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The Top Ten Estate Planning and Estate Tax Developments of 2021

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In an annual tradition, Ron Aucutt, Senior Fiduciary Counsel, has identified the following as the top ten estate planning and estate tax developments of 2021. Ron is a past president of The American College of Trust and Estate Counsel; he has been an observer and frequent participant in the formation of tax policy and regulatory and interpretive guidance in Washington, D.C.; and he is the editor of the Recent Developments materials that are presented each year at the Heckerling Institute on Estate Planning.

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Number Ten: Estate Tax Closing Letter for a Sixty-Seven Dollar User Fee (Reg. §300.13, CCA 202142010)

History. Before June 1, 2015, the IRS routinely issued a closing letter (sometimes referred to as IRS Letter 627, not the same as a formal "closing agreement") when the examination of an estate tax return was closed, except returns that were not required for estate tax purposes but were filed solely to elect portability. The "Frequently Asked Questions on Estate Taxes" on the IRS website was updated on June 16, 2015, to state that for such returns filed on or after June 1, 2015, closing letters would be issued only upon request. Notice 2017-12, 2017-5 I.R.B. 742, confirmed that and also confirmed that an estate tax account transcript that includes the transaction code "421" and the explanation "Closed examination of tax return" can, as the Notice put it, "serve as the functional equivalent of an estate tax closing letter."

Many estate planning professionals were frustrated with efforts to obtain such transcripts and in any event have not found that a transcript has the same dignity as a closing letter for purposes of obtaining the approval of courts and the release of liens and otherwise documenting the propriety of making distributions, closing accounts, and taking other financial actions.

Regulations: Closing Letter for a User Fee. In regulations proposed on December 31, 2020, and finalized on September 27, 2021, the IRS established a $67 user fee for issuing an estate tax closing letter, effective October 28, 2021. **Reg. §300.13, T.D. 9957, 86 Fed. Reg. 53539 (Sept. 28, 2021), 2021-41 I.R.B. 452.**

The preamble to the proposed regulations acknowledged the importance of closing letters to executors, but added:

> The practice of issuing estate tax closing letters to authorized persons is not mandated by any provision of the Code or other statutory requirement. Instead, the practice is fundamentally a customer service convenience offered to authorized persons in view of the unique nature of estate tax return filings and the bearing of an estate's Federal estate tax obligations on the obligation to administer and close a probate estate under applicable State and local law.

That is not persuasive at all. Surely the "unique nature of estate tax return filings" includes the IRS's benefit from liens, transferee liability, priority over other creditors, and other advantages, and with such power should come some level of responsibility. The preamble to the final regulations states that the IRS received comments opposing the establishment of a user fee, but it reaffirms the notion of the previous preamble that a user fee is appropriate because an estate tax closing letter is "the provision of a service that confers special benefits, beyond those accruing to the general public," without any acknowledgment of the fact that "the general public" does not face those liens, liabilities, and other burdens.

The preamble to the proposed regulations stated:

> In view of the resource constraints and purpose of issuing estate tax closing letters as a convenience to authorized persons, the IRS has identified the provision of estate tax closing letters as an appropriate service for which to establish a user fee to recover the costs that the government incurs in providing such letters. Accordingly, the Treasury Department and the IRS propose establishing a user fee for estate tax closing letter requests.

The preamble added that the practice of issuing closing letters for every filed estate tax return had been changed in 2015 primarily for two reasons – (1) the increase in the volume of filed returns since the enactment of portability and (2) the availability of the transcript alternative described in Notice 2017-12.

- Regarding the first reason, the preamble noted that in 2016 approximately 20,000 optional estate tax returns were filed solely to elect portability, compared to approximately 12,000 mandatory returns. But because closing letters were not routinely issued before June 2015 for portability-only returns anyway (as acknowledged in Notice 2017-12), it is hard to understand this as a reason for beginning to require a user fee in the case of closing letters that had previously been routinely issued. (A closing letter in the case of a portability-only return is arguably not as serious a matter, because no estate tax liability is at stake, and because the return may in effect be audited under section 2010(c)(5)(B) upon the surviving spouse's death anyway.)
- Regarding the second reason, the availability of a transcript alternative that Notice 2017-12 described as "the functional equivalent of an estate tax closing letter" actually seems to undermine the concern for "resource constraints." It is not at all clear why the same amount of diligence and review needed to issue a closing letter would not also be required for that "functional equivalent" of a notation in the transcript. Indeed, it is likely that the IRS computers could simply have been

programmed to issue a closing letter automatically upon entry of the code "421" and the explanation "Closed examination of tax return."

The preamble to the proposed regulations also included a detailed description of the calculation of the user fee, based on fiscal year 2017 and 2018 data, culminating in the determination of a full annual cost to the IRS (including direct labor and non-labor costs and a 74.08% overhead factor) of $1,160,058, divided by an estimated volume of 17,249 requests to produce the proposed user fee of $67 (rounded from $67.25). The calculations included an average of one-half hour of quality assurance review by a senior staff member applied to 5 percent of mailed closing letters.

Procedure. The regulations do not explain how to request a closing letter and pay the user fee, but the preamble to the proposed regulations stated:

> The Treasury Department and the IRS expect to implement a procedure that will improve convenience and reduce burden for authorized persons requesting estate tax closing letters by initiating a one-step, web-based procedure to accomplish the request of the estate tax closing letter as well as the payment of the user fee. As presently contemplated, a Federal payment website, such as http://www.pay.gov, will be used and multiple requests will not be necessary. The Treasury Department and the IRS believe implementing such a one-step procedure will reduce the current administrative burden on authorized persons in requesting estate tax closing letters and will limit the burden associated with the establishment of a user fee for providing such service.

On October 6, 2021, the IRS posted frequently asked questions, confirming the use of Pay.gov and addressing other procedural issues. See **https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-the-estate-tax-closing-letter**. On December 2, 2021, the IRS announced updates to its Internal Revenue Manual 4.25.2.5.10 to reflect the new estate tax closing letter and transcript request procedures.

Limitations of a Closing Letter. A closing letter does not preclude reopening an estate tax examination in some cases, as noted in **Chief Counsel Advice 202142010 (issued April 1, 2021; released Oct. 22, 2021)**. That CCA also confirms that if there has not been an examination of the estate tax return at all, then an examination may be begun without complying with the "reopening" protocols of Rev. Proc. 2005-32, 2005-1 C.B. 1206, under section 7605(b), and notwithstanding the issuance of a closing letter (Letter 627).

Takeaway. Despite the questionable justification for the user fee, $67 is such a modest charge for an estate complex enough to need a closing letter that this development is likely to put the matter to rest. Especially if response times at the IRS improve in 2022.

Number Nine: Intergenerational Split-Dollar Life Insurance (*Estate of Morrissette*)

Introduction. Split-dollar life insurance arrangements have been in use a long time and were the subject of Treasury regulations in 2003. T.D. 9092 (Sept. 11, 2003); Reg. §§1.61-22, 1.83-3(e), 1.83-6(a)(5), 1.301-1(q) & 1.7872-15. Simply put, a split-dollar arrangement is an arrangement by which the cost of life insurance is split between the insured and another party. In a common early use, the payor was the employer of the insured. Then split-dollar arrangements began to be used by individuals or within families for estate planning purposes. A recent variation, the subject of the 2021 *Estate of Morrissette* opinion, involves the payment of premiums by a member of one generation for insurance on the life or lives of members of a younger generation – intergenerational split-dollar arrangements.

Background of the Morrissette Family and Business. Since 1943, Arthur and Clara Morrissette had owned and operated, along with their three sons, a group of companies that became known as Interstate Van Lines, headquartered in Springfield, Virginia. There was tension among the three sons, and succession planning, in part to address that tension, had been underway since 1994. Arthur died in 1996.

In August 2006, a court appointed a company employee as the conservator of Clara's estate for a two-month term. Shortly thereafter, Clara's three sons became co-trustees of her revocable trust, and the conservator established three irrevocable multigenerational trusts, one for each of Clara's sons and their families. Those trusts, Clara's sons, and other trusts holding interests in the business executed a shareholders agreement providing, among other things, that upon the death of any of the sons the surviving sons and their respective trusts would seek to negotiate a price at which they would purchase the stock held by or for the benefit of the deceased son.

On October 4, 2006, each of the three sons' new irrevocable trusts purchased universal life insurance policies on the lives of the two other sons to fund the trusts' purchases under the shareholders agreement. On October 31, 2006, Clara's revocable trust (that is, her three sons as trustees) entered into two split-dollar agreements with each of the sons' trusts and contributed a combined $29.9 million to those trusts, which the trusts used to make the lump-sum premium payments on the life insurance policies. At that time the sons' life expectancies ranged from 14.6 to 18.6 years. Each split-dollar agreement provided that upon the death of the insured son, a portion of the death benefit equal to the greater of the total premiums paid or the cash surrender value of the policy immediately before his death would be payable to the revocable trust that had paid the premiums. Each split-dollar agreement also provided that it could be terminated during the insured son's life by the mutual agreement of the trustees of the premium-paying revocable trust and the trust that owned the policy. If one of the split-dollar agreements were terminated during the insured's life, the policy-owning trust could opt to retain the policy. In that case the policy-owning trust would be obligated to pay the premium-paying trust the greater of the total premiums the premium-paying trust had paid on the policy or the policy's current cash surrender value.

As part of this series of transactions, the revocable trust agreement was amended to provide that upon Clara's death the split-dollar rights would be distributed to the three multigenerational trusts, respectively, that owed the reimbursement amounts.

Clara died on September 25, 2009 (almost three years after the split-dollar transactions). Her gift tax returns for 2006 (the year of the transactions) through 2009 (the year of her death) reported annual gifts to the multigenerational trusts in accordance with the "economic benefit" regime for the taxation of split-dollar arrangements under the 2003 regulations, Reg. §1.61-22(d). Under the regulations, those gifts were the annual cost of the life insurance protection under the applicable premium rate table issued by the IRS, less the amount of premiums paid by each respective multigenerational trust. Those gifts totaled $636,657 for those four years. Because the multigenerational trusts became the owners of the revocable trust's reimbursement rights upon Clara's death, the multigenerational trusts (as the Tax Court's 2021 opinion puts it) were "on both sides of the agreements," which "terminated the split-dollar arrangements" and "also precluded any future gift tax … under the economic benefit regime," but "did not result in cancelation of the underlying life insurance policies."

Clara's sons, as her executors, reported on the estate tax return a total value of $7,479,000 for the split-dollar receivables, as determined by an appraiser. They later conceded that because of an error in the appraiser's original calculations the appraised value should be $10,449,000.

One of Clara's sons died in 2016. His trust distributed its Interstate nonvoting stock to a marital trust and its voting stock to three subtrusts for each of his three children, two of whom, along with one other of Clara's grandchildren, worked in the business at the time of the Tax Court trial.

