THE TOP TEN ESTATE PLANNING AND ESTATE TAX DEVELOPMENTS OF 2021

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Number Ten

Estate Tax Closing Letters for a $67 User Fee: Reg. §300.13 [p. 1*]

* Page numbers in square brackets refer to where this topic begins in "The Top Ten Estate Planning and Estate Tax Developments of 2021" available at www.bessemertrust.com/for-professional-partners/advisor-insights.

Estate Tax Closing Letters

- Routinely issued before June 1, 2015; since then available only on request.
- Notice 2017-12: Transcript code "421" with "Closed examination of tax return" can "serve as the **functional equivalent** of a closing letter."
- Reg. §300.13 (Sept. 27, 2021, effective Oct. 28, 2021) imposes a $67 user fee for what the preamble describes as "a service that confers special benefits."
- **Pay.gov** FAQs at **https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-the-estate-tax-closing-letter** (Oct. 6, 2021).

Number Nine

Intergenerational Split-Dollar Life Insurance: *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016), T.C. Memo. 2021-60 (May 13, 2021) [p. 2]

Background

- Interstate Van Lines, Springfield, Virginia, owned by Arthur and Clara's family (going back to 1943).
- Three sons active in business, but some tension.
- Succession planning since 1994; Arthur died in 1996.
- Employee was Clara's conservator 2 months in 2006.
- Policies owned by 3 new irrevocable trusts for sons.
- Clara (her revocable trust, sons as trustees) paid **$29.9 million** in lump-sum premiums; trust amended to leave reimbursement rights to sons' trusts.
- **$636,657** "economic benefit" gifts reported 2006-09.
- Clara died in 2009; rights valued at **$7.5 million**.

Tax Court Cases

- *Estate of Morrissette* (T.C. 2016): Arrangements met "economic benefit" standards of 2003 regulations.
- *Estate of Cahill* (T.C. Memo. 2018): Refused to rule that sections 2036, 2038, and 2703 did not apply.
- *Estate of Morrissette* (T.C. Memo. May 13, 2021):
  - Sections 2036, 2038, and 2703 do not apply.
  - Accepted IRS expert's discount rates (**6.4 & 8.85%** vs. **15 & 18%**) and **a maturity date of December 31, 2013** (about 3 years after filing of the 706).
  - Upheld 40% gross valuation misstatement penalty.
  - Decision (Dec. 13): Owed **$15.8 million** tax and penalties (vs. **$39.4 million** in notice of deficiency).

Takeaways

- The importance of "good facts," especially an operating business.
- The "smell test" for a rather small value for a very large right of reimbursement.
- Hazard of revocation rights in an intergenerational split-dollar arrangement.
- Bottom line: The technique works, but maybe not as well, and maybe not all the time.
- Time it takes to resolve issues: Clara died in 2009.

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Number Eight

John Doe Summons: *Taylor Lohmeyer v. United States*, 957 F.3d 505 (5th Cir. 2020), *en banc reh'g den.*, 126 AFTR 2d 2020-7208, *cert. den.* Oct. 4, 2021 [p. 5]

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Background

- A client paid almost $4 million in tax, interest, and penalties regarding underreporting income of foreign accounts that a Texas law firm had helped him structure.
- The IRS issued a “John Doe summons” to the law firm “seeking **documents** for … U.S. taxpayers, ‘who, at any time [over 23 years] 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.’”
- The firm invoked **attorney-client privilege**.

District Court (W.D. Texas), Enforcing

- “Ultimately, because **blanket assertions of privilege are disfavored** … the Firm does not carry its burden. … Upon 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.”
- There are about **32,000** documents!

Fifth Circuit, Affirming

- The summons would not reach "motive, or other confidential communication of [legal] advice."
- The full court voted **9-8** to deny *en banc* rehearing.

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Judge Elrod and 5 Others, Dissenting

- "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."

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Judge Elrod, Concluding

- The firm "will have the opportunity to produce a privilege log, asserting privilege on particular responsive documents. … [T]he 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]: **'[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.'**"

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ACTC Amicus Brief – What Next?

- "[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."
- The Supreme Court **denied certiorari** Oct. 4, 2021.

