitted by the IRS that SJTC's timberland had an estimated market value of $424 million. Yet, using an income approach and comparisons to guideline operating companies, Mr. Reilly calculated the weighted enterprise value of SJTC to be $107 million – barely one-fourth the asset value. The court noted that the parties did not dispute that SJTC is a going concern, but also noted that "SJTC has aspects of both an operating company ("SJTC … plants trees and harvests and sells the logs") and an investment or holding company ("SJTC's timberlands are its primary asset, and they will retain and increase in value, even if SJTC is not profitable on a year-to-year basis")."

The court noted:

> When valuing an operating company that sells products or services to the public, the company's income receives the most weight. See *Estate of Andrews v. Commissioner*, 79 T.C. 938, 944-945 (1982). When valuing a holding or investment company, which receives most of its income from holding debt, securities, or other property, the value of the company's assets will receive the most weight. Id. at 945.

Applying those principles, the court stated:

> [T]he less likely SJTC is to sell its timberlands, the less weight we should assign to an asset-based approach. See *Estate of Giustina v. Commissioner*, 586 F. App'x 417, 418 (9th Cir. 2014) (holding that no weight should be given to an asset-based valuation because the assumption of an asset sale was a hypothetical scenario contrary to the evidence in the record), rev'g and remanding T.C. Memo. 2011-141.

The court concluded that:

> SJTC and SSC were so closely aligned and interdependent that, in valuing SJTC, it is appropriate to take into account its relationship with SSC and vice versa … We, therefore, conclude that an income-based approach, like Mr. Reilly's DCF method, is more appropriate for SJTC than [the IRS's expert's] NAV method valuation. *See Estate of Giustina v. Commissioner*, 586 F. App'x at 418.

Giustina, which the court cites, had also involved the valuation of a Eugene, Oregon, timber business, and the counsel for the estate, the counsel for the IRS, and the estate's expert had all been the same as in the Jones case. Rejecting Mr. Reilly's view in *Giustina*, the Tax Court (Judge Morrison) had given a 25% weight to a $151 million value determined by an asset approach, compared to a value of $52 million determined by a cashflow method and given a 75% weight. As Judge Pugh's reference to *Giustina* (quoted above) acknowledges, that decision was reversed by the Court of Appeals for the Ninth Circuit's "holding that no weight should be given to an asset-based valuation because the assumption of an asset sale was a hypothetical scenario contrary to the evidence in the record." In fact, quoting from a previous opinion, the Ninth Circuit bluntly stated in *Giustina*:

> As in *Estate of Simplot v. Commissioner*, 249 F.3d 1191, 1195 (9th Cir. 2001), the Tax Court engaged in "imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect" with the existing partners.

If the Tax Court in Jones had accepted an asset-based valuation, the estate could have appealed that decision to the Ninth Circuit. It is certainly plausible that the taxpayer's victory in Jones, at least on the issue of the asset-based approach, is attributable in part to the rebuke the Ninth Circuit had given the Tax Court in *Giustina*.

(2) Reliability of 2009 Revised Projections. Mr. Reilly's valuation relied on revised projections that SJTC's management made less than two months after SJTC's annual report, out of concern that SJTC might violate its loan covenants. The revised projections were made in April 2009, and the gifts were made in May 2009. The IRS and its expert thought the revised projections "may have represented the worst-case scenario and were overly pessimistic."

The court acknowledged the ground for such alleged pessimism in its description of the background and history of the business, where it noted:

> As of the valuation date SSC's dimension and stud lumber were used primarily to build houses and, therefore, its lumber sales were almost completely dependent on housing starts.
>
> …
>
> As of the valuation date the United States was experiencing severe economic turmoil amidst the subprime mortgage crisis, especially in the housing market. Housing starts, which measure new residential construction projects during a given period, declined in the United States from 2.3 million units in early 2006 to 490,000 units in early 2009. The crisis required SSC to reduce production. It also reduced the hours that its employees worked so that it could avoid layoffs.

Regarding the IRS's objection to the 2009 revised projections, the court turned the objection around and concluded:

> The only ground for challenging the reliability of the revised projections is that the volatile economic conditions meant that they were not reliable for long. This is precisely why management wanted the revised projections. As they were the most current as of the valuation date, Mr. Reilly's use was appropriate.

(Compare *Kress v. United States*, where the court took judicial notice of the 2008 recession.)

(3) Tax-Affecting. "Tax-affecting" refers to the step in the valuation of a closely-held business that seeks to adjust for certain differences between passthrough entities and C corporations. Typically, the passthrough entity in mind is an S corporation, but tax-affecting can be applied in the partnership context too. Significantly, *Jones* involved tax-affecting for both an S corporation (SSC) and a partnership (SJTC).

While many discussions of tax-affecting are quite technical, the core justifications for tax-affecting are generally (1) that a hypothetical willing buyer in the willing-buyer-willing-seller construct of fair market value is looking for a return on the investment and necessarily will enjoy and therefore evaluate that return only on an after-tax basis and (2) that comparable data to use in the valuation process typically comes from public sources and therefore largely comes from C corporations, for which earnings are, again, necessarily determined on an after-tax basis. Corollaries to those justifications are that passthrough status (3) confers a benefit of a single level of tax compared to a C corporation, but also (4) limits the universe of potential buyers and investors, who might not be able to buy or invest without forfeiting or jeopardizing (or at least complicating) the S corporation status or other passthrough status. Thus, tax-affecting sometimes includes adjustments to accommodate those corollaries, or sometimes is followed by the application of, for example, an "S corporation premium" as the next step following the tax-affecting.

Tax-affecting was approved by the court in *Kress*, after being used even by the Government's expert in that case.

