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SELECTED FEDERAL AND ILLINOIS CASES, RULINGS AND STATUTES

Chicago Estate Planning Council

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FEDERAL STATUTES, REGULATIONS, AND ADMINISTRATIVE MATTERS

A. **Rev. Proc. 2017-58**, **2017-45 I.R.B. 489 (November 6, 2017)** sets forth the inflation-adjusted figures for exclusions, deductions, and credits for 2018, *as of October 19, 2017*, with the following caveat: "To the extent amendments to the Code are enacted for 2018 after October 19, 2017, taxpayers should consult additional guidance to determine whether these adjustments remain applicable for 2018. In the estate and gift tax area the figures contained in Rev. Proc. 2017-58, as amended by the Tax Cuts and Jobs Act discussed below, are the following:

- Applicable Exclusion Amount — Increases to $11,180,000*
- Annual Exclusion: — Increases to $15,000
- Foreign Spouse Annual Exclusion: — Increases to $152,000
- § 2032A Aggregate Decrease: — Increases to $1,140,000
- § 6601(j) 2% Amount: — Increases to $1,520,000
- § 6039F Gifts From Foreign Persons — Increases to $16,111
- 37%** Bracket for Trusts and Estates — Income over $12,700

* The applicable exclusion amount was doubled from $5,000,000 to $10,000,000 pursuant to the Tax Cuts and Jobs Act, indexed for inflation beginning after 2011. The exemption for 2018 of $11,180,000 is an estimate based on the new use of "chained CPI," which will produce slightly lower inflation-adjusted increases than under prior law. If the applicable exclusion amount was doubled but inflation adjustments were measured under prior law, the 2018 applicable exclusion amount would be $11,210,000. The IRS suggested guidance would be forthcoming in January or February, 2018.

** The Tax Cuts and Jobs Act reduced the top income tax rate to 37% from 39.6%.

B. **Tax Cuts and Jobs Act**

The "Tax Cuts and Jobs Act," as it is known[1] (TCJA), was signed by the President on December 22, 2017. Provisions related to estate and gift taxes, and trust fiduciary income taxes, include the following:

1. Basic Exclusion Amount Doubled

The TCJA doubles the basic exclusion amount provided in § 2010(c)(3) from $5 million to $10 million (indexed for inflation after 2011) for "estates of decedents dying or gifts made" after 2017 and before 2026.

The legislative history for the Act (the Joint Explanatory Statement of the Committee of Conference, referred to in this summary as the "Joint Explanatory Statement") refers to this

[1] The Senate parliamentarian ruled that the short title of the act was extraneous to reconciliation, and the short tile was removed in the final version of the act. The official title is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

change as doubling the "estate and gift tax exemption," but it also doubles the GST exemption because § 2631(c) states that the GST exemption is "equal to the basic exclusion amount under section 2010(c)."

The doubled basic exclusion amount will sunset on January 1, 2026, and there remains the prospect of exclusions decreasing based on the swinging of the political pendulum. Taxpayers may be motivated to make transfers to take advantage of the larger exclusion amount now available, but only significantly wealthy individuals are likely to be concerned with the gift tax exclusion amount decreasing to $5 million (indexed) upon a sunset.

2. Regulations Will Address "Clawback."

The Act amends § 2001(g) to add a new § 2001(g)(2), which reads as follows:

> (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—
>
> > (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and
> >
> > (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.

This provision deals with the possibility of a "clawback" – where a prior gift that was covered by the gift tax exclusion at the time the gift was made could arguable result in estate tax if the basic exclusion amount has decreased by the time of donor's death. , thus resulting in a "clawback" of the gift for *estate* tax purposes. This is the same concern that existed in 2012 when the possibility existed of the gift tax exclusion amount being reduced from $5 million (indexed) to $1 million.

3. Estate and Trust Expenses.

The TCJA added new § 67(g) to the Code, entitled "Suspension for Taxable Years 2018 Through 2025," which provides 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 67(a) provides, "in the case of an individual, the miscellaneous itemized deductions" may be deducted, but only to the extent the aggregate of such deductions exceeds 2% of adjusted gross income.

Miscellaneous itemized deductions are all itemized deductions *other than* those specifically listed in § 67(b). Executor and trustee fees are not listed in § 67(b), so does new § 67(g) preclude their deduction? It seems like it does not.

Executor and trustee fees and other estate and trust administrative expenses are deductible under § 67(e) to the extent that they are "paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in such trust or estate." Further, under § 67(e), such deductions shall be "allowable in arriving at adjusted gross income." (i.e. above-the-line deductions).

Section 67 does not authorize deductions (except for § 67(e) ?), but limits deductions that would otherwise be allowed under other Code sections. New § 67(g) says that miscellaneous itemized deductions are not allowed "notwithstanding § 67(a)," but makes no reference to § 67(e).

The specific reference to § 67(a) but not § 67(e) leaves the implication that deductions for estate and trust administration expenses continue to be allowed under § 67(e). Section 67(e) makes no reference to "itemized deductions" or "miscellaneous itemized deductions." Section 67(e)(1) states (independently of § 67(a)) that costs paid or incurred in connection with the administration of an estate or trust "shall be treated as allowable" in calculating the estate or trust's AGI as long as the expenses are "paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate," and § 67(e)(2) makes clear by specific reference that § 67 does not limit the deductions for estates or trusts under §§ 642(b), 651, or 661.

It seems that § 67(g) superseding § 67(e) would lead to illogical results. To say that new § 67(g) supersedes § 67(e) would suggest that it overrides not just § 67(e)(1) but also § 67(e)(2), which addresses §§ 642(b) (the deduction in lieu of personal exemption), 651, and 661. That would result in the illogical conclusion that § 642(b) is overridden although other provisions of the TCJA provide expanded relief under § 642(b), and would also mean that trusts and estates get no distribution deductions (which would completely overturn the basic premise of the income taxation of trusts and estates).

Further, because the deductions are allowable in "arriving at adjusted gross income," they are not "itemized deductions" at all (and therefore not miscellaneous itemized deductions) because of § 63(d)'s definition of itemized deductions: Section 63(d) provides:

> For purposes of this subtitle, the term 'itemized deductions' means the deductions allowable under this chapter other than (1) the deductions allowable in arriving at adjusted gross income, and (2) the deduction for personal exemptions provided by section 151."

Finally, the Joint Explanatory Statement describes the addition of § 67(g) as suspending "all miscellaneous itemized deductions that are subject to the two-percent floor under present law." Arguably, therefore, the intent was not to eliminate the deduction of items that were permitted under § 67(e) because they are not "subject to the two-percent floor under present law."

Excess Losses and Deductions at Termination of Estate or Trust.

Section 642(h) of the Code provides that on the termination of an estate or trust, if the estate or trust has a net capital loss carryover or a capital loss carryover, or has deductions in excess of gross income for such year, then the carryover or excess deductions shall be allowed, in accordance with regulations prescribed by the Secretary, to the beneficiaries succeeding to the property of the estate or trust.

Because net operating loss carryovers are allowed under § 172 and capital loss carryovers are allowed under § 1212, they are not itemized deductions, so new § 67(g) should not impact them.

However, with respect to excess deductions in the year of termination of an estate or trust, Treas. Reg. § 1.642(h)-2 provides that "the deduction is allowed only in computing taxable income and must be taken into account in computing the items of tax preference of the beneficiary; it is not allowed in computing adjusted gross income." Further, the deduction is not mentioned in § 67(b), and is thus a miscellaneous itemized deduction. Therefore, under new § 67(g), a beneficiary is not allowed a deduction for a final year estate or trust excess deduction (for 2018 through 2025). Indeed the Joint Explanatory Statement specifically includes "[e]xcess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust" as one of the "above listed items" that cannot be claimed as a deduction under § 67(g).

4. Planning Opportunities and Considerations.

a. Continued Use of Exemption for High Net Worth Clients

b. Use of Exemption as Sunset Approaches

c. Review Existing Formula Provisions

d. QTIP Trusts and Portability

e. State Estate Taxes

f. Basis Planning

g. *Causing Inclusion for Basis Step-Up and Eliminating Discounts*

h. *Nongrantor Trusts*

i. *Late Allocation of GST Exemption?* (the increased estate and gift (and GST) tax exclusion amount applies to "estates of decedents dying or gifts made after December 31, 2017.")

j. *Partnership Audit Rules*

k. *Business Entity Planning*

l. *Charitable Entity Planning*

All organizations subject to tax on UBTI, *except trusts*, are taxable at corporate rates on that income. Exempt trusts that are subject to tax on UBTI are taxed at trust rates. Given the reduction in the corporate income tax rate to 21%, charities operating as trusts may consider converting to non-profit corporations to take advantage of the lower rate for UBTI.

C. 2017-18 Priority Guidance Plan.

On October 20, 2017 Treasury and the Internal Revenue Service released their joint priority guidance plan for 2017-2018 ("Plan"). The plan was later than in prior years, and "contains guidance projects that [they] hope to complete during the twelve-month period from July 1, 2017, through June 30, 2018." The Plan is broken into four Parts. Part 1 focuses 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. Part 2 describes certain projects that the IRS has identified as burden reducing and that we believe can be completed in the 8 ½ months remaining in the plan year. As in the past, we intend to update the plan on a quarterly basis, and additional burden reduction projects may be added. Part 3 describes the various projects that comprise implementation of the new statutory partnership audit regime (which went into effect on January 1, 2018). Part 4, in line with past years' plans and the Service's long-standing commitment to transparency in the process, describes specific projects by subject area that will be the focus of the balance of our efforts this plan year.

1. Part 1. Identifying and Reducing Regulatory Burdens.

In last year's materials, nine pages were dedicated to proposed regulations issued under § 2704 on August 2, 2016. Thousands upon thousands of comments were submitted to the IRS and countless hours were spent on the proposed regulations and the effect they would have (or, according to the IRS, not have) on minority interest discounts. In general,

the proposed regulations dealt with 2 issues, one under section 2704(a) involving the lapse of liquidation and voting rights, and the other under section 2704(b), dealing with restrictions on (a) the ability of an entity to liquidate and (b) the ability of an individual holder of an interest to liquidate or redeem that interest. Now, those proposed regulations have been entirely withdrawn.