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Takeaways

- Care in choosing clients.
- Care in choosing, presenting, and implementing tax planning strategies.
- Care in discussing clients and the work done for them.
- Familiarity with privilege boundaries and privilege logs.

Number Seven

Moderate Consideration of Post-Death Developments in Valuation: *Estate of Michael J. Jackson v. Commissioner*, T.C. Memo. 2021-48 (May 3, 2021) [p. 7]

How Michael Jackson Made the Top Ten

- Well, just because …
- Everyone has heard of him.
- This may be the first reported case about the value of image and likeness for tax purposes.
- The numbers are dramatic [pun intended].
- It is an interesting 265-page opinion.

The Dramatic Numbers

	Image, Likeness	NHT II*	NHT III**
Return	$2,105	0	$2,207,351
IRS Notice of Def.	$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***	$4,153,912	0	$107,313,561
Change	197,235%		4,762%

* NHT II (New Horizon Trust II), a bankruptcy trust, held 50% of SONY/ATV Music Publishing, which owned rights to some Beatles music.

** NHT III (New Horizon Trust III), a bankruptcy trust, held Mijac Music, which owned rights to music Jackson (and some others) wrote.

*** The IRS imposed penalties, but the Tax Court disagreed.

What Happened?

"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."

– Tax Court Judge Holmes

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Takeaways

- Not expecting the worst when the IRS considers post-death developments in valuation. (*E.g.,* in 2011, Sony/ATV paid **$750 million** for NHT II's interest.)
- Choosing appraisers with care.
- Being wary of appraisals that are too pessimistic (or too optimistic).
- Time it takes to resolve issues: Like Clara Morrissette, Michael Jackson died in 2009.

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Number Six

Donor's Relinquishment of Control of a DAF: *Fairbairn v. Fidelity Investments Charitable Gift Fund* and *Pinkert v. Schwab Charitable Fund* (N.D. Cal., Feb. 26, 2021, and June 17, 2021) [p. 9]

Issues

- *Fairbairn*: DAF sold stock (given Dec. 28 & 29, 2006) all in the final 2½ trading hours of the year.
  - Said to have lost about 30% in value (about $9.6 million), although the court found it was not more than 10% of the daily trading volume (as the Fairbairns claimed Fidelity promised).
  - The Fairbairns also claimed that Fidelity broke promises not to trade until the new year and in any event to consult with them about a price limit.
- *Pinkert*: Invested through a Schwab affiliate.
  - Pinkert claimed the affiliate's fees were too high.

Holdings

- *Fairbairn*: Burden of proof not met.
  - Promises not documented and not relied on.
  - Did not prove sale was not reasonably prudent.
- *Pinkert*: No standing.
  - Pinkert had given up title to and control to Schwab (citing Code section 170(f)(18)(B)).
  - If anyone suffered injury, it was the potential charitable donees.
  - Court noted that “[t]he result might be different if the fund broke specific promises” (citing *Fairbairn*) but there were no allegations of that.

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Takeaways

- Encouraging: Donors to DAFs do not retain control. (See section 170(f)(18)(B).)

- Scary: These donors tried to exert control, or at least (in *Fairbairn*) to invoke promises, which the court seemed willing to enforce if they were documented.

- Challenge: Helping clients strike the right balance.
  - For example, DAF vs. private foundation.

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Number Five

Splitting Gifts and Bequests: *Smaldino v. Commissioner*, T.C. Memo. 2021-127 (Nov. 10, 2021); *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17 (Feb. 18, 2021) [p. 10]

Smaldino: What Appeared To Happen?

- On April 14, 2013, Mr. Smaldino gave his wife nonvoting units representing about 41% of the interests in an LLC holding California real estate.
- On April 15, she gave those units to a Dynasty Trust for the benefit of his descendants.
- Also on April 15, he gave the Dynasty Trust nonvoting units representing about 8% of the interests in the LLC.
- So the Dynasty Trust ended up owning a 49% interest received from the Smaldinos, including 41% that was owned by Mrs. Smaldino for a day.