Background of Tax Court Decisions. In ***Estate of Morrissette v. Commissioner*, 146 T.C. 171 (April 13, 2016)**, the Tax Court agreed that the economic benefit regime was appropriate, ratifying the Morrissettes' gift tax treatment, because the multigenerational trusts received no additional economic benefit beyond the current life insurance protection**.** But that still left open the determination of the amount includable in Clara's gross estate with respect to the reimbursement rights under the arrangements.

In another intergenerational split-dollar life insurance case, ***Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 (June 18, 2018)**, the decedent's son, as the decedent's attorney-in-fact and trustee of his revocable trust, had borrowed $10 million to pay premiums on almost $79.8 million of life insurance on the lives of the son and the son's wife. On the decedent's estate tax return, the son, as executor, valued his father's reimbursement rights under the split-dollar arrangements at $183,700. The IRS asserted that the reimbursement rights should be valued at $9,611,624, the aggregate cash surrender value of the policies as of the decedent's death. The Tax Court (Judge Thornton) denied the executor's motion for summary judgment that sections 2036, 2038, and 2703 did not apply in valuing the estate's interest under the split-dollar agreement. Citing *Strangi v. Commissioner*, T.C. Memo. 2003-145, *aff'd*, 417 F.3d 468 (5th Cir. 2005), and *Estate of Powell v. Commissioner*, 148 T.C. 392 (2017) (reviewed by the Court), the opinion viewed the power of the decedent, through the revocable premium-paying trust, to terminate the split-dollar agreement and recover at least the cash surrender value as "clearly rights … 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)." It did not matter that the premium-paying trust could exercise that power of termination only in conjunction with the policy-owning trust, because sections 2036(a)(2) and 2038(a)(1) explicitly use the phrases "in conjunction with any person" and "in conjunction with any other person." In a stipulated Decision of December 12, 2018, the court approved a settlement of the *Estate of Cahill* case, in which the executor apparently accepted both the IRS's $9,611,624 value of the reimbursement rights and its assessment of a 20 percent accuracy-related penalty.

Three days after *Estate of Cahill* was decided, the Tax Court (Judge Goeke), citing *Estate of Cahill*, denied the Morrissette executors' similar motion for summary judgment that section 2703 did not apply. ***Estate of Morrissette v. Commissioner*, Order, Docket No. 4415-14 (June 21, 2018).** The court's order also noted that the IRS had raised sections 2036 and 2038 as alternative arguments.

Outcome in *Estate of Morrissette*. The *Estate of Morrissette* case was tried in Washington, D.C., in October 2019, briefed in the first quarter of 2020, and decided by Judge Goeke on May 13, 2021. ***Estate of Morrissette v. Commissioner*, T.C. Memo. 2021-60**. The court held that the "bona fide sale for an adequate and full consideration in money or money's worth" exception in sections 2036(a) and 2038(a)(1) and the "bona fide business arrangement … [that] is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth … [and that has] terms … comparable to similar arrangements entered into by persons in an arms' length transaction" exception in section 2703(b) were satisfied and therefore those sections did not apply. These were unequivocal taxpayer victories.

Regarding valuation, the court was more sympathetic with the IRS. Most significantly, it accepted the lower discount rates for calculating present value of 6.4 and 8.85 percent derived by the IRS's appraiser from yields in the life insurance industry and in the particular insurance companies, rather than the range of 15 to 18 percent used by the appraiser on whom the executors had relied in preparing the estate tax return.

The court also agreed with the IRS that the maturity date used in the present value calculations should be December 31, 2013, not the life expectancies of the insured sons as the executors' experts had used. The court noted:

> When the 2006 plan was implemented, the [revocable] trust agreement was amended to distribute the split-dollar rights to the respective dynasty trusts that owned the underlying policies. Such a distribution indicates an intent … to give the dynasty trusts complete control after Mrs. Morrissette's death.

Against that background, facts that the court found supported a December 31, 2013, maturity date included "the decision to purchase policies with high premiums and modest death benefits and July 2010 emails between [one of the executors and the advisors that had been involved in the planning] that discuss the possibility of canceling certain policies." As the court put it, those emails included one advisor's response "that he insisted that the policies not be canceled until the three-year period of limitations on the estate return had expired" and that advisor's warning "that the IRS would likely see problems with the values of the split-dollar rights that the estate had planned to report on the return." The estate tax return had been filed on December 10, 2010, a couple weeks before the extended due date, which, applying the three-year statute of limitations, formed the basis for an assumed cancellation (maturity) date of December 31, 2013. The court even noted that "there are grounds for setting an earlier maturity date, but we will use respondent's date."

On December 13, 2021, the court entered a Decision, based on calculations implementing its opinion to which the parties had agreed, determining an estate tax deficiency of $12,575,459.24 and an accuracy-related penalty of $3,232,339.89, both subject to interest. That indicates estate tax values of the reimbursement rights significantly higher than those asserted by the executors. But the deficiency is significantly less than the approximately $39.4 million the opinion states the IRS had asserted in its notice of deficiency, and, to that extent, the case could also be viewed as a taxpayer victory.

Takeaways. *Estate of Morrissette* confirms the importance of "good facts," particularly in contrast with *Estate of Cahill* and, to the extent it is comparable, *Estate of Powell*: (1) an operating business with clear succession planning needs; (2) less participation of the same family member on both sides of the transaction (as in *Estate of Powell*); (3) self-financing of the insurance premiums, rather than borrowing as in *Estate of Cahill* (which suggested a short-term outlook for the arrangement); and (4) much less aggressive discounting of the estate tax value of the reimbursement rights, reported at about 25 percent of the premiums paid (in contrast to about

2 percent in *Estate of Cahill*). Nevertheless, the court could not get comfortable with even a value of 25 percent of the premiums paid, particularly with the presence of a revocation right, which at least one of Clara's sons had expressed interest in exercising. The court noted that:

> Mrs. Morrissette had significant, nontax reasons for entering into the split-dollar agreements. However, the only purpose for the substantially discounted values of the split-dollar rights as compared to the $30 million that the [revocable trust] paid is estate tax saving. Knowing that any estate tax saving would be from the undervaluation of the split-dollar rights, the brothers engaged an appraiser that [their lawyer] recommended. [The lawyer] reviewed a draft of [the appraiser's] appraisal and asked [the appraiser] to make changes that reduced his opined values.
>
> [The] appraisal was not reasonable, and petitioners did not rely on it in good faith. Accordingly, the estate is not entitled to rely on [the] appraisal as a reasonable cause defense. The estate did not act reasonably or in good faith in the valuation of the split-dollar rights. The estate is liable for the 40% penalty for the gross valuation misstatement of the split-dollar rights.

Clearly, a notable perceived benefit of intergenerational split-dollar arrangements is that, because the insureds are members of the next generation, their deaths are actuarially likely to occur significantly later than the grantor's death, and the reimbursement rights of the decedent's revocable (then irrevocable) trust are valued for estate tax purposes at a significant discount reflecting the time-value of money (even though the life expectancies of the insured sons in *Estate of Morrissette* were only from 14.6 to 18.6 years at the time of the split-dollar arrangements, three years before their mother's death). *Estate of Morrissette* confirms that this benefit exists but is subject to a test of moderation and reasonableness as well as a test of significant business or other non-tax purpose.

A final significant takeaway is to observe the length of time it can take to resolve estate tax issues. Clara Morrissette died in 2009, and it took 12 years to determine a very substantial estate tax liability.

Number Eight: John Doe Summons to a Law Firm (*Taylor Lohmeyer*)

On October 4, 2021, the United States Supreme Court denied certiorari, thus declining to hear a case involving the potentially troubling aggressiveness of the IRS in seeking identification of and information about a law firm's clients.

Background. A client (not identified in the court opinions) of Taylor Lohmeyer Law Firm PLLC of Kerrville, Texas, settled an income tax dispute with the IRS by paying almost $4 million in tax, interest, and penalties regarding about $5 million of unreported income, over the years from 1996 through 2000, of foreign accounts in the Isle of Man and the British Virgin Islands that the firm had helped him structure.

Summons. With court approval (***In re: Does*, 122 AFTR 2d 2018-6306 (W.D. Tex. Oct. 15, 2018)**), the IRS issued a "John Doe summons" to the law firm seeking what the firm subsequently determined to be 32,000 documents "for … U.S. taxpayers, 'who, at any time [over 23 years, from 1995 through 2017] used the services of [the Firm] ... to acquire, establish, maintain, operate, or control (1) any foreign financial account or other asset; (2) any foreign corporation, company, trust, foundation or other legal entity; or (3) any foreign or domestic financial account or other asset in the name of such foreign entity.'"

Enforcement. Over the firm's invocation of attorney-client privilege, the district court (Judge Rodriguez) granted the Government's motion to enforce the summons. ***Taylor Lohmeyer Law Firm PLLC v. United States*, 123 AFTR 2d 2019-1847 (W.D. Tex. May 15, 2019)**. The court concluded its opinion by stating (pp. 2019-1851-52):

> Ultimately, because blanket assertions of privilege are disfavored, the Firm bears a heavy burden at this stage, and the Firm relies only on a narrowly defined exception to the general rule that identities are not privileged, the Firm does not carry its burden. As the Government suggests, "[u]pon this Court ordering enforcement of the summons, if Taylor Lohmeyer wishes to assert any claims of privilege as to any responsive documents, it may then do so, provided that any such claim of privilege is supported by a privilege log which details the foundation for each claim on a document-by-document basis." [citation omitted] Whether certain documents fit the Liebman [*United States v. Liebman*, 742 F.2d 807, 54 AFTR 2d 84-5938 (3d Cir. 1984)] argument the Firm advances is better decided individually or by discrete category.

The district court granted the firm a stay pending appeal. ***Taylor Lohmeyer Law Firm PLLC v. United States*, 124 AFTR 2d 2019-6271 (W.D. Tex. Oct. 3, 2019)**. While declining to say that the firm was **likely** to succeed on appeal, the court noted (p. 2019-6272) that for purposes of the stay

> this Court finds the balance of equities does indeed "heavily favor" the Firm; on the one hand, the Firm would suffer potentially irreparable harm if the summons were enforced against it and that enforcement ultimately turned out to be wrongful upon appeal. On the other hand, the harm to the Government (and to the public) would be less consequential were the Government required to stay its enforcement of the summons and ultimately prevail on appeal. The Firm represented to this Court that it is compiling and preserving documents responsive to the summons [citation omitted], and if the Firm were to lose on appeal, enforcement of the summons would proceed just as it would if the Court had denied this stay.

