RECENT DEVELOPMENTS:

SELECTED FEDERAL AND ILLINOIS CASES, RULINGS AND STATUTES

Chicago Estate Planning Council

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FEDERAL STATUTES, REGULATIONS, AND ADMINISTRATIVE MATTERS

A. Rev. Proc. 2018-57, **2018-49 I.R.B. 827 (November 15, 2018)** sets forth the inflation-adjusted figures for exclusions, deductions, and credits for 2019. In the estate and gift tax area the figures contained in Rev. Proc. 2018-57 are the following:

- Applicable Exclusion Amount — Increases to $11,400,000
- Annual Exclusion: — Stays at $15,000
- Foreign Spouse Annual Exclusion: — Increases to $155,000
- §2032A Aggregate Decrease: — Increases to $1,160,000
- §6601(j) 2% Amount: — Increases to $1,550,000
- §6039F Gifts From Foreign Persons — Increases to $16,388
- 37%* Bracket for Trusts and Estates — Income over $12,750 (up $50)

B. Follow Up On Tax Cuts and Jobs Act

1. Proposed Regulations to Address "Clawback": Proposed Reg. §20.2010-1(c) and (e)(3), REG-106706-18, 83 FED. REG. 59343 (Nov. 23, 2018).

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

New Section 2010(g)(2) provides:

> (2) MODIFICATIONS TO ESTATE TAX PAYABLE TO REFLECT DIFFERENT BASIC EXCLUSION AMOUNTS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—
>
> (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.

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

2001(g)(2) appears to provide (perhaps even without regulations) that the answer is no – there will be no such clawback.

Under the proposed regulations, a new paragraph (c) would be added to Reg. §20.2010-1 (with the current paragraphs (c) through (e) redesignated as (d) through (f)). New Reg. §20.2010-1(c)(1) would provide that if the total of the unified credits attributable to the basic exclusion amount that are taken into account in computing the gift tax payable on any post-1976 gift is greater than the unified credit attributable to the basic exclusion amount that is allowable in computing the estate tax on the donor's estate, then the amount of the credit attributable to the basic exclusion amount that is allowable in computing that estate tax is not determined under Section 2010(c) but is deemed to be that greater total of gift tax unified credits attributable to the basic exclusion amount. The regulation (like the description in the preceding sentence) is painstakingly limited in all cases to the amount of the credit that is *attributable to the basic exclusion amount* – that is, the amount (indexed since 2012) defined in Section 2010(c)(3) – making it clear that the deceased spousal unused exclusion amount (DSUE amount) defined in Section 2010(c)(4) is not affected by this special rule and is still added under Section 2010(c)(2)(B), in effect thereby generating an additional credit of its own in cases in which the anti-clawback rule applies.

Proposed Reg. §20.2010-1(c)(2) provides the following example:

> Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $10 million in basic exclusion amount allowable on the dates of the gifts. A dies after 2025 and the basic exclusion amount on A's date of death is $5 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million basic exclusion amount used to determine those credits) exceeds the credit based on the $5 million basic exclusion amount applicable on the decedent's date of death, under paragraph (c)(1) of this section, the credit to be applied for purposes of computing the estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by A.

Viewed another way, if what would otherwise be the basic exclusion amount for estate tax purposes is less than the total of the basic exclusion amount applied to post-1976 taxable gifts, it is increased for estate tax purposes under this new regulation to equal that total. And if, in the example, the gift had been $12 million instead of $9 million, then the entire assumed $10 million basic exclusion amount would be used with still some gift tax payable (the donor having never married), and the estate tax credit would be computed as if the basic exclusion amount were $10 million.

The example in Proposed Reg. §20.2010-1(c)(2) is generally helpful, mainly because it is simpler and more readable than the rule in Proposed Reg. §20.2010-1(c)(1) itself. But, perhaps to help achieve that simplification, the drafters of the example used *unindexed* basic exclusion amounts of $10 million before 2026 and $5 million after 2025, thereby rendering it an example that could never occur under current law, and possibly causing concern that the proposed anti-clawback rule would apply only to the *unindexed* basic exclusion amount. Because the inflation adjustment is an integral part of the definition of "basic exclusion amount" in Section 2010(c)(3), there should be no question that it is the *indexed* amount that is contemplated and addressed by the regulation, despite the potential implication of the example.

The "restored exclusion amount pursuant to Notice 2017-15" referred to in the example is the exclusion amount that had been taken into account in connection with gifts to a spouse in a same-sex marriage, for which a marital deduction was not available prior to the Supreme Court's decision in *United States v. Windsor*, 133 S. Ct. 2675, 186 L. Ed. 2d 808 (2013), and which is retroactively restored as provided in Notice 2017-15, 2017-6 I.R.B. 783. Like the use of unindexed amounts, the redundant statement that the donor was not eligible for such relief – the example already says the donor "never married" – is probably intended only as a simplification and does not provide a reason to assume that the exclusion amount restored under Notice 2017-15 in a case in which it applies would not be taken into account in the usual manner under Notice 2017-15. Similarly, if the statute of limitations has expired on a refund of any gift tax paid in circumstances described in Notice 2017-15, that unrefunded gift tax would certainly continue to be recognized as gift tax paid in computing the estate tax under Section 2001, as Notice 2017-15 provides.

The proposed regulations would also revise the definition of "basic exclusion amount" in Reg. §20.2010-1(d)(3) (redesignated §20.2010-1(e)(3)) by adding a clause (iii) to reflect the temporary doubling accomplished by the 2017 Tax Act. This change, which merely conforms to the statute, will be effective January 1, 2018.

Under Proposed Reg. §20.2010-1(f)(2), the anti-clawback rule would take effect when it is adopted as a final regulation. The Notice of Proposed Rulemaking asks for comments from the public by February 21, 2019, and announces a public hearing to be held, if requested, on March 13, 2019.

What the Proposed Regulations Do Not Do.

In addition to describing the anti-clawback fix of Proposed Reg. §20.2010-1(c), the preamble to the Notice of Proposed Rulemaking cites three other concerns that comments from the public had raised, but which the IRS and Treasury found no need to address:

- Whether the increased basic exclusion amount will be applied by default to pre-2018 gifts that generated a gift tax, thereby reducing the credit otherwise available to shelter gifts from tax during the 2018-2025 period.

- Whether the increased basic exclusion amount, so applied by default to pre-2018 gifts that generated a gift tax, will likewise reduce the credit otherwise available to reduce the net estate tax during the 2018-2025 period.

- Whether the gift tax on a gift after 2025 will be inflated by a theoretical gift tax on gifts made during the 2018-2025 period that were sheltered from gift tax when made.

The preamble provides a detailed description of the steps involved in calculating the gift and estate taxes and concludes that all three of these concerns are already avoided under the statutory and regulatory rules that define those steps, and therefore no further regulatory attention is needed.

There had also been speculation that the regulations might address the option of making, for example, a $5 million gift during the 2018-2025 period (assuming no previous taxable gifts) and treating that gift as using only the temporary "bonus" exclusion resulting from the 2017 Tax Act, which is sometimes described as using the exclusion "off the top," still leaving the exclusion of $5 million (indexed) to generate a credit to be used against the estate tax after 2025. But that type of relief would go beyond the objective of *preserving the benefits* of making use of the 2018-2025 increase in the basic exclusion amount and would, in effect, *extend the availability of those benefits* beyond 2025. Although the preamble to the proposed regulations does not refer directly to that issue, it appears that it would require a different regulatory analysis to achieve that result.

Note that neither the proposed regulations, nor the preamble, nor the press release use the word "clawback."

2. Excess Deductions or Losses at Termination of Estate or Trust. (Executor or Trustee Fees and Other Miscellaneous Estate or Trust Expenses.) Notice 2018-61, 2018-31 I.R.B. 278 (July 13, 2018)

As discussed last year, the Tax Cuts and Jobs Act introduced new § 67(g), which states that "[n]otwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026." Section 67(a) provides that "miscellaneous itemized deductions" (described in §67(b)) may be deducted but only to the extent they exceed 2% of adjusted gross income. Miscellaneous itemized deductions are all itemized deductions *other than* those specifically listed in §67(b), and executor and trustee fees are not listed in §67(b) (but are deductible under §67(e)), so some questioned whether new §67(g) precludes their deduction.

In addition, §642(h)(2) states that on the termination of an estate or trust, any deductions for the last taxable year of the estate or trust (other than the deduction in lieu of personal exemptions and other than the charitable deduction) in excess of gross income for the year shall be allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust. Those deductions for individual beneficiaries are not mentioned in §67(b) and are miscellaneous itemized deductions, therefore their deduction is seem to be not allowed for 2018-2025 under new §67(g). Indeed the Joint Explanatory Statement specifically included "[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).

On July 13, 2018, the IRS release Notice 2018-61, entitled, "Clarification Concerning the Effect of section 67(g) on Trusts and Estates," wherein the Service indicated its intention to issue regulations to clarify that trust and estate administration expenses continue to be deductible because of section 67(e), despite the eight-year suspension of section 67(a) by new section 67(g). It appears, however, that deductibility will continue to be limited by the treatment in Reg. §1.67-4(b)(4) and (c)(2) of fiduciary investment advisory fees, including the portion of a "bundled" fiduciary fee attributable to investment advice. Notice 2018-61 states that "[n]othing in section 67(g) impacts the determination of what expenses are described in section 67(e)(1)." Although those regulations were written in the context of the Section 67(a) 2% floor on miscellaneous itemized deductions in light of recent litigation, the result will now (until the 2026 sunset) be total disallowance of those expenses, not just the limitation of a 2% floor.

A more challenging issue may be the availability now of "excess deductions" to individual beneficiaries under Section 642(h)(2) on termination of a trust or estate. Notice 2018-61 indicated that that will also be addressed in the regulations and asked for comments on that issue. Amazingly, it seems possible that section 642(h)(2) excess deductions will be available with respect to estate and trust expenses that would be deductible under section 67(e). Notice 2018-61 states:

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

3. Trusts for Divorced Spouse: Notice 2018-37, 2018-18 I.R.B. 521 (April 12, 2018)

The 2017 Tax Act eliminated the above-the-line deduction for alimony and separate maintenance payments under Section 215. In addition, the Act eliminated Sections 61(a)(8) and 71, which required payees of alimony and separate maintenance to include such payments in gross income. The Act also repealed Section 682, which had provided that if one spouse created a grantor trust for the benefit of the other spouse and the spouses divorced, thereafter the trust income would not be taxed to the grantor spouse to the extent of any income that the donee-spouse is entitled to receive.

In Notice 2018-37, the IRS stated that it intends to issue regulations regarding the application of Section 682 before its repeal is effective. The Notice offered the following preview:

> The regulations will provide that §682, as in effect prior to December 22, 2017, will continue to apply with regard to trust income payable to a former spouse who was divorced or legally separated under a divorce or separation instrument (as defined in § 71(b)(2)) executed on or before December 31, 2018, unless such instrument is modified after that date and the modification provides that the changes made by §11051 of the Act apply to the modification.

The IRS also requested comments on whether guidance is needed regarding the application of Sections 672(e)(1)(A), 674(d), and 677 following a divorce or separation in light of the repeal of Section 682.

Section 672(e)(1)(A) provides that the grantor of a trust shall be treated as holding any power or interest in such trust held by any individual who was the spouse of the grantor at the time of the creation of such power or interest. Section 674(a) provides, in general, that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the trust assets is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. Section 674(d), however, provides that Section 674(a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a Trustee or Trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, if such power is limited by a reasonably definite external standard that is set forth in the trust instrument. Section 677(a) provides that the grantor of a trust shall be treated as the owner of any portion of a trust, whether or not the grantor is treated as such owner under Section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse, or held or accumulated for future distribution to the grantor or the grantor's spouse. In light of the repeal of Section 682, there is concern that Sections 672(e)(1)(A), 674(a) and 677(a) may have the effect of triggering grantor trust status because of the non-grantor spouse's powers over a trust even after the spouses divorce.

4. Life Insurance Death Benefits: Notice 2018-41, 2018-20 I.R.B. 584 (April 26, 2018).

Section 101(a)(2)(A) and (B) provide exceptions to the general "transfer for value" rule contained in section 101(a)(2). The exceptions exempt the sale or exchange or other transfer of a life insurance policy from income tax if the transferee succeeds in whole or in part to the transferor's basis in the policy, or if the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. The 2017 Tax Act added a new paragraph (3) to Section 101(a), entitled "Exception to Valuable Consideration Rules for Commercial Transfers," to deny this exception in the case of a "reportable policy sale." To help enforce that change, the Act also added a new Section 6050Y to require reporting of a "reportable policy sale." New Section 101(a)(3)(B) provides that:

> For purposes of this paragraph, the term "reportable policy sale" means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract. For purposes of the preceding sentence, the term "indirectly" applies to the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

In Notice 2018-41, the IRS stated its intent to propose regulations under Sections 6050Y and 101(a) respecting the changes made by the 2017 Tax act to the taxation of life insurance policies. The Notice reviewed the statutory provisions and stated that the guidance in the proposed regulations should include items such as defining "reportable policy sale" to include a viatical settlement, distinguishing viatical settlements from other life settlement transactions for information reporting purposes, and setting forth requirements for written statements to be provided by acquirers to issuers.

The Notice also requested guidance from practitioners on several issues, such as the time and manner for reporting certain life insurance contract transactions and the definition of "buyer" for purposes of the reporting requirements for reportable death benefits.

5. Qualified Business Income Deduction

a. Final Regulations, 84 FR 2952 (Jan. 18, 2019; revised Feb. 1, 2019).

These regulations finalize the proposed regulations that were issued on August 8, 2018. The publication containing these final regulations consists of 248 pages.

b. Revenue Procedure 2019-11 (Jan. 18, 2019).

Rev. Proc. 2019-11 provides methods for calculating W-2 wages, as defined in section 199A(b)(4) and § 1.199A-2 of the Income Tax Regulations, (1) for purposes of section 199A(b)(2) of the Internal Revenue Code (Code) which, for certain taxpayers, provides a limitation based on W-2 wages to the amount of the deduction for qualified business income (QBI); and (2) for purposes of section 199A(b)(7), which, for certain specified agricultural and horticultural cooperative patrons, provides a reduction to the section 199A deduction based on W-2 wages.

c. Notice 2019-17 (Jan. 18, 2019).