On April 21, 2017, President Trump issued Executive Order 13789, requiring the Treasury Department to review all significant tax regulations issued in 2016 and to date in 2017, to identify those that (1) impose an undue financial burden on United States taxpayers, (2) add undue complexity to the Federal tax laws, or (3) exceed the statutory authority of the IRS. On July 8, 2017, the IRS issued Notice 2017-38, identifying eight temporary, proposed, and final regulations promulgated after January 1, 2016 that met at least one of the first two criteria described in Executive Order 13789, including the proposed § 2704 regulations. The IRS did not identify any regulations that exceeded statutory authority.

On October 2, 2017, the Treasury Secretary Steven Mnuchin issued his Second Report in response to Executive Order 13789, which provided:

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

The proposed regulations were withdrawn on October 20, 2017.

2. Part 2. Near-Term Burden Reduction.

After Executive Order 13789 and the Treasury's actions in withdrawal or amending regulations in response thereto, the Treasury and the IRS continue to seek ways to reduce burdens on the service. Part 2 of the Plan "describes certain projects that [they] have identified as burden reducing" and that they believe can be completed by June 30, 2018.

The first item in Part 2 of the plan is a general statement regarding continued "[g]uidance removing or updating regulations that are unnecessary, create undue complexity, impose excessive burdens, or fail to provide clarity and useful guidance." Two specifically identified projects related to estates and trusts (which the Service believes can be completed by June 30, 2018) have been identified in previous priority guidance plans:

a. Basis Consistency

Like the proposed § 2704 regulations, last year's materials contained considerable discussion of the proposed regulations issued on March 4, 2016 under §§ 1014(f) and 6035 regarding basis consistency between estates and persons acquiring property from a decedent. Unlike the proposed § 2704 regulations, which have been entirely withdrawn, the Plan indicates that final basis consistency regulations will be forthcoming.

The finalization of the basis consistency regulations is identified as burden reducing. Hopefully this means that we can expect final regulations that will amend or provide some relief from some "burdensome" requirements in the proposed regulations, including the following:

- the requirement to provide estate tax values to beneficiaries within 30 days after the estate tax return is filed, which is likely to be long before the executor knows which beneficiaries will receive which assets, necessitating a wasteful, confusing, and divisive report of all assets the beneficiary might ever receive;
- the requirement that transferees of property from an estate who make subsequent transfers to "related transferees" furnish those estate tax values to recipients of gifts and other transfers in carryover basis transactions, apparently in perpetuity; and
- a "zero basis" for certain after-discovered or otherwise omitted property.

b. *Section 2642(g) Regulations*

The Plan also identifies for burden reduction "[f]inal regulations under § 2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption."

3. Part 3. Bipartisan Budget Act of 2015 – Partnership Audit Regulations.

Part 3 of the Plan "describes the various projects that comprise implementation of the new statutory partnership audit regime." The projects listed under Part 3 of the Plan are the following:

a. *General guidance under new partnership audit rules.*

b. *Regulations addressing administrative and judicial review rules.*

c. *Regulations addressing push out election by tiered structures.*

d. *Regulations addressing adjustments to bases and capital accounts and the tax and book basis of partnership property.*

e. *Regulations addressing the operation of certain international provisions in the context of the centralized partnership audit regime, including rules relating to the withholding of tax on foreign persons, withholding of tax to enforce reporting on certain foreign accounts, and the treatment of creditable foreign tax expenditures of a partnership.*

The newly enacted partnership audit provisions generally will require partnership audits to be conducted at the partnership level. This appears to be to facilitate the collection of tax by the IRS (although the BBA was enacted in 2015 (before Trump), these regulations seem in the theme of "burden reduction"). One major downside to being subject to the partnership level audit regime is that the highest tax rate will apply to any deficiency (depending on the type of income at issue).

Two items of note for purposes of these materials:

First, the BBA and the proposed regulations issued thereunder allow for a "push-out" election, which must be made within 45 days of the final adjustment of the partnership tax return in question. The push-out election seeks to impose tax on the partners of the partnership (or LLC members), who were partners in the tax year being audited, if there has been a change in identity of any partnership between the taxable year in question and the audit year. The second set of proposed regulations, issued December 15, 2017, provide rules for pushing out through tiers of partners that are themselves "pass-through partners." For purposes of the tiered push out rules, "pass-through partners" includes partnerships, S-corporations, certain trusts, and estates of decedents. Each pass-through partner may separately choose to either pay entity-level tax or push the adjustments through to its partners or other owners.

Second, a partnership may elect out of the new BBA partnership level audit regime altogether, but only if certain requirements are met, including that the partnership have fewer than 100 partners and that each partner is an individual, an estate of a deceased partner, an S corporation, a C corporation, or a foreign entity that would be treated as a C corporation if it were domestic. See § 6221(b)(1)(C). A trust-partner does not satisfy these requirements – not even a grantor trust, and not even a revocable trust. A partner that is a partnership or an LLC will also prevent the underlying partnership from opting

out of the centralized partnership audit rules. While the Joint Committee on Taxation General Explanation of the BBA in 2015 suggested that the Treasury could issue rules to include additional allowable partnership for purposes of opting out (i.e., revocable trusts or single-member LLCs that are disregarded entities for tax purposes), neither the proposed regulations from June, 2017 nor the final regulations issued January 2, 2018 provide such relief. Perhaps further guidance will be forthcoming.

4. Part 4. General Guidance.

Part 4 of the Plan, like previous priority guidance plans, "describes specific projects by subject area that will be the focus of the balance of [Treasury's and the Service's] efforts this plan year." It lists 166 items (down from 281 last year), including 3 items (down from 12 last year) under the heading of "Gifts and Estates and Trusts":

a. Guidance on basis of grantor trust assets at death under § 1014.

This initiative was new in the 2015-16 priority guidance plan and relates to the position of some practitioners that a grantor's death, which causes the obligation to report income to shift from the grantor to the trust, is an event under Code section 1014(b)(1) that allows for a step-up in basis on the trust assets even though they are not included in the grantor's estate. See also Revenue Procedure 2015-37, which provides that until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations, or otherwise, it will not issue rulings to taxpayers concerning whether the assets in a grantor trust receive a § 1014 basis step-up at the death of the deemed owner of the trust for income tax purposes when those assets are not includible in the gross estate. The Revenue Procedure is effective for ruling requests received after June 15, 2015. Rev. Proc. 2015-37, 2015-26 I.R.B. 1196. This issue involves, among others, assets that have been sold to a grantor trust and which are not includible in the estate of the grantor-decedent at his or her death. Because the assets are not includible in the decedent's estate, there is no step-up under Section 1014(b)(9). However, there is precedent under Section 1014(b)(1) that assets not includible in the decedent's estate can receive a basis step up. See, for example, Rev. Rul. 84-139, 1984-2 C.B. 168 dealing with foreign real property owned by a foreign person and passing to a U.S. Person at death. See also PLR 201544002, also dealing with foreign grantors, in which the Service granted the ruling request because it was received before the June 15, 2015 effective date of the Rev. Proc. Rev. Rul. 84-139 concluded that the property was inherited from a decedent and eligible for basis step up under 1014(b)(1). The argument for a Section 1014(b)(1) basis step up for grantor trust assets is that when a grantor dies the ownership of the trust assets changes, for income tax purposes, from the now-deceased grantor to the trustee, and this transfer of ownership comes within the

language of (b)(1) allowing a step up for "property acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent."

b. *Final regulations under § 2032(a) regarding imposition of restrictions on estate assets during the six month alternate valuation period.*

Proposed regulations were published on November 18, 2011 (the "anti-*Kohler* regulations"). These regulations address the effect of post-death events such as corporate reorganizations, the creation of partnerships or LLCs, or other factors whereby the executor or family members have control over a potential decrease in value during the period between death and the alternate valuation date.

c. *Guidance under § 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.*

This issue probably relates to *Graegin* loans, which are structured to prohibit prepayment over the life of the loan. If the interest is considered an ordinary and necessary administration expense (e.g., estate has a closely held business, or substantial partnership assets that cannot be easily liquidated), the entire amount of interest that is required to be paid is deducted under Section 2053 without regard to present value issues.

The 2017-18 Plan omitted several initiatives related to "Gifts and Estates and Trusts" that were in previous priority guidance plans:

a. *Guidance on qualified contingencies of charitable remainder annuity trusts under § 664.*

b. *Guidance on definition of income for spousal support trusts under § 682.*

c. *Final regulations under §§1014(f) and 6035 regarding consistent basis reporting between estate and person acquiring property from decedent.*

This project is included in Part 2 of the Plan, discussed above. Proposed and temporary regulations were published on March 4, 2016.

d. *Revenue procedure under §2010(c) regarding the validity of a QTIP election on an estate tax return filed only to elect portability.*

This was done. See Rev. Proc. 2017-34, discussed below.

e. *Guidance on the valuation of promissory notes for transfer tax purposes under §§2031, 2033, 2512, and 7872.*

This project seemed to have been aimed at the difference in valuation of promissory notes for gift tax purposes and estate tax purposes. (i.e., *Estate of Morrissette v. Commissioner*, 2016 T.C. No. 11).

f. *Guidance on the gift tax effect of defined value formula clauses under §§2512 and 2511.*

g. *Guidance under §§2522 and 2055 regarding the tax impact of certain irregularities in the administration of split-interest charitable trusts.*

h. *Regulations under §2704 regarding restrictions on the liquidation of an interest in certain corporations and partnerships.*

Proposed regulations were published in on August 2, 2016. These regulations have been withdrawn in the administrations burden-reduction efforts, as discussed above in Part 1 of the Plan.

i. *Guidance under §2801 regarding the tax imposed on U.S. citizens and residents who receive gifts or bequests from certain expatriates.*

j. *Regulations under §2642 regarding available GST exemption and the allocation of GST exemption to a pour-over trust at the end of an ETIP.*

This project appeared in previous years' priority guidance plan, but had been removed last year from the 2016-17 plan.

k. *Final regulations under §2642(g) regarding extensions of time to make allocations of the generation-skipping transfer tax exemption.*

This project appeared in previous years' priority guidance plan, but had been removed last year from the 2016-17 plan. However, this project reappears in Part 2 of the 2018-18 Plan, discussed above, for "near-term burden reduction." Proposed regulations were published on April 17, 2008.