Affirmance. A three-judge panel of the Court of Appeals for the Fifth Circuit unanimously affirmed the enforcement of the summons. ***Taylor Lohmeyer Law Firm PLLC v. United States*, 957 F.3d 505, 125 AFTR 2d 2020-1844 (5th Cir. April 24, 2020)**. The court's opinion, written by Judge Barksdale, stated (p. 2020-1849) that

> disclosure of the Does' identities would inform the IRS that the Does participated in at least one of the numerous transactions described in the John Doe summons issued to the Firm, but "[i]t is less than clear … as to what motive, or other confidential communication of [legal] advice, can be inferred from that information alone". [citation omitted] Consequently, the Firm's clients' identities are not "connected inextricably with a privileged communication", and, therefore, the "narrow exception" to the general rule that client identities are not protected by the attorney-client privilege is inapplicable.

The full court voted 9-8 to deny the firm's petition for rehearing *en banc*. ***Taylor Lohmeyer Law Firm PLLC v. United States*, 957 F.3d 505, 125 AFTR 2d 2020-7208 (5th Cir. Dec. 14, 2020)**. Judge Elrod, joined by five others (including Chief Judge Owen), wrote a dissent, in which she argued (p. 2020-7209):

> The IRS has traditionally served such summonses on financial institutions and commercial couriers. Not lawyers. There is good reason to be wary of investigations that exert pressure on lawyers. The relationship between a customer and a financial institution or commercial courier plays little, if any, role in our system's ability to administer justice – but the same cannot be said of the lawyer-client relationship. When the IRS pursues John Doe summonses against law firms, serious tensions with the attorney-client privilege arise. Courts play a crucial role in moderating the executive power with respect to a John Doe summons. See *United States v. Bisceglia*, 420 U.S. 141, 146 (1975) ("Substantial protection is afforded by the provision that an Internal Revenue Service summons can be enforced only by the courts.").
>
> Hearing this case *en banc* would have helped clarify the boundaries of attorney-client privilege in this precarious area. I write to explain that the opinion can and should be read – consistently with our existing precedent – not to impose any new standard with respect to what is required for the attorney-client privilege to protect client identity.

Judge Elrod concluded her dissenting opinion (p. 2020-7210):

> In the district court, the enforcement order is currently stayed and the case has been administratively closed to facilitate our review of the enforcement order. Once our mandate issues, it may be that the case is reopened and the stay lifted. If so, the May 15, 2019 enforcement order provides that the Lohmeyer law firm will have the opportunity to produce a privilege log, asserting privilege on particular responsive documents. If the law firm does so, the district court may choose then to conduct an in camera review of those documents. I am confident that any such review will be guided by the following [quoting the panel's opinion]: "[i]f the disclosure of the client's identity will also reveal the confidential purpose for which he consulted an attorney, we protect both the confidential communication and the client's identity as privileged."

Addressing in a footnote the district court's assertion that "blanket assertions of privilege are disfavored," Judge Elrod wrote:

> The fact that the law firm made "blanket" assertions of privilege was perhaps because the IRS demanded a very broad array of documents to be identified using a client list. When a summons is so structured, a blanket assertion of privilege may be appropriate.

The American College of Tax Counsel had filed an amicus brief (which Judge Elrod's dissent cited), including this warning:

> [T]he panel's decision could facilitate the issuance of John Doe summons to a law firm seeking documents identifying … any individuals who engaged the firm for legal advice regarding structuring a family limited partnership or annuity trust. Departing from longstanding and established precedent in this and other circuits, the panel's decision subjects the John Doe summons power to abuse by allowing the IRS to make broad requests to law firms to circumvent the privilege.

In line with that warning, many estate planners hoped that the Supreme Court would take up the case after the Fifth Circuit narrowly denied the petition for *en banc* rehearing. But the Supreme Court denied certiorari on October 4, 2021 (Docket No. 20-1596).

Takeaways. These opinions emphasize the need for estate planning lawyers to exercise care in taking on clients, advising those clients about estate planning actions with tax consequences, and perhaps in some cases following up the implementation of that advice. Indeed, the American Bar Association's Standing Committee on Ethics and Professional Responsibility's Formal Opinion 491, issued April 29, 2020, citing Model Rule of Professional Conduct 1.2(d), describes a lawyer's duty to inquire when there is suspicion that a client is or may be using the lawyer's services to further a crime or fraud.

But there is no suggestion in the opinions that the courts believed that the law firm had encouraged, anticipated, or even knew about underreporting of income by its unidentified client the opinions call "Taxpayer-1." On the contrary, the district court cited and did not question the firm's contention "that had Taxpayer-1 followed the advice given 'there would have been a lawful position that no income was reportable ... [but] the taxpayer obviously did not follow the lawful advice ….'" 123 AFTR 2d at 2019-1850. The opinion added:

> Further, the Firm argues that Lohmeyer "has reviewed his remaining client files and has determined that they are distinguishable from Taxpayer-1" because unlike with Taxpayer-1, "there is no evidence that any of the remaining taxpayers disregarded Taylor Lohmeyer's advice regarding the proper structure and maintenance of foreign grantor trusts."

Ironically, the firm's contention that the circumstances of "Taxpayer-1" were unique might seem to undermine its implicit argument that disclosure of the identities of other clients would in effect betray them as criminals. But the courts did not pursue that line of reasoning.

Number Seven: The Weight To Be Given to Post-Death Developments (*Estate of Michael J. Jackson*)

The "King of Pop," Michael Jackson, died on June 25, 2009. In ***Estate of Michael J. Jackson v. Commissioner*, T.C. Memo. 2021-48 (May 3, 2021)**, possibly the first reported case about the value for tax purposes of a celebrity's image and likeness, Judge Holmes states at the beginning of his 265-page opinion:

> From the time he was a child Michael Jackson was famous; and there were times in his life, testified his executor, when he was the most famous person in the world. There were certainly years when he was the most well-known popular-music star, and even after his death there have been years when he was the world's highest-earning entertainer.
>
> But there were also many years when he was more famous for his unusual behavior and not his unusual talent. And there were some years where his fame was turned infamous by serious accusations….

Dramatic Numbers. Jackson's executors and the IRS reached agreement on the value of all but three assets of his estate:

- His "image and likeness," that is, publicity rights;
- New Horizon Trust II (NHT II), a Delaware bankruptcy trust, which owned 50 percent of SONY/ATV Music Publishing (Sony was the other 50 percent owner), which in turn owned rights to some Beatles music; and
- New Horizon Trust III (NHT III), another bankruptcy trust, which owned Mijac Music, which in turn owned rights to music Jackson (and some others) had written.

The positions of the estate and the IRS and were summarized by the court as follows (with the court's findings added):

Estate of Michael J. Jackson: Assets in Dispute			
	Image and Likeness	**NHT II**	**NHT III**
Reported on Estate Tax Return	$2,105	0	$2,207,351
IRS Notice of Deficiency	$434,264,000	$469,005,086	$60,685,944
Estate at Trial	$3,078,000	0	$2,267,316
IRS at Trial	$161,307, 045	$206,295,934	$114,263,615
Tax Court's Finding	$4,153,912	0	$107,313,561
Increase over Estate Tax Return	197,235%		4,762%

The estate's position regarding Jackson's image and likeness was based on his controversial conduct and reputation at the time of his death and on the fact that he had received almost no revenue for about a decade prior to his death, and the appraisal that was used to support the $2,105 value reported on the estate tax return was based on those facts. The IRS's position was based on consideration of five "opportunities" for raising revenue that the court viewed as "fantasy." Judge Holmes provided a lengthy and interesting discussion about the poor state of Michael Jackson's reputation at his death and observed that the estate would have to spend a significant amount of money to rehabilitate his image. He determined a value much closer to the estate's position than to the IRS's.

The estate did not dispute that the Beatles music owned by NHT II was valuable, but it noted that its value was exceeded by the amount of Jackson's debt (incurred to fund his very extravagant lifestyle) that it secured. The court agreed.

The assets of NHT III, especially Jackson's own works, were difficult to value, including the difficulty in finding "comparable" artists and in predicting the "postdeath spike" in Jackson's case. The experts for both the estate and the IRS used a discounted cash flow analysis, which the court also adopted to determine a value closer to the IRS's position than to the estate's.

Credibility of the IRS's Expert. The court made a point of noting that the IRS's expert lied twice at trial. First, when asked if he had ever represented the IRS before and whether he wrote a valuation report for the IRS in Whitney Houston's estate tax case, he said "No, Absolutely not." "That was a lie," the court said. After "recess and advice from the Commissioner's counsel," the expert admitted he had been retained by the IRS in that case. (In the expert's defense, it should be noted that questions about previous engagements can raise questions about privilege, perceived privilege, and confidentiality agreements, and can be very awkward as a result.)

Second, according to the court, the expert also "testified that neither he nor his firm ever advertised to promote business. This was also a lie." He had sent an email blast bragging that he "is the expert of the century and will be testifying on behalf of the IRS," and he referred to his involvement in this "Billion Dollar Case" in a lecture given before trial.

The estate moved to strike his entire testimony, as tainted by perjury. The court found that remedy "too severe," but concluded that the court would "discount the credibility and weight we give to [the expert's] opinions."

Takeaways: Consideration of Post-Death Developments. Much of the divergence in the valuation opinions in this case could be attributed to what appears to be the consideration of post-death events. Judge Holmes captured the effect Jackson's death had on the productivity and thus the value of his works this way:

> What Jackson had created during his lifetime was now fixed, and it was to the considerable benefit of the Estate that he was no longer able to get in the way of the rational profit maximizers who were now in control. And nearly everyone involved in these early days after Jackson's death turned out to be accomplished in the business side of the entertainment business. As crass as it might have seemed to Jackson's more sentimental fans, the business began almost immediately.

In other words, it was predictable that Jackson's death would free up the businesspeople around him to turn a profit from his legacy. And certainty it would eliminate, going forward, the demands for support of his extravagant lifestyle. But the court was unwilling to go to the lengths the IRS proposed, recognizing that the ultimate success of those businesspeople was still in doubt. Just as many who were disturbed by Jackson's behavior in the last years of his life might have been surprised by the success of the exploitation of his image, the court found that much of that surprising success was not reasonably foreseeable at the time of his death.

"Foreseeability can't be subject to hindsight," the court stated, citing *Estate of Gallagher v. Commissioner*, T.C. Memo. 2011-148. Nevertheless, the court appeared to consider post-death developments in determining what was foreseeable, which is obviously a potential contradiction and therefore very tricky. But the court did so in moderation, not aggressively. For example, the opinion notes that Sony bought out NHT II's interest in SONY/ATV Music Publishing in 2011 for $750 million. Even so, the court valued NHT II at zero for estate tax purposes (taking into account, of course, the debts that interest secured).

Penalties. And the trickiness of considering post-death developments probably contributed to the court's decision to reject the IRS's assertion of penalties, even though the values of Jackson's image and likeness and

NHT III determined by the court were almost 200,000 percent and 5,000 percent, respectively, greater than what the executors had reported on the estate tax return.