What Really Happened

- On **about April 14 or 15**, Mr. Smaldino **hired an appraiser** to determine the value of a **49%** interest in the LLC as of April 15, 2013.
- The appraiser's report dated **August 22** determined the value of a 49% interest to be **$6,281,000**.
- Then by formula* Mr. Smaldino assigned to his wife nonvoting units **with a value of $5,249,118.42**, not dated but "Effective April 14, 2013."
- She made the same formula* assignment to the Dynasty Trust, not dated but "Effective April 15, 2013."

* The Formula

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**)"

What Really Happened (continued)

- 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 $6,281,000!**
- Which helped Judge Thornton figure out that those assignments could not have been signed in April.
- And no operating agreement amendment or income tax return of the LLC ever showed her as a member.

What Really Really Happened

- Judge Thornton: "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**."

The Clincher

- "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.'**"
  - Regardless of the timing of the transfers.
- So the IRS and the Tax Court clearly got it right.

Takeaways

- The court also increased the gift tax value from $6,281,000 to $7,820,000.
- Mr. Smaldino could have shifted $3,910,000 of the gift to Mrs. Smaldino by simple gift-splitting.
- By trying to shift more he shifted nothing!

- But doesn't this kind of thing happen all the time between spouses?

Warne: Summary

- Ms. Warne died in 2014 owning, through a trust, from 72.5% to 100% interests in five LLCs that held California real estate.
- The 100%-owned LLC was left **75%** to a family charitable foundation and **25%** to a church.
- The court allowed discounts for lack of control and lack of marketability for the majority LLC interests that were somewhat favorable to the estate.
- But the court applied **additional discounts** to the 25% and 75% interests **in calculating the charitable deductions**, which then totaled less than the value included in the gross estate.

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Takeaways

- **"BUT IT'S ALL GOING TO CHARITY!"** is an intuitive and understandable reaction.
- But there is well-established support for this result. *E.g., Ahmanson* (9th Circuit, where the Warnes live).
- The same issue could arise with the marital deduction or with a combination of charitable and marital deductions. *E.g.*, "reverse *Chenoweth*" in TAM 9050004.
- Consider a single bequest, for example to a DAF or foundation, which might give 25% to the church?

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Number Four

Bold Proposals to Coordinate Transfer Taxes and Income Taxes: Grantor Trust and Deemed Realization Proposals [p. 12]

HR 5376: Grantor Trusts & Transfer Tax

OMITTED FROM HOUSE-PASSED VERSION

- New chapter 16, **section 2901**, would **align** transfer tax treatment with grantor trust treatment if the grantor is the deemed owner:
  - Value is included in grantor's gross estate.
  - Distributions are taxable gifts.
  - Termination of grantor trust status is a taxable gift.
- Unless a trust is fully revocable, new **section 1062** would **ignore grantor trust status** in determining whether a transfer is **a taxable sale**.
  - Nullifying Rev. Rul. 85-13.
  - Would apply to a §678 deemed-owned trust too.

Effective Date of New §§2901 and 1062

- Trusts **created** – or **portion** of trust attributable to "a **contribution**" – **on or after date of enactment**.
- Committee report: "The portion of the provision relating to sales and exchanges between a deemed owner and a grantor trust is intended to be effective for **sales** and other **dispositions** after the date of enactment" [*i.e.*, regardless when created or funded].
  - Footnote 935: "A **technical correction** may be necessary to reflect this intent."
- Estimated 10-year revenue effect: **+$8 billion**.

Value of Interests in Entities

OMITTED FROM HOUSE-PASSED VERSION

- **Look-through** values for **nonbusiness** assets.
  - As if those assets had been transferred directly.
  - **No** "non-tax reason" exception.
- Estimated 10-year revenue effect: **+$20 billion**.

Special Use Valuation

OMITTED FROM HOUSE-PASSED VERSION

- §2032A: Estate tax value of real property **used in a family farm or business** is its value **in that use**.
- **Many technical tests** – "material participation," "family," continuity, share of estate, etc. – plus **potential recapture** within 10 years.
- Limit on reduction (**$1,190,000** in 2021, $1,230,000 in 2022) would be **$11,700,000**, indexed, in 2022.
- Estimated 10-year revenue effect: -$317 million.
- Does not reduce tax **on farm or business as such**!