In *Jones*, Mr. Reilly tax-affected the earnings of SJTC and SSC by using a proxy for the combined federal and state income tax rates they would bear if they were C corporations, albeit taxed at individual, not corporate rates, in order to adjust for the differences between passthrough entities and C corporations (like the public companies used for comparison in the valuation process). The IRS objected to tax-affecting, arguing that there was no evidence that SJTC or SSC would lose its passthrough status and insisting that the Tax Court had rejected tax-affecting in cases such as *Gross v. Commissioner*, T.C. Memo. 1999-254, aff'd, 272 F.3d 333 (6th Cir. 2001), *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148, and *Estate of Giustina v. Commissioner*, T.C. Memo. 2011-141.

Tellingly, Judge Pugh summarized the dispute by suggesting that tax-affecting had inappropriately become more an issue with examiners and lawyers than a factual inquiry informed by experts and suggesting that the experts needed to be listened to. She said:

> While respondent objects vociferously in his brief to petitioner's tax-affecting, his experts are notably silent. The only mention comes in [the IRS's expert's] rebuttal report, in which he argues that Mr. Reilly's tax-affecting was improper, not because SJTC pays no entity level tax, but because SJTC is a natural resources holding company and therefore its "rate of return is closer to the property rates of return". They do not offer any defense of respondent's proposed zero tax rate. Thus, we do not have a fight between valuation experts but a fight between lawyers.

Against that background, Judge Pugh explained that prior cases such as *Gross, Gallagher,* and *Giustina* did not prohibit tax-affecting the earnings of a flow-through entity per se. Instead, she viewed the issue as fact-based, and noted that the court in those cases had simply concluded that tax-affecting was not appropriate for various reasons on the facts of those cases. The court viewed those cases as concluding that (1) assuming a zero income tax rate on the earnings properly reflected the overall tax savings of operating as an S corporation (*Gross v. Commissioner*); (2) the taxpayer's expert did not justify tax-affecting the earnings in balancing the burden of the individual level tax with the benefit of the reduced total tax burden (*Estate of Gallagher v. Commissioner*); and (3) tax-affecting the earnings resulted in a post-tax cash flow but the expert applied a pretax discount rate (*Estate of Giustina v. Commissioner*). In *Jones*, on the contrary, Judge Pugh concluded that Mr. Reilly's detailed tax-affecting analysis was appropriate:

> We find on the record before us that Mr. Reilly has more accurately taken into account the tax consequences of SJTC's flowthrough status for purposes of estimating what a willing buyer and willing seller might conclude regarding its value. His adjustments include a reduction in the total tax burden by imputing the burden of the current tax that an owner might owe on the entity's earnings and the benefit of a future dividend tax avoided that an owner might enjoy.… Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate.

Footnote 5 emphasized that Gross was decided on the evidence before the court, which was far different than in the current case:

> In *Gross* the expert applied a hypothetical 40% corporate tax rate to earnings but did not apply any premium to reflect the benefit of avoided dividend tax. Thus the Court was presented with a choice between a 40% or a 0% corporate tax rate. *Id.* That is not the choice before us here.

As stated, *Jones* involves tax-affecting for both an S corporation (SSC) and a partnership (SJTC). The court's discussion of tax-affecting is addressed to the partnership, SJTC, which comes first in its opinion, probably so that the court could address first what it regarded as

the "primary dispute" over the use of an income approach to value SJTC. But in the discussion specifically targeting SSC the court stated, without qualification:

> Mr. Reilly used the same methodology to tax-affect his valuation of SSC except that he used a different rate for the dividend tax avoided because his analysis of the implied benefit for SSC's shareholders in prior years yielded a different rate. We accept Mr. Reilly's method of tax-affecting the valuation of SSC for the same reasons we accepted it for the valuation of SJTC.

(4) Intercompany Loans. The IRS had argued that the intercompany debt (owed by SJTC to SSC) should be treated as a nonoperating investment asset and added to the value of SSC. Again emphasizing the interrelationship of the two companies, the court concluded:

> By eliminating SSC's receivable and SJTC's payable and treating their intercompany interest income and expense as operating income and expense, Mr. Reilly captured their relationship as interdependent parts of a single business enterprise. Because SJTC's intercompany interest income and expense were accounted for in the DCF method valuation, the intercompany debt need not be added in at the end as a nonoperating asset. See *Estate of Heck v. Commissioner*, T.C. Memo. 2002-34.

(5) SSC's General Partner Interest in SJTC. The IRS had argued that SSC's 10% general partner interest in SJTC should be valued as a nonoperating asset and a controlling interest by valuing it at simply 10% of the value of SJTC, rather than on the basis of expected distributions as in Mr. Reilly's DCF valuation. Consistently with its view of SSC and SJTC as a single business enterprise, the court rejected that argument.

(6) Discount for Lack of Marketability. The court noted that only 5% separated Mr. Reilly (35%) and the IRS's expert (30%) on the subject of lack-of-marketability discounts. The court added:

> Respondent contends that Mr. Reilly's 35% discount for lack of marketability was excessive and that he did not explain sufficiently how he arrived at the discount. We disagree. Mr. Reilly attached an appendix to his report in which he explained the reasoning behind the discount for lack of marketability. In doing so, he explained in detail the common empirical models--studies on the sales of restricted stock and on private, pre-IPO sales of stock--and the two theoretical models--the option pricing model and the DCF model--summarizing the methodology and results of individual studies. He then discussed the effect that restrictions on transferability have on a discount, as well as the other factors listed in *Mandelbaum v. Commissioner*, T.C. Memo. 1995-255, aff'd, 91 F.3d 124 (3d Cir. 1996). Mr. Reilly arrived at a 35% discount on the basis of the studies he previously discussed and on SJTC's unique characteristics, such as its Buy-Sell Agreement, its lack of historical transfers, a potentially indefinite holding period, its reported loss in the 12

> months before to [sic] the valuation date, and the unpredictability of partner distributions.