Tax-Affecting. In valuing all three of the assets in dispute, the estate's experts used "tax-affecting," as in *Estate of Jones v. Commissioner*, T.C. Memo. 2019-101 (included in Number Three in the Top Ten Estate Planning and Estate Tax Developments of 2019 found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**). The experts based their use of tax-affecting on their assumption that a C corporation would be the most likely hypothetical buyer and would have to pay a corporate level income tax on the assumed income that the experts had taken into account in valuing the assets. Noting that "[w]e view this disagreement just as we have in the past, as one that is a dispute about fact," the court found that "the Estate has failed to persuade us that a C corporation would be the hypothetical buyer of any of the three contested assets." The court added:

> We distinguish Estate of Jones as an instance where the experts agreed to take into account the form of the business entity and agreed on the entity type. The Commissioner argued there, as he does here, that we shouldn't tax affect, but his own experts didn't seem to be on board. As we observed, "[t]hey do not offer any defense of respondent's proposed zero tax rate. Thus, we do not have a fight between valuation experts but a fight between lawyers." …
>
> We do not hold that tax affecting is never called for. But our cases show how difficult a factual issue it is to demonstrate even a reasonable approximation of what that effect would be. In Estate of Jones, there was expert evidence on only one side of the question, and that made a difference.
>
> That was not the case here.

But despite that accurate depiction of *Estate of Jones* as a case in which the IRS's expert did not contest tax-affecting, there is nothing in the *Estate of Jones* opinion that indicates that the court would not have allowed tax-affecting even over the objection of the IRS's valuation experts. Likewise, there is nothing in the *Estate of Jackson* opinion to suggest that the court would never again allow tax-affecting in an appropriate case. Indeed, the court explicitly states (emphasis added) that its review of the circumstances of the case "leads us to find that tax affecting is inappropriate **on the specific facts of this case**," adding, as quoted above, that "[w]e do not hold that tax affecting is never called for."

Tax-affecting remains a complicated, fact-driven subject, as highlighted, for example, by the court's following observation:

> Many of our precedents arose from S corporations, which have sharp restrictions on who and what can own them. With the advent and popularity of other, less restrictive, forms of pass-through ownership we cannot but find that the gap between C corporations and other entities has narrowed over time. The Estate's experts did not consider such distinctions and did not consider both the tax detriments and benefits of pass-through status.

That final point about "both the tax detriments and benefits of pass-through status" is important. The Jackson estate's experts apparently used only what the court describes as "a 35% rate based on the federal rate," "a 39.615% rate based on a combined federal and New York State rate," and "a 39.8% rate based on a combined federal and undisclosed state rate," with no balanced passthrough "premium," which the court had found so significant in *Estate of Jones*, as discussed in 2019's Top Ten. It is also entirely possible that a long-standing integrated business of growing and harvesting timber, converting it into lumber, and marketing and delivering that lumber, as in *Estate of Jones*, is simply an easier context in which to apply tax-affecting.

The Time It Takes To Resolve Estate Tax Issues. Like Clara Morrissette (in Number Nine), Michael Jackson died in 2009, and it took 12 years to determine a very substantial estate tax liability.

Postscript. It is interesting, although perhaps only a coincidence, that the Tax Court case involving the estate of the singer and songwriter Prince, docketed in August 2020 and also assigned to Judge Holmes, was reported to Judge Holmes on November 23, 2021, to have been settled by the parties. Order, *Estate of Prince R. Nelson v. Commissioner*, Docket No. 11442-20 (Nov. 30, 2021).

Number Six: The Donor's Relinquishment of Control over a Donor Advised Fund (*Fairbairn, Pinkert*)

***Fairbairn v. Fidelity Investments Charitable Gift Fund* (N.D. Cal. Feb. 26, 2021)**, and ***Pinkert v. Schwab Charitable Fund* (N.D. Cal., June 17, 2021)**, decided by different judges of the same federal district court, highlight the importance that a contributor to a donor advised fund (DAF) relinquish control over the contributed assets.

Fairbairn. In *Fairbairn*, donors gave publicly traded stock to a DAF on December 28 and 29, 2006, and the DAF, pursuant to its policy in such cases, sold all the stock on December 29, in the last two and a half trading hours of the year. The donors complained that these sales drove down the price of the stock by about 30 percent and broke promises the DAF sponsor had made not to sell until the new year, not to sell more than 10 percent of the daily trading volume, and to consult with the donors about a price limit. The court found that the donors had not proved that these promises were made and relied on and had not proved that the sales were not reasonably prudent. The court also noted that in fact the sales had not exceeded the 10 percent daily trading volume.

Pinkert. In *Pinkert*, the donor to a DAF complained that the DAF had invested through an affiliate of the DAF sponsor and could have found lower investment fees elsewhere. The court held that the donor lacked standing, noting that he had made a "completed gift" and had "relinquished dominion and control over the donated property," citing sections 170(a), (c), and (f)(18) of the Internal Revenue Code. Citing *Fairbairn*, the court acknowledged that "[t]he result might be different if the fund broke specific promises that it had made," but noted that there were no allegations of that.

Neither opinion finds that the DAF sponsor broke a promise to the donors or violated either its fiduciary duty or its policies.

Takeaways. It is encouraging that the courts confirmed that a DAF sponsor "has exclusive legal control over the assets contributed," as section 170(f)(18)(B) requires as a condition of the donor's charitable contribution deduction. On the other hand, it could be ominous that the donors in these cases in effect tried to exercise such control, or at least to exact promises from the DAF sponsor before making the gift, and that this district court seemed inclined to enforce such promises if they were documented. The challenge for advisors is to help clients strike the right balance – for example, by considering a private foundation instead of a contribution to a DAF if control over investment decisions is a concern.

In addition, although year-end transfers are sometimes hard to avoid, the Fairbairns' contributions on December 28 and 29 and the hurried sale that such timing prompted are an example of why caution is warranted.

Number Five: Splitting Gifts and Bequests (*Smaldino, Estate of Warne, Buck*)

Three 2021 cases addressed the practice of splitting up a gift or bequest of an illiquid asset, but in three different contexts, with three different results, and offering three (or at least two) sets of lessons for estate planners. And none involve traditional "gift-splitting" – that is, treating all gifts made by a married couple as made one-half by each of them for gift and GST tax purposes.

Splitting the Paths of Intrafamily Gifts: *Smaldino v. Commissioner*, T.C. Memo. 2021-127 (Nov. 10, 2021)

The Plan. Mr. Smaldino owned 100 percent of the voting and nonvoting interests in an LLC that in turn owned several parcels of California real estate. In early 2013, he decided to give a substantial nonvoting interest to a Dynasty Trust for the benefit of his children and grandchildren, but he did not want to transfer an interest greater than 50 percent because that would have triggered reassessment of California property taxes on the real estate. He chose 49 percent. He also wanted to use both his and his wife's basic exclusion amount, which in 2013 was $5,250,000. His wife was not the mother of his children (they had married in 2006) or a beneficiary of the Dynasty Trust, but she fully supported his plan. She had her entire $5,250,000 exclusion amount available, but he did not, apparently because he had used some of it before marrying her.

He could have used a multi-factor *Wandry*-style defined value clause (*Wandry* had been decided about a year earlier, in March 2012). For more on the evolving use defined value clauses, see Number Three in the Top Ten Estate Planning and Estate Tax Developments of 2020 found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. For example, he could have given his wife LLC interests with a formula value of $5,250,000, but not greater than a 49 percent interest, and then given the Dynasty Trust LLC interests in a formula amount of the excess, if any, of 49 percent over the formula amount given to his wife. She in turn could have given her entire interest received from him to the Dynasty Trust.

The Execution. But they decided to try another way. Mr. Smaldino, probably in April, hired an appraiser to determine the value of a 49 percent nonvoting interest in the LLC as of April 15. The appraiser's report, dated August 22, determined the value of a 49 percent interest to be $6,281,000. Then Mr. Smaldino executed an assignment to his wife of a "sufficient number" of nonvoting units in the LLC "so that the fair market value of such nonvoting units as determined for federal gift tax purposes shall be Five Million Two Hundred Forty Nine Thousand One Hundred Eighteen and 42/100ths Dollars ($5,249,118.42)" – $881.58 less than the 2013 basic exclusion amount. The assignment was not dated but recited that it was "Effective April 14, 2013." Mrs. Smaldino executed the same formula assignment to the Dynasty Trust, not dated but "Effective April 15, 2013." And Mr. Smaldino made a similar formula assignment to the Dynasty Trust of nonvoting units with a value of $1,031,881.58, not dated but "Effective April 15, 2013."

And $5,249,118.42 plus $1,031,881.58 happens to be exactly $6,281,000, the amount in the appraiser's August 22 report, which helped Judge Thornton figure out that those assignments could not have been signed in April but had to have been drafted and signed after receipt of the appraiser's August 22 report.

Collapse of the Purported Transfers by the Court. But ultimately the timing of the execution of the documents was not dispositive. In the first paragraph of his opinion, Judge Thornton foreshadowed his conclusion by summarizing (emphasis added) that "petitioner **purportedly** transferred about 41% of the LLC class B member interests to his wife, Agustina Smaldino, who **purportedly** retransferred them to the Dynasty Trust the next day." Consistently, he concluded:

> On the basis of all the evidence in the record, we conclude that petitioner never effectively transferred any membership interest in the LLC to Mrs. Smaldino and consequently that the Dynasty Trust received its entire 49% of the class B membership interests as a gift from petitioner.

That evidence included Mrs. Smaldino's own testimony about her role as a conduit in the transaction, which Judge Thornton described as follows:

> Mrs. Smaldino testified that before the purported transfer in question she had already made "a commitment, promise" to her husband and family that she would transfer the LLC units to the Dynasty Trust. When asked on direct examination whether she could have changed her mind if she had wanted to, she responded: "No, because I believe in fairness."

Further evidence was that no operating agreement amendment or income tax return of the LLC ever showed Mrs. Smaldino as a member, the Smaldinos never followed the formalities required by the LLC operating agreement to make someone who was not a descendant of Mr. Smaldino a full member in contrast to just an assignee, and on April 15 Mr. Smaldino signed an amendment to the operating agreement as the LLC's "SOLE MEMBER."

The result was that none of Mrs. Smaldino's basic exclusion amount was available for the gift and thus more of the gift was taxable to Mr. Smaldino. And the court increased the gift tax value of a 49 percent interest from $6,281,000 to $7,820,008. In determining that value, the court dealt with amendments of the operating agreement to replace Mr. Smaldino's management fees with guaranteed payments (the April 15 "SOLE MEMBER" amendment) and then switch back, with a doubled percentage (on December 31). And that gave Judge Thornton the opportunity to provide a first-ever substantive discussion of section 2701, which Mr. Smaldino had cited to support the treatment of guaranteed payments in the valuation of the LLC interest, even though section 2701 itself did not apply in this case.