Notice 2019-17 contains a proposed revenue procedure that provides for a safe harbor under which a rental real estate enterprise will be treated as a trade or business solely for purposes of section 199A of the Internal Revenue Code (Code) and §§ 1.199A-1 through 1.199A-6 of the Income Tax Regulations.

d. Proposed Regulations, REG-134652-18 (Jan. 18, 2019).

This new set of proposed regulations provide guidance on the treatment of previously suspended losses that constitute qualified business income. The proposed regulations also provide guidance on the determination of the section 199A deduction for taxpayers that hold interests in regulated investment companies, charitable remainder trusts, and split-interest trusts.

C. 2018-19 Priority Guidance Plan.

On November 8, 2018, Treasury and the Internal Revenue Service released their joint priority guidance plan for July 2018 – June 2019 ("Plan"). The Plan is again broken into four Parts, but the four parts have change slightly from last year's Plan. Part 3 of last year's plan, describing the various projects that comprise implementation of the new statutory partnership audit regime (which went into effect on January 1, 2018), has been removed. Part 1 of this year's Plan is now titled, "Implementation of the Tax Cuts and Jobs Act (TCJA)". Part 2 of this year's plan was Part 1 of last year's Plan – "Identifying and Reducing Regulatory Burdens" – focusing 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 3 of this year's Plan was Part 2 of last year's plan, but has been changed from "Near-Term Burden Reduction" to simply "Burden Reduction." Part 4, in line with past years' plans and the Service's long-standing commitment to transparency in the process, provides "General Guidance."

1. Implementation of the 2017 Tax Act: Notice 2018-61

Part 1 of the 2018-2019 Plan, titled "Implementation of Tax Cuts and Jobs Act (TCJA)," contains 62 items, compared to 25 in the Fourth Quarter Update of the 2017-2018 Plan.

Trust and Estate Administration Expenses. Item 3 of Part 1, which was not in the 2017-2018 Priority Guidance Plan, is described as "Guidance clarifying the deductibility of certain expenses described in §67(b) and (e) that are incurred by estates and non-grantor trusts." As previewed in Notice 2018-61 (discussed above), regulations anticipated from this project should clarify that trust and estate administration expenses continue to be deductible because of Section 67(e). Notice 2018-61 also indicated that the Service will also address the availability of section 642(h) excess deductions and asked for comments on that issue.

Qualified Business Income Deduction. "Computational, definitional, and anti-avoidance guidance under new §199A" (item 7 in the 2017-2018 Plan) has now ballooned into the following four items in 2018-2019 Plan, confirming the complexity of this new deduction:

13. Final regulations on computational, definitional, and anti-avoidance rules under new §199A and §643(f). Proposed regulations on computational, definitional, and anti-avoidance guidance under new §199A and §643(f) published on August 16, 2018 in FR as REG-107892-18 (NPRM) (Released on August 8, 2018).

14. Revenue Procedure on methods for calculating W-2 wages for purposes of new §199A. Notice of proposed revenue procedure published on August 27, 2018 (Released on August 8, 2018).

15. Regulations under §199A and other guidance for cooperatives and their patrons.

16. Guidance on methods for calculating W-2 wages for purposes of new §199A for cooperatives and their patrons.

Clawback. "Guidance on computation of estate and gift taxes to reflect changes in the basic exclusion amount" (item 16 in the 2017-2018 Plan) was expanded to "Regulations under §2010 addressing the computation of the estate tax in the event of a difference between the basic exclusion amount applicable to gifts and that applicable at the donor's date of death" (item 37 in the 2018-2019 Plan).

The proposed regulations were released on November 20, 2018, and are discussed above.

2. Reducing Regulatory Burdens

Part 2 of the Plan, titled "Identifying and Reducing Regulatory Burdens," was Treasury's response to Executive Order 13789 of April 21, 2017. Last year it included the withdrawal of the proposed regulations under Section 2704 that had been published in August 2016. Nothing has been added this year.

3. Burden Reduction

Part 3 of the 2017-2018 Plan was titled "Near-Term Burden Reduction." In the current Plan it is simply "Burden Reduction." It is reduced from 20 to 14 projects, reflecting the elimination of projects that have been completed. No new projects have been added. Two projects, with the same numbers as in last year's Plan, are of special interest to estate planners:

4. Final regulations under §§1014(f) and 6035 regarding basis consistency between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016.

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

To fulfill the “burden reduction” promise, these final regulations should provide some relief – for example, relief from harsh rules like the 30-day due date in the consistent basis regulations and some relief from the requirements for affidavits in the 2642(g) regulations.

4. General Guidance

As in the 2017-2018 Plan, Part 5 is titled “General Guidance” and is divided into traditional subject areas. Four items appear under the heading of “Gifts and Estates and Trusts”:

1. Guidance on basis of grantor trust assets at death under §1014.
2. 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.
3. Regulations under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.
4. Regulations under §7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests.

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

Items 2 and 3 both reflect Treasury’s responses to public criticism of previously proposed regulations. Regulations under Section 2032(a) were proposed in 2008 and then reproposed in 2011 to take a new approach to distributions and other transactions within six months after death that might affect estate tax value. Regulations under Section 2053 were proposed in 2007 and then finalized in 2009 with §20.2053-1(d)(6) reserved to eventually address present value concepts differently from the 2007 proposed regulations. Both new approaches were prompted by criticism of the original proposed regulations in the public comments.

Item 4 is new in the 2018-2019 Plan. The current mortality tables, based on 2000 census data, became effective May 1, 2009, and Section 7520(c)(2) mandates revision of the tables at least once every ten years. Thus, this project appears to be that routine revision, to take effect by May 1, 2019.

FEDERAL TRANSFER TAX CASES AND RULINGS

A. FLP / LLC / 2036 / 2038 Cases

1. *Estate of Streightoff v. Commissioner*, T.C. Memo. 2018-178 (Oct. 24, 2018).

The Tax Court agrees with the IRS in cutting a valuation discount to less than half of what the executor had claimed.

In *Estate of Streightoff v. Commissioner*, the Tax Court (Judge Kerrigan) valued a limited partnership interest that the decedent had transferred to the decedent's revocable trust as a limited partnership interest rather than as an assignee interest as submitted by the estate. The partnership owned publicly traded marketable securities and fixed-income investments. The court reasoned that the transfer to the revocable trust satisfied all of the requirements under the partnership agreement for the revocable trust to be recognized as a substitute limited partner rather than merely as an assignee. The court allowed no lack of control discount (because the 88.99% interest was sufficient under the partnership agreement to remove the general partner, which would have dissolved the partnership). The court adopted the IRS expert's approach of allowing an 18% lack of marketability discount, highlighting various factors that were recognized in *Mandelbaum v. Commissioner*, T.C. Memo. 1995-255, *aff'd*, 91 F.3d 124 (3d Cir. 1996).

The decedent's daughter, acting under a power of attorney for her father, formed a limited partnership under the Texas Revised Limited Partnership Act, with an LLC as the sole general partner having the daughter as the manager of the LLC, and transferred marketable securities and fixed-income investment assets to the partnership on October 1, 2008. The decedent, his daughters, his sons, and a former daughter-in-law were the original limited partners (the owners other than the decedent having received their interests by gift).

On that same day, the decedent created a revocable trust for himself, with the daughter as the sole trustee. The daughter, acting under the power of attorney, transferred her father's 88.99% limited partnership interest in the partnership to the revocable trust under an "Assignment of Interest" document that assigned all of his interest in the limited partnership and agreed to execute any further legal documents needed to assign all rights decedent may have had in the property. The trustee of the revocable trust signed the Assignment document, which provided that the assignee agreed to abide by all the terms and provisions in the partnership agreement.

The decedent died May 6, 2011, and his federal estate tax return reported the interest in the partnership on Schedule G as a Transfer During Life. The interest was reported as an assignee interest in an 88.99% limited partnership interest. It was valued on the alternate valuation date at $4,588,000, applying a 37.2% discount for lack of marketability, lack of control, and lack of liquidity. The IRS examiner allowed an 18% discount in the estate tax audit.

Under the Texas Revised Limited Partnership Act, an assignee of a partnership interest is entitled to allocations of income, gain, loss, deduction, credit, or similar items, and to receive distributions to which the assignor is entitled, but is not entitled "to become, or to exercise rights or powers of, a partner." The assignee may become a substituted limited partner, with all rights and powers under the partnership agreement, in the manner that the partnership agreement provides or if all partners consent.

The partnership agreement provided that a transferee who has not been admitted as a substituted limited partner would be an "unadmitted assignee" and would hold the right to allocations and distributions with respect to the transferred interest but would have no right to any information or accounting or to inspect the books or records of the partnership and would not have any of the rights of a general or limited partner (including the right to vote on partnership matters).

The partnership agreement provided that the partnership was a fixed-term limited partnership (terminating on December 31, 2075, unless terminated upon the occurrence of certain events). The partnership agreement provided that 75% or more of the partnership interests held by limited partners could remove the general partner, which would terminate the partnership unless 75% of the limited partners reconstituted the partnership and elected a successor general partner.

The partnership agreement also included restrictions on transfers of partnership interests, but allowed certain permitted transfers.

As a matter of form, the decedent transferred to the revocable trust a limited partnership interest and not an assignee interest, because all of the requirements under the partnership agreement for becoming a substituted limited partner were met. For a transferee to be admitted as a substituted limited partner under the terms of the partnership agreement, (1) the general partner must consent to the transferee's admission [the daughter signed the agreement as manager of the LLC-general partner and consented to its terms], (2) the transferee must have acquired the interest by means of a permitted transfer [which was stipulated by the parties], and (3) the transferee must agree and execute the instruments necessary to be bound by the terms of the partnership agreement [the daughter, as trustee of the revocable trust, signed the Assignment document which provided that the trust agreed to abide by all the terms and provisions of the partnership agreement].

Furthermore, as a matter of substance and economic realities the transferred interest was a limited partnership interest. There would have been no substantial difference before and after the transfer to the revocable trust. While assignees had no rights to information, that distinction made no difference because the daughter was also individually a partner entitled to information and trustee of the revocable trust. Whether the revocable trust held voting rights would have been of no practical significance because there were no votes by limited partners and decedent held the power to revoke the revocable trust which would have reinstated all rights of a limited partner in the decedent.

The court agreed with the IRS expert that no lack of control discount should be allowed. The 88.99% limited partnership interest could remove the general partner, which would terminate the partnership. The 88.99% interest had the ability to terminate the partnership unilaterally if the owner did not agree with the management of the general partner. Thus, the interest did not lack control.

The IRS's and estate's experts both relied on the nonexclusive list of factors identified in *Mandelbaum v. Commissioner*, T.C. Memo. 1995-255, *aff'd*, 91 F.3d 124 (3d Cir. 1996), that make an entity more or less marketable. These factors include (1) an analysis of the entity's financial condition, (2) the entity's capacity to pay and history of paying distributions, (3) the nature of the entity and its economic outlook, (4) the management of the entity, (5) the amount of control held by the interest, (6) restrictions on the transferability of the interest, (7) the required holding period for the interest, (8) the entity's redemption policy, and (9) the costs associated with making a public offering.

The IRS's expert relied on restricted stock studies using more recent studies, which considered stocks with shorter holding periods in light of SEC regulations that have shortened the holding periods required for purchasers of restricted stock to resell their interests. The expert observed various factors having a depressant effect on the amount of the marketability discount. The partnership was capable of making distributions in light of its overall financial condition. The assets were highly liquid, and the diversification and high liquidity of the assets would make the interest highly attractive to a hypothetical buyer. The amount of control provided by an 88.99% limited partnership interest and the existence of the right of refusal favored a lower discount.

The court gave less weight to the taxpayer's expert because its report valued the interest as an assignee rather than as a limited partnership interest, and the expert testified that his analysis would have included different considerations if the interest was a limited partnership interest with voting rights.

The court adopted the IRS expert's analysis of an 18% discount for lack of marketability.

Note. Whether merely transferring a limited partnership interest to a revocable trust can be sufficient to value the interest as an assignee interest rather than a limited partnership interest (assuming, unlike in *Streightoff*, that the requirements for admission as a substitute limited partner were not satisfied) seems unclear at best. If an assignee interest would be valued significantly lower than a limited partnership interest, allowing a mere transfer to a revocable trust to achieve that reduction in value of the transfer tax base seems unwarranted.

An 18% marketability discount for a situation in which the decedent had the unilateral ability to force the dissolution of the partnership and a return of the decedent's assets seems very favorable for the taxpayer. The IRS's expert, whose conclusion was adopted by the court, did observe that the amount of control provided by an 88.99% limited partnership interest favored a lower discount.

B. Valuation

1. Private Letter Rulings 201820010 (May 18, 2018), 201815001 (April 13, 2018), and 201825013 (June 22, 2018).

The IRS allows extensions of time to make the alternate valuation date election.

The executor (co-executors in Letter Ruling 201825013) of the decedent's estate engaged an attorney (in Letter Rulings 201820010 and 201825013) or accountant (in Letter Ruling 201815001) to prepare the federal estate tax return (Form 706). The Form 706 was timely filed, but the tax professional failed to make the alternate valuation date election under Section 2032. The executor then requested an extension of time to make the election and use the alternate valuation date in reporting values on the return. (In Letter Ruling 201825013, this was done after the IRS rejected an attempt to make the late election merely by filing a supplemental Form 706.)

Under Reg. §§301.9100-1 and 301.9100-3, a reasonable extension of time may be granted if the taxpayer proves that the taxpayer acted reasonably and in good faith and granting the relief will not prejudice the interests of the government. The 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 the election.

In these rulings the IRS ruled that the requirements of regulations had been satisfied and granted an extension of time to make the alternate valuation election.

2. Private Letter Ruling 201814004 (April 6, 2018).

The IRS allows an extension of time to make the special use valuation election for farmland.