(7) Conclusion. The court concluded simply that "we therefore adopt the valuations in Mr. Reilly's report." Note: In February 2016, the Tax Court tried a case, still awaiting decision, that includes tax-affecting for valuing S corporation stock as one of its issues. *Estate of William Cecil v. Commissioner*, Cause Nos. 14639-14 and 14640-14 (trial held February 2016). As of November 30, 2019, the only entries on the Tax Court's dockets since the filing of briefs in July 2016 have been papers in January 2018 to change the captions of the cases to reflect both William and Mary Cecil's deaths and Petitioner's Notices of Supplemental Authority on April 12, 2019 (probably *Kress*), and August 20, 2019 (undoubtedly *Jones*), with IRS answers three days later in each case. In Cecil, as in Kress, both the taxpayer and the IRS's expert used tax-affecting in their analysis. In light of Jones, the Tax Court may have an especially hard time rejecting tax-affecting as a matter of law when both experts agree in its application. (Tax-affecting is not the only issue in the case.)

3. *Cavallaro v. Commissioner*, T.C. Memo. 2019-144 (Oct. 24, 2019)

On remand, the Tax Court finds an IRS expert's valuation to be generally sound, but defective in one mathematical detail that had overstated the gift by $6.9 million.

a. History. William and Patricia Cavallaro started Knight Tool Co. in 1976 to manufacture tools and parts used by other companies in assembling their own products. Knight Company developed a special prototype tool, with which it had limited success. At some point the Cavallaros' adult sons developed an interest in the special tool, and worked to improve and market it. The sons formed their own company to sell this product. Some years later, the two companies were merged, and the issue was whether the sons received too large an interest in the merged company. The IRS maintained that the sons' company had a pre-merger value of zero and that the parents had made gifts totaling $46.1 million to their sons as a result of the merger.

The Tax Court (Judge Gustafson) upheld the IRS position, reasoning that there was no evidence of arm's-length negotiations between the two companies. A key fact was that the parents' company owned the technology for the special tool and there was no documentation that the technology had ever been transferred to the sons' company. The Tax Court lowered the amount of the gift to approximately $29.7 million, adopting the conclusion of the expert the IRS had engaged in preparation for the Tax Court trial. The taxpayers were not able to meet their burden of proof to establish a lower gift amount. The court refused to hear challenges to the method used by the IRS expert on the grounds that the taxpayers could not show the correct amount of their tax liability. But the court rejected accuracy-related penalties, finding that the taxpayers had reasonably relied on the advice of their professional advisors.

The Court of Appeals for the First Circuit remanded the case to the Tax Court. The appellate court rejected the taxpayers' argument that the burden of proof shifted to the IRS, but agreed

with the taxpayers that they should have the opportunity to challenge the IRS expert's report to show that the Commissioner's valuation was "arbitrary and excessive," and, if they succeeded, then the Tax Court "must determine the proper amount of tax liability for itself."

b. Remand. On remand, the Tax Court (again Judge Gustafson) refused to allow the taxpayers to relitigate their view that the technology for the special tool had been owned by the sons' company, on which they had rested so much of their argument but which had been rejected by the "law of the case" determined by the Tax Court in 2014 and affirmed by the Court of Appeals in 2016. Similarly, the court refused to find "bias" in the IRS expert's failure to interview the principals of the business and to visit the site of the businesses, citing Shannon P. Pratt & Alina V. Niculita, Valuing a Business: The Analysis and Appraisal of Closely Held Companies 92 (5th ed. 2008) ("The need for the valuation analyst to visit the company facilities and have personal contact with the company personnel and other related people varies greatly from one valuation to another.")

Thus, upon reexamination the court found that the IRS expert's explanations demonstrate "the elements of common sense, informed judgment and reasonableness" (quoting Rev. Rul. 59-60, 1959-1 C.B. 237, 238, sec. 3.01) and "[his] valuation was not arbitrary and excessive, except in the one respect to which we now turn." That issue involved not judgment, but math. The expert's report and testimony made it clear that he intended to place the Cavallaro sons' company in the 90th percentile for profitability within its industry, and his report had used a profit margin of 7.5% to serve that purpose. The correction of his statistical method for developing the 7.5% figure showed that the correct profit margin for the 90th percentile is 9.66%. Because using 9.66% in the expert's own calculations showed a reduction in the amount of the gift by approximately $6.9 million as a matter of math, the court was "therefore able to say now that further proceedings are not necessary." In other words, while the parties filed additional briefs following the First Circuit decision, there was no new trial.

Thus, the Tax Court reduced its finding of the total taxable gifts from $29.7 million to $22.8 million.

4. CCA 201939002 (Sept. 27, 2019).

The IRS states that stock used to fund a GRAT while a merger is under consideration must be valued by taking the merger price into account.

The co-founder and Chairman of the Board of "Corporation A," a publicly-traded corporation, transferred shares of stock of the corporation to a GRAT on "Date 1." Prior to Date 1, there had been "negotiations with multiple parties" about a merger and eventually "exclusive negotiations with Corporation B." The ultimate merger agreement apparently was based on a certain value being attributed to the shares of Corporation A, substantially greater than the value at which the shares were trading. Not stated in the CCA is whether the merger negotiations had proceeded to the point of having an agreed, or at least strongly anticipated, merger price attributed to the shares of Corporation A on Date 1 when the gift was made. Later, on "Date 2," the merger with Corporation B was announced, which resulted in the

value of the Corporation A stock increasing substantially, though less than the agreed merger price.

