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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2266

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From: Steve Leimberg's Estate Planning Newsletter
Subject: **Ron Aucutt's Top Ten Estate Planning and Estate Tax Developments of 2014**

"It is impossible to complete this list without looking at what everyone is looking at, without talking about what everyone is talking about- the political landscape after the 2014 elections. The election resulted in 54 Republican Senators (a pick-up of 9) and 247 Republicans in the House of Representatives (a pick-up of 14), the largest number of Republicans in the House since Herbert Hoover was President. It is possible that a majority of both the House and the Senate would favor the complete repeal of the estate tax.

In recent years, repeal discussions have been tempered by the fact that many who favored estate tax repeal (mostly Republicans but also some Democrats) appeared reluctant to put the estate tax in play, for fear of losing some of the gains of recent years, including the 40 percent rate and the high exemption indexed annually for inflation. With the Republican gains from the 2014 elections, that may not be as true anymore. Meanwhile, those who favor a more robust estate tax, returning to a variation of 2009 or even 2001 law, simply don't have the votes to gain traction. And while the Obama Administration has called basically for a return to 2009 law, the President has not pushed that. But the President might be inclined to veto a repeal of the estate tax, unless it was packaged with other sufficiently important measures that he favors.

Initial public indications of 2015 Republican priorities have not referred to the estate tax, and the estate tax is not included in the fundamental reform outlines and drafts that have originated largely with outgoing House Ways and Means Committee Chairman Dave Camp (R-MI) and incoming Finance Committee Chairman Orrin Hatch (R-UT), although many Republican leaders in both the House and Senate have voiced their support for repeal. This subject could be the most watched subject within the scope of these Top Ten observations as the congressional leadership forges its agenda in 2015. This commentary sees the odds against estate tax changes in the near future. But if that proves wrong, the subject is very likely to be Number One again in 2015."

In an eagerly anticipated annual tradition, **Ronald Aucutt**, a **McGuireWoods**partner and co-chair of the firm's **Private Wealth Services Group**, shares with**LISI** members his "Top Ten" estate planning and estate tax developments of 2014.

Ronald D. Aucutt is a partner in the Tysons Corner, Virginia office of**McGuireWoods LLP** and is co-chair of the firm's **Private Wealth Services Group**. Ron concentrates on planning and controversy matters involving the estate, gift, and generation-skipping transfer taxes, the income taxation of trusts and estates, and the rules regarding tax-exempt organizations and charitable contributions. He is experienced in resolving tax issues through rulings in the Internal Revenue Service's National Office and in administrative appeals throughout the country. He has contributed to the formation of estate tax policy through legislation since 1976, as well as in Treasury regulations, has served as an expert witness in estate and gift tax matters, and was named in January 2014 to the Internal Revenue Service Advisory Council. Ron is a Fellow and former President (2003-04) of The American College of Trust and Estate Counsel (ACTEC), an academician of The International Academy of Estate and Trust Law and former member of its Council (2000-04), a former Vice Chair (Committee Operations) of the American Bar Association's Section of Taxation (1998-2000), a Fellow of the American College of Tax Counsel and the American Bar Foundation, and a member of the Christian Legal Society. He is also a member of the Advisory Committee of the University of Miami Philip E. Heckerling Institute on Estate Planning, the Editorial Board of Estate Planning, the Board of Advisors of Business Entities, and Tax Management's Advisory Board on Estates,

Gifts, and Trusts. Ron was elected to the National Association of Estate Planners and Councils Estate Planning Hall of Fame and given the designation of Distinguished Accredited Estate Planner in 2009. He was awarded the 1995-1996 Estate Planner of the Year Award by the Washington, D.C. Estate Planning Council.

Before we get to Ron's commentary, members should note that a new **60 Second Planner** by **Bob Keebler** was recently posted to the **LISI** homepage. In his commentary, Bob reports on PLR 201450003, in which the IRS approved the reformation, pursuant to Code section 2055(e)(3), of a trust to a charitable remainder trust. You don't need any special equipment to listen, just click on this link

Now, here is Ron Aucutt's commentary:

COMMENT:

Number Ten: Foreign Account Tax Compliance Act (FATCA) Takes Effect

2014 has been a challenging year for identifying "Top Ten" developments. The usual candidates - significant cases, groundbreaking rulings, important regulations -are hard to find. That, together with a permanent estate tax statutory environment for the first time since 2001, made 2014 a lean year for "recent developments." In the absence of actual developments, much of this summary will address themes, trends, and general climates. But the Foreign Account Tax Compliance Act (FATCA) actually produced an event in 2014. It took effect.