Upon decedent's death, her son and daughter were the co-trustees of her revocable trust and co-executors of her estate, which included farmland. The co-trustees retained an accountant to prepare and file the federal estate tax return (Form 706). The accountant failed to advise them to make the Section 2032A special use valuation election for the farmland. The Form 706 was timely filed.

After filing the Form 706, the son met with an attorney to discuss estate planning. The attorney discovered that the special use valuation election was not made on the Form 706. As a result of this discovery, the estate requested an extension of time to make the special use valuation election.

Applying the standards of Reg. §§301.9100-1 and 301.9100-3, the IRS ruled that the requirements had been satisfied and granted the extension of time to make the special use valuation election.

3. Private Letter Rulings 201808001-201808003 (Feb. 23, 2018).

The IRS rules on the gift tax consequences under Chapter 14 of a gift of a life estate interest created in a pre-October 9, 1990 transaction.

Prior to the enactment of Chapter 14 in 1990, husband, wife, and their six children purchased real estate from an unrelated party for the property's fair market value. Husband, wife, and each of the children executed an agreement whereby husband, wife, and each of the children paid the actuarial value of their respective interests from their own resources and none of the six children used any funds acquired from their parents to acquire their respective interests. Under the agreement, wife acquired a life interest in the use of and income from the real property, husband acquired a life interest in the use of and income from the real property that became effective upon the death of the wife, and each of the children had a one-sixth undivided interest in the remainder.

The life tenants wished to give a geographically defined portion of the acreage of their life interest in the real property to the children. As a result, the six children would become the outright owners of that geographically defined real estate.

The taxpayers requested rulings that

1. The remaining acreage of the real estate after the transaction would continue to be treated as resulting from a pre-October 9, 1990, transfer for purposes of the application of Chapter 14.

2. The proposed conveyances by the life tenants would be treated as gifts for federal gift tax purposes.

3. The proposed conveyances would not result in any portion of the real estate being includible in the gross estate of either life tenant for federal estate tax purposes.

The IRS first ruled that the conveyance of the real estate by the life tenants would be treated as gifts for federal gift tax purposes and that the gifts would be valued using the actuarial value of the individual life estate interests determined by the application of the appropriate Section 7520 rate. In addition, the life tenants would not be considered to retain any interest in, or any right to alter or revoke, or any reversion in the portion of the real estate that was conveyed to the remainder beneficiaries and that the transaction would not result in any adverse estate tax consequences to wife and husband. The IRS held that the transaction would not be subject to the application of Chapter 14.

C. Inclusion in Gross Estate

1. *Badgley v. United States*, 2018 WL 2267566, 121 AFTR 2d 2018-1816 (N.D. Cal. May 17, 2018), *app. filed* (9th Cir. June 7, 2018).

A District Court holds that the value of GRAT assets is subject to estate tax.

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

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

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

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

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

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

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

This case is on appeal to the United States Court of Appeals for the Ninth Circuit.

D. Marital Deduction

1. *Estate of Turner v. Commissioner*, 151 T.C. No. 10 (Nov. 20, 2018) (*Turner III*).

The Tax Court holds after long consideration that the right of recovery under Section 2207B avoids reduction of the estate tax marital deduction for estate taxes (and interest) on lifetime nonmarital gifts included in the gross estate under Section 2036(a).

Clyde W. Turner, Sr. and his wife, Jewell, each transferred $4,333,671 in cash, certificates of deposit, and publicly-traded securities, to Turner & Co., a family limited partnership they had created. Each donor received a 0.5-percent general partnership interests and a 49.5 percent limited partnership interest. The donors retained adequate assets outside of the partnership to support themselves comfortably. Over a two-day period less than five weeks before the decedent's death, he and his wife gave limited partnership interests to their children, a trust for one of their children, and their grandchildren by a deceased child. The IRS argued that the undiscounted value of 50 percent of the partnership assets should be included in the decedent's gross estate.

In *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209 (*Turner I*), the Tax Court held that the gifts to the partnership were transfers with a retained right to beneficial enjoyment, and that the value of the transferred limited partnership interests was includible in the decedent's gross estate under Section 2036.

In *Estate of Turner v. Commissioner*, 138 T.C. 306 (2012) (*Turner II*), the Tax Court held that the decedent's estate was not entitled to the marital deduction with respect to the value of the partnership interests included in the decedent's gross estate under Section 2036, because the property was the subject of lifetime gifts and did not pass to the widow.

After *Turner II*, the IRS filed computations and amended computations for entry of decision pursuant to Tax Court Rule 155, but the executor objected over the issues of (a) whether the estate must reduce the marital deduction by the amounts of the estate taxes owed that the government claims must be paid from estate assets passing to the widow; and (b) whether the estate may increase the marital deduction by post-death income that was not included in the gross estate but was generated by marital deduction property.

The Tax Court (Judge Marvel) held that the decedent's estate was not required to reduce the marital deduction by the amounts of the estate taxes it owes. The court noted that decedent's will expressed his intent to leave assets to the widow undiminished by any estate, inheritance, succession, death, or similar taxes and having a value "equal to the maximum marital deduction." A residuary nonmarital trust was supposed to be created for the benefit of the decedent's children and grandchildren, but because the entire unified credit was exhausted on the Section 2036 assets, that trust was not created. The Tax Court held for the estate, noting that the estate taxes due were all attributable to the value of property included in the gross estate under Section 2036. While the will did not address estate tax apportionment, the court noted that the executor has the right under Section 2207B to recover from the persons who received the Section 2036 property during the decedent's lifetime an amount equal to the estate taxes plus interest attributable to those transfers. Furthermore, the executor must, because of his duty to carry out the terms of the will, exercise the right of recovery in order to prevent the marital deduction property from bearing the decedent's estate's tax burden contrary to his intent. Thus, the widow does not bear the burden of the estate taxes and her share of the estate passes free of the estate taxes.

The court also held that the decedent's estate could not increase the marital deduction by the amount of post-death income generated by the marital deduction property. The estate argued that post-death income should be allocated to the marital share and increase the marital deduction, relying on Reg. §20.2056(b)-4(d)(1)(iii). The court disagreed, noting that the post-death income interest is not a deductible interest under the regulation because it was not included in the gross estate. Furthermore, the regulation in question (the *Hubert* regs) relates to which estate administrative expenses are chargeable properly against the marital deduction, and not whether income earned during the administration augments the marital deduction. The court held that income earned during administration does not augment the marital deduction.

Note. The Tax Court opinion refers to the taxes involved as "Federal estate and State death taxes." But the right of recovery in Section 2207B is cast in terms of "tax under this chapter" – that is, the *federal* estate tax only. The opinion does not elaborate on its reference to "State death taxes." And the opinion does not say whether there even were any state death taxes, but the decedent had died in Georgia, a "coupled" state, in 2004, when the federal state death tax credit had been phased down to 25%.

Turner III should apply to most situations in which an estate plan includes a reduce-to-zero marital deduction formula and assets are returned to the gross estate under Section 2036 (transfers with a reserved right to receive or control beneficial enjoyment), 2041 (property subject to a decedent's general power of appointment; *see* Section 2207), or 2044 (QTIP property; *see* Section 2207A). The court noted that the decedent's will in *Turner III* did not address the payment of estate taxes, which most wills would do, but the court still found that it manifested the decedent's "intention that the marital deduction not be reduced or diminished by the estate's tax liabilities." Most well-drafted reduce-to-zero estate plans do address estate and other death taxes, and charge them away from the marital share, to the extent possible. Furthermore, many such instruments expressly state the testator's or grantor's desire to obtain the lowest possible estate tax at the first spouse's death, consistent with lowering taxes at the surviving spouse's death. Therefore, there seem to be no unusual features of the documents or state law in *Turner III* that would limit its operation in other states and with other documents.

It is interesting, however, to note that the tax laws include tax recovery provisions for assets includible in a decedent's gross estate under Section 2036, 2041, or 2044, but not assets includible only under Section 2035 (transfers within three years of death), 2037 (transfers taking effect on death), 2038 (transfers with a power to alter, amend, revoke or terminate), or 2039 (certain annuities). Therefore, while *Turner III* is helpful, it is no substitute for careful drafting of a tax apportionment clause and for provisions in the documents for transactions that might raise issues under Section 2035, 2037, 2038, or 2039, providing for the contribution from those transferees to the payment of the deceased transferor's estate taxes.

2. Private Letter Ruling 201834011 (Aug. 24, 2018).

The IRS rules favorably on the tax consequences of the division of a QTIP trust and a gift of a QTIP income interest.

Decedent's revocable trust created a QTIP Marital Trust for the lifetime benefit of Spouse, and then to be distributed to Charitable Trust, established under the same revocable trust. The trust also states that, if Spouse disclaims any or all of the Marital Trust, the disclaimed property will be added to Charitable Trust. State Court, on the petition of Spouse and the trustee of Marital Trust, approved the division of Marital Trust into separate identical Trusts 1 and 2. Trust 1 will be funded with cash and property having a net fair market value on the date of division equal in value to $x. Trust 2 will be funded with the rest of Marital Trust. The division of Marital Trust will be done on a non-pro rata basis as authorized under Statute 2. Spouse will assign her income interest in Trust 1 to Charitable Trust.

The IRS ruled that: (a) the non-pro rata division of Marital Trust would not cause Marital Trust, Trust 1, Trust 2 or any beneficiary of these three trusts to recognize ordinary income or loss, or capital gain or loss, under Section 61 or 1001; (b) the division of Marital Trust would not disqualify either trust as a QTIP for estate tax purposes; (c) Spouse will be treated as having made a gift of her qualifying income interest in Trust 1 under Section 2511 and as having made a gift of the remainder interest in Trust 1 under Section 2519, both of which gifts qualify for the gift tax charitable deduction; (d) the disclaimed assets of Trust 1 are not deemed to have been transferred under Section 2519 and will not be included in Spouse's gross estate under Section 2044(a); (e) Spouse's assignment of her income interest and discretionary principal interest in Trust 1 will not cause any property in Trust 2 to be deemed a gift by Spouse under Section 2519; and (f) Spouse's renunciation of her income and discretionary principal interests will not cause her interest in Trust 2 to be valued at zero under Section 2702.

E. Gift Tax

1. Private Letter Rulings 201837005-201837009 (Sept. 14, 2018) and 201845029 (Nov. 9, 2018).

The IRS rules that a reformation of *Crummey* powers to correct scrivener's errors does not result in the release a general power of appointment.

Settlor executed and funded an irrevocable trust (Trust) for the benefit of three grandchildren and their descendants. Settlor also made additional gifts to Trust in year 2. Trust provides for division into one separate share for each grandchild and his or her issue. Trust gives each beneficiary a 30-day *Crummey* right to withdraw additions to the trust. As the IRS put it:

> Based on affidavits of Spouse and Attorney 1, Settlor created Trust to provide for his descendants of all generations, and to reduce the overall transfer taxes payable on Trust assets by ensuring that the assets held in Trust would not be includible in the grandchild's gross estate upon the grandchild's death, and to minimize the amount subject GST tax by utilizing Settlor's and Spouse's GST exemption.

Son's new attorney discovered two drafting errors in Trust: (a) Trust grants each grandchild the right to withdraw the entire amount of any contribution to that grandchild's separate share of the trust and fails to limit the withdrawal right to the gift tax annual exclusion amount, causing the grandchild to possess general powers of appointment over the entire amount of the contribution to that grandchild's separate share of Trust; (b) each withdrawal right over the assets contributed to Trust in any given year is non-cumulative and lapses in its entirety on an annual basis, and should have been limited to the greater of $5,000 or 5% of the value of the trust assets to avoid a taxable gift on the lapse of the withdrawal rights. In addition, Settlor and Spouse had incorrectly reported the initial gift to Trust as an indirect skip, rather than a direct skip, and allocated GST exemption to Trust. Spouse had incorrectly reported the Year 2 gift as an indirect skip and allocated GST exemption to Trust.

No GST transfers have been made from Trust. At Trustee's request, a state court reformed Trust to eliminate the scrivener's error retroactively to the date of Trust's creation. As reformed, Trust limits the beneficiaries' withdrawal rights to the gift tax annual exclusion amount, and it limits the annual lapse of the withdrawal rights to the greater of $5,000 or 5% of the value of the trust assets.

The IRS stated that: (a) because of the reformation, the grandchildren do not possess general powers of appointment over their respective shares of Trust, except to the extent of each grandchild's withdrawal rights under the reformed trust instrument; (b) the reformation does not constitute the exercise or release of a grandchild's general power of appointment; (c) the lapse of any grandchild's withdrawal right over additions to Trust did not result in a gift for gift tax purposes; (d) none of Trust's assets will be included in a grandchild's gross estate for federal estate tax purposes, except to the extent of each grandchild's withdrawal rights under the reformed trust instrument exercisable at the grandchild's death; and (e) Settlor and Spouse substantially complied with Section 2632(a) to allocate their available GST exemption to the initial gift to Trust.

The IRS recognized that, under *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute, but that when there is no binding precedent of the highest court of a state, federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. The purpose of the reformation is to correct the scrivener's error, not to alter or modify the trust instrument. In this case, Settlor and Spouse elected to gift-split on their timely filed gift tax return, and so should be each treated as the transferor of one-half of the assets given to Trust in the first year, and Spouse filed a timely gift tax return and should be treated as the transferor for the gift to Trust in Year 2. While Settlor and Spouse did not literally comply with the instructions to Form 709 to properly allocate their remaining GST exemption to the initial gift to Trust, an allocation that does not strictly comply with the instructions on Form 709 or the applicable regulations will be deemed valid if the information on the return is sufficient to indicate that the donor intended to make the allocation. In this case, Settlor and Spouse substantially complied with the GST exemption allocation rules of Section 2632(a) in the initial year of Trust, and Spouse did so in Year 2.

2. Private Letter Ruling 201825003 (June 22, 2018).

Transfer of the legal title, naked ownership, and remainder interest in and to artwork as defined by the deed of transfer is a completed gift for gift tax purposes.