The issue was whether the shares should be valued under Reg. §25.2512-2(b)(1) at the mean between the highest and lowest quoted selling prices on the date of the gift, or by taking into consideration the anticipated merger. Reg. §25.2512-2(e) states that if the value determined from the mean between the high and the low selling prices does not represent the fair market value of the shares, then some reasonable modification of the value shall be considered in determining fair market value.

Fair market value for transfer tax purposes is the price that a hypothetical willing buyer would pay a hypothetical willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Reg. §25.2512-1. The CCA reasons that the presumption of having "reasonable knowledge of relevant facts" applies even if the relevant facts were unknown to the actual owner of the property, citing *Estate of Kollsman v. Commissioner*, T.C. Memo. 2017-40, aff'd, 123 AFTR 2d 2019-2296 (9th Cir. June 21, 2019). It notes that "both parties are presumed to have made a reasonable investigation of the relevant facts," and "reasonable knowledge includes those facts that a reasonable buyer or seller would uncover during the course of negotiations," even though not publicly available (the "hypothetical willing buyer is presumed … to have asked the hypothetical willing seller for information that is not publicly available").

The CCA repeats the oft-stated general rule that post-transfer events may be considered only to the extent they are relevant to the value on the transfer date. E.g. *Estate of Noble v. Commissioner*, T.C. Memo. 2005-2.

The CCA cites two cases for authority that the value should be determined after taking into consideration the anticipated merger. In *Silverman v. Commissioner*, T.C. Memo. 1974285, aff'd, 538 F.2d 927 (2d Cir. 1976), cert denied, 431 U.S. 938 (1977), there was a gift of shares of preferred stock while in the process of reorganizing with the intent to go public, and the court rejected expert testimony that failed to consider the circumstances of the anticipated future public sale. In *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), aff'g 108 T.C. 244 (1997), the taxpayer was an officer and director of a corporation of which the board of directors had approved a merger agreement. After the merger was "practically certain to go through" but before the actual merger occurred, the taxpayer gave shares to charities. The court held that when the charities sold the shares, the taxpayer realized the gain under the assignment of income doctrine. While Ferguson was an anticipatory assignment of income case rather than a gift tax valuation case, the CCA points to the many factual similarities with Ferguson (a target search to find merger candidates, exclusive negotiations before the final agreement, generous terms of the merger, and an agreement that was "practically certain" to go through) in relying on it for the proposition that "the facts and circumstances surrounding a transaction are relevant to the determination that a merger is likely to go through."

The CCA concludes:

> Under the fair market value standard as articulated in §25.2512-1, the hypothetical willing buyer and willing seller, as of Date 1, would be reasonably informed during the course of negotiations over the purchase and sale of Shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger would undermine the basic tenets of fair market value and yield a baseless valuation.

The donor was the Chairman of the Board of the publicly traded corporation, and federal securities laws may have prohibited the donor from disclosing confidential information regarding the merger to a purchaser, but the CCA does not even mention, much less evaluate, that important point.

The CCA concludes categorically that "as of Date 1 [the date the GRAT was funded], the hypothetical willing buyer of the stock could have reasonably foreseen the merger and anticipated that the price of Corporation A stock would trade at a premium" and that "the hypothetical willing buyer …, as of Date 1, would be reasonably informed during the course of negotiations over the purchase and sale of Shares and would have knowledge of all relevant facts, including the pending merger." Although that may have been true on the full facts behind the CCA (which of course the authors of the CCA would have known), such confidence is not explained in the CCA itself. Under applicable case law, the CCA correctly views the willing buyer and willing seller in the valuation standard of Reg. §25.2512-1 as "hypothetical." The regulation deems those hypothetical parties to have "reasonable knowledge of relevant facts," and the anticipated merger certainly seems to be "relevant" to the value of the shares. The question under the regulation is whether knowledge of the merger would be "reasonable" in the case of secrecy imposed by law or agreement. The CCA seems to assume that such knowledge would be "reasonable" without discussion and without even acknowledging the question.

On the other hand, if on the full facts behind the CCA it was reasonable for hypothetical willing buyers to know about or suspect the pending merger discussions, then it might be possible that the market had already at least partly built the anticipated merger into the price of the stock. The CCA does not mention that either.

Finally, even if the anticipated merger were taken into account as a factor in determining the value of the stock for gift tax purposes on the date the GRAT was funded, that would not necessarily mean that the anticipated merger price would be the presumptive value on that date. There may have been some possibility that the merger would fall through, and even if the merger were consummated, the extent to which the merger actually impacted the value of stock after the merger was announced would be uncertain. Indeed, the CCA acknowledges that "after the merger was announced, the value of the Corporation A stock increased substantially, though less than the agreed merger price" (emphasis added).

B. Inclusion in Gross Estate

1. Powers of Appointment: PLRs 201845006, 201920001-201920003 & 201941008-201941023

Modifying a trust document to fill a vacancy in the role of an independent trustee with the power to create or alter a general power of appointment will not give rise to gift or estate taxes. Letter Ruling 201845006 (issued July 28, 2018; released Nov. 9, 2018).

In this ruling, the Trustee of an irrevocable trust had discretion to distribute income and principal to the primary beneficiary during such beneficiary's lifetime. The primary beneficiary held a testamentary general power of appointment. The permissible appointees were the primary beneficiary's creditors and descendants. The trust document also appointed an independent special Trustee, who had the power to (1) create a testamentary general power of appointment in any of grantor's descendants, (2) convert a general power of appointment to a nongeneral power and (3) eliminate a power of appointment in whole or in part.

The trust did not have an independent special Trustee because the individual designated as such declined to serve. The other Trustees were beneficiaries. The trust document did not provide a procedure for designating another independent special Trustee.