FATCA was enacted as part of the Hiring Incentives to Restore Employment Act (HIRE Act) (Public Law 111-147), signed into law on March 18, 2010. It is codified in sections 1471 through 1474 of the Internal Revenue Code of 1986, as amended ("the Code"). Its purpose is to combat tax evasion by taxpayers with undisclosed foreign financial accounts and other offshore assets, by requiring reporting with respect to those accounts and assets by both U.S. taxpayers and foreign financial institutions, and backing up that requirement by a 30 percent withholding obligation at the source of the income.

Proposed regulations were published on February 15, 2012 (77 Fed. Reg. 9022), numerous public comments were received, a public hearing was held on May 15, 2012, and final regulations were promulgated by T.D. 9610 on January 29, 2013. Withholding on some U.S.-source income payable to foreign financial institutions took effect on July 1, 2014.

Meanwhile, the worldwide commitment to the transparency FATCA encouraged has been strong. According to Announcement 2014-38, 2014-61 I.R.B. 951, as of July 1, 2014, 101 foreign jurisdictions had substantially committed to one of the two model intergovernmental agreements (IGAs) the Treasury Department had promulgated in 2012.

Number Nine: A Cloud over Trust Protectors: SEC v. Wyly, (S.D.N.Y. Sept. 24, 2014)

A case that was not even a tax case became one of the most discussed cases in the fourth quarter of 2014. In a civil enforcement action, a jury convicted two brothers, Samuel and Charles Wyly, of nine counts of federal securities law violations regarding their use of trusts and other entitles in the Isle of Man to trade in the stock of public corporations on whose boards they sat. In this decision, the court imposed the familiar securities law penalty of disgorgement, in the amount of almost $820 million. Included in that sum was an amount calculated with reference to the federal income taxes the Wylys saved when the stock was sold on the theory that the stock was owned and sold by the trusts, not by them. The court found that the trusts were grantor trusts, by reason of the Wylys' ability to control the discretionary actions of the trustees through "trust protectors," who among other things had the power to remove and replace the Isle of Man trustees. The protectors were the Wylys' family attorney, the chief financial officer of the Wylys' family office, and the chief financial officer of another Wyly entity.

The court was struck by the fact that the investment recommendations of the Wylys, passed on by the protectors, appeared to be consistently followed by the trustees. With little or no analysis or elaboration, the court found that

that indicated that the trustees "made no meaningful decisions" and the Wylys themselves "freely directed the distribution of trust assets." The section 674(c) "independent trustee" exception, the court said, did not apply.

It is hard to defend the Wylys, given the facts and jury verdict in this case. And for income tax and estate tax purposes, it would be hard to defend collusion between the grantor and the protectors whereby the grantors had de facto control of the trusts. But it is also unsettling to imply that a court might find such de facto control merely in a record of the trustees' consistent agreement that the grantors' suggestions were good. To be sure, a domestic corporate trustee, for example, could probably be counted on to document its exercise of due diligence in accordance with its published policies, something the trustees in the Wyly case apparently did not do. But the court's open-ended reasoning could leave a cloud over the independence of trustees and other fiduciaries in far more sympathetic cases where grantors understandably choose trusted friends, associates, and advisors as protectors.

Number Eight: Application of the Material Participation Standard to Trusts: Frank Aragona Trust, Paul Aragona, Executive Trustee v. Commissioner, 142 T.C. No. 9 (March 27, 2014)

There is a fascination these days with income tax rates and the step-up in basis of appreciated assets at death. Both are affected by the highest-ever estate tax exemption, which shifts the attention of many to income tax planning and results in a lower overall estate tax cost of including the value of appreciated assets in the gross estate to obtain a stepped-up basis. The basis analysis lends itself to exaggeration and probably has been exaggerated, to the extent it overlooks the fact that some assets will be sold during life, some will not be sold until long after death, and there is obviously more control over the timing of sales than of death in any event.