Exempt Organizations. Several items appear in the Plan regarding exempt organizations:

a. *Update revenue procedures on grantor and contributor reliance under §§170 and 509, including update to Revenue Procedure 2011-33 for EO Select Check.*

b. *Final regulations on §509(a)(3) supporting organizations. Proposed regulations were published on February 19, 2016.*

c. *Guidance under §512 regarding methods of allocating expenses relating to dual use facilities.*

d. *Guidance on §529(c)(3)(D) on the recontribution within 60 days of refunded qualified higher education expenses as added by section 302 of the Protecting Americans from Tax Hikes Act of 2015.*

e. *Final regulations under §529A on Qualified ABLE Programs as added by section 102 of the ABLE Act of 2014. Proposed regulations were published on June 22, 2015.*

f. *Guidance under §4941 regarding a private foundation's investment in a partnership in which disqualified persons are also partners.*

g. *Update to Revenue Procedure 92-94 on §§4942 and 4945.*

PUBLISHED 10/02/17 in IRB 2017-40 as REV. PROC. 2017-53 (RELEASED 09/14/17).

h. *Guidance regarding the excise taxes on donor advised funds and fund management.*

i. *Final regulations under §6104(c). Proposed regulations were published on March 15, 2011.*

j. *Final regulations designating an appropriate high-level Treasury official under §7611. Proposed regulations were published on August 5, 2009.*

K. Rev. Proc. 2017-34: **Extension of Time to File a Portability Return**

Portability of a decedent's "DSUE" amount to a surviving spouse was enacted in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and made permanent by the Taxpayer Relief Act of 2012. Section 2010(c)(5)(A) requires that the executor of the deceased spouse's estate make a portability election on an estate tax return, which must include computation of the DSUE amount. Under § 2010 (c)(5)(A), a portability election is effective only of made on an estate tax return that is filed within the time prescribed by law (including extensions) for filing such return.

Rev. Proc. 2014-18, 2014-7 I.R.B. 513, allowed relief for certain estates through December 31, 2014. Namely, relief was allowed for late elections of "portability only" estate tax returns, or estate tax returns that are filed to elect portability but would not otherwise be required if the decedent's estate did not exceed the estate tax exemption amount. While the due date for filing estate tax returns for estates that are required to file due to the estate exceeding the exemption amount is statutory, found in Code § 6018(a), the due date to file a return for portability when the estate does not exceed the exemption amount is regulatory, found in section 20.2010-2(a)(1) of the Treasury Regulations. Therefore, an extension of

time to elect portability would be available under Treas. Reg. § 301.9100-3 for portability only returns but not required returns.

Rev. Proc. 2017-34 states that, since December 31, 2014 "the Service has issued numerous letter rulings under § 301.9100-3 granting an extension of time to elect portability under § 2010(c)(5)(A) in situations in which the decedent's estate was not required by § 6018(a) to file an estate tax return." Further, "the considerable number of ruling requests for an extension of time to elect portability received since December 31, 2014, indicates a need for continuing relief for the estates of decedents having no filing requirement under § 6018(a).," and "the considerable number of ruling requests received has placed a significant burden on the Service."

Therefore, provided that certain requirements are met, Rev. Proc. 2017-34 provides for another simplified procedure for estates with no filing requirement under § 6018(a) to obtain an extension of time under § 301.9100-3 to elect portability. The relief period is "the later of January 2, 2018, or the second anniversary of the decedent's date of death." January 2, 2018 has now passed, but the two year anniversary provision is permanent, meaning that so long as a portability only estate tax return is filed within two years of a decedent's death, an extension will be granted under § 301.9100-3 without having to request a letter ruling and pay the substantial user fee otherwise required for "9100 relief," provided that certain requirements are met:

1) the decedent (i) was survived by spouse, (ii) died after December 31, 2010, and (iii) was a citizen or resident of the United States;

2) the executor was not required to file an estate tax return under Section 6018(a) based on the value of the gross estate and adjusted taxable gifts and without regard to the need to file for portability purposes;

3) the executor did not file an estate tax return within the time required under Reg. § 20.2010-2(a)(1);

4) the election is made on a complete and properly prepared Form 706 that is filed on or before the second annual anniversary of the decedent's data death; and

5) the following statement appears at the top of the Form 706 – "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)." (§§ 3.01 & 4.01.)

Note the following:

- Relief under Rev. Proc. 2017-34 is not available if a return was filed.

- If a return was not filed within two years of a decedent's death, relief may still be available by filing a letter ruling request asking for 9100 relief. If two years have not passed since the decedent's death, a letter ruling will not be issued and the exclusive relief is the procedure contained in Rev. Proc. 2017-34.

- Relief under Rev. Proc. 2017-34 is null and void if it is later determined that a return was required to be filed under § 6018(a).

FEDERAL TRANSFER TAX CASES AND RULINGS

A. FLP / LLC / 2036 / 2038 Cases

Estate of Powell v. Commissioner, 148 T.C. No. 18 (May 18, 2017)

On May 18, 2017, the Tax Court issued a court reviewed decision in *Estate of Powell*, with some frightful analysis of the estate tax treatment of family limited partnerships.

This is another case of "bad facts make bad law." One week before the decedent's death, and while the decedent was hospitalized and concededly incapacitated (because the POA was only good in that event), her son, acting as agent under his mother's power of attorney, transferred $10,000,000 to a newly formed limited partnership for a 99% LP interest. That son and his brother contributed only unsecured promissory notes for the 1% GP interest. The same day, the POA agent son transferred the 99% LP interest to what was probably a close to zeroed out CLAT based on the decedent's life expectancy. The decedent died seven days later, so virtually nothing in fact passed to charity. Seven concurring judges viewed this as "what is best described as aggressive deathbed tax planning."

For gift tax purposes, the IRS reduced the discount of about 25 percent claimed by the taxpayer with respect to the transfer of the LP interest to the CLAT to about 15 percent, but also sought to tax virtually the entire value of the LP interest on the ground that the donor was terminally ill. As the main opinion pointed out, the IRS also added the resulting gift tax deficiency to the gross estate without allowing a corresponding increase in the Section 2053(a) deductions, which was plainly wrong but mooted by the estate tax treatment of the transaction.

For estate tax purposes, the IRS argued that the gift to the CLAT was invalid (because the authority of the agent under the power of attorney to make gifts was limited to the annual exclusion amount), that the LP interest remained part of the estate, and that the assets transferred to the LP were includible under Sections 2036(a)(1), 2036(a)(2), or 2038(a). It also argued that, if the gift to the CLAT was valid, the transferred assets were includible under Section 2035(a).

Judge Halpern, writing for only a plurality (eight judges, while nine judges concurred, seven in an opinion and two in the result only) found that section 2036(a)(2) applied to the decedent's transfer of assets into the LP. Eight judges joined the "court reviewed" opinion, seven joined in an opinion concurring in result only, and two concurred in the result without joining in either opinion.

The estate did not even argue against the application of § 2036(a)(2) had the decedent owned the LP interests at her death. The opinion stated, "[t]he estate does not deny that decedent's ability to dissolve [the LP] with the consent of her sons constituted a 'right … in conjunction with … [others], to designate the persons who shall possess or enjoy the property [she transferred to the partnership] in the income therefrom', within the meaning

of section 2036(a)(2)." The estate also conceded that "decedent's transfer of cash and securities to the partnership was 'not a bona fide sale for an adequate and full consideration in money or money's worth'." The estate argued only that § 2036(a)(2) did not apply because the decedent had given away her interest in the LP before her death.

The court found that the gift of LP interests to the CLAT was either void or revocable under California state law because the power of attorney only allowed gifts up to the annual exclusion amount. In addition, the court held that section 2035(a) would have applied to include the *assets transferred to the partnership* in the gross estate. Section 2035(a) provides as follows:

> (a) Inclusion of certain property in gross estate If—
>
> > (1) the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death, and
> >
> > (2) the value of such property (or an interest therein) would have been included in the decedent's gross estate under section 2036, 2037, 2038, or 2042 if such transferred interest or relinquished power had been retained by the decedent on the date of his death,
>
> the value of the gross estate shall include the value of any property (or interest therein) which would have been so included.

Importantly, the court relied not on a transfer of an interest in any property as described in § 2035(a)(1), but on the relinquishment of the power under § 2036(a)(2) (to dissolve the partnership with the consent of decedent's sons), to conclude that the assets of the LP (not the LP interest itself) would be included in the estate under § 2035(a).

The bona fide sale exception to inclusion under Section 2036(a)(2) generally depends in parts on the presence of a non-tax business purpose for the arrangement. In *Powell*, the court wrote that the transfer to the LP *was* made "'for a consideration in money or money's worth,' that is, a 99% limited partner interest." However, the estate did not challenge the IRS contention that Ms. Powell had no legitimate and significant nontax reason for creating the partnership; thus the transfer to the partnership was not a bona fide sale.

Powell is the first case to apply § 2036(a)(2) to include the assets of an LP in the gross estate of a decedent who owned only LP interests in the limited partnership (and never owned any GP interest). *Estate of Strangi v. Commissioner*, T.C. Memo 2013-145, *aff'd*, 417 F.3d 468 (5th Cir. 2005), involved similar facts and contained an analysis of § 2036(a)(2), and the Tax Court had relied on that section as an "alternative" to inclusion under § 2036(a)(1). The Fifth Circuit in *Strangi* wrote, however:

> Because we hold that the transferred assets were properly included in the taxable estate under § 2036(a)(1), we do not reach the Commissioner's alternative contention that Strangi retained the 'right ... to designate the persons who shall possess or enjoy the property', thus triggering inclusion under § 2036(a)(2).