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Greenbook (May 28): Realization

- Effective January 1, 2022 (**no "fresh start" basis**).
- Gain = fair market value minus basis:
  - "Valued using … gift or estate tax … methodologies."
  - But a "partial interest would be its proportional share of the fair market value **of the entire property**."
- Income tax **deductible for estate tax purposes**.
- **In addition,** the rate would be **39.6%** for AGI over $1 million.
- Thus, rate on appreciation = .396+.4(1-.396) = **63.76%**.

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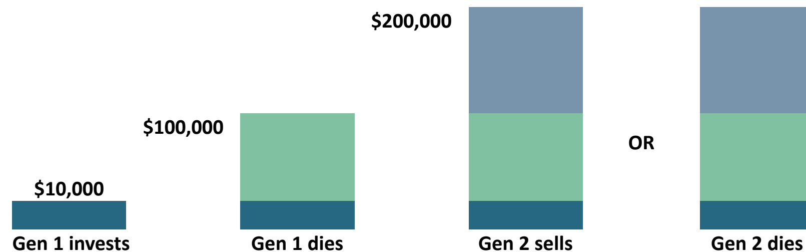
Illustration



	Gen 1 dies	Gen 2 sells	Gen 2 dies
Current Law:			
20% Income Tax		$20,000	
40% Estate Tax	$40,000		$80,000
Greenbook:			
39.6% Income Tax	$35,640	$39,600	$39,600
40% Estate Tax	$25,744		$64,160
Total	$61,384 (61.4%)		$103,760 (51.9%)

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Exclusions

- Tangible personal property (other than collectibles).
- "Transfers by a decedent to a **U.S. spouse**."
- Transfers to charity:
  - "Based on the charity's share of the value transferred" in the case of a split-interest trust.
- Unified lifetime/at death exclusion of **$1,000,000**:
  - Indexed for inflation after 2022.
  - "**Portable** to the decedent's surviving spouse."
- $250,000 retained for residences (lifetime and death).
  - "Would apply to **all residences**."
  - "**Portable** to the decedent's surviving spouse."

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Special Rules for Trusts and Entities

- For "a **grantor trust** that is deemed to be **wholly owned** and **revocable** by the donor," gain taxed:
  - To deemed owner on any asset **distributed** (except to the deemed owner or "U.S. spouse" or in discharge of the deemed owner's obligation).
  - On all assets "at the deemed owner's **death** or at any other time when the trust **becomes irrevocable**."
- For other trusts (and **partnerships and other non-corporate entities**), gain taxed:
  - On "transfers **into** and distributions in kind **from**"
  - Beginning in 2030, for any asset held, but not the subject of a recognition event, for the last **90 years**.

Targeted Relief Provisions

- "Payment 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."
- Other illiquid assets would qualify for a "**15-year** fixed-rate payment plan."
- The IRS would be authorized to require reasonable **security** "at any time … from any person, and in any form, deemed acceptable by the IRS."

Broad Regulatory Authority

- Including **"rules and safe harbors for determining the basis of assets in cases where complete records are unavailable."**

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Revenue Estimate

- 39.6% rate on capital gains **and** proposed deemed realization of capital gains **together** estimated to increase revenue by **$322.485 billion** over the next 10 fiscal years.

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Previous Congressional Rumblings

- Deemed realization proposals in Congress (3/29/21):
  - H.R. 2286, Rep. Bill Pascrell, Jr. (D-New Jersey).
  - "Sensible Taxation and Equity Promotion Act" ("STEP Act"), "discussion draft," Sen. Chris Van Hollen (D-Maryland).
- Notable differences from Greenbook approach:
  - Test for trusts is includability in gross estate, not revocability.
  - Taxation of appreciation in other trusts not deemed owned:
    - Every **30 years** in H.R. 2286.
    - Every **21 years** in STEP Act.
  - Very broad annual reporting to IRS for trusts in STEP Act.
  - No mention of **partnerships**.
  - **January 1, 2021, effective date in STEP Act.**

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"Bold" Proposals?