The beneficiaries obtained a court order modifying the trust document to appoint an independent special Trustee. The beneficiaries then requested a ruling from the IRS that (1) the proposed modification of the trust would not adversely affect its GST inclusion ratio; (2) the appointment of the independent special Trustee would not constitute the exercise or release of a general power of appointment that would give rise to a taxable gift by the primary beneficiary; and (3) the exercise of the independent special Trustee's powers to limit or eliminate the primary beneficiary's testamentary general power of appointment would not constitute the exercise or release of a general power of appointment that causes inclusion in the primary beneficiary's gross estate under Section 2041(a)(2).

The exercise or release of a general power of appointment is deemed a taxable gift by Section 2514(b). Moreover, under Section 2041(a)(2), a power released by a powerholder during his or her lifetime is subject to estate tax upon his or her death if the release is of such a nature that, if it were a transfer of property owned by the decedent, the property would be includible in the decedent's estate under Sections 2035 through 2038.

The IRS granted the requested rulings. The IRS stated that the modification and the appointment of the independent special Trustee does not change or transfer the interests of the primary beneficiary during his lifetime, nor does it confer any new rights to any beneficiaries. Since the exercise of the power of appointment would occur, if at all, at the primary beneficiary's death, he retained the same interest in the trust both before and after the modification.

Thus, the IRS concluded that the appointment of the independent special Trustee will not constitute the exercise or release of a general power of appointment, and therefore would not be a taxable gift by the primary beneficiary under Section 2514. In addition, the exercise of the independent special Trustee's powers regarding the power of appointment will not constitute the exercise or release of general power of appointment under Section 2041(a)(2).

The ruling also concluded that the proposed modification of the trust will not adversely affect its GST inclusion ratio.

The IRS rules that the reformation of trusts to correct scrivener's errors regarding Crummey withdrawal powers results in powers of appointment that are limited and not general. Letter Rulings 201920001-201920003 (issued Nov. 26, 2018; released May 17, 2019) and 201941008-201941023 (issued May 29, 2019; released Oct. 11, 2019).

Letter Rulings 201920001-201920003: Grantor created three irrevocable trusts, Trusts A, B, and C, for the benefit of his grandchildren by his three children, Son 1, Son 2, and Daughter. Trust A is for the benefit of Son 1's children (Grandchildren A, B, and C); Trust B is for the benefit of Son 2's children (Grandchildren D and E); Trust C is for the benefit of Daughter's children (Grandchildren F and G). Each trust provides (a) the trust property is divided into equal parts for each grandchild; (b) the trustee may distribute income and principal to or for the benefit of the grandchild in such amounts, at such times, and in such manner as the trustee in its sole discretion deems advisable for health, education (including college and professional education), welfare, and support in reasonable comfort and to permit the grandchild to enter into or engage in a business or profession in which the trustee believes the grandchild has reasonable prospects of success; (c) each grandchild has a broad testamentary power to appoint his or her trust; and (d) each grandchild has a 30-day *Crummey* power.

Grantor died and left part of his estate to each of the trusts. Spouse continued to make gifts to each trust until Spouse's later death. After Grantor's death, the trustees realized that the powers of appointment could be general, whereas they were intended to have limited the class of appointees to family members. Court, on petition of the trustees, reformed the three trusts to include the necessary limiting language to qualify each power of appointment as a limited power of appointment, expressly prohibiting the appointment of trust assets to a grandchild, his or her estate, his or her creditors, or the creditors of his or her estate. Grantor's accountant and attorney affirmed that the trusts were supposed to be GST tax exempt, and that the powers of appointment were supposed to be limited, rather than general. Court later amended its order to clarify that the trusts will end on the death of each grandchild, and the terminating distributions are outright and per stirpes. Court also amended its orders to limit the Crummey powers to the greater of $5,000 or 5% of the value of the assets out of which the power could be satisfied.

The IRS stated that (i) the judicial reformation and modification of the trusts will not cause their corpus to be included in the gross estate of Spouse for federal estate tax purposes; (ii) as reformed, the trusts do not give the grandchildren general powers of appointment for estate and gift tax purposes; (iii) the reformations do not constitute the exercise or release of any general powers of appointment for gift tax purposes; and (iv) the trusts are skip persons for

GST tax purposes (see Section 2613(a)(2)) and the deemed allocation rules allocate Grantor's and Spouse's GST exemptions to their gifts and bequests to the trusts.

The IRS stated that the relevant trust instruments, affidavits, and representations strongly indicated that Grantor and Spouse did not intend for the grandchildren to have general powers of appointment, and that the reformation was supported by clear and convincing evidence of scrivener's errors.

Letter Rulings 201941008-201941023: Settlor created six irrevocable trusts, one each for the benefit of a child of Settlor and Spouse during the child's lifetime, and thereafter in separate share trusts for the child's descendants. Each beneficiary was given a 30-day *Crummey* withdrawal power, limited only by the gift tax annual exclusion. Settlor and Spouse elected to gift-split, but on their gift tax return no GST exclusion was expressly allocated to the transfers, and the automatic allocation was not reported on the gift tax return Schedule C, "Computation of Generation-Skipping Transfer Tax." Grandparents also made gifts to the trusts, elected to gift-split, and incorrectly reported the gifts as direct-skip transfers, so there was no affirmative allocation of their GST exemption made to the transfers.

New estate planning counsel for Settlor informed him and Spouse that the withdrawal provisions should have limited the withdrawal rights to the greater of $5,000 or 5% of the aggregate value of the assets subject to withdrawal for each year. Failure to do so could create a general power of appointment in each beneficiary, frustrating the intended estate tax planning results of the trusts. On request by the trustees, State Court issued an order reforming the trust to eliminate the scrivener's error retroactive to the date of the trust's creation, contingent upon the issuance of a favorable private letter ruling. As reformed, the annual lapse of each withdrawal right is limited to the greater of $5,000 or 5% of the value of the trust assets.