Takeaways: The idea that spouses who are U.S. citizens can generally make unlimited outright gifts to each other without even a gift tax reporting requirement probably encourages transfers-of-convenience like this quite frequently. And to many it might seem very intuitive and natural. But it doesn't always work. The estate planning advisor should try to monitor this.

What the Smaldinos tried to do, in effect, was to "split" Mr. Smaldino's gift, just as section 2513 allows. But, because she had more of her exclusion amount available than he did, they tried to "split" that gift on a basis other than half and half, as section 2513 requires. If Mr. Smaldino had simply reported the entire gift himself and they elected gift-splitting, he would have avoided gift tax on half of the court-determined value of $7,820,008. By trying to shift more than half of the gift to his wife, he ended up shifting none. And who knows? – without the wonkiness of the multiple gifts the returns might not have attracted audit attention in the first place.

Splitting the Destinations of Charitable Bequests: *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17 (Feb. 18, 2021)

Ms. Warne died in 2014 owning, through a trust, interests in five LLCs that held California real estate. Her interests in those LLCs ranged from 72.5 percent to 100 percent. The operating agreements all gave significant powers to the majority interest holders, including the power to dissolve the LLCs and to remove and appoint managers. Even though they were not "minority" interests, the Tax Court (Judge Buch) allowed discounts for lack of control and lack of marketability that were somewhat favorable to the estate.

Ms. Warne left her interests in the 100 percent owned LLC 75 percent to a family charitable foundation and 25 percent to a church. But the court applied additional discounts to those 75 percent and 25 percent interests in calculating the charitable deductions, which then totaled less than the value included in the gross estate.

"But it's all going to charity!" is an intuitive and understandable reaction. But there is well-established support for the result in *Estate of Warne*, including in the Ninth Circuit where Mrs. Warne lived. In *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981), the decedent owned the one voting share and all 99 nonvoting shares of a corporation. The voting share was left to the decedent's sons and the 99 nonvoting shares were left to a charitable foundation. The gross estate value of the 100 shares took into consideration that the decedent held full voting control of all of the shares, but "the estate's deduction attributable to the donation of the 99 nonvoting shares necessitated a 3% discount to account for the foundation's lack of voting rights." The fact that the asset in *Ahmanson* was split between an individual and a charity rather than between two charities made no difference in *Estate of Warne* because that did not affect the values the foundation and the church each received, and, as the court put it, "it is the value of the property received by the donee that determines the amount of the deduction available to the donor."

Takeaways. In cases like this, an estate planner might consider a single bequest, for example to a donor advised fund or a private foundation, which subsequently might give 25 percent to the church. But not subject to a prearrangement, or the result might be the same.

It may also be possible to divide entities like the LLC prior to death.

A Postscript: Splitting Gifts Among Donees: *Buck v. United States*, 128 AFTR 2d 2021-6043 (D. Conn. Sept. 24, 2021)

In *Buck*, a donor's simultaneous gifts over four years of 48 percent interests in various tracts of timberland to each of his two sons (while retaining a 4 percent interest for himself) were each valued on his gift tax returns with a 55 percent discount. But, unlike the **gross estate** in *Estate of Warne*, the donor's **total gifts** of 96 percent interests with respect to each tract would be valued as simply the sum of the two separate gifts. The court (Judge Thompson) did not rule on the appropriate level of discount, but he denied the Government's motion for partial summary judgment that had asked the court to

> conclude as a matter of law that no discount should be available for a gift of a fractional interest unless the taxpayer held such interest in fractional form before the gift, rather than viewing several simultaneously gifted portions of the property as fractional interests in the hands of the donor for purpose of valuing the gift.

The court reached this result after scrupulous comparison of decided cases and other analysis that showed the gift tax to be different from the estate tax. Therefore, the court concluded, "[u]nder applicable law, the gifts here are not a single 96% interest but two 48% interests given to two different donees, and the gifts must be valued separately at the time of transfer."

Takeaways. None really. We all know that's the result under Rev. Rul. 93-12, 1993-1 C.B. 202, although surprisingly the IRS did not follow Rev. Rul. 93-12 and the court did not even cite it.

Number Four: Bold Proposals to Coordinate Transfer Taxes and Income Taxes

Introduction

In 2021, both the Biden Administration (including the Treasury Department) and members of Congress revealed bold plans to substantially change the tax characterization and treatment of trusts and transactions with trusts (especially grantor trusts) and of transfers by gift and at death. A very broad theme that might be identified is a move toward more coordination between transfer taxes and income taxes – if a transaction is

subject to transfer tax it should be subject to income tax, if a trust is still subject to income tax payable by the grantor it should not be treated as a completed gift, and so forth. There is more detail about these proposals in Parts 1 and 2 of Washington Update: Pending and Potential Administrative and Legislative Changes (January 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

These proposals were all either omitted from the provisions of the "Build Back Better Act" (H.R. 5376) that originated in the House Ways and Means Committee or dropped from that bill as it made its way through the House of Representatives. And while it is always technically **possible** that some of those proposals would be added to the bill if and when some variation of it is enacted, that seems very very unlikely. Even so, it is important to monitor developments like this because they are evolving, and each iteration, especially one expressed in actual proposed statutory language, may bring a proposal closer to being embraced at some time in the future, either as a comprehensive or targeted policy-driven reform or simply because it has the right revenue-raising estimate to opportunistically fill a revenue need. A real-life example of the latter is the consistent basis rules of sections 1014(f) and 6035 enacted on short notice in the Surface Transportation and Veterans Health Care Choice Improvement Act (Public Law 114-41) on July 31, 2015, the day that funding for the Highway Trust Fund was scheduled to expire, because the revenue estimate was just right to help extend that infrastructure funding for three months.

Thus, the 2021 "development" is that we got some insight about what might be "developing," if not now then maybe for the future. And maybe what lawmakers need to understand to make any future action more palatable.

"Deemed Realization" in Treasury's Greenbook

The Treasury Department released its "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" (**https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf**), popularly called the "Greenbook," on May 28, 2021. It proposes no changes to the estate and gift taxes. But, at pages 60-64, it proposes

- to increase the top marginal individual income tax rate to 39.6 percent (as it was before the 2017 Tax Act), effective January 1, 2022;
- to tax capital gains at the same rate as ordinary income for taxpayers with adjusted gross income greater than $1 million, effective "for gains required to be recognized after the date of announcement" (presumably April 28, 2021); and
- to tax "deemed realization" of accumulated appreciation upon transfers by gift and at death.

The articulated reasons for the deemed realization proposal are (1) reducing the rate disparity between capital and labor income, (2) removing the encouragement of economically wasteful efforts to convert labor income into capital income, (3) eliminating the incentive for taxpayers to inefficiently lock in portfolios of assets and hold them primarily for the purpose of avoiding capital gains tax on the appreciation rather than reinvesting the capital in more economically productive investments, and (4) raising revenue.

Effective Date. The proposal would have taken effect on January 1, 2022. But it would apply to pre-2022 appreciation. There would be no "fresh start" as, for example, in the 1976 carryover basis legislation.

Realization Events. Gain would be explicitly realized on transfers by gift or at death, equal to the excess of an asset's fair market value over the donor's or decedent's basis in that asset. Losses at death would also be allowed to offset gains. "The tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any)," making the 39.6 capital gains rate and 40 percent estate tax rate a combined rate of 63.76 percent (0.396 + 0.4 × (1 - 0.396)) on appreciation.

Exclusions. The proposal would exclude from tax "tangible personal property such as household furnishings and personal effects (excluding collectibles)," "[t]ransfers by a decedent to a U.S. spouse" (not defined, but presumably a U.S. citizen), and transfers to charity (the charity's share in the case of a transfer to a split-interest trust). In addition, there would be a single unified exclusion of capital gains for transfers both by gift and at death of $1 million per person, indexed for inflation after 2022 and "portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes." To the extent of that exclusion, the current basis rules under sections 1014 and 1015 (stepped up at death, carryover for gifts)

would apply. The exclusion of $250,000 per person of gain from the sale or exchange of a taxpayer's principal residence under section 121 would apply to the gain realized under this proposal with respect to all residences, and would be portable. The exclusion for certain small business stock under section 1202 would continue to apply.

Valuation. A transfer generally "would be valued using the methodologies used for gift or estate tax purposes." But the Greenbook adds that "a transferred partial interest would be its proportional share of the fair market value of the entire property." In other words, no minority or other partial-interest discounts.

Special Rules for Trusts and Entities. The Greenbook provides that transfers into, and distributions in kind from, a trust would be recognition events, unless the trust is a grantor trust deemed wholly owned and revocable by what the Greenbook calls "the donor." There is no mention of exempting irrevocable trusts in existence on the date of enactment, and therefore this Greenbook feature would apparently apply to distributions of appreciated assets to both current and successive or remainder beneficiaries of preexisting trusts, including, for example, both the grantor and the remainder beneficiaries of a pre-2022 GRAT. With regard to revocable trusts, the deemed owner would recognize gain on the unrealized appreciation in any asset distributed (unless in discharge of the deemed owner's obligation) to anyone other than the deemed owner or the deemed owner's "U.S. spouse" (again undefined), and on the unrealized appreciation in all the assets in the trust when the deemed owner dies or the trust otherwise becomes irrevocable.

The rules about transfers into and distributions in kind from a trust would also apply to a "partnership" or "other non-corporate entity." This seems like a far reach, but the Greenbook does not explain further.

The Greenbook also proposes a "mark-to-market" treatment of trust assets not otherwise subject to a realization event for 90 years.

Deferral of Tax. The Greenbook reprises the Obama Administration's Fiscal Year 2016 and 2017 proposals that "[p]ayment of tax on the appreciation of certain family-owned and -operated businesses would not be due until the interest in the business is sold or the business ceases to be family-owned and operated." Providing that the payment of tax is not "due" (rather than merely providing for a section 6166-like "extension of time for payment") implies at a minimum that there would be no interest charged (which can otherwise be a big problem, even for the no-more-than-14-year deferral of section 6166). In addition, there would be "a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made."

Regulations. Treasury would be granted authority to issue any regulations necessary or appropriate to implement the proposal. In a tacit acknowledgment of the harshness of such a proposal without a "fresh start" for basis as in 1976, the Greenbook explicitly contemplates that the regulations will include "rules and safe harbors for determining the basis of assets in cases where complete records are unavailable."

Contrasts with Previous Congressional Proposals. On March 29, 2021, Ways and Means Committee Member Bill Pascrell, Jr. (D-New Jersey) introduced H.R. 2286, described as a bill "to amend the Internal Revenue Code of 1986 to treat property transferred by gift or at death as sold for fair market value, and for other purposes." On the same day, Senator Chris Van Hollen (D-Maryland), released a 32-page "discussion draft" of statutory language titled the "Sensible Taxation and Equity Promotion ("STEP") Act of 2021," with the acronym of "STEP" evidently designed to recall the "step-up" in basis that it attacks. Notable differences of those proposals from the Greenbook proposal include (1) includability in the gross estate rather than revocability as the test for trusts, (2) mark-to-market treatment for trusts not deemed owned every 30 years in H.R. 2286 and every 21 years in the STEP Act rather than every 90 years, (3) very broad annual reporting to the IRS for trusts in the STEP Act, (4) no mention of partnerships, and (5) a January 1, 2021, effective date in the STEP Act.