The taxpayer asked for a ruling that the gift of a remainder interest in art would be incomplete. In an unusual negative ruling, the requested ruling was denied because the taxpayer had relinquished dominion and control over the art. The ruling recited the following facts:

> On Date 2, prior to Spouse's death, Taxpayer and Spouse entered into a Deed of Transfer ("DOT") with two museums ("Museums") located in Country. Under the DOT, Taxpayer and Spouse agreed to donate the artwork to Museums, with possession of the artwork to transfer to Museums on the death of the second of Taxpayer and Spouse. Museums desired to accept the artwork to effectuate Taxpayer and Spouse's donative purpose and enhance its collection of artwork. The estimated value of the artwork at the time of the execution of the DOT was $x.

> The DOT, as it currently applies to Taxpayer as the surviving spouse and sole owner of the artwork, provides that Taxpayer shall grant to the Museums the legal title, naked ownership and remainder interest in and to the artwork. The DOT further provides that Taxpayer shall expressly reserve for her benefit a life interest and usufruct in and to the artwork. The life interest and usufruct shall automatically expire on the death of Taxpayer.
>
> Section 3.1 of the DOT provides that the parties intend for the transfer of artwork to not qualify as a completed inter vivos gift for United States gift tax purposes on the basis that Taxpayer is not releasing dominion and control over the artwork until her death. If Taxpayer receives a favorable ruling on the gift tax treatment, the donation under the DOT is deemed to take effect as of the date of the favorable ruling. If Taxpayer does not obtain a favorable ruling, then the DOT does not come into force.
>
> Section 3.2 imposes certain conditions subsequent. If any of the conditions subsequent are not satisfied, Taxpayer would have the option to revoke the transfer of the artwork. The conditions subsequent, which apply during the life of Taxpayer are: (i) Museums must comply with the requirements regarding the housing, display and exhibition of the artwork as set forth in the DOT (applicable to artwork delivered to Museums prior to Taxpayer's death pursuant to Section 4.1.1); (ii) the X law principles currently governing in Country must not be replaced by Y law; (iii) Museums must not become privately owned; and (iv) the tax laws of Country must not change to cause Taxpayer to become subject to taxation in Country during Taxpayer's life or upon death in connection with the transfer of the artwork.

The IRS concluded that none of the factors that could terminate the gift were within the taxpayer/donor's control. Therefore, the IRS ruled (emphasis added):

> Taxpayer's grant to the Museums of the legal title, naked ownership and remainder interest in and to the artwork, as defined by the DOT, would be a completed gift for gift tax purposes, *but for the condition precedent of receipt of a favorable ruling on the gift tax treatment*.

But because the ruling was negative, the gift in fact did terminate, because the DOT never came into force.

F. Generation-Skipping Transfer Tax

1. Private Letter Rulings 201811002 and 201811003 (March 16, 2018).

The IRS rules on the application of the split-gift rules to the allocation of GST exemption.

In these rulings, Husband created four irrevocable trusts, one for each of his four children of which each child was the primary beneficiary. Upon each child's death, the principal was to be held in further trust and distributed outright to the child's children upon those children obtaining age 35. An accounting firm prepared the gift tax returns for Husband and Wife. Husband and Wife consented to treat the gifts as being split between them, but Husband's gift tax return reported his portion of the total transfer to the trust to be 3/4 (rather than 1/2) of the amount actually transferred to the trust. Wife's gift tax return reported her portion of the total transfer to the trust to be 1/4 (rather than 1/2) of the amount transferred to the trust. No amount of either Husband's or Wife's available GST exemption was allocated to the transfers on the gift tax returns.

Several years later, after discovering the error, the accounting firm advised Husband of the ability to make a late allocation of GST exemption to the trust. The accounting firm prepared Husband's new gift tax return to include the late allocation of GST exemption to the original transfers to the trust. The late allocation of Husband's GST exemption erroneously allocated an amount equal to 100% of the value of the initial transfers to the trust with such value determined as of the effective date of the allocation. The notice of allocation attached to the new gift tax return stated that, as a result of the late allocation, the inclusion ratio of the trust was zero. Wife was not advised to make a late allocation of GST exemption to Wife's portion of the initial transfers to the trust.

A ruling was requested that because the period for the assessment of gift tax had expired, Husband was to be treated as the transferor of the amount reported for Husband's portion of the initial transfers on the initial gift tax return. In addition, rulings were also requested that Wife was to be treated as the transferor of the amount reported for Wife's portion of the initial transfers to the trust on Wife's initial gift tax return and that an extension of time would be granted to Wife's estate to make a timely allocation of GST exemption to Wife's portion of the initial transfers to the trust.

The IRS ruled that because the time had expired under Section 6501 as to when a gift tax may be assessed, Husband was treated as having transferred 3/4 of the total amount to the trust and Wife was treated as having transferred 1/4 for gift tax purposes.

Under Reg. §26.2652-1(a)(4), however, Husband is regarded for generation-skipping transfer tax purposes as the transferor of 1/2 of the total value of the property transferred to the trust regardless of the interest that Husband was treated as having transferred for gift tax purposes. As a result, Husband's late allocation of the GST exemption of the trust on the Form 709 was effective only to 1/2 of the property transferred to the trust. The IRS granted the request of Wife's estate for an extension of time to allocate GST exemption to the trust for her portion.

It found that the requirements of Reg. §9100-3 had been met. Under this regulation, requests for relief will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith when the taxpayer reasonably relied on a qualified tax professional. Wife's GST exemption would be allocated to 1/2 of the transferred property and the allocation would effective as of the date of the transfer to the trust

2. Private Letter Rulings 201814001 and 201814002 (April 6, 2018).

Construction of ambiguous terms of a grandfathered GST trust will have no adverse generation-skipping transfer tax, gift tax, or income tax consequences.

Settlor established an irrevocable trust for the benefit of his lineal descendants prior to September 25, 1985. Consequently, the trust was grandfathered from the GST tax. The current trustees of the trust were child, individual, and a bank. The terms of the trust were ambiguous. Settlor was currently living at the time of the ruling request, however, and attested that at the time the trust was created and all times thereafter, Settlor intended for the trust to benefit only blood descendants. The trustees petitioned a state court for declaratory judgments construing the ambiguous terms of the trust consistent with Settlor's intent to benefit only blood descendants and a court entered that order conditioned upon a favorable ruling by the IRS that the order would have no adverse generation-skipping transfer tax, gift tax, or income tax consequences.

The IRS first ruled that the terms of the trust presented a bona fide issue regarding whether an adopted grandchild of the Settlor was considered a member of the class of issue, descendants, or children. It also ruled that the state court's order construing the ambiguous terms was consistent with the applicable state law that would be applied by the highest court of the state. The IRS followed Reg. §26.2601-1(b)(4)(i)(C), which provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to GST tax if the judicial action involves a bona fide issue and the construction is consistent with the applicable state law that would be applied by the highest court of the state, pursuant to *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967). Here the declaratory judgment met the requirements of the regulations and the construction of the trusts would not affect its exempt status.

Next, the IRS ruled that because the state court's order clarified the ambiguous terms at issue, the order was not a transfer for gift tax purposes. Finally, the IRS ruled that because the court's order resolved an ambiguity as to the construction of the trust and carried out the intent of the Settlor rather than resulting in a disposition of the interest of the trust, there would be no realization of gain or loss to the trust for income tax purposes.

3. Private Letter Ruling 201845006 (Nov. 9, 2018).

Modifications of provisions of a (non-grandfathered) generation-skipping trust regarding a testamentary general power of appointment will not affect the trust's inclusion ratio.

Settlors created an irrevocable generation-skipping trust after September 25, 1985, for the benefit of their son and his descendants. The trust instrument gave the son a testamentary general power of appointment over the trust assets, but authorized a trustee other than a beneficiary to expand or limit certain general powers of appointment under the trust instrument. The ruling states that the grantors contemplated that their daughter (the primary beneficiary's sister) would serve as a non-beneficiary trustee, but she declined to accept the appointment. As a result, there was no trustee authorized to exercise the discretion to limit the son's testamentary general power of appointment.

The trustees petitioned a court to appoint an independent special trustee and to modify the trust to provide a method for appointing independent special trustees.

As is typical in such rulings with respect to post-September 25, 1985, trusts, the IRS noted:

> No guidance has been issued concerning the modification of a trust that may affect the status of a trust that is exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the exempt status of such a trust.

Citing Reg. §26.2601-1(b)(4)(i)(D)(2), the IRS ruled that the proposed modification will not result in a shift of any beneficial interest in the trust to any beneficiary who occupies a generation lower than the persons holding the beneficial interests and will not extend the time for vesting of any beneficial interest in the modified trust beyond the period provided for the original trust. Accordingly, the IRS concluded that the proposed modification of the trust will not adversely affect the trust's GST inclusion ratio.

The IRS also found that the proposed modification will neither change or transfer the interests of the settlors' son during his lifetime nor confer any new rights to any beneficiaries. It noted that the testamentary power of appointment granted to the son in the trust instrument occurs upon the death of the son and is not currently exercisable by the son. Therefore, the son retains the same interest in the trust, both before and after the modification. Accordingly, the IRS ruled that the appointment of an independent trustee and the exercise by the independent trustee or a successor independent trustee to limit or eliminate the son's testamentary general power of appointment granted by the trust instrument will not constitute the exercise or release of a general power of appointment under Section 2041(a)(2), and, as a result, the value of the trust assets will not be included in the son's gross estate under Section 2041(a)(2).

G. Intergenerational Split-Dollar Arrangements.

1. Introduction

Split-dollar is a method of financing the purchase of life insurance. It most typically takes the form of an arrangement between a closely held business and an owner-employee, or between a public corporation and its executives, in which the employer and employee agree to split the payment of premiums on an insurance policy on the life of the insured. In 2001, Notice 2001-10, 2001-1 C.B. 459, announced the IRS's intent to change its tax treatment of split-dollar arrangements. Thereafter, the IRS issued new regulations in 2003. The new taxation scheme created under these regulations significantly altered the way in which split-dollar arrangements were used for estate planning purposes thereafter.

Under the 2003 regulations, the tax treatment of a split-dollar life insurance arrangement is now determined under one of two mutually exclusive methods, the economic benefit regime or the loan regime. If the employer is the owner of the insurance policy, the split-dollar arrangement will be taxed as a compensation-related agreement under the economic benefit regime. The value of the current life insurance protection and any other benefits derived by the insured employee from the arrangement will be treated as taxable income to the employee under Section 61. The economic benefit rules apply both to arrangements in which the policy is actually owned by the employer (endorsement method split-dollar arrangements) and to arrangements in which the employee owns the policy (collateral assignment split-dollar arrangements) but the employee's only right is to the insurance protection. In the latter situation, the employer will be deemed to own the policy. Reg. §1.61-2(c)(1)(ii)(A)(2).

Any other split-dollar arrangement in which the employee owns the policy will be governed under the loan regime by the Section 7872 below market loan rules. Transfers by the employer will be treated as loans and there will be deemed interest to the extent that the arrangement does not mandate adequate interest. The deemed interest will be treated as compensation paid by the employer to the employee and then repaid as interest by the employee. The same rules will apply to split-dollar arrangements in all other contexts, such as shareholder-company and private donor-donee arrangements.

The distinguishing feature in *Cahill* and *Morrissette* was that the split-dollar arrangements were *intergenerational*. The individuals whose lives were insured were in the generation below that of the donor – the donor's son and daughter-in-law in *Cahill* and the donor's three sons in *Morrissette*.

2. *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018).

The IRS prevails in a summary judgment motion regarding the value of split-dollar arrangements in the decedent's gross estate.

In 2010, Richard F. Cahill was 90 years old and unable to manage his own affairs. His son, Patrick, served as his attorney-in-fact and as Trustee of Richard's revocable trust, named the Richard F. Cahill Survivor Trust (the "Survivor Trust").

In September 2010, Patrick, acting as Richard's attorney-in-fact, established an irrevocable trust titled the Morrison Brown Trust (the "MB Trust"). William Cahill, Patrick's cousin and business partner, served as Trustee of the MB Trust. The MB Trust owned three life insurance policies, two on Patrick's life and one on the life of Patrick's wife. The total of the premiums for the three policies was $10 million and the total death benefit was $79.8 million.

The Survivor Trust then entered into a split-dollar arrangement with the MB Trust regarding each policy. Under each arrangement, the Survivor Trust was obligated to pay the full premium, which the Survivor Trust financed with an independent lender. Richard was personally liable on the loan through an agreement executed by Patrick as his attorney-in-fact. Each split-dollar arrangement provided that, upon the death of the insured, the Survivor Trust would receive a portion of the death benefit equal to the greater of: (1) any remaining balance on the loan related to the policy, (2) the total premiums paid by the Survivor Trust or (3) the cash surrender value of the policy immediately before the insured's death. The remaining proceeds would be paid to the MB Trust.

Each split-dollar arrangement also provided that it could be terminated during the insured's life by written agreement between the Trustees of the Survivor Trust and the MB Trust. Upon termination, if the MB Trust retained the policy, it would be obligated to pay the Survivor's Trust the greater of the total premiums paid or the policy's cash surrender value. If, upon termination, the policy was not retained, then the policy would be transferred to the Survivor Trust's lender in full or partial satisfaction of the Survivor Trust's liability. The MB Trust was not permitted to sell, assign, transfer, borrow against, surrender or cancel the policy without the consent of the Survivor Trust.

Richard's gift tax return for 2010 reported gifts to the MB Trust in an amount equal to the cost of the life insurance protection, which was in accordance with the economic benefit regime for the taxation of split-dollar arrangements under Reg. §1.61-22.

Richard died on December 12, 2011. Patrick served as executor of his estate (the "Estate"). Upon Richard's death, the total cash surrender value of the policies was $9,611,624. The estate tax return for Richard's estate stated that the value of Richard's interests in the split-dollar arrangements totaled $183,700.

Citing Sections 2036(a)(2), 2038(a)(1), and 2703(a)(1) and (2), the IRS adjusted the value of Richard's rights in the split-dollar arrangements from $183,700 to the cash surrender value of $9,611,624, and asserted an estate tax deficiency of $6,282,202. The IRS also asserted penalties for negligence or disregard of rules or regulations, for gross valuation misstatements and, alternatively, for substantial valuation misstatements.