The IRS stated that the reformation will not be deemed a release or lapse of a child's general power of appointment, that the only transferors to each trust are Settlor, Spouse, and the two grandparents, and that each of Settlor's and Spouse's GST exemption is automatically allocated to the transfers by Settlor and Spouse to each child's trust and each of the grandparents' GST exemption is automatically allocated to their transfers to each child's trust. The IRS concluded from the trust instruments, affidavits, and representations of the parties that the original terms were, because of a scrivener's error, contrary to the intent of Settlor, so that as a result of the reformation, the powers held by each child were retroactively recognized as limited powers of appointment, rather than general powers of appointment. Furthermore, each child's trust was a GST Trust for purposes of Section 2632(c), so the GST exemption of Settlor, Spouse, and each grandparent would have been deemed made automatically to the transfers.

C. Gift Tax

1. PLR 2019901003

A buyout of a former spouse's interest in jointly held property was incident to divorce and neither taxable sales nor taxable gifts under Sections 1041 and 2516.

Within seven months after A and B were divorced, Court entered Stipulation and Order 1, providing that (a) A and B would hold equal interests in Property as tenants in common; (b) A and B would each be responsible for payment of an equal share of the mortgage, taxes, and similar expenses; (c) improvements, repairs, or changes to the structure or décor of the Property would require the consent of both A and B; (d) the costs of improvements, repairs, and changes would be shared equally by A and B; (e) neither A nor B could sell his or her interest without first giving written notice to the other, which would trigger a 60day right of purchase; and (f) the purchase under this clause would be for 50% of the then-current fair market value as established by a professional appraisal, less the then-current payoff figure on the mortgage.

The Property then sustained heavy smoke and water damage during a fire at an adjoining home. These damages required repairs greater than those A and B had contemplated when they agreed to Stipulation and Order 1, which lacked a provision for resolving this dispute. A, who had the greater ability to handle unforeseen expenses, paid a disproportionate share of the costs of repairs not covered by insurance, and then negotiated a buyout of B's interest consistent with the terms of Stipulation and Order 1. At the request of A and B, Court reopened the divorce case and entered Stipulation and Order 2, stipulating that each party had obtained an independent appraisal of the fair market value of Property and that this value had been used for the buy-out, with adjustments for the additional costs expended by A in the remediation and repair of Property.

The IRS ruled that the transfers made by A and B were not taxable for either income or gift tax purposes. The IRS noted that B's transfer of an undivided one-half interest in Property to A and A's transfer of the net purchase price to B were made pursuant to a divorce or separation instrument, as defined in Section 71(b)(2). Although they occurred more than six years after the date on which the marriage ceased, Stipulation and Order 2 modified and amended the earlier Stipulation and Order 1, and the transfers were made to effect the division of property owned by A and B at the time of the cessation of their marriage. Thus, the transfers were "incident to divorce" under Section 1041, and no gain or loss was recognized. In addition, the couple's divorce occurred less than one year before Stipulation and Order 1 was entered, so that under Section 2516 the transfers pursuant to Stipulation and Order 1, as modified by Stipulation and Order 2, were deemed for gift tax purposes to have been made for full and adequate consideration in money or money's worth and thus not subject to gift tax.

D. Generation-Skipping Transfer Tax

1. PLR 201936001 (Sept. 6, 2019).

Taxpayer substantially complied with the requirements for allocating GST exemption to an indirect skip trust, despite failure to include a notice of allocation.

Taxpayer created and funded an irrevocable generation-skipping trust, Trust, to benefit Spouse and their descendants. Taxpayer retained Law Firm to prepare Taxpayer's gift tax return, which correctly reported the transfer as an indirect skip (on Schedule A, Part 3), and as intended, elected out of the automatic allocation rules with respect to the transfer to Trust. Taxpayer also allocated GST exemption to the transfer (on Schedule C, Part 2, Line 6), but Law Firm failed to attach a Notice of Allocation for this transfer. The gift tax return was timely filed and a copy of Trust was attached.

The IRS concluded that Taxpayer had substantially complied with the requirements of Section 2632(a) to allocate Taxpayer's GST exemption to the transfer to Trust. The IRS noted that Section 2642(g)(2) provides that an allocation of GST exemption that demonstrates an intent to have the lowest possible inclusion ratio with respect to a transfer or a trust shall be deemed to be an allocation of as much of the transferor's unused GST exemption as produces the lowest possible inclusion ratio, and that substantial compliance may be determined by the IRS from all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer. Here, that the information on the gift tax return, together with the terms of Trust (a copy of which was attached to the return), demonstrated an intent to allocate GST exemption to Trust and provided sufficient information to constitute substantial compliance.

E. Late Filing Penalties.

1. *Estate of Skeba v. United States*, 2019 WL 4885697 (D. N.J. Oct. 3, 2019).

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

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 days 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 later, 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.

STATE INCOME TAXATION OF TRUSTS

A. State Income Taxation of Trusts.

1. *North Carolina Dept. of Revenue v. Kimberly Rice Kaestner 1992 Family Trust*, 139 S. Ct. 2213 (June 21, 2019).

A state statute that taxes trust income solely on the basis of the residence of a beneficiary violates the Due Process Clause as applied.

The U.S. Supreme Court affirmed the decision of the North Carolina Supreme Court in *Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Dept. of Revenue*, 814 S.E.2d 43 (N.C. June 8, 2018). The summary and background from the North Carolina Supreme Court case is copied below.