The plurality opinion in *Powell*, on the other hand, decided the case on the basis of § 2036(a)(2) inclusion and did not discuss §§ 2036(a)(1) or 2038. The tax court memorandum opinion in *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209, also held that § 2036(a)(2) would apply, but in that case the decedent and his wife owned the 1% general partner interest upon the formation of the partnership and the decedent owned his 0.5% GP interest at his death.

Although there is no indication that the taxpayer addressed the issue, the *Powell* court, discussing *Strangi*, concluded that the "the grounds on which we distinguished *Estate of Strangi* from *Byrum* apply equally in the present case." The main opinion also pointed out that the facts in *Powell* are similar to the ones in *Strangi* in that the decedent had a 99 percent interest in the partnership and the GP was also the decedent's attorney-in-fact both prior to and after the creation of the partnership. It is not at all clear, however, why those facts have any bearing on the analysis of whether the decedent, "either alone or in conjunction with any person," had a Section 2036(a)(2) power. Possibly the court would give a little more weight to *Byrum* in that regard if there were other partners with more substantial interests, even if the other partners are family members, but it is not at all clear from the opinion that the court would do so.

Further, the main opinion engaged in analysis of the application of § 2043(a), an issue that was not raised by either party. Indeed, the concurring opinion observed that neither the estate nor the IRS had even cited that section anywhere in any briefs, and that the "Court's exploration of section 2043(a) [is] a solution in search of a problem."

Judge Halpern relied on Section 2043(a) to conclude that the Section 2036(a)(2) inclusion was limited to the difference between the value of the transferred assets and the discounted value of the LP interest. The main opinion includes a footnote noting a potential double inclusion issue where the LP interest are included in a decedent's estate if the assets appreciated in the meantime because the appreciation would be reflected to some extent in the date-of-death value of the LP interest, as well as the date-of-death value of the Section 2036(a)(2) inclusion. There was no double inclusion here because of the timing and the fact that nobody was claiming that the values had changed during the week before the decedent's death.

The concurring opinion disagreed with the Section 2043(a) analysis (after considering it unnecessary). As the court has done in the past (citing *Estate of Thompson*, 84 T.C.M. at 391; *Estate of Harper v. Commissioner*, T.C. Memo 2002-121; *Estate of Gregory v. Commissioner*, 39 T.C. 1012), the concurring opinion would treat the LP as having no

distinct value where the assets of the partnership are included under §§ 2035 – 2038, because the LP should be considered "an alter ego for the [assets contributed to the LP].

The analysis in this case suggests that any assets transferred to a family limited partnership in exchange for an LP interest may be subject to Section 2036(a)(2) inclusion if the partnership cannot be liquidated without the transferor's consent and the LP interest is includible in the transferor's gross estate. For the 99% interest type cases, the decision strongly indicates that, at a minimum, the 99% LP should not have any right to participate in a decision to liquidate the entity (and the GP should not have a POA from the LP).

B. Portability

***Estate of Sower v. Commissioner*, 149 T.C. No. 11 (Sept. 11, 2017)**

When Congress enacted portability between spouses in 2010 (made permanent in by the ATRA of 2012), it included Section 2010(c)(5)(B), as follows:

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

Despite this statutory provision, the taxpaying estate in *Sower* put forth several arguments against the IRS's ability to review a predeceased spouse's return to adjust the DSUE amount.

Minnie Sower was the surviving spouse of Frank Sower, who died in 2012, and his estate reported a deceased spousal unused exclusion (DSUE) amount and elected portability of the DSUE. In 2013, the IRS sent Frank's estate a letter stating that the return had been accepted as filed. Minnie died in 2013 and her estate claimed the DSUE amount reported by Frank's estate on Minnie's estate tax return. As part of an examination of the estate tax return filed by Minnie's estate, the IRS also examined the estate tax return filed by Frank's estate and reduced the amount of the DSUE amount by the amount of taxable gifts made by Frank but did not determine or assess a deficiency against Frank's estate.

However, the IRS determined an estate tax deficiency against Minnie's estate because of the reduction in Frank's DSUE amount. Minnie's estate filed a petition in which it made several arguments regarding why the IRS should be should not be allowed to examine the estate tax return filed by Frank's estate to determine the proper DSUE amount allowable to Minnie's estate.

Frank and Minnie had each given away $997,920 in taxable gifts before 2010, and they filed gift tax returns for the years the gifts were made. After Frank died in 2012, his estate filed an estate tax return reporting no estate tax liability, but which failed to report the taxable gifts. Frank's estate reported a DSUE amount of $1,256,033 and elected portability.

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

Minnie died on August 7, 2013. Her estate filed a timely return claiming a DSUE amount of $1,256,033.00 from Frank's estate. Her estate initially reported and paid an overall estate tax liability of $369,036. Three months later the estate paid an additional $386,424 in tax and interest to correct a mathematical error on the original return. Like Frank's estate, Minnie's estate did not include the lifetime taxable gifts on the estate tax return.

The IRS examined the estate tax return filed by Minnie's estate. In connection with that examination, the Commissioner also opened an examination of the return filed by Frank's estate to determine the proper DSUE amount available to Minnie's estate. On March 25, 2015, the IRS sent a letter and draft revised report showing an adjustment to the amount of Frank's lifetime taxable gifts. On July 20, 2015, the IRS sent a second estate tax closing letter to Frank's estate, which was identical to the first. The IRS did not request any additional information from or determine any additional liability for Frank's estate.

As a result of the examination of the return filed by Frank's estate, the IRS reduced the DSUE amount available to Minnie's estate from $1,256,033 to $282,690. The IRS also adjusted Minnie's taxable estate by the amount of her lifetime taxable gifts. These adjustments increased the estate tax liability for Minnie's estate by $788,165, and the IRS sent a notice of deficiency for that amount.

The court held as follows, rejecting Minnie's respective arguments:

- The IRS acted within the authority granted by I.R.C. § 2010(c)(5)(B) when it examined the estate tax return of a predeceased spouse to determine the correct DSUE amount.

- A letter stating that the estate tax return of a predeceased spouse has been accepted as filed is not a closing agreement under I.R.C. § 7121.

- A letter stating that the estate tax return of a predeceased spouse has been accepted as filed does not estop the IRS from examining the return of the predeceased spouse.

- An examination of the estate tax return of a predeceased spouse in which the IRS reviews the records in his possession and asserts no additional tax is not a second examination within the meaning of I.R.C. § 7605(b).

- The estate of a later deceased spouse cannot challenge whether an examination of the estate tax return of a predeceased spouse is an improper second examination within the meaning of I.R.C. § 7605(b) because only the examined party can seek protection from a second examination under I.R.C. § 7605(b).

- The applicable regulations relating to I.R.C. sec. 2010 do not prohibit the IRS from examining the predeceased spouse's return.

- The effective date of I.R.C. § 2010(c)(5)(B) does not preclude the IRS from adjusting the DSUE amount by gifts given before Dec. 31, 2010, when the DSUE amount affects an estate tax return for a decedent dying after Dec. 31, 2010.

- The IRS's application of I.R.C. § 2010(c)(5)(B) did not frustrate congressional intent with respect to portability.

- The period of limitations on assessment of tax for the estate of the predeceased spouse is not implicated if the IRS does not determine an estate tax deficiency for the estate of the predeceased spouse (and thus the application of § 2010(c)(5)(B) was not "unconstitutional for lack of due process").

In rejecting the estate's argument that the IRS could not adjust the DSUE amount on the basis of gifts given before December 31, 2010, the court cited the effective date of § 2010(c)(5)(B) contained in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which "shall apply to estates of decedents dying and gifts made after December 31, 2010." The court concluded, "[i]n context, it is clear that the effective date of section 2010(c)(5)(B), the estate tax amendment, is for decedents dying after December 31, 2010." Thus, "[b]ecause both Frank and Minnie died after December 31, 201, section 2010(c)(5)(B) applies to both their estates.

In rejecting the estate's argument that the examination of Frank's return violated Congress's intent with respect to portability and was an unconstitutional violation of due process because it overrode the statute of limitations on assessments established in Section 6501, the court wrote that Section 2010(c)(5)(B) does not give the IRS the power to assess any tax against the estate of the predeceased spouse outside of the period of limitations. However, quoting Reg. § 20.2010-3(d), the IRS "may examine returns of each of the surviving spouse's deceased spouses whose DSUE amount is claimed to be included in the surviving spouse's applicable exclusion amount, regardless of whether the period of limitations on assessment has expired for any such return."

***In re Vose*, 390 P.3d 238 (Okla. 2017) (January 17, 2017)**

A unanimous Oklahoma Supreme Court held that the executor has a duty to make an available portability election and may not refuse a surviving spouse's request to do so.

Mr. Vose was the surviving spouse of the decedent and the executor was (not surprisingly) a child of the decedent from a prior marriage. Mr. Vose had signed a prenuptial agreement in 2006 (predating portability) waiving any rights to a share of the estate, and had no interest in the estate other than the potential benefit of the portability election.

Despite having no other interest in the estate, the court wrote that the availability of a portability election under section 2010 of the Internal Revenue Code "grants Vose a potential interest in a part of Decedent's estate…. Vose may have a pecuniary interest as the surviving spouse in the portability of the DSUE, independent of his ability to take as an heir." The court found that the prenuptial agreement did not bar Mr. Vose from claiming an interest in the DSUE because it predated the existence of portability in the federal tax code.

The executor argued that, because the DSUE is valuable only to Vose, while at the same time being an estate asset under [the executor's] complete control, he should be allowed to demand consideration from Mr. Vose in exchange for making the election. The court rejected that argument because, indeed, the only person with an interest in and ability to use the DSUE is the surviving spouse. The court noted that Mr. Vose agreed to pay for the preparation of the return necessary to make the election.