The Estate filed a motion for partial summary judgment, asserting that Sections 2036(a)(2), 2038(a)(1), and 2703(a)(1) and (2) did not apply to this case. The Estate also asserted that the regulation regarding split-dollar arrangements, Reg. §1.61-22, applied in valuing Richard's interests in the split-dollar arrangements. The Estate contended that the Survivor Trust's interest in the policies upon Richard's death was equal only to his rights in the death benefit, worth only $183,700 because the insureds were projected to live for many more years. The Estate asserted that the termination right in the split-dollar arrangement was worthless because it could be exercised only in conjunction with the MB Trust and it would never make economic sense for the MB Trust to allow termination of the split-dollar arrangement.

The Tax Court (Judge Thornton) denied the Estate's motion for summary judgment. The court first determined that the economic benefit regime under the split-dollar regulations applied because the only economic benefit provided to the MB Trust was current life protection. Reg. §1.61-22(c)(1)(ii). The IRS argued that these regulations applied only for gift tax purposes, not estate tax purposes. Reg. §1.61-22(a). Although agreeing with the IRS's reading of these regulations, the Tax Court concluded:

> [T]o the extent that (1) the regulations illuminate the gift tax treatment of transfers arising out of the split-dollar agreements at issue, (2) those transfers are relevant to estate tax issues, and (3) obvious reasons do not compel divergent interpretations of the relevant gift and estate tax Code sections, we shall look to the regulations in deciding this case.

Regarding Sections 2036(a)(2) and 2038(a)(1), the court explained that the issue was whether the cash surrender value of the policies was includable in the gross estate under these sections. Relying on *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (2017), and *Estate of Strangi v. Commissioner*, T.C. Memo. 2003-145, *aff'd*, 417 F.3d 468 (5th Cir. 2005), the Tax Court stated:

> [T]he rights to terminate and recover at least the cash surrender value were clearly rights, held in conjunction with another person (MB Trust), both to designate the persons who would possess or enjoy the transferred property under section 2036(a)(2) and to alter, amend, revoke, or terminate the transfer under section 2038(a)(1).

The Estate had argued that the decedent held no such right because the right to terminate was held only in conjunction with the MB Trust, and as the recipient of the benefit of the arrangement, it could prevent the decedent from terminating the agreement. The court responded that the statute refers to "in conjunction with *any* person" in Section 2036(a)(2) and "in conjunction with *any other* person" in Section 2038(a)(1). The Estate apparently acknowledged that the "in conjunction with" provision could apply if the decedent had been in complete control of the other party who had to agree with the termination, but the court answered that the statute by its terms does not require unilateral control.

The court held that the bona fide sale for adequate and full consideration did not apply to the split-dollar arrangement. It was not a "bona fide sale" because Patrick "stood on both sides of the transaction." For purposes of the motion for summary judgment, there were unresolved factual questions as to whether the stated non-tax reason of smoothing the transfer of a business owned by the son to his children at his death was a legitimate business purpose. (The court was skeptical, suggesting that perhaps the purpose was merely to eliminate the cash surrender value from the decedent's estate rather than to provide liquidity decades in the future, observing that the guaranteed return on the investment in the policies appeared to be lower than the interest rate on the loan used to finance the purchase of the policies, and that the loan required a balloon payment of the entire principal amount in only five years.)

In addition, the transfer was not for "adequate and full consideration" because, according to the way the estate valued the reimbursement right on the estate tax return, the value of what the decedent received "was not even close to the value of what decedent paid" that is, \$183,700 for \$10 million or a discount of over 98%. The court believed that the circumstances that gave rise to the 98% discount for the cash surrender value claimed by the Estate upon Richard's death had also existed at the time the arrangement was entered into a year earlier.

Relying on Section 2703(a)(1)&(2), the IRS had also argued that the MB Trust's ability to veto termination of the split-dollar arrangements should be disregarded for the purposes of valuing the Survivor Trust's rights in the split-dollar arrangements. The court found that Section 2703(a)(1) applied because the split-dollar arrangements allowed the MB Trust to obtain rights in the life insurance policies for less than fair market value. The court found that Section 2703(a)(2) also applied because the Survivor Trust's ability to terminate the split-dollar arrangements was subject the MB Trust's consent, which therefore was a restriction on the Survivor Trust's ability to exercise this right. The Tax Court added that, for purposes of the summary judgment motion before it, the parties had not addressed the application of Section 2703(b), which provides an exception to the application of Section 2703(a).

Within two months after this disappointing Tax Court opinion, the Estate reportedly settled the estate tax audit with the IRS, with the estate conceding all of the issues regarding the intergenerational split-dollar arrangement (agreeing that the value of the decedent's reimbursement right was the \$9.6 million cash surrender value of the policies) and the imposition of a 20% accuracy-related penalty under Section 6662; the IRS conceded as to the value of certain notes from family members unrelated to the split-dollar transaction.

3. *Estate of Morrissette v. Commissioner,* 146 T.C. 171 (2016); Order, Docket No. 4415-14 (June 21, 2018).

The Tax Court denies a summary judgment motion seeking to avoid the application of Section 2703 to split-dollar arrangements.

In 1994, Clara Morrissette established a revocable trust ("Clara's Trust"), to which she contributed all of her shares in Interstate Group Holdings, which, in turn, owned eleven moving and other companies.

In August 2006, upon the petition of Clara's three sons, a court declared her incompetent and appointed an employee of an Interstate Group company to a two-month term as the conservator of her estate. Shortly thereafter, Clara's three sons became co-trustees of Clara's Trust. Acting on behalf of Clara, the conservator established three dynasty trusts (the "Dynasty Trusts"), one for each of Clara's sons and their respective families. On September

19, 2006, Clara's Trust was amended (the "2006 Amendment") to allow the Trustee to pay life insurance premiums on "policies acquired to fund the buy-sell provisions of the [Interstate Group's] business succession plan" and to enter into split-dollar arrangements. The 2006 Amendment also allowed, but did not require, the Trustee to transfer receivables from the split-dollar arrangements back to the Dynasty Trust that owed the receivable or directly to Clara's sons. Two days later, the shareholders entered into a shareholder agreement. The shareholder agreement provided, among other things, that upon the death of any of Clara's sons, the surviving sons and their respective Dynasty Trusts would purchase the stock held by or for the benefit of the deceased son.

In October 2006, the Dynasty Trust for each son purchased universal life insurance policies on the lives of the two other sons. At the end of October, Clara's Trust entered into two split-dollar arrangements with each Dynasty Trust. Under the arrangements, Clara's Trust contributed a combined $29.9 million in nearly equal values to each of the Dynasty Trusts. The Dynasty Trusts used the funds to pay lump-sum premium payments on the life insurance policies held in each trust. The arrangements further provided that, upon the death of the insured, Clara's Trust was to receive a portion of the death benefit of the policy equal to the greater of the cash surrender value or the aggregate premium payments on the life insurance policies. The Dynasty Trust would receive the balance of the death benefit, which would then be used to buy the stock of the deceased son. If the arrangement was terminated during a son's life, Clara's Trust would receive the greater of the cash surrender value or the aggregate premiums paid, and the Dynasty Trust would not receive any funds. The arrangements also contained the following recital:

> WHEREAS, the parties intend that this Agreement be taxed under the economic benefit regime of the Split-Dollar Final Regulations, and that the only economic benefit provided to the [Dynasty] Trust[s] under this arrangement is current life insurance protection.

Neither Clara's Trust nor the Dynasty Trusts retained the right to borrow against the cash value of the policies.

From 2006 to 2009, Clara's gift tax returns reported her gifts to the Dynasty Trusts using the economic benefit regime set forth in Reg. §1.61-22. The amount reported was the cost of the life insurance protection reduced by the amount of the premiums paid by the Dynasty Trusts. In January 2009, the co-trustees, along with the remaining shareholders of the various companies of the Interstate Group, contributed their stock to Interstate Group Holdings, Inc. ("IGH") in exchange for IGH stock.

Clara died on September 25, 2009, and the receivables were valued for inclusion in Clara's gross estate at $7,479,000. The IRS issued a deficiency notice in December 2013 for Clara's 2006 gift tax liability in the amount of $13,800,179 and assessed an accuracy-related penalty of $2,760,036 under Section 6662. The IRS took the position that Clara should have reported the full value of $29.9 million on her gift tax returns.

2016 Decision. The executor filed a petition with the Tax Court in March 2014 and moved for partial summary judgment as to whether the split-dollar arrangements should be governed under the economic benefit regime. The IRS argued that summary judgment was inappropriate because whether Clara's Trust provided the Dynasty Trusts with an economic benefit other than current life insurance protection was an issue of fact. The Tax Court (Judge Goeke) disagreed and granted the Estate's motion. *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016).

The court held that the split-dollar arrangement was a valid contract between Clara's Trust and the Dynasty Trusts, and, accordingly, Clara's Trust was entitled to recover the premiums paid under the arrangement. Pursuant to the Regulations, as stated in the Introduction above, split-dollar arrangements are governed under either the loan regime or the economic benefit regime. This determination hinges on who owns the policy, which is typically the owner of the insurance contract. *See* Reg. §1.61-22(c)(1). A non-owner is any person other than the owner who has a direct or indirect interest in the insurance contract. Reg. §1.61-22(c)(2). Because the Dynasty Trusts owned the policies, the loan regime would apply, except that the economic benefit rule provides that if the only economic benefit provided under the arrangement is the life insurance protection, the donor will be treated as the deemed owner of the insurance contract and the economic benefit regime will apply. Reg. §1.61-22(c)(1)(ii)(A)(2).

Therefore, the primary consideration for the court was whether the money gifted by Clara's Trust to the Dynasty Trusts for the premium payments provided the Dynasty Trusts with an additional economic benefit in addition to the life insurance protection. If not, then Clara's Trust would be the deemed owner and the economic benefit regime would have applied to her gifts. The value of the economic benefit provided to a non-owner under a split-dollar arrangement is equal to the cost of the current life insurance protection, plus the amount of cash value to which the non-owner has current access, plus any additional economic benefits. Reg. §1.61-22(d)(2). The value will be reduced in all events by any consideration provided by the non-owner. Therefore, the Tax Court found that the determination turned on whether the Dynasty Trusts had current access to the cash value of the insurance policies.

A non-owner has current access to the cash value if: (i) the non-owner has a current or future right to all or a portion of the cash value and (ii) that right currently is directly or indirectly accessible by the non-owner, inaccessible to the owner or inaccessible to the owner's creditors. Reg. §1.61-22(d)(4)(ii). The court found that the Dynasty Trusts did not have current access to the cash value because, if the insurance contracts were terminated during life, the entire cash value would have been paid to Clara's Trust. If the contracts terminated as a result of death of the insured, the Dynasty Trusts would have only received the excess death benefit remaining after payment to Clara's Trust of the greater of the aggregate premiums paid or the cash surrender value. The IRS argued that the 2006 Amendment to Clara's Trust gave the Dynasty Trusts a direct or indirect right to the cash value because any amount paid to Clara's Trust would pass either to the Dynasty Trusts or directly to the sons pursuant to the provisions of Clara's Trust. The court disagreed, stating that Clara retained the right to amend or revoke the trust during her lifetime and the split-dollar arrangement itself did not require such a disposition of the receivables. In fact, the agreement was silent as to their disposition.

The IRS argued that the circumstances addressed in Notice 2002-59, 2002-36 I.R.B. 481, regarding reverse split-dollar arrangements, forbade the use of the economic benefit regime. The court viewed the transaction between Clara's Trust and the Dynasty Trusts as "the opposite" of reverse split-dollar arrangements because it did not attempt to take advantage of an out-of-date rate schedule to provide an influx of cash to the Dynasty Trusts to capitalize on the difference between the actual insurance cost and the published schedule. Instead, the court noted that Clara wanted the company stock to remain in the family and devised the split-dollar plan to achieve that goal while remaining within the requirements of the regulations.

Summary Judgment Motion Regarding Section 2703(a)(2). After the 2016 Tax Court opinion, the executor filed a petition for partial summary judgment that Section 2703 does not apply for purposes of valuing Clara's property rights under the split-dollar arrangements. Section 2703(a)(2) provides that the value of property is determined without regard to any restriction on the right to sell or use the property. Furthermore, the value of any property transferred between family members is determined without regard to any restrictions on the sale or use of the property.

The split-dollar arrangements could be terminated only upon the mutual agreement of Clara's Trust and the respective Dynasty Trust (the "Termination Restriction"). The executor argued that Section 2703(a)(2) did not apply to the Termination Restriction. The executor further argued that Clara held only the right to proceeds upon the insured's death, and that that right was not subject to any restriction to which Section 2703 could apply. The IRS argued that Section 2703 applied to the Termination Restriction, and added that Clara's Trust and the Dynasty Trusts entered into agreements regarding the assignment of the policies to Clara's Trust and those agreements contained other restrictions that were also subject to Section 2703.

On June 21, 2018, three days after the decision in *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018), the Tax Court (again Judge Goeke), citing *Cahill*, viewed the Termination Restriction as subject to Section 2703(a)(2) and denied the executor's summary judgment motion regarding the applicability of Section 2703. But the court did not *rule* that Section 2703(a)(2) applied, because the IRS had not moved for summary judgment on that issue. In addition to thereby preserving the Section 2703 issues for trial, the court further stated, also citing *Cahill*, that the IRS's claims that the split-dollar arrangements are includible in Clara's gross estate under Sections 2036 and 2038 also remain to be determined at trial.

By order dated November 2, 2018, trial is set for May 6, 2019, in Washington, D.C.

H. Liability for Tax.

1. *United States v. Paulson*, 2018 WL 4282682, 122 AFTR 2d 2018-5808 (S.D. Calif. Sept. 7, 2018), *motion for reconsideration denied* Nov. 13, 2018.

An executor is held personally liable for estate taxes to the extent of distributions made before the estate taxes were paid.

The decedent, Allen Paulson, was the founder of Gulfstream Aerospace Corp., manufacturer of the popular large private jet. The decedent and his fiancée (later wife), Madeleine, signed a premarital agreement stating that, at the decedent's death, Madeleine could elect to receive the property designated in the antenuptial agreement or property designated in the decedent's revocable trust (the Revocable Trust), but not under both.