Changes Originally Included in H.R. 5376

On September 15, 2021, the House Ways and Means Committee approved the "Build Back Better Act" (H.R. 5376), as part of the budget reconciliation process. Only one Democratic member of the Committee, Rep. Stephanie Murphy (D-Florida), joined all the Republicans in voting against it. The Ways and Means Committee's bill did not include deemed realization, but it included a number of other changes to the income

and transfer taxes affecting trusts, family businesses, and other things of interest to estate planners. None of the following proposals, however, survived in the bill that was passed by the House on November 19.

Closer Alignment of Grantor Trust and Transfer Tax Rules. The Ways and Means Committee's bill included a proposed new chapter 16, consisting solely of a new section 2901, effectively linking the grantor trust rules and the transfer tax rules so that a trust designed as a grantor trust would continue to be exposed to gift or estate tax with respect to the grantor. Specifically, with respect to a trust or portion of a trust of which "the grantor is the deemed owner," which is not otherwise includable in the grantor's gross estate, and which is funded on or after the date of enactment (either upon initial formation or by a contribution to an existing trust), section 2901 would (1) include the value of such portion in the grantor's gross estate for estate tax purposes, (2) subject to gift tax any distribution from such portion during the grantor's life, other than distributions to the grantor or the grantor's spouse or in discharge of an obligation of the grantor, and (3) treat as a gift by the grantor, subject to gift tax, all of such portion at any time during the grantor's life if the grantor ceases to be treated as the owner of such portion for income tax purposes. As a result, one of the chief benefits of a grantor trust – the ability to shelter from estate tax its future growth in value, including growth from the grantor's payment of income tax on its income – would disappear.

Certain Sales Between Deemed Owned Trust and Deemed Owner. The Ways and Means Committee bill would also have added a new section 1062 providing:

> In the case of any transfer of property between a trust and a person who is the deemed owner of the trust (or portion thereof), such treatment of the person as the owner of the trust shall be disregarded in determining whether the transfer is a sale or exchange for purposes of this chapter.

In other words, gain would be recognized by the deemed owner or by the trust (or possibly by both of them, in the case of a substitution of assets or other in-kind exchange, for example). Rev. Rul. 85-13, 1985-1 C.B. 184, the hinge on which almost all grantor trust planning swings, would be nullified. The new rule would not apply to a trust that is fully revocable by the deemed owner, although the carryover basis that would apply in such a case would simply postpone recognition of the gain to a future time.

Like the closer alignment of grantor trust and transfer tax rules in section 2901, this rule, as written, would apparently apply only to a trust created, and any portion of an existing trust attributable to a contribution made, on or after the date of enactment. But the Ways and Means Committee report stated that it "is intended to be effective for sales and other dispositions after the date of enactment" – that is, regardless of when the trust was created or funded – and it added in a footnote (footnote 935) that "[a] technical correction may be necessary to reflect this intent." Such a technical correction, for example, would cause gain to be recognized on an in-kind distribution to the grantor from a GRAT created before the date of enactment.

Valuation of Certain Nonbusiness Assets in Entities. In a proposal traceable at least to the Reagan and Clinton Administrations and virtually identical to section 6 of the "For the 99.5 Percent Act" (S. 994), introduced by Senator Bernie Sanders (I-Vermont) on March 25, 2021, the Ways and Means Committee bill would in effect have required the valuation of nonbusiness assets in an entity by a look-through method. The proposal would add a new section 2031(d) to the Code, applicable to transfers (by gift or upon death) after the date of enactment. Section 2031(d)(1) would provide:

> In the case of the transfer of any interest in an entity other than an interest which is actively traded … the value of any nonbusiness assets held by the entity with respect to such interest shall be determined as if the transferor had transferred such assets directly to the transferee (and no valuation discount shall be allowed with respect to such nonbusiness assets).

Like the "For the 99.5 Percent Act," the proposal included a detailed list of what are considered "passive assets," detailed rules about passive assets that might be used in a business, and "look-thru rules" for entities that are at least 10 percent owned by another entity. The proposal also included a broad grant of regulatory authority, specifically including the issues of whether a passive asset is used in the active conduct of a trade or business or is held as part of the reasonably required working capital needs of a trade or business. Unlike the "For the 99.5 Percent Act," however, the proposal does not also include a general prohibition on "minority discounts" in family owned or controlled entities, a prohibition that in the "For the 99.5 Percent Act" is not limited to "nonbusiness" entities or assets and thus would arguably have a much broader and harsher impact on family businesses.

Increased Benefit of Special Use Valuation. In contrast to the preceding provisions that would make the estate and gift tax more burdensome, the Ways and Means Committee bill, would have increased the limit on the reduction under section 2032A in the estate tax value of real property used in a family farm or other family business resulting from valuing the real property in that farm or business use, even if that is not its "highest and best use." Currently the limit on that reduction is $750,000, indexed for inflation since 1998 ($1,190,000 in 2021 and $1,230,000 in 2022). Such an increase in the limit has often been offered by lawmakers opposed to across-the-board repeal or reduction of the estate tax as a way to target relief to the family farms and businesses that are often cited as justifications for such repeal or reduction. Unlike section 3 of Senator Sanders' "For the 99.5 Percent Act," which would increase the limit to only $3 million, indexed for inflation going forward, the Ways and Means Committee proposal would raise the limit to $11.7 million (which happened to be the 2021 basic exclusion amount), indexed going forward.

Takeaways. As 2021 drew to a close without action on any of these proposals, it became apparent that many clients and many of their advisors had become very anxious about dramatic imminent changes in the law that did not materialize. The challenge will be to figure out, going forward, which scares are real and which are not. Because no one wishes to be caught unprepared when they actually had several months' "warning," this will be a hard challenge.

The heading of this "development" described these proposals (which have not been enacted) as "**bold**." Let's consider some of the definitions of "bold" found in a dictionary and see how they fit.

"Fearless before danger," "courageous"! These proposals take on tough policy issues. For example, why shouldn't the transfer tax and income tax treatment of trusts and other transfer be synchronized? If a gift is "complete," should that mean – well "complete"? Why would anyone design on purpose a tax system that was so uncoordinated?

"Brave," "intrepid," "unconcerned about consequences"! Consider, for example, the effect of these proposals on family businesses and farms. When a farmer has spent a lifetime working the farm through droughts, storms, and supply chain disruptions, or when a business owner has spent a lifetime investing profits back into the business, there is sometimes no other source for paying the estate tax on the significant wealth the farm or business represents than the farm or business itself. This is much different, for example, from a public corporation where the shareholder's stock can just be sold – the corporation itself is in effect exempt from tax – which can be a big competitive advantage for the publicly owned business over the family-owned business. Is that fair? And when the tax from a new deemed realization proposal is postponed until the business ceases to be owned and operated by the family, doesn't that pending burden, aggravated by a carryover basis each generation and the threat of liens in the meantime, just impair the family business's ability to raise capital or secure financing? Likewise, doesn't a proposal for a nearly tenfold increase in the reduction of taxable value under the "special use valuation" rules merely prevent a tax, for example, on a speculative prospect of development, not really on the family farm or business as such? The presence of such "relief" provisions suggests an awareness of these concerns and a desire to address them, at least nominally, but do they prove that lawmakers really "get it"?

"Unconventional"! Do some of these proposals look like a scary new tax? Even though they arguably would only refocus the taxes already in place? But the deemed realization rules for trusts would also apply to a "partnership" or "other non-corporate entity"? Seriously? Aren't the rules of subchapter K already complex enough?

"Brash," "impudent," "presumptuous"! No concern for details? What is the test anyway? Deemed owned under subchapter J? Includable in the grantor's gross estate? Both (as in the Greenbook)? Something else? Would enactment of these proposals really bring more synchronization? Or just create more layers of Venn diagrams of different treatments?

And that's why some things don't get enacted. But when the consistent basis rules were added to the Surface Transportation and Veterans Health Care Choice Improvement Act in 2015, were they really time-tested just because they had been proposed in every Congress since 2010? Or were there still a lot of things that didn't seem to have been thought through? Anyone who has worked with or even just studied the 30-day rule, or the zero-basis rule, or the successive-transfers rule knows the answer.

Number Three: Playing with the Basic Exclusion Amount, Including Anti-Anti-Clawback

Proposed Early Sunset for Doubled Basic Exclusion Amount. In contrast to the wide-sweeping and complicated proposals discussed in Number Four, the "Build Back Better Act" (H.R. 5376) approved by the House Ways and Means Committee on September 15 would have simply accelerated to January 1, 2022, the "sunset" of the doubling of the $5 million basic exclusion amount (indexed for inflation since 2012) that had been provided for in the 2017 Tax Act. How simple! The work had already been done in 2017. The entire statutory proposal – section 138207 of the original H.R. 5376 – was only 50 words, including the title and the subsection numbers. Yet it was dropped from the House-passed version.

Is It Really That Simple? As with a duck that seems to be gliding gracefully on the water, however, there is a lot of thrashing beneath the surface. Much of this goes back to the Tax Reform Act of 1976. Section 2001 of that Act replaced the separate gift tax and estate tax exemptions with a "unified credit," which Congress viewed as "more equitable" because in an environment of graduated rates "a deduction or exemption tends to confer more savings on larger estates." STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 94TH CONG., 2D SESS. 531 (1976). Of course, even then it was necessary to have the concept of an "exemption equivalent" to determine the estate tax return filing requirement under section 6018. Then the Taxpayer Relief Act of 1997 turned the calculation around and started with an "applicable exclusion amount." Then the Economic Growth and Tax Relief Reconciliation Act of 2001 tied the GST exemption to the applicable exclusion amount. Then came portability, temporarily in 2010 and permanently in 2012, and the need to introduce both a "basic exclusion amount" and a "deceased spousal unused exclusion amount" as components of the applicable exclusion amount. Meanwhile, whatever it's called, the exemption equivalent/applicable exclusion amount/basic exclusion amount grew to levels far exceeding the top estate tax bracket, making the 1976 "equity" argument largely moot.

So we had section 2001(g), which Congress superimposed on the 2001 structure in 2010 to prevent "clawback," and section 2001(g)(2), which Congress added contemporaneously with the 2017 doubling but in that case leaving the actual implementation to the Treasury Department to

> 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 Problem Under the 2017 Tax Act. The concern that prompted that mandate for regulations is that the remedy added in 2010 as subsection (g) (now paragraph (1) of subsection (g)) addressed only changes in tax **rates**, and the 2017 Tax Act did not change any **rates** when it doubled **the basic exclusion amount ("BEA")**. New paragraph (2) obviously contemplated that regulations would reach a similar result for the potential sunset of the doubled BEA, but left the details to the IRS and Treasury.