- "Fearless before danger," "courageous":
  - Takes on tough policy issues?
- "Brave," "intrepid":
  - Unconcerned about consequences?
- "Unconventional":
  - Looks like a scary new tax?
- "Brash," "impudent," "presumptuous":
  - No thought about details?

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Number Three

Playing with the Unified Credit/Basic Exclusion Amount: Build Back Better Act (H.R. 5376, Sept. 15, 2021); Priority Guidance Plan, Gifts, Estates & Trusts, Item 3 (Sept. 9, 2021) [p. 17]

"Sunset"

- The Ways and Means Committee's original version of the "Build Back Better Act" (H.R. 5376, Sept. 15, 2021) would have accelerated the "sunset" of the doubled basic exclusion amount (enacted in 2017) from January 1, 2026, to January 1, 2022.
- Therefore probably $6,030,000 in 2022 (instead of $12,060,000).
- This was dropped from the Rules Committee's version of October 28, which the House passed on November 19.

Anti-Anti-Clawback Regs.

- Anti-clawback regulations implementing section 2001(g)(2) (in anticipation of sunset) were proposed in November 2018 and finalized in November 2019.
- Preventing clawback after 2026 sunset for gifts made before then.
- Preserving portability elections.
- Warning of future **"anti-abuse" additions to the regulations regarding inclusion under section 2036, etc.**
  - Now in the Treasury-IRS Priority Guidance Plan.

From the Preamble to the Final Regs.

"A commenter [NYSBA Tax Section] recommended consideration of an anti-abuse provision to prevent the application of the special [anti-clawback] rule to transfers … 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. … 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."

[Compare tables on pages 18 and 19.]

Effective Date of the Addition

- Presumably prospective from date the addition to the regulations is finalized.
- But the anti-clawback rules are **estate tax** rules, and "prospective" therefore means the addition could apply to the estates of decedents **dying** after the addition is finalized.
- The addition could – and presumably would – apply to the effects on the estate tax after 2025 of **any gift made after 2017** that results in such an inclusion in the gross estate.

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Number Two

Proposed Increased Income Tax Rates for Trusts and Estates: "Build Back Better Act" (H.R. 5376) [p. 20]

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House-Passed "Build Back Better Act"

- The Ways and Means Committee proposal to restore the 39.6% top income tax rate was dropped.
- But the Committee's 3% "surcharge" was **increased** in the House-passed bill to **5%** at a threshold of $10 million MAGI **($200,000** for trusts and estates) and **8%** over $25 million **($500,000** for trusts and estates).
- And the **3.8%** tax on net investment income would be expanded by eliminating the "trade or business" exception.
- For a combined potential top rate of **48.8%**.

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Number One

Continued Health Challenges [p. 22]

Number One last year too

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COVID-19

- Was viewed as unique last year.
- Was thought to be pulling us together, making us more others-focused.
- Now fatigue, impatience, and the tension between interdependence and autonomy drive us apart.

- But technology has actually enabled more contact in some contexts, such as firms with multiple offices.
- And some have gotten used to being home more.
  - Which is a development to take advantage of in a constructive way.

Continued Professional Challenges

- Lingering long-term concerns about preparing, executing, and storing documents.
- Training, mentoring, and developing teamwork.
  - *E.g.*, it is hard to offer correction in an affirming way without full body language (if virtual) or full facial expression (if in person wearing a mask).
- Same with:
  - Developing trust.
  - Developing advice and estate planning options.
  - Delivering advice and options candidly, sensitively.
  - Detecting and evaluating the responses.

RECAP

1. Continued health challenges
2. Proposed higher tax rates for trusts and estates
3. Playing with the basic exclusion amount
4. Proposed coordination of transfer and income taxes
5. Splitting gifts and bequests: *Smaldino*, *Warne*
6. Control of a donor advised fund: *Fairbairn, Pinkert*
7. Hindsight in valuation: *Estate of Michael Jackson*
8. John Doe summons: *Taylor Lohmeyer Law Firm*
9. Split-dollar life insurance: *Estate of Morrissette*
10. Estate tax closing letters for a $67 user fee