The United States Supreme Court granted the North Carolina Department of Revenue's petition for a writ of certiorari on January 11, 2019. Oral argument was held on April 16. On June 21, 2019 the U.S. Supreme Court issued a unanimous opinion, delivered by Justice Sotomayor, holding that as applied to the Trust the North Carolina statute subjecting the Trust to state income taxation on the sole basis of a trust beneficiary's residence in the state violates the Due Process Clause. The first paragraph of the opinion is an excellent synopsis:

> This case is about the limits of a State's power to tax a trust. North Carolina imposes a tax on any trust income that "is for the benefit of" a North Carolina resident. N. C. Gen. Stat. Ann. §105–160.2 (2017). The North Carolina courts interpret this law to mean that a trust owes income tax to North Carolina whenever the trust's beneficiaries live in the State, even if – as is the case here – those beneficiaries received no income from the trust in the relevant tax year, had no right to demand income from the trust in that year, and could not count on ever receiving income from the trust. The North Carolina courts held the tax to be unconstitutional when assessed in such a case because the State lacks the minimum connection with the object of its tax that the Constitution requires. We agree and affirm. As applied in these circumstances, the State's tax violates the Due Process Clause of the Fourteenth Amendment.

Clearly the result is a taxpayer victory. But, does the Court's opinion shed any further light on the broader issue: in what circumstances does the state taxation of undistributed trust income satisfy the Due Process Clause? Notably, as the Court states in its footnote 8, "[w]e do not decide what degree of possession, control, or enjoyment would be sufficient to support taxation." Consider the various reasons the Court cites in its opening paragraph, and develops further in its opinion, that the mere residence of the beneficiaries in North Carolina does not supply the required "minimum connection" necessary to support state taxation of the trust.

First, the beneficiaries did not actually receive any income during the years in question. What if they had received some but not all of the distributable income?

Second, "the beneficiaries had no right to demand trust income or otherwise control, possess, or enjoy the trust assets in the tax years at issue." The trustee had "absolute discretion" in deciding when, whether, and to whom distributions would be made. The Court emphasizes that "[c]ritically, this meant that the trustee had exclusive control over the allocation and timing of trust distributions." Distributions could be made to one beneficiary to the exclusion of others, "with the effect of cutting one or more beneficiaries out of the Trust." What if distributions were governed by a standard involving, for example, the health, education, support, or maintenance of the beneficiary? Moreover, the trustee and not beneficiaries made investment decisions. A spendthrift clause prevented beneficiaries from assigning their interests in trust property to anyone. What if there were no spendthrift clause? In footnote 9 the Court answers that "[w]e do not address whether a beneficiary's ability to assign a potential interest in income from a trust would afford that beneficiary sufficient control or possession over, or enjoyment of, the property to justify taxation based solely on his or her in-state residence." While the trust agreement directs the trustee to be liberal in exercising its distribution discretion and the trustee could not act in bad faith or from some improper motive, the beneficiaries still could not demand distributions or direct that Trust assets be used for their benefit.

Third, the beneficiaries "could not count on necessarily receiving a specific amount of income from the Trust in the future." While the trust had been scheduled to terminate in 2009, the trustee, under the New York decanting statute, had distributed the trust assets to a new trust with a later termination date. As a result of these facts, as the Court states in its footnote 10, "one might characterize the interests of the beneficiaries as 'contingent' on the exercise of the trustee's discretion." The Court adds, predictably, that "[w]e have no occasion to address, and thus reserve for another day, whether a different result would follow if the beneficiaries were certain to receive funds in the future."

Giving still more emphasis to these three negative points, the Court summarizes:

> The beneficiaries received no income from the Trust, had no right to demand income from the Trust, and had no assurance that they would eventually receive a specific share of Trust income. Given these features of the Trust, the beneficiaries' residence cannot, consistent with due process, serve as the sole basis for North Carolina's tax on trust income.

The Court rejected North Carolina's counterarguments. For example, the Court stated (footnotes omitted, emphasis added):

> [T]he State argues that ruling in favor of the Trust will undermine numerous state taxation regimes. Tr. of Oral Arg. 8, 68; Brief for Petitioner 6, and n. 1. Today's ruling will have no such sweeping effect. North Carolina is one of a small handful of States that rely on beneficiary residency as a sole basis for trust taxation, and one of an even smaller number that will rely on the residency of beneficiaries regardless of whether the beneficiary is certain to receive trust assets. Today's decision does not address state laws that consider the in-state residency of a beneficiary as one of a combination of factors, that

> turn on the residency of a settlor, or that rely only on the residency of noncontingent beneficiaries, see, e.g., Cal. Rev. & Tax. Code Ann. §17742(a). We express no opinion on the validity of such taxes.

And in a footnote following its citation of the California statute, the Court elaborates on an ominous theme that had arisen at oral argument: "The Trust also raises no challenge to the practice known as throwback taxation, by which a State taxes accumulated income at the time it is actually distributed. See, e.g., Cal. Rev. & Tax. Code Ann. §17745(b)." Whether trustees and beneficiaries of trusts with California contacts should be frightened or reassured by this attention may be a question, as the Court put it, they must "reserve for another day."

As if there were any remaining doubt about the narrowness of the Court's opinion, Justice Alito, joined by Chief Justice Roberts and Justice Gorsuch, wrote a concurring opinion for the purpose, as he described it in his first paragraph, "to make clear that the opinion of the Court merely applies our existing precedent and that its decision not to answer questions not presented by the facts of this case does not open for reconsideration any points resolved by our prior decisions."