Presumably, while Mr. Vose's prenuptial agreement predated portability, the inference is that a prenuptial agreement could now address the issue (to require the filing of the election?). Also, it is possible that any future court's determination of whether a portability return must be filed will be conditioned upon an agreement by the surviving spouse to pay for it.

C. Valuation

***Estate of Kollsman v. Commissioner*, T.C. Memo. 2017-40 (Feb. 22, 2017)**

Eva Franzen Kollsman died owning two 17th-Century Old Master paintings – "Village Kermesse, Dance Around the Maypole" by Pieter Brueghel the Younger, and "Orpheus Charming the Animals" by Jan Brueghel the Elder or Jan Brueghel the Younger or a Brueghel studio (the artist was uncertain). A Sotheby's expert (cochairman of Sotheby's Old Master Paintings Worldwide), had seen the paintings during several visits to decedent's residence during her lifetime, and near her date of death (according to the opinion, the letter was dated on the date of death), outlined proposed terms by which Sotheby's would auction the two paintings. The Sotheby's expert provided "preliminary estimates of $600,000 to $800,000 for Maypole and $150,000 for Orpheus. A few weeks later, the Sotheby's expert wrote to the executor that the fair market values of Maypole

and Orpheus, “based on firsthand inspection of the property,” were $500,000 and $100,000, respectively. The letter enclosed a proposed contract to auction the paintings. The executor was the legatee of the paintings.

About three to four weeks after the decedent’s death, the executor began the process of having the paintings cleaned and put in new frames by a leading art restorer, who provided a condition and treatment report stating that Orpheus had a “convex warp” and was “substantially bowed at the top and bottom.” The condition and treatment report for Maypole stated that it had a surface coating of “discolored natural resin” varnish and “heavy” surface dirt.

About 3.5 years after the date of death, Sotheby’s sold Maypole for a hammer price of $2.1 million (total price of $2,434,500), against a presale estimate of $1,500,000 to $2 million. Orpheus remained in the possession of the executor at the time of trial. On the estate tax return, the estate had valued Maypole at $500,000 and Orpheus at $100,000. In its initial notice of deficiency, the IRS asserted that the fair market values of Maypole and Orpheus were $1,750,000 and $300,000, respectively. “Subsequently,” according to the opinion (perhaps after the sale??), in an amended answer, the IRS asserted that the fair market values of Maypole and Orpheus were $2,100,000 and $500,000, respectively.

The Sotheby’s expert attributed the substantial difference between the actual sales price of Maypole and the appraised value to the improved condition produced by the cleaning and an increased market demand for Old Masters, and with respect to Orpheus, identified uncertain attribution, the bowing, and the dirtiness of that painting.

The tax court rejected the use of the informal appraisal by the Sotheby’s expert as a basis for estate tax valuation, and relied instead on that of the IRS expert, a Ph.D. and art historian with extensive art appraisal experience. The court found that the Sotheby’s expert overstated the dirtiness of the paintings and the risks involved in cleaning them and found it “remarkable” that the estate’s expert did not include comparable sales. But the court did allow a 5% discount against each painting for the risk of cleaning, a 10% discount for Orpheus for the fact that it was bowed, and a 10% discount for Orpheus for the questions about its attribution (for a total discount of 25% for Orpheus).

The court stated that the price for which Maypole was actually sold was relevant, even though the sale occurred after the date of death, citing *Ithaca Tr. Co. v. United States*, 279 U.S. 151 (1929); *First Nat’l Bank of Kenosha v. United States*, 763 F.2d 891, 894 (7th Cir. 1985); *Estate of Jung v. Commissioner*, 101 T.C. 412, 431-432 (1993); *Estate of Newberger v. Commissioner*, T.C. Memo. 2015-246, at *6.

***Estate of Koons v. Commissioner*, 686 Fed. Appx. 779 (11th Cir. April 27, 2017)**

This unpublished opinion from the Eleventh Circuit affirms the previously-reported-on *Estate of Koons* Tax Court Case, T.C. Memo 2013-94, denying a deduction for interest expense on a *Graegin* loan and reducing the valuation discount on LLC interests.

John Koons, III invested along with his father in a Cincinnati brewery, and eventually became the company's president and CEO. Thereafter, the company became a successful distributor of Pepsi products and entered the vending-machine business. The company was called Central Investment Corp. and by the 1980s Koons was the largest shareholder. In 1998 a lawsuit and countersuit began between PepsiCo and CIC, which ended with a settlement involving the sale of all of CIC's Pepsi distribution and vending machine businesses to an affiliate of PepsiCo.

In preparation for the sale, CIC transferred all of its non-soft-drink and non-vending-machine assets to a wholly owned subsidiary called Central Investment LLC ("CI LLC"). Part of the settlement involved PepsiCo paying $50 million to CIC which would in turn contribute the $50 million to CI LLC prior to the sale of CIC stock to PepsiCo. The CIC shareholders would transfer their stock to another LLC, called CIC Holding LLC, which would sell all of the CIC shares to the PepsiCo affiliate – that sale took place for about $352.4 million. After the closing of the sale, CIC Holding LLC was merged into CI LLC. All of the Koons children had owned CIC shares, either directly or through a Koons Family Trust.

The Koons children's agreement to sell their CIC shares was conditioned on CI LLC's redemption of their interest in CI LLC, which after the closing owned all of the non-Pepsi assets contributed by CIC, the $50 million cash payment from the settlement, and the $352.4 million from the sale (after the merger of CIC Holding LLC into CI LLC). CI LLC did offer to redeem the children's interests. Although some of the children were unhappy with the structure of the sale and redemption, all sold their interests in the LLC in the redemption.

When Koons died, his revocable trust owned a 50.5 total percentage interest in CI LLC, which included a 46.94% voting interest and a 51.59% nonvoting interest, but Koons' death occurred prior to the complete redemption of the children's interests. Following the redemptions, the decedent's revocable trust owned 70.42% of the voting interests and 71.07% of the nonvoting interests in CI LLC.

Koons' estate had about $19 million of liquid assets outside CI LLC. His estate tax return reported that Koons' estate owed about $21 million of estate tax and about $5 million of GST tax. To pay these taxes, Koons' estate borrowed $10.75 million from CI LLC in exchange for a promissory note. The note provided for equal installments of principal and interest over 6½ years, but not to begin for over 18 years. The interest rate was 9.5%, and the note prohibited prepayment. Total interest payments to be made under the note were calculated to be over $71.4 million, which the estate deducted under § 2053 as an administration expense.

<u>Valuation</u>

The estate valued its interests in the LLC with a 31.7% discount – a cumulative 26.6% discount for lack of marketability, 4% discount for post-sale contingent liabilities, and 3% discount for the 75% vote required to transfer interests outside of

the family. The estate's appraiser indicated an assumption that the redemption of the children's remaining interests would not occur.

The Tax Court held for the IRS, finding that the appropriate discount was 7.5%, rather than 31.7%. The court strongly favored and adopted the views of the IRS's expert, ignoring the 30% discretionary distribution limitation because a simple majority vote could remove it. He also noted that the LLC's underlying assets were overwhelmingly liquid, so a 70.42% owner could distribute most of these assets without liquidating the entity. The Tax Court was convinced that the signed redemption agreements would be carried out, and those agreements provided that the children's interests would be redeemed based on the full pro rata value of the LLC's assets.

Graegin Loan

The Tax Court held for the IRS, finding that the loan interest was not deductible, after determining that the revocable trust did not need to borrow the $10.75 million from CI LLC in order to pay the federal tax liability. First, there were significant liquid assets in the trust – more than $19 million. Second, when the trust borrowed the money in February, 2006, its voting interest had increased to 70.42% because of redemptions of some of the other members' interests, and the LLC had over $200 million dollars in highly liquid assets. The revocable could have forced distributions to pay estate taxes, and thus the loan was not necessary for the administration of the Estate.

The IRS issued a Litigation Guideline Memorandum dated March 14, 1989 in response to the decision in *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477. The Memorandum states the Service's position that interest on indebtedness is deductible as an administration expense only if the indebtedness is incurred to enable the estate to pay taxes due without selling non-liquid estate assets at a forced sales price. In order to be deductible, the interest must be certain to be paid, and the amount must be subject to reasonable estimation. The IRS also stated that the transaction must have substance and that unusual financing techniques, such as unsecured loans, high rates of interest, and loans with long terms should receive close scrutiny, especially if less expensive lending alternatives are available from third party sources.

The Court of Appeals for the Eleventh Circuit affirmed both holdings of the Tax Court. With respect to the valuation of the membership interests, the court held that the Tax Court had properly concluded that the redemptions would occur and that, after those redemptions, the revocable trust would have over 70% of the voting interests. The court agreed that it was reasonable to assume that these redemptions would be carried out, because the testimony at trial suggested that the children were not interested in an ownership stake in the LLC, but instead wanted cash, and that the managers of the LLC did not want the children to remain. The children had raised objections to some of the terms of the redemptions, but then they had signed the agreement, effectively waiving those objections.

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

PLR 201719014 (May 12, 2017)

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

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

Settled case: *Estate of Johnson v. Commissioner*, T.C. Docket No. 11708-16

In 2005, Ms. Johnson sold shares of a closely-held company in exchange for a self-cancelling installment note. The SCIN provided for current interest payments, but a balloon principal payment on April 28, 2013. Ms. Johnson died in January 2012, seven years after the SCIN transaction but about one year before the maturity date of the SCIN. The principal payments were cancelled pursuant to the terms of the SCIN.

In a somewhat "good facts" SCIN case, not only did the decedent survive for seven years after the transaction, of the $5,532,589 face amount of the SCIN, $2,941,356 represented a principal premium to compensate for the actuarial risk of Ms. Johnson's premature death and the cancellation of the note (a difference of $2,591,233). The risk premium "was determined by actuarial computations based on the life expectancy factors of Reg. § 1.72-9 (Table V)." In addition, the interest rate on the note was 4.28% per annum, which was a premium over the AFR of 4.09%.