To illustrate the concern, assume that an unmarried individual made a $9 million gift (the donor's only lifetime gift) in 2019 when the indexed exclusion amount was $11.4 million. With no change in the law, the donor dies in 2026 with a taxable estate of $20 million. Assume further that the 2026 $5 million exclusion amount (indexed) is $6.8 million. With a 40 percent rate and the exclusion amount used up, the intuitively correct estate tax is 40 percent of $20 million, or $8 million. But, as illustrated in the table below, without anti-clawback relief the estate tax turns out to be $8,880,000, producing a "clawback penalty" of $880,000. Other ways to look at this $880,000 million are

- 40 percent of the amount by which the $9 million gift exceeded the $6.8 million date-of-death exclusion amount; or
- the gift tax on the gift if the gift had been made in 2026; or
- the additional estate tax on a taxable estate of $29 million if the gift had not been made at all.

In other words, all the benefit the 2017 Tax Act apparently promised this donor for making a gift before the sunset would be wiped out by the sunset.

The Solution Under Reg. §20.2010-1(c). Anti-clawback regulations were proposed in November 2018 and finalized in November 2019. They are discussed in more detail as Number Seven in the Top Ten Estate Planning and Estate Tax Developments of 2019 found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. New Reg. §20.2010-1(c) (with the former paragraphs (c), (d), and (e)

re-lettered (d), (e), and (f)) states the heart of the anti-clawback rule, applicable to the extent the credit is based on the basic exclusion amount (emphasis added):

> If the total of the **amounts allowable as a credit in computing the gift tax payable** on the decedent's post-1976 gifts … **exceeds** the credit allowable within the meaning of section 2010(a) in computing the estate tax, … then the portion of the credit allowable in computing the estate tax on the decedent's taxable estate … is **the sum of the amounts … allowable as a credit in computing the gift tax payable** on the decedent's post-1976 gifts.

In other words, in the example above (which has the same facts as Example 1 in the regulations), because $9 million of basic exclusion amount used for the 2019 gift (the only post-1976 lifetime gift) is greater than the $6.8 million basic exclusion amount otherwise allowable in computing the 2026 estate tax, that larger amount of $9 million is used for estate tax purposes instead of the $6.8 million. (This is simplified for the sake of readability; technically, the credits based on the exclusion amounts are compared under the regulation.) The elimination of the clawback penalty under that rule is illustrated in the following table, by changing the entry on line 9a from $6.8 million (the 2026 basic exclusion amount) to $9 million (the amount of the 2019 basic exclusion amount used for computing the gift tax).

Calculation of the Estate Tax with and without Clawback
Using the Estate Tax Return, Form 706 (August 2019) as a Template

Line		Illustrating Clawback	Under Reg. §20.2010-1(c)*
3c	Taxable estate	20,000,000	20,000,000
4	Adjusted taxable gifts	9,000,000	9,000,000
5	Add lines 3c and 4	29,000,000	29,000,000
6	Tentative tax on the amount on line 5	11,545,800	11,545,800
7	Total gift tax paid or payable	0	0
8	Gross estate tax	11,545,800	11,545,800
9a	**Basic exclusion amount**	**6,800,000**	*** 9,000,000**
9b	DSUE amount [not applicable]	0	0
9c	Restored exclusion amount [not applicable]	0	0
9d	Applicable exclusion amount (add lines 9a, 9b, and 9c)	6,800,000	9,000,000
9e	Allowable credit amount (tentative tax on line 9d)	2,665,800	3,545,800
10	Adjustment [not applicable]	0	0
11	Allowable applicable credit amount	2,665,800	3,545,800
12	Subtract line 11 from line 8	8,880,000	8,000,000
16	Net estate tax [same as line 12 in this case]	8,880,000	8,000,000
	Intuitively correct tax	8,000,000	8,000,000
	Clawback penalty	880,000	0

The regulations include Example 2 to illustrate what the preamble to the final regulations acknowledges is the "use or lose" nature of the doubled exclusion amount when a donor uses some but not all of the exclusion amount available from 2018 through 2025 and Examples (3) and (4) to confirm the preservation of portability elections during the eight years of a doubled BEA.

An Anti-Abuse Warning. Finally, the preamble to the final regulations adds:

> A commenter recommended consideration of an anti-abuse provision to prevent the application of the special rule to transfers made during the increased BEA period that are not true inter vivos transfers, but rather are treated as testamentary transfers for transfer tax purposes. Examples include transfers subject to a retained life estate or other retained powers or interests, and certain transfers within the purview of chapter 14 of subtitle B of the Code. The purpose of the special rule is to ensure that bona fide inter vivos transfers are not subject to inconsistent treatment for estate tax purposes. Arguably, the possibility of inconsistent treatment does not arise with regard to transfers that are treated as part of the gross estate for estate tax purposes, rather than as adjusted taxable gifts. An anti-abuse provision could except from the application of the special rule transfers where value is included in the donor's gross estate at death. Although the Treasury Department and the IRS agree that such a provision is within the scope of the

regulatory authority granted in section 2001(g)(2), such an anti-abuse provision would benefit from prior notice and comment. Accordingly, this issue will be reserved to allow further consideration of this comment.

The "commenter" is the New York State Bar Association Tax Section, in a February 20, 2019, letter available at **https://nysba.org/NYSBA/Sections/Tax/Tax%20Section%20Reports/Tax%20Section%20Reports%202019/1410%20Report.pdf**. For an in-depth discussion of this issue, see Lynagh, "Potential Anti-Abuse Rules May Limit Use of the Temporarily Increased Gift Tax Exclusion," 45 Tax Mgmt. Est., Gifts & Tr. J. 183 (May 14, 2020).

To illustrate the circumstances in which such an anti-abuse rule might apply, consider again the example above, a $9 million gift in 2019 and an otherwise taxable estate of $20 million and basic exclusion amount of $6.8 million in 2026, except that the gift is of such nature that the value of the property is included in the donor's gross estate under, for example, section 2036, thereby making the taxable estate $29 million (assuming no intervening change in value), **while the gift itself is excluded from "adjusted taxable gifts" under the last phrase of section 2001(b)**. In that case, the intuitively correct estate tax seems to be the tax on a taxable estate of $29 million, which is $8,880,000 (as shown under "Illustrating Clawback" in the above table, calculated on the tax base of $29,000,000 on line 3 after adding adjusted taxable gifts in that case). Two ways of computing that are:

- $11,545,800 (the tax on $29,000,000 under the section 2001(c) rate schedule) minus $2,665,800 (the applicable credit amount, which is the tax on the applicable exclusion amount of $6,800,000 under the section 2001(c) rate schedule) = $8,800,000, or
- 40% times (the taxable estate of $29,000,000 minus the applicable exclusion amount of $6,800,000) = 0.4 × $22,200,000 = $8,800,000.

Thus, application of the anti-clawback calculation in this case would not eliminate an $880,000 clawback penalty, it would in effect produce an $880,000 bonus, as the following table indicates.

Calculation of the Estate Tax with and Without the Anti-Clawback Regulations Again Using the Estate Tax Return, Form 706 (August 2019) as a Template

Line		Without Reg. §20.2010-1(c)	Under Reg. §20.2010-1(c)*
3c	Taxable estate	29,000,000	29,000,000
4	Adjusted taxable gifts	0	0
5	Add lines 3c and 4	29,000,000	29,000,000
6	Tentative tax on the amount on line 5	11,545,800	11,545,800
7	Total gift tax paid or payable	0	0
8	Gross estate tax	11,545,800	11,545,800
9a	**Basic exclusion amount**	**6,800,000**	*** 9,000,000**
9b	DSUE amount [not applicable]	0	0
9c	Restored exclusion amount [not applicable]	0	0
9d	Applicable exclusion amount (add lines 9a, 9b, and 9c)	6,800,000	9,000,000
9e	Allowable credit amount (tentative tax on line 9d)	2,665,800	3,545,800
10	Adjustment [not applicable]	0	0
11	Allowable applicable credit amount	2,665,800	3,545,800
12	Subtract line 11 from line 8	8,880,000	8,000,000
16	Net estate tax [same as line 12 in this case]	8,880,000	8,000,000
	Intuitively correct tax	8,880,000	8,880,000
	Unintended anti-clawback bonus	0	880,000

That "bonus" is probably what has prompted the IRS and Treasury to consider an "anti-abuse provision," and probably what such an amendment would curtail. Put another way, it would simply preserve the "clawback,"

in effect, that provisions like section 2036 have been **designed** to achieve since at least the 1930s. The "commenter" was right.

Effective Date. It is likely that the contemplated amendment of the regulations would apply only prospectively – that is, after the date it is published as a final regulation. But it should also be noted that it would apply only to the calculation of the estate tax when a provision like section 2036 (including those in chapter 14) applies. Thus, it should be expected to first apply to the estate of someone who dies after December 31, 2025, when the "sunset" enacted in 2017 occurs, Thus, it would achieve the "anti-abuse" outcome described above with respect to gifts made and other lifetime actions taken **since 2017** that result in estate includability, **whether or not those actions have been taken before the regulations are amended**.

The proposal of the Ways and Means Committee to accelerate the "sunset" to January 1, 2022, could have meant that, unless the "anti-abuse" regulations were issued before the end of 2021 (which was possible but by no means certain), some persons who have made post-2017 gifts with potential for inclusion in the gross estate would die before the regulations were effective. Those persons' estates might have benefited from the anti-clawback bonus. Or the regulations might have provided for retroactive application to their estates, which is sometimes done in true "abuse" cases. Such planning after December 31, 2017, by persons who die after December 31, 2021, and after the regulations are final would have been caught in any event.

And Now – the 2021 Development. In the first Treasury-IRS Priority Guidance Plan in the Biden Administration (**https://www.irs.gov/pub/irs-utl/2021-2022-pgp-initial.pdf**), published on September 9, 2021, for the plan year from July 1, 2021, through June 30, 2022, Item 3 under the subject heading of "Gifts and Estates and Trusts" is described as "Regulations under §2010 addressing whether gifts that are includible in the gross estate should be excepted from the special rule of § 20.2010-1(c)." Now we have additional confirmation that an anti-abuse rule illustrated in the above table is an active project. And, unlike the legislative proposals of 2021 described in Number Four, we should really expect to see it happen (which earns it a higher ranking as Number Three, despite the unquestioned drama created by those legislative proposals).