Last year's summary and background from *Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Dept. of Revenue*, 814 S.E.2d 43 (N.C. June 8, 2018):

> Joseph Lee Rice, III (the "Settlor"), a resident of New York, created the Joseph Lee Rice, III Family 1992 Trust (the "Family Trust") for the benefit of his children. William B. Matteson, also a resident of New York, served as the initial Trustee. The trust agreement provided that the Family Trust was to be governed by the laws of the State of New York. In 1997, Kimberley Rice Kaestner ("Kaestner"), one of the Settlor's children, moved to North Carolina. William B. Matteson resigned as Trustee in 2005, and David Bernstein ("Bernstein"), a Connecticut resident, became Trustee.
>
> In 2006, pursuant to the terms of the Family Trust Agreement, Bernstein divided the Family Trust into separate trusts for each of the three children. One of the separate trusts was the Kimberley Rice Kaestner 1992 Family Trust (the "Kaestner Trust"). The Kaestner Trust benefited Kaestner as well as her three children, each of whom resided in North Carolina from 2005 to 2008, the years at issue. The contingent beneficiaries of the Kaestner Trust were Kaestner's siblings, none of whom resided in North Carolina.
>
> From 2005 to 2008 the Kaestner Trust's assets were held by a custodian in Boston, Massachusetts. The ownership documents for some of the assets were located in New York, along with financial and legal records. Tax returns and trust accountings were all prepared in New York. The Kaestner Trust provided that all income and principal distributions from the trust were in Bernstein's discretion. Neither Kaestner nor her children received distributions from the Kaestner Trust between 2005 and 2008, although the Kaestner Trust made two loans during the same period, a $250,000 loan to Kaestner for an investment and another loan to a separate trust "to enable [that trust] to make a capital call on a limited partnership interest" held in that trust. Both

loans were eventually repaid to the Kaestner Trust. Kaestner and Bernstein communicated regularly regarding Kaestner's need for distributions and investment of the trust assets. In 2009, Bernstein transferred the Kaestner Trust assets to a new trust, the KER Family Trust.

Each year, from 2005 to 2008, the North Carolina Department of Revenue (the "State") taxed the Kaestner Trust on its income. The Kaestner Trust paid the taxes and sought a refund, which the State denied in 2011. Section 105-160.2 of the North Carolina statutes provides, in relevant part, that the state may tax the income of a trust "that is for the benefit of a resident of [North Carolina]." The Kaestner Trust sued, alleging that this statute was unconstitutional under the Due Process and Commerce Clauses of the United States Constitution as well as Article I, Section 19 of the North Carolina Constitution. The Commerce Clause argument was not addressed by the Court of Appeals and was therefore not addressed in the Supreme Court decision either.

The "minimum contacts" component of the Due Process Clause requires "some definite link, some minimum connection, between a state and a person, property or transaction [the government] seeks to tax." *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). In addition, the income attributed to the State for tax purposes must be rationally related to values connected with the taxing state. *Id.* And "it is essential in each case that there be some act by which the [party] purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws." *Skinner v. Preferred Credit*, 638 S.E.2d 203, 210-11 (N.C. 2006).

The *Kaestner* court found it critical in this case that a trust is an entity legally independent from its beneficiary, and that it was the trust beneficiaries, not the trust, that were North Carolina residents. Given the separate legal entities, the Court found that the beneficiaries' residence in North Carolina was irrelevant and the trustee's contact with North Carolina was insufficient to satisfy due process.

The court chose not to follow cases from Connecticut and California that had held that taxation of a trust did not violate due process when the beneficiary was a resident of that state. *Chase Manhattan Bank v. Gavin*, 773 A.2d 782 (Conn. 1999), *cert. denied*, 528 U.S. 965; *McCulloch v. Franchise Tax Board*, 390 P.2d 412 (Cal. 1964). The *Kaestner* court found those decisions unpersuasive because they failed to consider the separate legal existence of the trust in the analysis, and they imputed a benefit received by the beneficiary to the trust.

The Department of Revenue also argued that Bernstein restructured the trust at Kaestner's request and communicated with her regarding management of the assets, and that this indicated a continuing relationship with a North Carolina resident. The court found that the communication was infrequent, the meetings were held outside the state of North Carolina, and the restructuring occurred after the years at issue. The

court reiterated that the trust, not the beneficiary, would have to avail itself of the benefits and protections of the state to satisfy the requirements of due process.

The North Carolina Business Court, Court of Appeals, and Supreme Court all focused on the unique facts of the case in finding that the statute is unconstitutional as applied to the trust. The Supreme Court emphasized that its opinion is limited to an "as applied" standard, meaning the court considered only whether the statute is constitutional as applied to the trust. In responding to the trust's continued challenge to the constitutionality of the statute, on its face, the North Carolina Supreme Court noted the presumption that "any act passed by the legislature is constitutional" and stated that "any individual challenging the facial constitutionality of a legislative act must establish that no set of circumstances exists under which the Act would be valid." Because the trust presented only facts and evidence relevant to it, the North Carolina Supreme Court did not (and could not) consider whether the statute is unconstitutional on its face.

Dissent. Justice Samuel J. Ervin IV (whose grandfather, Senator Sam Ervin, had chaired the Senate Select Committee on Presidential Campaign Activities, known as the Watergate Committee, in 1973 and 1974) dissented in *Kaestner*, believing that the Connecticut and California cases of *Chase Manhattan Bank v. Gavin* and *McCulloch v. Franchise Tax Board* supported North Carolina's effort to tax accumulated trust income. The dissent did not address the possibility that *McCulloch* was distinguishable because the trustee in that case was also a resident of California.

Justice Ervin's dissent also noted the advancements of modern technology related to communications online and by telephone, rather than in person. He opined that a traditional analysis of physical presence in a state may need to be amended to reflect those changes in determining whether a taxpayer "purposefully" directs its activities to a state. His view is especially interesting in light of the decision of the United States Supreme Court only 13 days later in *South Dakota v. Wayfair*.

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.