According to the petition filed with the Tax Court, the IRS refused to treat the SCIN "as bona fide consideration equal in value to (i) the fair market value of such units, plus (ii)

the fair market value of the risk associated with the possibility of cancellation in the event that Decedent did not survive the term of the SCIN."

In addition, the estate reported the gain on the cancellation of the note as gain on the decedent's final income tax return rather than on the estate's first fiduciary income tax return, resulting in a substantial debt deduction for estate tax purposes. The IRS argued that the gain should be reported on the fiduciary income tax return, based on the Eighth Circuit Court of Appeals opinion in *Estate of Frane v. Commissioner* (998 F.2d 567) and Revenue Ruling 86-72. The taxpayer's position was that the Tax Court decision in *Estate of Frane* (98 T.C. 341) remains the controlling law in the Tenth Circuit, despite its reversal by the Eighth Circuit. The Tax Court in *Frane* held that the installment obligations were cancelled within the meaning of § 453B(f) and therefore the gain was recognized under § 453B(a) at the decedent's death, and that § 691 was therefore not implicated.

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

That case has now been settled, largely in the taxpayer's favor. The IRS settled for a $969,761 deficiency in a stipulated decision entered in the Tax Court on August 30, 2017.

D. Claims and Estate Tax Deductions

***Estate of Sommers v. Commissioner*, 149 T.C. No. 8 (August 22, 2017)**

The *Sommers* was a case involving a "net gift" transaction, and involved the taxpayer's argument that the gift tax paid was deductible on the federal estate tax return. The case also involved two distinct marital deduction issues, one of which related to the inclusion of the gift tax paid in the gross estate under § 2035 when the decedent died within three years of making the gift.

In 2001, the decedent (who was then divorced from the wife he later re-married) sought legal advice on how to transfer works from his art collection to his three nieces, who were then his closest living relatives. His attorneys offered two proposals to reduce or eliminate gift tax on the gift of the artwork. First, they recommended that decedent transfer the artwork to a newly formed limited liability company and then make gifts of the units representing ownership interests in the entity to the nieces. This recommendation assumed that, as a result of applicable valuation discounts, the appraised value of the units in the limited liability company would be less than the value of the artwork they represented. The attorneys also recommended that the decedent make the intended gifts in two stages, transferring some units to each niece on or before December 31, 2001, and the rest thereafter. Spreading the gifts across the end of the year would increase the portions of the gifts that could be covered by the gift tax annual exclusion and also allow the decedent to use the increased applicable exclusion amount of $1,000,000 that was scheduled to take effect in 2002. Decedent wanted to transfer the

maximum number of units possible to the nieces without incurring gift tax in 2001 and then complete the gifts of the units in 2002.

In accordance with the plan, decedent transferred the artwork to Sommers Art Investors, LLC and executed two sets of gift and acceptance agreements with his nieces, the first dated December 27, 2001 and the second dated January 4, 2002. When decedent and his nieces initially executed the agreements, they left blanks for the number of units for each transfer, pending completion of an appraisal of the artwork. The appraisal, completed in March 2002, assigned a value to the artwork that led decedent's attorneys to conclude that dividing the transfers of the units between 2001 and 2002 would not allow for the complete avoidance of gift tax.

After the nieces agreed to pay any gift tax resulting from the 2002 transfers, the gift and acceptance agreements were completed by filling in the blanks for the numbered units covered by each transfer. In addition, decedent and his nieces amended each of the 2002 agreements to add a provision in which each donee-niece "agreed to pay the gift taxes, if any, relating to the gift of the units, including, without limitation, any gift taxes, penalties, and interest that may later correctly be assessed." None of the 2002 agreements referred to apportionment of any federal estate tax liability resulting from the gifts, but none of them specifically exculpated the donees from other liabilities.

In June 2002, shortly before remarrying his ex-wife, decedent initiated litigation in Indiana against his nieces challenging the validity of the purported gifts and seeking return of the artwork. The litigation in Indiana and similar litigation initiated by his wife in New Jersey after decedent's death on November 1, 2002 ultimately upheld the validity of the gifts.

In an earlier case, *Estate of Sommers v. Commissioner*, T.C. Memo. 2013-8, the Tax Court held that a decedent made valid gifts of interests in a limited liability company holding artwork to his three nieces in December 2001 and January 2002. The surviving spouse had initiated that case as well, seeking a ruling that the gifts were not valid, therefore the inclusion of the artwork in the decedent's gross estate would result in the entire estate due on them being apportioned to the nieces under the New Jersey estate tax apportionment statute. The Tax Court ruled that the gifts were completed, but denied the motion for summary judgment on the estate tax apportionment issue, stating that the parties at that stage had not adequately briefed the issue. After the ruling in the prior *Sommers* case, the parties stipulated that the 2002 gift tax liability for the second tranche of LLC transfers to the nieces was $273,990. After the entry of that stipulation, in accordance with the agreements governing their gifts from decedent, the three nieces paid the gift tax due on the 2002 gifts.

In April 2002, decedent executed his will that directed his executor "to pay all of … [his] just debts … including funeral and burial costs, and expenses of … [his] last illness, and all costs and expenses of administering and settling … [his] estate." The will gave everything left after payment of those debts to decedent's surviving spouse.

Decedent died in November 2002. Decedent's wife succeeded to the property she owned jointly with decedent, received other property pursuant to beneficiary designations, and would have received all assets remaining in decedent's estate remaining after the payment of debts and expenses.

On the decedent's federal estate tax return, the executor (the surviving spouse) included assets totaling $1,734,476.29 that were either held in joint tenancy or tenancy by the entireties with the surviving spouse, or given to the surviving spouse directly through beneficiary designations. The estate also included "other miscellaneous property" of $59,494 and "lifetime transfers" of $507.34. The estate tax return included a potential claim of $200,000 against a trust of which the decedent was a beneficiary and co-trustee, and the artwork which had been given to the nieces. Both of these last two items were removed from the taxable estate. On the estate tax return, the decedent's estate took deductions for legal and accounting fees, other administration expenses, and debts of $413,459.86, and a marital deduction of $3,330,510.43 (including the value of the claim and the artwork). All of this left the decedent with a taxable estate, as reflected on the return, of $507.34.

The IRS, upon examination, and after the stipulation as to the amount of gift tax owed on the 2002 gifts, determined estate tax of $220,726 on a taxable estate of $494,716.65. The estate tax deficiency of $220,726 would reduce the marital deduction that the IRS would allow to $1,054,362.77.

The estate filed three motions for partial summary judgement seeking determinations that:

> (1) The gift tax owed at decedent's death on his gifts to nieces was deductible under Section 2053;
>
> (2) The estate was entitled to a marital deduction equal to the value of decedent's non probate property that the wife received or to which she succeeded that, under applicable state law, was exempt from decedent's debts and the expenses of the estate; and
>
> (3) Any federal estate tax due must be apportioned to the nieces and thus did not reduce the estate's marital deduction.

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

The IRS objected to the estate's first two motions but supported the third motion (that federal estate taxes should be apportioned to the nieces). The nieces supported the estate's first two motions but of course object to the third motion, and filed their own motion contrary to the estate's third motion. Thus, both the estate and the IRS opposed the niece's motion for summary judgment.

Deduction for Gift Taxes Paid After Death

The court wrote that the "gross-up" rule of § 2035, which adds to a decedent's gross estate the amount of gift tax paid on gifts made by a decedent within three years of death, was included in the Tax Reform Act of 1976 to "deter taxpayers from making gifts shortly before death to exclude from their estate (and avoid transfer tax on) the property used to pay the transfer tax." At the same time, the regulations under § 2053 provide that "[u]npaid gift taxes on gifts made by a decedent before his death are deductible." Treas. Reg. § 20.2053-6(d). The decedent's estate sought to invoke that provision of the regulations in this case, even though the nieces agreed to pay the gift tax in a net gift agreement.

The court noted that longstanding precedent established that a claim against an estate is deductible in computing the estate tax liability only to the extent that it exceeds any right to reimbursement to which its payment would give rise, and that this principal required denying to the estate any deduction for the gift tax owed at the decedent's death on his 2002 gifts to his nieces. Even if the estate had paid the gift tax after the decedent's death, it would have had a right to reimbursement from the nieces pursuant to the net gift agreements.

Further, the court wrote, the "key question" was when the decedent parted with the value that was used to pay the gift tax. Decedent effectively provided the nieces with the wherewithal to pay tax on the taxable gifts because for each niece, a portion of the units transferred in 2002 was ultimately determined to be a taxable gift, while another portion was determined to be the value necessary to pay the gift tax with respect to the net gift. Therefore, because the decedent made the transfers to the nieces before he died, he reduced his gross estate by not only the value of the taxable gifts but also the by the amount of the tax on the gifts.

Ultimately, the court found that inclusion of the gift tax in decedent's estate did not justify allowing a deduction for gift tax paid in this case any more than in a case of a gross gift for which the decedent paid the gift tax before the decedent died. The estate had "acknowledge[d] that the deduction [it] seeks would neutralize the impact of section 2035(b)."

Marital Deduction Reduced Due to Payment of Debts and Expenses

The court also denied the estate's motion for partial summary judgment regarding the effect of the payment of debts and claims on the marital deduction because the amount of the allowable deduction turned on the factual question of the extent to which assets otherwise exempt from claims against the estate were used to pay estate debts and expenses.

Section 2056(a) allows a deduction for the "value of any interest in property which passes or has passed from the decedent to the surviving spouse." Treas. Reg. § 20.2056(b)-4(a) provides that value for that purpose means net value. Consequently,

when property that would otherwise have been distributed to surviving spouse is used to satisfy debts of the estate, it is not included in the allowable marital deduction. The court stated, "[e]ven when marital assets would otherwise be exempt from debts and expenses under State law or the terms of the decedent's will, executors may be forced to sell those assets to satisfy debts and or pay expenses if nonmarital assets are insufficient."