Allen was survived by Madeline, his three sons, and a granddaughter. Most of his assets were held in the Revocable Trust. One son, Michael, was named executor of the estate and one of the trustees of the Revocable Trust. The estate reported a total gross estate of $187,729,626, a net taxable estate of $9,234,172, and an estate tax liability of $4,459,051. The estate elected to pay part of its taxes and defer the rest under Section 6166.

The IRS assessed a $38 million estate tax deficiency, which the Tax Court redetermined as $6,669,477. The estate also elected to pay this additional tax amount under the 15-year installment period permitted under Section 6166. In response to missed installment payments, the IRS accelerated the deferred taxes under Section 6166, which acceleration the Tax Court sustained. Several disputes arose among the family members and trustees, which were settled by an agreement and general release approved by the appropriate California Probate Court, under which, in part, Michael agreed to resign as executor. Michael was also removed as trustee for malfeasance. The Government sued Michael to collect the estate tax deficiency, because he had made distributions from the Revocable Trust before the estate taxes were paid. Several of the fiduciaries and beneficiaries also filed claims, cross-claims, and multiple motions.

The successor trustees moved to stay the federal proceedings while the probate court considered a petition they had filed on February 13, 2018, which they said could potentially resolve the claims and disputes among family members, including claims and disputes that had gotten mixed up with the federal tax case. On August 22, 2018, the U.S. District Court for the Southern District of California (Judge Battaglia) denied the motion to stay, pointing out that the Government's tax claim involved a federal question and the Government had the right to be paid first.

Barely two weeks later, on September 7, 2018, the federal court held, with respect to the tax issues, that:

1. Michael was a statutory executor under Section 2203 because he was appointed by the Probate Court. He is still a statutory executor, because although he had agreed to resign, he did not, as required by state law, both file a statement with the

Probate Court and settle all of the accounts of the estate. The court found that filing of the settlement agreement with the Superior Court was not the same as filing a resignation with the Probate Court.

2. Michael was personally liable for the estate tax as trustee of the Revocable Trust under Section 6324(a)(2), because while he was trustee he had possession of the estate assets held by the Revocable Trust, and the value of those assets was includible in the gross estate under Section 2038. Michael had both made distributions to some beneficiaries from the Revocable Trust and made improper investments, the losses from which were the basis for his removal as a trustee.

3. Michael was not discharged of his personal liability in all fiduciary capacities under Section 2204. Section 2204(b) permits a fiduciary other than the executor to obtain a discharge from personal liability upon an application to the Treasury. The court found that there were still genuine issues of material fact as to whether Michael successfully requested discharge as the trustee of the Revocable Trust. The letter submitted to the Treasury did not strictly meet the requirements of the Code and regulations, and required notification after nine months, rather than the statutory six months.

4. Madeleine was not liable for the estate tax deficiency as a co-trustee of the Revocable Trust under Section 6324(a)(2), because she did not acquire the trusteeship until three years after the date of death and Section 6324(a) refers to fiduciaries who "receive[ ], or ha[ve] on the date of the decedent's death, property included in the gross estate."

2. *United States v. Johnson*, 2018 WL 327245, 121 AFTR 2d 2018-341 (D. Utah. Jan. 8, 2018), *app. filed* 10th Cir. March 8, 2018.

Taxpayers were awarded attorneys' fees and expert witness costs because the Government's positions on personal liability were not substantially justified.

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

In *United States v. Johnson*, 224 F. Supp. 3d 1220 (C.D. Utah, Dec. 1, 2016), *app. filed* (10th Cir. 2017), the U.S. District Court (Judge Waddoups) held that the fiduciaries had no personal liability for the unpaid estate taxes. The court explained that the trustees' liability extended only to assets that were included in the gross estate under Section 2036 or 2038, but that the revocable trust assets were actually includible under Section 2033, because the decedent did not surrender her beneficial interest in the trust assets by transferring them to a trust that she could revoke and of which she was trustee. Rev. Rul. 75-553, 1975-2 C.B. 477. The executors were not personally liable for estate taxes under 31 U.S.C. §3713(b), because the special estate tax lien under Section 6324A had relieved them of personal liability. The Government argued that Section 2204 did not discharge the personal representatives because they never specifically requested a discharge, but the court held that either a separate written request for discharge is not required, or if it were, the communications between the fiduciaries and the IRS satisfied that requirement. The court also held that the fiduciaries had validly requested a special lien under Section 6324A, because they had (a) made an election by applying to the IRS office (Reg. §301.6324A-1(a)); (b) filed a proper agreement satisfying the requirements of Reg. §301.6324A-1(b); and (c) provided lien property (collateral) that "can be expected to survive the deferral period, and are designated in the agreement." Section 6324A(b)(1). The children then sought attorney's fees under Section 7430(a).

Judge Waddoups again held for the children. The court explained that Section 7430(a) allows the award of reasonable litigation costs to a taxpayer with a net worth of less than $2 million at the time the proceeding was commenced, who "has substantially prevailed with respect to the amount in controversy or has substantially prevailed with respect to the most significant issue or set of issues presented." Section 7430(c)(4)(A). The Government conceded both the fact that the fiduciaries met the net worth requirement and that they had won the suit but argued that they had not substantially prevailed because the Government's position was substantially justified. Section 7430(4)(B)(ii) states that the United States' position is presumed "not to be substantially justified if the Internal Revenue Service did not follow its applicable published guidance…." *See Pierce v. Underwood*, 487 U.S. 552, 565 (1988) ("substantially justified" means "justified to a degree that could satisfy a reasonable person," or in other words, having a "reasonable basis both in law and fact.") The taxpayers argued that the Government's position was not substantially justified with respect to the questions whether: (a) the trust assets were included in the gross estate of Anna S. Smith under one of Sections 2034 through 2042, so that there could be transferee liability under Section 6324(a)(2); (b) a Section 6324A special lien had in fact been furnished to the IRS, which wrongfully rejected it, and therefore Carol Johnson and James Smith were entitled to discharge under Section 2204 as a matter of law; and (c) the Government's attempts to enforce the Distribution Agreement and foreclose its tax lien were untimely or otherwise improper.

The Government argued that defendants could not have received a valid discharge of personal liability under Section 2204 through a valid special lien because the IRS had never accepted the proposed special lien, but the court noted that there is no specific "form, method, procedure, or policy by which such a 'written application'" is properly made. Thus, the Government lacked a reasonable basis in law and fact for its position. The court also held that the Government's position with regard to the trustee's liability under Section 6324(a)(2) was not substantially justified, because the Government had never been able to establish a reason why it could argue for the application of Sections 2036 and 2038 – it merely continued to do so. Finally, the court noted that the Government had no substantial justification for waiting too long to foreclose its tax lien and to enforce the distribution agreement among the estate and its beneficiaries. The court awarded the taxpayers $285,648.06 in attorney's fees and $30,558.00 in expert witness report costs.

I. Tax Liens.

1. *Bennett v. Bascom*, 2018 WL 1473798, 121 AFTR 2d 2018-1232 (E.D. Ky. March 26, 2018), *app. filed* (6th Cir. April 26, 2018).

An IRS estate tax lien has priority over the rights of other partners respecting partnership terminating distributions.

Duane Bennett, Sr. died in 2006, leaving an estate that included a 40% interest in two limited partnerships. The IRS assessed nearly $3 million in federal estate tax liabilities against his estate, and after the estate made the payments it could, the liability was reduced only to about $2 million, and interest, penalties, and costs continue to accrue. A state court appointed a receiver for the two partnerships, and the receiver found a buyer, Kingdom Energy Resources, LLC, for the partnerships' assets. Each partner was thus entitled to a proportionate share of the sales proceeds. Certain large sums had been advanced to the decedent and reported as loans in the partnership records, and the parties disagreed as to how these payments should be treated. The other partners sought to treat them as excess distributions to the decedent, which had to be recouped by the partnership before any distributions could be made. The Government claimed that it should receive the estate's share of the sales proceeds, to satisfy the estate tax liability.

The court (Chief Judge Caldwell) held for the Government. The court found no evidence that the payments to the decedent were anything other than loans. Thus, either the IRS or Kingdom Energy had a right to the estate's portion of the proceeds from the sale of the partnerships' assets. The estate owed Kingdom Energy for the balance of the notes owed to the limited partnerships, and it owed the IRS for unpaid taxes. As between the two of them, the Government argued that its tax liens were superior to any claim by Kingdom Energy, and Kingdom Energy argued that the estate's 40% ownership interest in the limited partnerships was collateral on the loans to the decedent. The court noted that a holder of a security interest has "priority over a tax lien only if the security interest is perfected before the IRS has filed notice of its lien in the proper location." *Bank of Mt. Vernon v. United States*, 1987 WL 9100 at *1, 59 AFTR 2d 87-631 (E.D. Ky. 1987). Kingdom Energy did not perfect its lien before this date, and, as the IRS had a lien against the sales proceeds themselves, the IRS had priority.

STATE ESTATE AND INCOME TAXATION OF TRUSTS

A. State Estate Taxation of QTIP Trusts.

1. Background.

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

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

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

Consistent with the Washington legislation, *Estate of Ackerley v. Dep't of Revenue*, 389 P.3d 583 (Wash. 2017), subsequently held that federal gift tax included in a decedent's federal gross estate under Section 2035(b) (the so-called "gross up" rule) also is subject to state estate tax, because the state tax piggybacks on the federal taxable estate. Essentially these developments reveal an effort to tie state estate tax to the federal estate tax return, making whatever is includible for federal purposes also includible for state estate tax purposes. And they indicate that the state death tax posture is fundamentally different from that at the federal level.

In this context, then, consider first the facts in *Estate of Brooks v. Commissioner of Rev. Servs*, 159 A.3d 1149 (Conn. 2017), in which the settlor of two QTIP trusts died in Florida, which has no state estate tax. These trusts qualified for the federal estate tax marital deduction but served no state death tax deferral function because there was no state death tax to be deferred. The surviving spouse relocated to and subsequently died in Connecticut, which does have an estate tax. These QTIP trusts didn't garner a deferral of Connecticut estate tax either, because the trust settlor had not died in Connecticut. Nevertheless, Connecticut successfully imposed its estate tax on these QTIP trusts when the surviving spouse died, based on the logic in both *Bracken* and *Ackerley* that the state estate tax piggybacks on the federal gross estate and QTIP trusts are includible in the federal gross estate of a surviving spouse. The lack of deferral and notions of payback notwithstanding, the court also stated that termination of the surviving spouse's life estate is a "sufficient 'shifting at death of particular incidents of property' to properly impose an excise tax" on the transfer of wealth.

2. *Comptroller of the Treasury v. Taylor,* 189 A.3d 799 (Md. Ct. Special App. 2018).

Maryland court holds that a QTIP trust of a decedent who died domiciled elsewhere is not subject to state estate tax when the surviving spouse dies.

In *Taylor*, which is contrary to *Brooks* (although never citing it), the settlor died in Michigan and created a QTIP trust, and a QTIP election was made for both state and federal tax purposes. The surviving spouse died in Maryland, which has an estate tax. Nevertheless, the court held that the QTIP trust was *not* includible in the survivor's estate for state estate tax purposes, notwithstanding that it was includible for federal purposes. Potentially unique about *Taylor* is that Maryland's estate tax references a "*transfer* of the Maryland estate" of a Maryland domiciliary and there is no actual transfer when the survivor's income interest terminates. More important is Code of Maryland – Tax – General §7-309(b)(6)(i):

> For purposes of calculating Maryland estate tax, a decedent shall be deemed to have had a qualifying income interest for life under §2044(a) of the Internal Revenue Code with regard to any property for which a marital deduction qualified terminable interest property election was made for the decedent's predeceased spouse on a timely filed Maryland estate tax return.

The rationale for this provision appears to reflect Code of Maryland – Tax – General §7-309(b)(5)(ii), which allows a Maryland QTIP election, separate from that made for federal purposes, causing Maryland estate tax inclusion of a trust that was not subject to Section 2044 inclusion for federal purposes. The state argued "that Maryland could tax the assets of a QTIP for which no Maryland election was made," which the court rejected as "not plainly within the statute's language" and that "[t]he fiction created by the QTIP election, which includes the trust in the estate of the surviving spouse, is explicitly limited to those instances where an election has been made to create it" for state estate tax purposes. There having been no Maryland marital deduction and no Maryland QTIP election in *Taylor* meant that there could be no payback inclusion in the survivor's Maryland estate.

***3. In re Estate of Seiden*, 2018 NY Slip Op 32541(U) (NY County Surr. Ct. Oct. 9, 2018).**

New York court holds that a QTIP trust of a decedent who died in 2010 is not subject to state estate tax when the surviving spouse dies.

Again applying the "piggyback" concept of *Ackerley* and *Brooks*, but this time to the state's disadvantage, is *Seiden*, in which the settlor of a QTIP trust died in 2010, when the federal estate tax was in hiatus, and the estate therefore did not need to make a QTIP election to qualify for the federal estate tax marital deduction. As a result, Section 2044 did not require inclusion of the QTIP trust in the survivor's gross estate when the surviving spouse subsequently died. However, the estate of the settlor *did* make a New York-only QTIP election upon settlor's death in 2010.

New York Tax Law §954(a) expressly provides that the New York gross estate of a deceased resident "means his or her federal gross estate," a typical piggyback form of state estate tax. Therefore, because the QTIP trust was not includible in the survivor's federal gross estate, the estate did not include it in the survivor's New York gross estate either, which the court held to be correct. The opinion does not indicate what the New York estate taxation of the settlor's estate entailed, nor whether a state QTIP election had been made that could have meant that payback inclusion in the estate of the survivor would be appropriate. The court simply dismissed the state's argument for New York estate tax inclusion because of the very clear piggyback nature of the New York statute.

4. Comment. A case lacking the specific legislation in *Taylor* may not be as easy for a taxpayer to win, and the *Seiden* opinion essentially invited the New York legislature to amend its statute, saying "the legislature could still amend the Tax Law to apply to future estates." Also, query the result in *Brooks* if the facts had been reversed, and the surviving spouse had qualified for the estate tax marital deduction in Connecticut but then moved to and died in Florida. The *Seiden* opinion noted this anti-payback result, saying that "it is not guaranteed that all or even part of any QTIP trust would be subject to New York estate tax at the death of the surviving spouse under present law. The trust property might decrease in value; it might be distributed and spent down; or the surviving spouse might change domicile to another state."