Number Two: Proposed Increased Income Tax Rates for Trusts and Estates

Individual Income Tax Rates in the Ways and Means Committee Bill. Under the September 15, 2021, Ways and Means Committee version of the "Build Back Better Act" (H.R. 5376), the 39.6 percent top individual income tax rate, suspended for eight years by the 2017 Tax Act, would have been be reinstated on January 1, 2022, for taxable incomes over $400,000 ($450,000 for joint returns and surviving spouses) and $13,450 for trusts and estates. In addition, a new section 1A would apply a 3 percent "surcharge" to "modified adjusted gross income" (defined as AGI minus any investment interest deducted "below the line," not deducted in determining AGI) over $5 million for individual returns, including joint returns of married couples (half that amount in the case of married individuals filing separately). For trusts and estates the threshold is $100,000, and AGI is determined as provided in section 67(e) (that is, after deducting certain unique fiduciary expenses, the personal exemption of section 642(b), and the distribution deduction of section 651 or 661), with a further deduction for charitable payments and set-asides under section 642(c) that was helpfully added in a November 3 update while the bill was pending in the Rules Committee.

Administration's "Build Back Better Framework." On October 28, 2021, the White House released a short document titled "Build Back Better Framework." It was widely viewed as reflecting negotiations among the Administration and members of Congress in both parties. The Framework added that its spending proposals would be "more than fully paid for by asking the wealthiest Americans and most profitable corporations to pay their fair share," including a "new surtax on multi-millionaires and billionaires."

House Rules Committee Version Passed by the House. On the same day, October 28, 2021, the House Rules Committee released a new version of H.R. 5376, mirroring the White House Framework. An updated version, with both technical and substantive additions, was released on November 3, 2021. The White House Framework's "new surtax on multi-millionaires and billionaires" proved to be the new section 1A of the original Ways and Means Committee version, effective January 1, 2022, with some significant changes in the numbers. The **threshold** for imposition of the surcharge would be **doubled** to $10 million for individual returns, including joint returns of married couples (half that amount in the case of married individuals filing separately), and $200,000 for trusts and estates. But the ultimate **rate** of the surtax would be **almost tripled**, beginning at that threshold at 5 percent (rather than 3 percent) and then increasing to 8 percent at a level of

$25 million for individual returns, including joint returns of married couples (half that amount in the case of married individuals filing separately) and $500,000 for trusts and estates. And, as noted above, the November 3 update helpfully added a provision allowing the deduction for charitable payments and set-asides under section 642(c) in calculating the threshold for the surcharge, which has the effect of making "modified adjusted gross income" for trusts and estates very close in many cases to taxable income.

The House of Representatives passed the updated version of H.R. 5376 on November 19, 2021. The vote was 220-213, with no Republicans voting for it and only one Democrat (Representative Jared Golden of Maine) voting against it. On December 11, the Senate Finance Committee released a version with some editing but with the same rates and thresholds. The Senate adjourned for the year on December 18, and Senator Joe Manchin III (D-West Virginia) announced on December 19 that he could not support the bill, a serious setback to the prospects of passing the bill in the equally divided Senate.

Words Matter. There obviously has been a lot of political tension about H.R. 5376. Reportedly, there was resistance to increasing income tax rates that the Senate Democratic leadership, in particular, thought it might be difficult to overcome. But this 5 percent, then 8 percent, proposal is not an increase in "rates"; it is a "surcharge." So, at least as of November 19, it stayed in the bill.

But Numbers Matter More. The obvious effect, however, is that, under the House-passed bill, what had been a top rate of 37 percent for 2018 through 2025 under the 2017 Tax Act would become 45 percent. While this 45 percent rate would take effect at very high income levels – $25 million for single individuals and married couples filing joint returns – it would apply to incomes above only $500,000 for trusts and estates. This is quite a dramatic distortion, but it is roughly proportional to the difference already observed in the regular top income tax bracket, which is $647,850 for a joint return and $13,450 for a trust or estate (a factor of just over 48), compared to $25 million for a joint return and $500,000 for a trust or estate (a factor of 50).

Before 1987, the income tax brackets and rates for trusts and estates closely matched those of married individuals filing separately, and before 1977 they had actually been addressed in the same table. The Tax Reform Act of 1986 started a compression of brackets that was perpetuated and escalated in subsequent legislation. The Senate Finance Committee summarized the reasons for this compression by stating its belief "that the tax benefits which result from the ability to split income between a trust or estate and its beneficiaries should be eliminated or significantly reduced." S. REP. NO. 99-313, 99TH CONG., 2D SESS. 868 (May 29, 1986). (It is interesting that the committee included "estates," as if estates are created for tax-avoidance reasons.)

Another Income Tax Increase for Some Trusts. With the 3.8 percent tax on net investment income under section 1411 (enacted in 2010), the combined top rate under the House-passed bill would be 48.8 percent. In fact, under the bill passed by the House (with only a slight technical correction by the Senate Finance Committee) the net investment income tax would be expanded, beginning January 1, 2022, by effectively eliminating the "trade or business" exception in section 1411(c)(1)(A)(i) for individuals with "modified adjusted gross income" (in this case already defined in section 1411(d) as AGI plus, in effect, net foreign earned income excluded under section 911) over $400,000 ($500,000 for joint returns and surviving spouses) and for trusts and estates with adjusted gross income in excess of the threshold for the highest income tax bracket for trusts and estates ($13,450 in 2022).

Ironically, if this change were enacted, it would essentially moot the decade-old issue of how a trust or estate can satisfy the "material participation" requirement to qualify for that "trade or business" exception. Congress applied that "material participation" requirement in 2010 to the "trade or business" exception by including in section 1411(c)(1)(A)(i) the qualifier "not described in paragraph (2)" and by including in subparagraph (A) of paragraph (2) "a passive activity (within the meaning of section 469)," thus incorporating into section 1411 the definition of section 469(c)(1) that "[t]he term 'passive activity' means any activity (A) which involves the conduct of any trade or business, and (B) **in which the taxpayer does not materially participate**."

Chief Counsel Advice 201244017 (issued Aug. 3, 2012; released Nov. 2, 2012) took the position that

> a trust cannot meet the qualifying tests of 469(c)(7)(B) because those tests are intended to apply only to individuals. Only individuals are capable of performing "personal services" …, and the statute specifically states that the personal services must be performed by the taxpayer.

Final regulations addressing many issues under section 1411 were issued on November 26, 2013, but did not address the issue of material participation in the context of trusts. The preamble (T.D. 9644) candidly acknowledged Treasury's sympathy with the problems of material participation and the difficulty of dealing with those problems, which it described as "very complex." The preamble to proposed regulations published on December 2, 2013, cited the preamble to the November 26, 2013, final regulations and deferred the issue of material participation by estates and trusts, including QSSTs, which it said "is more appropriately addressed under section 469."

Then, in the section 469 case of *Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (March 27, 2014), the Tax Court (Judge Morrison) held that the material participation by the trust in real estate operations may be determined by considering the activities of the trustees, including the activities of some of the trustees in their roles as employees of an LLC wholly owned by the trust, and that by that standard the court was "convinced that the trust materially participated in the trust's real-estate operations."

There has been no acquiescence or nonacquiescence or any other formal indication of the IRS's view of this subject in light of *Aragona*. But five months after the *Aragona* decision, on August 26, 2014, the 2014-2015 Treasury-IRS Guidance Plan, under the heading of "General Tax Issues," included for the first time a project described as "Guidance regarding material participation by trusts and estates for purposes of §469." That project was repeated in two more annual Plans but was dropped from the 2017-2018 Plan, thus essentially leaving the regular published Tax Court decision in *Aragona* as the last word on the subject.

Until, perhaps, the enactment of the Build Back Better Act, which would moot the issue.

Takeaways. While it is difficult to predict the outcome of the Build Back Better Act in 2022, when the political climate is likely to be at least as challenging as it was in 2021 and to become more challenging as 2022 goes by, it is entirely possible that, if and when it is passed in some form, both of these tax increases – the 3 to 8 percent surcharge (which is not a "tax rate," of course!) and the expansion of the 3.8 percent net investment income tax – will be in it. In that case, for affected trusts, the pressure to consider distributions to beneficiaries in lower income tax brackets, and the strain such pressure puts on a fiduciary with a duty to respect the purposes of the trust and treat current and future beneficiaries impartially, could be significantly increased.

And in the case of an estate, this could mean that the higher rate created by the surcharge would apply to the estate of an individual whose income was never close to the thresholds of $10 million or $25 million, and, in the early years of the administration of the estate, distributions to obtain a deduction under section 661 might not be feasible.

Number One: Continued Health Challenges

The COVID Pandemic. It is awkward to acknowledge this subject as Number One, because it was Number One last year too. See the Top Ten Estate Planning and Estate Tax Developments of 2020 found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**. A year ago, for example, it seemed for many that COVID-19 was perhaps a once-in-a-century crisis that warranted the Number One ranking for its sheer uniqueness. Many of us assumed last year that after another year we would be back to "normal" and the only open question was whether and how "normal" would be "new." Now we see that the crisis has continued, aggravated by fatigue, impatience, and, it seems, even greater tension. It has achieved the linguistic impossibility of being "more unique," and thus, again, Number One.

But there may also be some positive aspects. Technology has enabled more contact without travel – a lesser degree of contact for those in the same office, but perhaps a greater degree of interaction among colleagues in different offices than would have been achieved or attempted in the absence of the health concerns. The virtual meetings that were a distant-second-place necessity for the single office became a bonus for multiple offices.

As I wrote last year, we stayed home to avoid contagion, but might like to stay home to avoid traffic. But as we have gotten used to being home more, and to having colleagues that are home more, we have seen ways to better accommodate, for example, mothers of young children to a degree that, if it had been observed by my generation, could have improved diversity, and thereby improved the quality of advice, that we largely missed out on.

But, especially in cases where there is not that type of offsetting benefit, it will still be a challenge to strike the right balance. Again drawing from last year's Top Ten, without face-to-face meetings in which to fully express feelings and opinions and apprehend and appreciate reactions, how can we:

- mentor and be mentored?
- train and be trained?
- develop teamwork?
- develop trusting relationships?
- develop focused advice?
- deliver that advice candidly and sensitively?

Whether getting to know the values, concerns, and needs of new clients or explaining estate plans or particular techniques to clients of long standing, we will face challenges. Without face-to-face, unmasked meetings with clients, we will miss the smiles and frowns, squints and squirms, raised eyebrows, leaning forward, leaning back, glancing at or nudging a spouse, and other body language that often communicates interest or concern or other emotions that would not necessarily be expressed in words. And the advisor's ability to respond to both verbal and nonverbal signals, such as by pointing to a word in a document, drawing an imaginary line of connection, making other gestures, or just looking someone in the eye with empathy, is also impaired.

On a different subject, we may continue to struggle with retaining both the solemnity of the formal conference table execution and the expediency of getting executed documents in place without unnecessary personal contact.

A year later, it continues. Unprecedented. Unique. Number One.