Further, the deduction allowed to an estate under section 2053(a) for expenses and claims generally cannot "exceed the value, at the time of the decedent's death, of property subject to claims," but claims and expenses paid from property not subject to claims is nonetheless deductible if they are paid before the due date of the estate tax return. § 2053(c)(2). As described above, the assets of the estate other than assets passing directly to the surviving spouse as surviving joint tenant or by beneficiary designation totaled $59,494, but the estate claimed deductions on the estate tax return of $413,459.86 for fees, expenses, and debts.

The court held that either the allowable marital deduction must be reduced by the amount of the decedents fees, expenses, and debts paid from property otherwise passing to the surviving spouse, or the estate is not entitled to deduct in full the debts and expenses reported on the estate tax return. The factual question of the extent to which assets otherwise exempt were used to pay debts and expenses precluded the court's re-determination of the actual amount of the allowable marital deduction.

Marital Deduction Reduced by Estate Tax Incurred on Gift Tax Inclusion

Finally, the court ruled on the estate's third motion for summary judgment and the niece's opposing summary judgment. The court found, after a lengthy analysis, that under the New Jersey's estate tax apportionment statute, no portion of any estate tax could be apportioned to the three nieces. Because the LLC units the nieces received from their uncle were not included in computing the decedent's federal estate tax liability under the New Jersey apportionment statute, the nieces were not "transferees" against whom any of the estate tax liability could be apportioned for purposes of the New Jersey apportionment statute. **Notably, however, the court compared the New Jersey apportionment statute to statutes and common law from other jurisdictions, and appeared to concluded in *dicta* that under some state laws, estate taxes owed on the gift tax component of a net gift could be apportioned to the lifetime donees**.

The court went on to discuss whether the payment of the estate tax would reduce the marital deduction claimed by the estate, with respect to which the estate had argued, "New Jersey law does not permit apportionment of the tax to a surviving spouse's share of an estate, and so under no circumstances may the marital deduction be reduced for any estate tax."

The court, however, wrote that the New Jersey statute "does not provide absolute protection to a surviving spouse against bearing the economic burden of a tax

imposed on the decedent's estate." Further, "to the extent that property that would otherwise have been distributed to the spouse must be used to pay the tax, it would not be covered by the marital deduction allowed by section 2056(a)." If neither the estate nor the nieces were "transferees" subject to the apportionment statute, the federal estate tax liability would be apportioned entirely to the estate. To the extent that any tax apportioned to the estate reduced the residuary distributions ultimately made to the wife's beneficiaries, the tax would be paid out of that marital share of the estate.

The court did note that the New Jersey statute requires that total estate tax be apportioned in a manner that preserves for the benefit of decedent's spouse, to the extent possible, the benefit of any marital deduction. That statute provided insufficient grounds to rule that as a matter of law any estate tax due could not affect the allowable marital deduction. The court concluded that the existing record did not allow for the court to determine the extent to which the estate tax would reduce the value of the marital share of the decedent's estate.

E. Inclusion in Gross Estate

PLRs 201707007 and 201707008 (February 17, 2017)

Husband and Wife negotiated a settlement agreement in their divorce regarding marital support obligations and property rights. As part of that settlement, Husband proposed to transfer shares in Company to an irrevocable trust for the benefit of Wife, in exchange for which Wife relinquishes all marital rights and property claims that she might have acquired while married to Husband.

Under the trust terms, Wife will receive all net income during life and may, at the trustee's discretion, receive distributions of principal. The trustee is prohibited, however, from distributing Company shares to Wife or selling such shares in order to make principal distributions to Wife. If and when the trust hold assets other than Company stock, wife can withdraw the greater of a stated dollar amount or a stated percentage of the principal of the trust each year. The trust does not grant any powers of appointment to Wife. At Wife's death, any remaining trust principal will be distributed to Husband, or, if he predeceased Wife, his estate. The settlement agreement would not become final or binding until receipt of a favorable private letter ruling.

The IRS ruled that

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

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

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

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

CCA 201745012 (Nov. 9, 2017)

On Date 1, Donor formed Trust 1, an irrevocable discretionary trust for the benefit of Donor's first spouse and issue. Trust 1 terminates on the later of the death of Donor or his first spouse, at which time the principal and any accumulated income are distributed outright to Donor's issue per stirpes. Donor's first spouse predeceased him; Donor then married Spouse.

On Date 2, Donor formed Trust 2, an irrevocable trust – a GRAT – for the benefit of Donor and his issue. Under the terms of Trust 2, an annuity is payable to Donor for the term of the trust, and the remainder is payable under the terms of Trust 1.

On Date 3, Donor formed Trust 3, a GRAT for the benefit of Donor and his issue. Under the terms of Trust 3, an annuity is payable to Donor for the term of the trust, and the remainder is payable under the terms of Trust 1.

On Date 4, a date before the expiration of the annuity terms of Trusts 2 and 3, Donor bought the remainder interests in Trusts 2 and 3 from the trustees of Trust 1. Donor paid the purchase price with two unsecured promissory notes. Donor died the following day (before the annuity terms of Trusts 2 and 3 expired).

Donor's executor filed a gift tax return and reported the purchases of the remainder interests as non-gift transfers, asserting that Donor received adequate and full consideration in money or money's worth in the form of the remainder interests in Trusts 2 and 3. Spouse elected to split gifts with Donor.

Donor's executor filed an estate tax return, and included the corpus of Trusts 2 and 3 in the gross estate. Donor's executor deducted the value of the outstanding promissory notes payable to the trustees of Trust 1 as claims against the estate.

The IRS analyzed two issues: whether adequate consideration was provided by Donor for the GRAT remainder interests, and whether the notes were properly deductible on the estate tax return (also an "adequate consideration" issue, but under § 2053(c)(1)(A)).

> Adequate Consideration. The Chief Counsel's Office relied on *Commissioner v. Wemyss*, 324 U.S. 303 (1945) and *Merrill v. Fahs*, 324 U.S. 308 (1945), in which the Supreme Court held that "adequate and full consideration in money or money's worth" has a different meaning for contracts law purposes then it does for gift tax purposes. The gift tax law requires consideration that is reducible to a money value *and thereby replenishes the recipient's estate for the value of the property for which it was transferred*. The right to decide how property shall be disposed of may have value for contract law purposes, but it does not replenish the transferor's estate and thus does not constitute adequate and full consideration for gift tax purposes.
>
> Here, Donor's liability on the promissory notes depleted his taxable estate. However, the Chief Counsel's Office wrote, "in the context of a deathbed purchase of a remainder interest in transferred property in which a donor has retained a § 2036 'string,' the receipt of the remainder does not increase the value of the donor's taxable estate, because the value of the entire property, including that of the remainder, will be includible in the donor's gross estate pursuant to § 2036(a)(1)." Thus, the Donor's receipt of the remainder interests cannot constitute adequate and full consideration in money or money's worth for gift tax purposes.
>
> Deductibility of the Notes. Section 2053(c)(1)(A) provides, in part, that the deduction allowed in the case of claims against the estate, unpaid mortgages, or any indebtedness shall, when founded on a promise or agreement, be limited to the extent that they were contracted bona fide and for an adequate and full consideration in money or money's worth. Treas. Reg. § 20.2053-1(b)(2)(i) provides, in part, that amounts allowed as deductions under § 2053 must be expenses and claims that are bona fide in nature. No deduction is permissible to the extent it is founded on a transfer that is essentially donative in character (a mere cloak for a gift or bequest). Treas. Reg. § 20.2053-4(d)(5) provides in part, that the deduction for a claim founded upon a promise or agreement is limited to the extent that the promise or agreement was bona fide and in exchange for adequate and full consideration in money or money's worth; that is, the promise or agreement must have been bargained for at arm's length and the price must have been an adequate and full equivalent reducible to a money value. In *Merrill v. Fahs*, the Supreme Court held that adequate and full consideration should be deemed to have the same meaning in both the estate tax and the gift tax. 324 U.S. at 313 (1945).
>
> The Chief Counsel's Office concluded that the notes were not deductible as a claim against Donor's estate: "[w]here the purchase of the remainder occurs on the donor's deathbed while he is holding a § 2036 'string' to the transferred property, the remainder does not increase the value of the donor's taxable estate … because the entire value of the transferred property, including that of the remainder, will be

includible in the donor's gross estate pursuant to § 2036(a)(1)." For that reason, the Donor's deathbed receipt of the remainder interests cannot constitute adequate and full consideration within the meaning of § 2053(c)(1)(A). The CCA concluded that the "promissory notes are a mere cloak for a gift," citing Treas. Reg. § 20.2053-1(b)(2)(i).

Note that the Chief Counsel's Office made reference several times to the "donor's deathbed." Would the result be any different if the Donor survived several years but nevertheless died before the end of the GRAT term? It seems the same analysis, in which the Donor's estate was not diminished by the purchase of the remainder interest, would apply.

F. Gift Tax

PLRs 201737001 and 201737008 (Sept. 15, 2017)

Grantor created an irrevocable trust to benefit the grantor's spouse and descendants. The irrevocable trust contained a power of appointment providing that on the death of the spouse, the trustee is to distribute such amounts of principal and income as the spouse directs "to such persons, or charities, for such estates and interests and outright or upon such terms, trusts, conditions and limitations" as the spouse appointed by her will. The terms of the power of appointment did not specifically limit the exercise of the power to appoint to persons other than the spouse, the estate of the spouse, the creditors of the spouse, or the creditors of the spouse's estate.

The grantor filed a petition with the state court to correct a "scrivener's error," to reform the trust to provide that the spouse would have a limited power of appointment, "to such persons, or charities other than Spouse, the creditors of Spouse, the estate of Spouse, and the creditors of the estate of Spouse." The state court granted the relief and made it retroactive.

It was represented in the ruling request that the grantor did not intend for Spouse to have a general power of appointment.