The fundamental notion articulated in *Brooks* is that the law of the surviving spouse's domicile at death is the applicable law for purposes of the state death tax imposed, again regardless of the federal payback concept. That notion is worth considering when planning the estate of a surviving spouse, which (as between two spouses) is the estate in which tax liability is more likely to be incurred.

B. State Income Taxation of Trusts.

1. *Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Dept. of Revenue,* 814 S.E.2d 43 (N.C. June 8, 2018), *aff'g* 789 S.E.2d 645 (N.C. App. 2016).

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

Joseph Lee Rice, III (the "Settlor"), a resident of New York, created the Joseph Lee Rice, III Family 1992 Trust (the "Family Trust") for the benefit of his children. William B. Matteson, also a resident of New York, served as the initial Trustee. The trust agreement provided that the Family Trust was to be governed by the laws of the State of New York. In 1997, Kimberley Rice Kaestner ("Kaestner"), one of the Settlor's children, moved to North Carolina. William B. Matteson resigned as Trustee in 2005, and David Bernstein ("Bernstein"), a Connecticut resident, became Trustee.

In 2006, pursuant to the terms of the Family Trust Agreement, Bernstein divided the Family Trust into separate trusts for each of the three children. One of the separate trusts was the Kimberley Rice Kaestner 1992 Family Trust (the "Kaestner Trust"). The Kaestner Trust benefited Kaestner as well as her three children, each of whom resided in North Carolina from 2005 to 2008, the years at issue. The contingent beneficiaries of the Kaestner Trust were Kaestner's siblings, none of whom resided in North Carolina.

From 2005 to 2008 the Kaestner Trust's assets were held by a custodian in Boston, Massachusetts. The ownership documents for some of the assets were located in New York, along with financial and legal records. Tax returns and trust accountings were all prepared in New York. The Kaestner Trust provided that all income and principal distributions from the trust were in Bernstein's discretion. Neither Kaestner nor her children received distributions from the Kaestner Trust between 2005 and 2008, although the Kaestner Trust made two loans during the same period, a $250,000 loan to Kaestner for an investment and another loan to a separate trust "to enable [that trust] to make a capital call on a limited partnership interest" held in that trust. Both loans were eventually repaid to the Kaestner Trust. Kaestner and Bernstein communicated regularly regarding Kaestner's need for distributions and investment of the trust assets. In 2009, Bernstein transferred the Kaestner Trust assets to a new trust, the KER Family Trust.

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

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

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

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

The Department of Revenue also argued that Bernstein restructured the trust at Kaestner's request and communicated with her regarding management of the assets, and that this indicated a continuing relationship with a North Carolina resident. The court found that the communication was infrequent, the meetings were held outside the state of North Carolina, and the restructuring occurred after the years at issue. The court reiterated that the trust, not the beneficiary, would have to avail itself of the benefits and protections of the state to satisfy the requirements of due process.

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

Dissent. Justice Samuel J. Ervin IV (whose grandfather, Senator Sam Ervin, had chaired the Senate Select Committee on Presidential Campaign Activities, known as the Watergate Committee, in 1973 and 1974) dissented in *Kaestner*, believing that the Connecticut and

California cases of *Chase Manhattan Bank v. Gavin* and *McCulloch v. Franchise Tax Board* supported North Carolina's effort to tax accumulated trust income. The dissent did not address the possibility that *McCulloch* was distinguishable because the trustee in that case was also a resident of California.

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

2. *Fielding v. Commissioner of Revenue*, 2018 WL 3447690 (Minn. July 18, 2018), *aff'g* 2017 WL 2484593 (Minn. T.C. 2017).

A tax residency statute violates the Due Process Clause when applied to a trust with insufficient connections to the state.

Reid V. MacDonald ("Grantor"), a resident of Minnesota, formed four grantor trusts (the "Trusts") in 2009, retaining the power to substitute trust assets. The Trusts were funded with shares of common stock in Faribault Foods, Inc., a Minnesota S corporation. The trustee, trust administration, and all but one of the beneficiaries of the Trusts were always located outside of Minnesota.

The Grantor gave up the power to substitute trust assets in 2011, and (according to the court) the Trusts then became irrevocable. Under Minnesota Statute §290.01, subd. 7b(a)(2), Minnesota law defines a "resident trust," in part, as "an irrevocable trust, the grantor of which was domiciled in this state at the time it became irrevocable." At the time the Trusts became irrevocable, the Grantor was domiciled in Minnesota.

On August 1, 2014, the trustee sold the stock held by the Trusts, resulting in substantial deposits in each of the Trusts' accounts. Under the trust terms, the trustee made distributions to each beneficiary during 2014. Each Trust timely filed a 2014 Minnesota income tax return as a Minnesota "resident trust" and paid the reported tax under protest, including a statement asserting that the statutory definition of a "resident trust" was unconstitutional. Each Trust then filed an amended 2014 Minnesota income tax return without treating itself as a Minnesota "resident trust," and requested a refund.

The Trustee argued that Minnesota's definition of a "resident trust" violated the due process provisions of the Minnesota and United States Constitutions. Due process analysis imposes two constraints on state taxation. There must be both "a minimum connection" between a state and the person, property, or transaction subject to tax and a rational relationship to the benefits conferred on the taxpayer by the State. *Luther v. Commissioner of Revenue*, 588 N.W.2d 502 (Minn. 1999).

The Minnesota Tax Commissioner cited the following as factors requiring taxation:

1. Reid MacDonald was a Minnesota resident when the trusts were created.

2. Reid MacDonald was domiciled in Minnesota when the trusts became irrevocable and was still domiciled in Minnesota in 2014.

3. The trusts were created in Minnesota with the assistance of a Minnesota law firm, which drafted the trust documents and until 2014 retained the trust documents.

4. The trusts held stock in a Minnesota S corporation.

5. The trust documents provided that questions of law arising out of the trust documents were to be determined in accordance with Minnesota law.

6. One beneficiary had been a Minnesota resident through the tax years in question.

The Trustee, on the other hand, noted that:

1. No trustee had been a Minnesota resident.

2. The trusts had not been administered in Minnesota.

3. The records of the trust assets and income were maintained outside of Minnesota.

4. Some of the trusts' income was derived from investments with no direct connection to Minnesota.

5. Three of the four beneficiaries of the trusts lived outside of Minnesota.

As a result, the contacts between the trusts and Minnesota from 2014 on were tenuous. The trusts had no contact with Minnesota during the applicable tax year. All trust administration activities by the trustees occurred outside Minnesota.

Largely following the reasoning of the Minnesota Tax Court, the Minnesota Supreme Court concluded that the contacts on which the Tax Commissioner relied were either irrelevant or too attenuated to establish that Minnesota's tax on the trusts income from all sources complied with due process requirements. The court held that the statute failed the due process analysis for three reasons.

First, the court held that the Grantor's residence at the time the Trusts became irrevocable was

> not relevant to the relationship between the Trusts' income that Minnesota seeks to tax and the protection and benefits Minnesota provided to the Trusts' activities that generated that income. The relevant connections are Minnesota's connection to the trustee, not the connection to the grantor who established the trust years earlier.

Thus, the court looked largely to each trust's independence as a legal entity, separate from the grantor or beneficiary. *See Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947). Second, the Trusts owned no physical property in Minnesota that might serve as a basis of taxation. *See, e.g., Westfall v. Dir. of Revenue*, 812 S.W.2d 513 (Mo. 1991). The stock of a Minnesota company was intangible property held and controlled outside the state of Minnesota which could not be the basis for taxation.

Third, the court did not find any contacts with Minnesota by the Grantor, the Trusts or the beneficiaries that occurred prior to the tax year at issue, including the decision to use a Minnesota law firm, to be relevant. Citing *Luther*, the court determined that the relevant facts for evaluating the sufficiency of a taxpayer's contacts must be drawn from the tax year at issue. In addition, the Minnesota residency of one beneficiary did not establish the necessary minimum connection to justify taxing the trusts income.

Under *Fielding*, residence of a trust beneficiary would allow Minnesota to tax trust income distributed to that beneficiary, regardless of its source. But, consistent with *Kaestner*, some other nexus must exist for Minnesota to tax trust income not distributed to Minnesota domiciliaries. Residence of the grantor at the time the trust was created, however, was not a sufficient nexus to tax income that is not sourced to Minnesota. The Minnesota Tax Court had stated that "state protections must be contemporaneous with the accumulation of the income to be taxed" and "[i]t is unsurprising that courts universally rejected state efforts to tax trusts as 'residents' based solely on the domicile of the grantor at the time an *inter vivos* trust became irrevocable." The Minnesota Supreme Court added that "[t]he relevant connections are Minnesota's connection to the trustee, not the connection to the grantor" or, for that matter, to the beneficiaries. It is the state's relationship between the income of the trust "and the protection and benefits Minnesota provided to the [trust's] activities that generated that income."

Thus there are a number of factors that might cause a state to have a sufficient nexus: domicile of beneficiaries, trustees, or settlor, along with source income. In *Kaestner* there was only one factor – domicile of the beneficiaries – and it alone was held not to be sufficient. In *Fielding* there was an additional factor – domicile of the grantor at the time the trust became irrevocable – and it also was not sufficient.

The *Fielding* opinion viewed irrevocable *inter vivos* trusts as distinguishable from testamentary trusts for purposes of finding a tax nexus. The court agreed with this notion expressed by some:

> The case for asserting jurisdiction to tax a testamentary trust based on the domicile of the decedent … is probably a stronger one because of the

> connection that a testamentary trust has to the state's probate courts … given the continuing supervisory relationship which [state] courts have with respect to administration of such a trust.

The court added:

> [U]nlike cases in other states that considered testamentary trusts, the *inter vivos* trusts at issue here have not been probated in Minnesota's courts and have no existing relationship to the courts distinct from that of the trustee and trust assets.

The court did not explain how long after the death of the settlor this distinction would hold up.

Dissent. A dissent argued that it cannot violate due process to tax a trust created by a resident invoking Minnesota law:

> First, there is a "minimum connection" between Minnesota and the Trusts. From their creation, the Trusts were Minnesota residents. They were created by Reid MacDonald, a Minnesota resident. The Trusts were created to hold almost exclusively Minnesota assets – the common stock of a Minnesota S corporation – over which Minnesotan MacDonald retained control. Further, the trust instruments themselves instruct the trustee – wherever located – to apply the Minnesota Revised Uniform Principal and Income Act and to resolve all questions of law arising under the trust agreements according to "the laws of the State of Minnesota."
>
> Most importantly, when MacDonald made the Trusts irrevocable in 2011, he did so as a Minnesota domiciliary. He was on statutory notice that, as a Minnesotan, his decision would cause the Trusts to become Minnesota "resident trusts." *See* Minn. Stat. §290.01, subd. 7b(a)(2) (2016). When a Minnesota grantor knowingly chooses to create a Minnesota resident trust and the trust itself incorporates Minnesota law, why would it be unconstitutional for Minnesota to tax that trust? Put another way: how can it violate due process for a state to tax its residents (in this case, the Trusts) as residents?

3. *South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (June 21, 2018).

States may charge sales tax on internet purchases even where the seller does not have a physical presence in the state.

In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Supreme Court held that the Dormant Commerce Clause barred states from compelling retailers to collect sales or use taxes from mail order and internet sales made to their residents unless those retailers have a physical presence in the taxing state. Given the post-1992 boom of electronic commerce, states were losing a lot of revenue. South Dakota alone, it seems, was losing between $48 and $58 million in sales and use taxes from the application of *Quill*. So the South Dakota Legislature enacted a law requiring out-of-state sellers to collect and pay sales tax "as if the seller had a physical presence in the State." The Act applied only to sellers that delivered more than $100,000 of goods or services annually into South Dakota or engaged in 200 or more separate transactions annually for the delivery of goods or services into South Dakota. A group of online retailers with no employees or real estate in South Dakota filed suit in state court, claiming the Act's requirements violated *Quill*. The trial court granted their motion, and the South Dakota Supreme Court affirmed.

But in *Wayfair*, 13 days after *Kaestner* and 27 days before *Fielding*, the United States Supreme Court reversed (in a 5-4 decision), declaring that because the physical presence rule of *Quill* is unsound and incorrect, *Quill* is hereby overruled. Writing for the majority, Justice Kennedy noted that the physical presence rule from *Quill* has long been criticized as giving out-of-state sellers an advantage. Physical presence is not required, just that there be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." A business need not have physical presence in a state to satisfy the requirements of due process. Here, the Act applies only to sellers who engage in a significant quantity of business in South Dakota, and respondents are large, national companies that undoubtedly maintain an extensive virtual presence.

Justice Kennedy observed that 41 states, two territories, and the District of Columbia have asked the Court to overrule *Quill*. He wrote:

> Helping respondents' customers evade a lawful tax unfairly shifts an increased share of the taxes to those consumers who buy from competitors with a physical presence in the State. It is essential to public confidence in the tax system that the Court avoid creating inequitable exceptions. And it is also essential to the confidence placed in the Court's Commerce Clause decisions. By giving some online retailers an arbitrary advantage over their competitors who collect state sales taxes, *Quill*'s physical presence rule has limited States' ability to seek long-term prosperity and has prevented market participants from competing on an even playing field.

Justices Thomas, Ginsburg, Alito, and Gorsuch joined Justice Kennedy in the majority. Chief Justice Roberts and Justices Breyer, Sotomayor, and Kagan dissented.

ILLINOIS CASES

1. *Illinois State Bar Association Mutual Insurance Company v. Leighton Legal Group, LLC,* 2018 IL App (4th) 170548 (May 22, 2018)

Insurer has no duty to defend intentional misconduct by attorney.

Plaintiffs, Carol McClure and Cynthia McClure, had filed a complaint in the District of Columbia against attorney G. Timothy Leighton (and the Leighton Legal Group, LLC), who served as co-trustee of a trust of which plaintiffs were remainder beneficiaries, alleging that the attorney engaged in willful misconduct.

ISBA Mutual, the attorney's professional liability insurer, filed an action for declaratory judgment contending that it had no duty to defend because the attorney's actions constituted intentional conduct and was excluded from coverage. The trial court found that the insurer did have a duty to defend under the terms of the policy, and ISBA Mutual appealed. The appellate court reversed, finding that the attorney's conduct, as alleged in the underlying complaint, was excluded from coverage because the allegations were those of willful misconduct.

The professional liability policy provided coverage for "any actual or alleged negligent act, error, or omission in the rendering of or failure to render professional services," including conduct as a trustee, but it explicitly excluded from coverage any claim "arising out of any criminal, dishonest, fraudulent or intentional act or omission."

Joseph McClure died on July 11, 1995, leaving a trust providing a lifetime income interest for his brother, Cecil McClure, with remainder to a charity and to Cecil's children, the plaintiffs in the underlying action. Joseph's will provided that after satisfying specific bequests, the remainder of his property should be sold. The Joseph McClure Trust had specific provisions for nomination of trustees, designation of beneficiaries, use of a qualified financial institution to co-manage the trust, and instructions for distribution of the trust corpus to the remainder beneficiaries.

After Joseph's death, defendant Leighton drafted the Cecil O. McClure Irrevocable Trust and attempted to unlawfully "decant" the Joseph McClure Trust by transferring Joseph's property to the Cecil McClure Trust. The Cecil McClure Trust contained key differences from the Joseph McClure Trust, such as (1) including an *in terrorem* clause, (2) eliminating the requirement to use a qualified financial institution as a co-trustee, (3) appointing the insured as a co-trustee, and (4) eliminating the requirement to sell Joseph's property. Joseph's property had not been sold, and the Cecil McClure Trust continued to hold real estate.

After Cecil's death, Leighton told the plaintiffs that the remainder beneficiaries would receive quarterly income distributions. Plaintiffs requested the trust corpus be liquidated and the proceeds distributed to the remainder beneficiaries. The complaint asserted that the Leighton denied this request because the real estate market was poor and because plaintiffs were not entitled to any distribution of trust corpus. Instead, Leighton continued to administer the Cecil McClure Trust and give quarterly income distributions.

Plaintiffs alleged that Leighton created a "self-compensation scheme" by eliminating the requirement to use a qualified financial institution as a co-trustee and appointing himself as a co-trustee, and that thereafter Leighton and others collected excessive fees while managing the trust.

The court wrote, "[t]hroughout the underlying complaint, plaintiffs alleged willful conduct by the insured," with allegations as follows: (1) the insured "*willfully* refused to distribute the remaining trust assets;" (2) self-dealing by the insured, by refusing to liquidate the trust corpus "in order to perpetuate [his] self-compensation *scheme*;" (3) the insured "*willfully* misinformed the plaintiffs in bad faith that they were not entitled to distribution of the trust corpus;" (4) the insured "committed breach of trust by *willfully* disregarding the termination provision of the trust and refusing to distribute the trust assets;" and (5) the insured as trustee "*willfully* committed [a] serious breach of trust in failing to fulfill [his] fiduciary duties." 2018 IL App (4th) at ¶ 17 (emphasis in original).

Leighton argued that an insurer has a duty to defend against an underlying complaint if the "allegations fall within, *or potentially within*, the policy's coverage." Leighton contended that "to the extent that the allegations have any merit, they are much more likely to be the result of mere negligence," and therefore ISBA Mutual had a duty to defend.

The court stated that the construction generally afforded to intentional act exclusions is to deny coverage where the insured has (1) intended to act and (2) specifically intended to harm a third party. In discussing the element of intent, the court noted that "[t]he word 'intent' for purposes of exclusionary clauses in insurance policies denotes that the actor desires to cause the consequences of his action or believes that the consequences are substantially certain to result from it." 2018 IL App (4th) 170548 at ¶ 48.

Noting that the insurer may refuse to defend only if it is clear from the face of the underlying complaint that the allegations fail to state facts that bring the cause within — or potentially within — coverage, the appellate court agreed with the insurer that it had no duty to defend because the alleged actions were "dishonest, intentional, and fraudulent and therefore excluded from coverage." The court explained that phrases in the underlying complaint such as mislead, conceal, scheme, deceive, intentionally, or willfully are the "paradigm of intentional conduct and the antithesis of negligent actions," so that the alleged conduct could not be the result of mere professional negligence, but was intentional conduct. As a result, the insurer did not have a duty to defend.

2. ***Parmar v. Madigan,*** **2018 IL 122265 (May 24, 2018)**

State of Illinois and its officers have sovereign immunity from lawsuit to recover estate tax payment.

Surinder Parmar died on January 9, 2011, leaving an estate valued at over $5 million. Due to the one-year repeal of the federal estate tax in 2010 and the Illinois estate tax statute basing its tax on the "state death tax credit" available for Illinois decedents, Illinois effectively had no estate tax for 2010, or for any year thereafter – until January 13, 2011, when the Governor signed a bill that had been adopted by the General Assembly on January 11, 2011, reviving the Illinois estate tax for the estates of decedents who died after December 31, 2010. The latest period of time covered by the prior version of the statute was for persons "dying after December 31, 2005 and on or before December 31, 2009."

Plaintiff, the decedent's son, had paid $560,000 to the Illinois Treasurer in September and October of 2012. In April 2013, plaintiff requested a waiver of penalties, which the Illinois Attorney General granted in September 2013.

The "Certificate of Discharge and Determination of Tax" issued by the Attorney General on July 24, 2015, stated that the estate's tax liability, including interest and penalties, had been paid and that the certificate was evidence of the complete release of all estate property from lien imposed by the Estate Tax Act and the discharge from personal liability of the executor for the estate tax, penalties, and interest. Shortly thereafter, plaintiff filed another amended return, based on his belief that the amendment to the Estate Tax Act did not apply to his mother's estate and no tax was due.

Plaintiff filed a complaint in the circuit court of DuPage County against defendants, the Attorney General and the Treasurer of the State of Illinois, challenging the application and constitutionality of the amendment to the Illinois Estate and Generation-Skipping Transfer Tax Act ("Estate Tax Act") with respect to his mother's estate, who had died before the amendment was enacted, and seeking a refund of all monies paid to the Treasurer. Plaintiff claimed that retroactive application of the statutory amendment to the estates of persons who, like his mother, died after December 31, 2010, but before January 13, 2011 (the effective date of the amendment), was contrary to section 4 of the Statute on Statutes (5 ILCS 70/4) and would violate the due process and takings clauses of the Illinois and United States Constitutions, as well as the *ex post facto* clause of the Illinois Constitution.

Defendants filed a combined motion to dismiss pursuant to section 2-619.1. Defendants first argued that the complaint should be dismissed under section 2-619(a)(1) of the Code because the circuit court lacked jurisdiction. Defendants maintained that, because the complaint seeks a money judgment against the State, it is barred under sovereign immunity principles embodied in the State Lawsuit Immunity Act (745 ILCS 5/1) and the complaint must be filed in the Illinois Court of Claims. Defendants also argued that the complaint should be dismissed under section 2-619(a)(9) of the Code (735 ILCS 5/2-619(a)(9)) because the voluntary payment doctrine bars recovery. Finally, defendants argued that certain counts of the complaint should be dismissed pursuant to section 2-615 of the Code for failure to state a claim upon which relief may be granted.

In response, plaintiff argued that his suit was properly brought in the circuit court because section 15 of the Estate Tax Act (35 ILCS 405/15) vests jurisdiction in the circuit court to hear all tax disputes arising under the Estate Tax Act. Plaintiff also argued that he was not seeking payment from the State because his claim is not against the General Revenue Fund. Rather, his claim is against the Estate Tax Refund Fund, a special fund created under section 13 of the Estate Tax Act. Plaintiff further argued that his complaint was not barred by the voluntary payment doctrine because he made the tax payments under "implied duress" created by the threat of penalties imposed by the Estate Tax Act. Plaintiff also defended the sufficiency of his constitutional claims.

The circuit court dismissed the complaint for lack of jurisdiction, pursuant to the State Law Immunity Act (745 ILCS 5/0.01 et seq.). The appellate court reversed the circuit court and remanded the case for further proceedings; but the Illinois Supreme Court reversed the appellate court, affirming the dismissal by the circuit court.

First, regarding sovereign immunity, the court cited the State Lawsuit Immunity Act, 745 ILCS 5/1, which provides as follows:

> Except as provided in the Illinois Public Labor Relations Act, the Court of Claims Act, the State Officials and Employees Ethics Act, and Section 1.5 of this Act, the State of Illinois shall not be made a defendant or party in any court.

The Court of Claims Act creates a forum for actions against the State, and provides with limited exceptions, that the Illinois Court of Claims "shall have exclusive jurisdiction to hear and determine … [a]ll claims against the State founded upon any law of the State of Illinois." 705 ILCS 505/8(a).

Because the plaintiff filed suit against the Attorney General and the Treasurer in his or her "official capacity," the court wrote that the bar of sovereign immunity would "seemingly apply in this case." The appellate court had reversed the circuit court based on the "officer suit exception" to sovereign immunity, which requires that a State officer's conduct violates statutory or constitutional law or is in excess of his or her authority. However, the Supreme Court found, that the Estate Tax Act, on its face, is applicable to the estates of decedents who died after 2010. "[t]he Attorney General is responsible for administering and enforcing the Estate Tax Act, and the Treasurer is responsible for receiving and refunding moneys collected pursuant to the Estate Tax Act."

The plaintiff alleged that defendants' conduct was unlawful because they acted pursuant to an unconstitutional statute. To this, the Supreme Court responded that one of the principles of the "officer suit exception" to sovereign immunity is that it applies to enjoin future conduct (i.e., a State officer's actions contrary to law), not redress for past wrongs. "[A] complaint seeking damages for a past wrong does not fall within the officer suit exception to sovereign immunity."

The plaintiff also argued that section 15 of the Estate tax Act provides for jurisdiction and venue in the circuit court. Section 15(a) provides:

> (a) Jurisdiction. Jurisdiction to hear and determine all disputes in relation to a tax arising under this Act shall be in the circuit court for the county having venue as determined under subsection (b) of this Section, and the circuit court first acquiring jurisdiction shall retain jurisdiction to the exclusion of every other circuit court.

The court agreed with the State that the jurisdictional provision in the Estate Tax Act did not operate as a waiver of sovereign immunity, but was "only intended to fix jurisdiction and venue for all disputes that do not implicate sovereign immunity."

Next, Plaintiff argued that even if section 15 of the Estate Tax Act does not constitute a waiver of sovereign immunity, a judgment in his favor would not result in a judgment against the State and, therefore, his complaint does not implicate sovereign immunity. Rather, a judgment in favor of plaintiff would by payable from a special "Estate Tax Refund Fund" created under section 13(c) of the Estate Tax Act. Indeed, the defendants did not dispute that if a judgment could be satisfied by moneys in the refund fund, then plaintiff's complaint would not implicate principles of sovereign immunity.

The statutory framework for estate tax refunds in Illinois requires that an application for refund be filed with the Treasurer. Section 14 of the Estate Tax Act provides as follows:

> In case it appears that the amount paid with respect to any taxable transfer is more than the amount due under this Act, then the State Treasurer shall refund the excess to the person entitled to the refund, provided that no amount shall be refunded unless application for the refund is filed with the State Treasurer no later than one year after the last date allowable under the Internal Revenue Code for filing a claim for refund of any part of the related federal transfer tax or, if later, within one year after the date of final determination of the related federal transfer tax.

The court concluded that plaintiff's claim for refund, filed in the circuit court, did not fit within the statutory framework for an estate tax refund, even finding that "[p]laintiff's claim is not predicated on a reduction of the 'state tax credit,' as provided in section 7(b) of the Estate Tax Act." "Nor is plaintiff's claim based on an overpayment of taxes with respect to a 'taxable transfer,' as provided in section 14." Rather, plaintiff's claim was predicated on the notion that no taxable transfer occurred. "In other words, this is not a case where a downward adjustment to the estate's tax liability has occurred, requiring the filing of an amended return under section 7(b), and the subsequent filing of an application for refund with the Treasurer, pursuant to section 14."

The appellate court held that, because plaintiff paid the taxes involuntarily, he was not required to seek recovery under the State Officers and Employees Money Disposition Act (Protest Moneys Act) (30 ILCS 230/1 et seq.). The Supreme Court pointed out that the plaintiff could, indeed, have litigated his claims in the circuit court had he followed the procedures for paying taxes under protest pursuant to the Protest Moneys Act. However, under the Protect Moneys Act, the "person who has paid the money under protest has 30 days in which to obtain a temporary restraining order or a preliminary injunction restraining the transfer of the money into the State treasury or other fund into which the money would have been transferred absent the protest."

A complaint filed in accordance with the Protest Moneys Act would name State officers but would operate outside the bar of sovereign immunity. Indeed, the court noted, the statutory procedure under the Protest Money Act has been utilized to challenge the retroactive application and constitutionality of an amendment to the Estate Tax Act (*McGinley v. Madigan*, 366 Ill. App. 3d 974 (2006) and to challenge the construction of an amendment to the Estate Tax Act (*Brooker v. Madigan*, 388 Ill. App. 3d 410 (2009). Plaintiff could have availed himself of the statutory procedure under the Protest Money Act but failed to do so.

Finally, the appellate court had rejected defendants' alternative argument that dismissal of plaintiff's complaint was proper pursuant to the voluntary payment doctrine. Under this common law doctrine, "a taxpayer may not recover taxes voluntarily paid, even if the taxing body assessed or imposed the taxes illegally" unless "such recovery is authorized by statute." The plaintiff argued that he did not make the tax payments voluntarily, but under duress due to the prospect of penalties, interest, and personal liability under the Estate Tax Act. Defendants argued that if the voluntary payment doctrine can be avoided by pointing to a subjective fear of the mere possibility of incurring penalties and interest, then the doctrine is eroded to the point of irrelevance. The Supreme Court wrote that the appellate court in this case took "an expansive view of duress," but declined to address this issue further because it was not necessary to the resolution of this case.

The Plaintiff filed a writ of certiorari to the United States Supreme Court, which denied to hear the case.