The IRS ruled that because of the representation that the grantor did not intend for the spouse to have a general power of appointment, and the state court's order to correct a scrivener's error was consistent with the applicable state law that would be applied by the highest court of the state. Therefore, the power of appointment as reformed by the local court would not constitute a general power of appointment, and the reformation of the trust was not the exercise or release of a general power of appointment that would constitute a gift by the spouse for federal gift tax purposes.

PLR 201721006 (May 26, 2017)

In this ruling, two spouses had created a joint revocable trust. Upon the first spouse's death, the trust became irrevocable and was divided into a Marital Trust, a Decedent's

Trust, and a Survivor's Trust. The ruling pertains to the Marital Trust, which qualified for the estate tax marital deduction as a QTIP marital deduction trust.

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

The following rulings were requested:

> 1. When the surviving spouse renounces his interest in Marital Trust One, the surviving spouse will not be deemed to have made a gift of the property in Marital Trust *Two* under § 2519.
>
> 2. When the surviving spouse renounces his interest in Marital Trust One, the value of surviving spouse's income interest in Marital Trust One would not be valued at zero under Section 2702.
>
> 3. After the surviving spouse renounces his interest in Marital Trust One, no part of Marital Trust One being transferred under Section 2519 would be included in the surviving spouse's gross estate under § 2044(b)(2).

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

With respect to the second ruling request, the IRS noted that after the division of Marital Trust One and Marital Trust Two, the surviving spouse's interests in the two trusts will be separate and distinct. Therefore, when the surviving spouse renounces his rights, title, and interest in Marital Trust One, his interest in Marital Trust Two would not be treated as a retained interest under § 2702. Consequently, the renunciation of the entire interest in Marital Trust One would not result in the surviving spouse's interest in Marital Trust Two being valued at zero under § 2702.

With respect to the third ruling request, when the surviving spouse renounces the interest in Marital Trust One, the surviving spouse will be deemed to have made a transfer of all

the property of Marital Trust One other than his qualifying income interest. Section 2044(b)(2) provides that 2044(a) does not apply to any property if Section 2519 applies to the disposition of part or all of that property prior to a surviving spouse's death. Thus, the property owned by Marital Trust One that is deemed transferred pursuant to Section 2519 will not be included in the surviving spouse's gross estate under Section 2044 at the surviving spouse's death.

LAFA 20172801F (July 14, 2017)

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

The gift tax return disclosure rules go beyond whether a gift is just listed on the return. The disclosure must be adequate under the regulations. Section 301.6501(c)-1(f) of the regulations sets forth a list of requirements for what constitutes adequate disclosure, sufficient to start the statute of limitations. Under Reg. § 301.6501(c)-1(f)(2), adequate disclosure is defined as a disclosure that adequately apprises the IRS "of the nature of the gift and the basis for the value so reported." The regulations provide (in the nature of a safe harbor?), that disclosure is adequate if it includes:

1. A description of the transferred property and any consideration received for it;

2. The identity of the transferor and transferee and how they are related;

3. If the transferee is a trust, the trust's taxpayer identification number and a brief description of the trust terms (or instead of a description, a copy of the trust instrument);

4. A detailed description of the method used to determine the fair market value of the property; and

5. A statement describing any position that is contrary to IRS regulations or Revenue Rulings.

With respect to gifts of closely-held interests for which there is not a readily determinable market value, Treas. Reg. § 301.6501(c)-1(f)(2)(iv) states that the return must include a detailed description of the method used to determine the fair market value, including financial data used in making the determination. For example, if the value of an interest in a closely-held corporation or partnership was derived by using the entity's financial

statements and projections, those statements and projections should be attached or summarized.

This particular memorandum does not provide details on what the donor did disclose on the gift tax return. It only says that the donor "did not describe the transferred property, nor did Donor provide a description of the method used to determine the value of the transferred property." From past cases and rulings, an example of inadequate disclosure would be a listing of a gift of "a 10% limited partnership interest in the Smith Family Limited Partnership … $100,000." *See*, *e.g.*, Chief Counsel Advice 200221010 (issued Feb. 12, 2002; released May 24, 2002). The disclosure does not state how the value is determined, what the underlying assets of the partnership are if the value was based on net asset value, or what valuation discounts were applied. The failure to include any one of those items could make the disclosure inadequate.

G. Conversion of CLAT from Nongrantor Trust to Grantor Trust

PLRs 201730012, 201730017, and 201730018 (July 28, 2017)

In these PLRs, grantor had created CLATs that were nongrantor trusts. As such, the trust was previously allowed charitable deductions under § 642(c)(1) for amounts of gross income included in the annuity amounts each year. The trustee sought to amend the trust agreements pursuant to state law to permit the "substitutor" to have the power, exercisable at any time in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity, to acquire or reacquire trust principal by substituting other property of an equivalent value, determined as of the date of substitution.

In each PLR, the grantor requested three rulings: (1) the conversion of the CLAT from a nongrantor trust to a grantor trust (assuming the substitutor is found to hold the substitution power in a nonfiduciary capacity) is not a taxable transfer of property held by the trust to the grantor as settlor for income tax purposes; (2) the conversion of the CLAT from a nongrantor trust to a grantor trust is not an act of self-dealing that would result in a tax under § 4941; and (3) the conversion of the CLAT from a nongrantor trust to a grantor trust would result in an income tax charitable deduction for the grantor in the year of conversion under § 170.

While granting favorable rulings on the first two requests, the IRS did not allow the grantor to take a charitable deduction in the year of conversion. Rev. Proc. 2007-45 provides that a donor to a grantor CLAT may claim a federal income tax charitable deduction under § 170(a) *in the year that assets are irrevocably transferred to the trust*. Because the conversion of the CLAT from a nongrantor trust to a grantor trust was not a transfer of property, the grantor is not able to take an income tax charitable deduction under § 170(a).

ILLINOIS STATUTES

Public Act 100-0085: Posthumous Children

Public Act 100-0085 was enacted to clarify the treatment of posthumously conceived children for inheritance purposes. Black's law dictionary defines "posthumous child" as a "child born after the *father's* death." The definition did not contemplate the possibility of birth after the *mother's* death, probably due to posthumous conception using genetic materials after a parent's death being a relatively new phenomenon. Historically the term "posthumous child" has referred to a child conceived during the life of both parents and then born after the father's death. Certainly, however, a child both conceived and born after the father's death would fit into the definition of posthumous child.

Prior to amendment effective January 1, 2016, 755 ILCS 5/2-3 provided as follows:

> § 2-3. Posthumous child. A posthumous child of a decedent shall receive the same share of an estate as if the child had been born in the Decedent's lifetime.

Did this provision apply to posthumously conceived children? The Illinois Parentage Act of 2015, effective January 1, 2016, provided: "The rights of a posthumous child to an inheritance or to property under an instrument shall be governed by the provisions of the Probate Act of 1975." The Illinois Parentage Act of 2015 also revised 755 ILCS 5/2-3 to read as follows:

> § 2-3. Posthumous child. A posthumous child of a decedent shall receive the same share of an estate as if the child had been born in the Decedent's lifetime; provided that such posthumous child shall have been in utero at the decedent's death.

Public Act 100-0085 amends 755 ILCS 5/2-3 to provide that *for purposes of intestate succession*, a "posthumous child not in utero at the decedent's death" will receive an intestate share if the following conditions are satisfied:

> (1) The child is born of the decedent's gametes, whether those gametes form an embryo before or after the decedent's death ("gametes").
>
> (2) The child is born within 36 months of the death of the decedent.
>
> (3) The decedent had provided consent in writing to be a parent of any child born of such gametes posthumously and had not revoked the consent prior to death.
>
> (4) The administrator of the estate receives a signed and acknowledged written notice with a copy of the written consent attached within 6 months of the date of issuance of a certificate of the decedent's death or entry of a judgment determining the fact of the decedent's death, whichever event occurs first, from a person to whom such consent applies that:

> (i) the decedent's gametes exist;
>
> (ii) the person has the intent to use the gametes in a manner that could result in a child being born within 36 months of the death of the decedent; and
>
> (iii) the person has the intent to raise any such child as his or her child.

These requirements "impose no duty on the administrator of an estate to provide notice of death to any person and apply without regard to when any person receives notice of the decedent's death."

With respect to determining the property rights of any person under any instrument, the presumption is that a posthumous child "not in utero at the decedent's death" is not treated as a child of the decedent, unless:

> (1) the intent to include the child is demonstrated by the express terms of the instrument by clear and convincing evidence; or
>
> (2) the fiduciary or other holder of the property treated the child as a child of the decedent for purposes of a division or distribution of property made prior to January 1, 2018 under the instrument based on a good faith interpretation of Illinois law regarding the right of the child to take property under the instrument.

Public Act 100-0085 became effective January 1, 2018, for intestate estates of decedents who die after January 1, 2018, and with respect all instruments executed before, on, or after January 1, 2018.

Public Act 100-0519

Public Act 100-0519 amends sections 10 and 15 of the Principal and Income Act (760 ILCS 15/10 and 15/15), to provide that "…with respect only to nontrust estates described in Section 15 of this Act, for oil or gas from non-coal formations, proceeds from the sale of such minerals produced and received as royalty, overriding royalty, limited royalty, working interest, net profit interest, time-limited interest or term interest, or lease bonus shall be deemed income."

Public Act 100-0478

Public Act 100-0478 amends Sections 15-1 and 15-2 of the Probate Act (755 ILCS 5/15-1 and 5/15-2) regarding awards for adult dependent children. The amendment removes the generic phrase "adult dependent children" from 15-1(a) and 15-2(a) and (b), and adds new Sections 15-1(a-5) and 15-2(b-5). These sections provide that an award is allowable "for each child of the decedent who is likely to become a public charge and was financially dependent on the decedent." The minimum amount of an award for such a child is $5,000, which is a decrease from the prior minimum amount of $10,000 (which remains the minimum amount for each minor child).