The focus on income tax rates in general is driven by legislation that took effect in 2013. For 2012, the top income tax rate on trusts and estates was 35 percent for taxable incomes over $11,650. For 2013, under the American Taxpayer Relief Act of 2012, the regular top rate jumped 4.6 percent to 39.6 percent for taxable incomes over $11,950. Also in 2013 the 3.8 percent tax on net investment income under section 1411 enacted by the 2010 health care reconciliation legislation took effect. The result was a total top rate of 43.4 percent - a comparative 24 percent tax increase over the 2012 rate of 35 percent. The level at which those rates apply increased modestly to $12,150 for 2014 and $12,300 in 2015.

The 3.8 percent tax on net investment income seems to have attracted much more attention from estate planners than the 4.6 percent increase in the regular rate. Why is that? Simply because the separate 3.8 percent tax has an optional or voluntary element, driven by the exemption of income from a trade or business that in general, as stated in section 1411(c)(2)(A), is not "a passive activity (within the meaning of section 469) with respect to the taxpayer." Suddenly, section 469, enacted by the Tax Reform Act of 1986 to curb tax shelters, became relevant to estate planners and others using trusts. We rediscovered that section 469(c)(1) generally defines "passive activity" as "the conduct of any trade or business ... in which the taxpayer does not materially participate" and section 469(h)(1) defines material participation as involvement in the operations of the activity on a "regular, continuous, and substantial" basis, but the places for regulations that might have applied those principles to trusts had been merely "reserved" since 1988. Such regulations, under section 469, not exclusively section 1411, are being worked on, to supplement the detailed regulations under section 1411 promulgated in 2013 (including Reg. §1.1141-3 relating to estates and trusts). "Guidance regarding material participation by trusts and estates for purposes of §469" is on the Treasury-IRS 2014-2015 Priority Guidance Plan published August 26, 2014.

How a trust "materially participates" - a distinctly human notion - is a challenge. Mattie K. Carter Trust v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003), held that "common sense" and the notion of the "trust" as the "taxpayer" dictate that "material participation" in the context of a trust be determined with reference to the individuals who conduct the business on behalf of the trust, but that approach seems way too broad and, if applied to individuals, for example, could erode the anti-tax-shelter impact of section 469. In Technical Advice Memorandum 201317010, the IRS took the position that the substantial business activity of a "special trustee" who was also the president of an operating company was attributable to his role as an "employee" and not attributable to his role as trustee and hence to the trust, but that approach seems way too narrow and would frustrate the congressional expectation that "[a]n estate or trust is treated as materially participating in an activity ... if an executor or fiduciary, in his capacity as such, is so participating." S. Rep. No. 99-313, 99th Cong., 2d Sess. 735

(1986). In the view of many observers, the IRS position was tantamount to a refusal to acknowledge that any trust could ever materially participate in a trade or business for purposes of the passive loss rules of section 469.

That appears to have been essentially the IRS position in Aragona, and the Tax Court (Judge Morrison) rejected that position. The court held that a trust operating a real estate business could avoid the per se characterization of a real estate business as passive under section 469(c)(2), as could a natural person, if, as provided in section 469(c)(7)(B), "(i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates." The court also held that the trust in this case materially participated in the business because some of its cotrustees materially participated to the extent required by section 469(c)(7)(B). Therefore, the trust could fully deduct its expenses, including trustee fees.

Echoing Technical Advice Memorandum 201317010, the IRS had argued that the activities of trustees who were also employees of the business could be treated only as the activities of employees and not the activities of trustees. The court rejected that notion in part because "[t]he trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another, i.e., a beneficiary."

The Aragona decision does not predict how the pending guidance will apply to every case under section 469 and thus under 1411. But this decision should encourage the IRS to find a balanced outcome that avoids both the nothing-works implication of its historical position and the anything-goes permissiveness of the district court in Mattie Carter.

Number Seven: IRS Problems with Image and with Congress

The tax collector is rarely popular. In addition, some have a vision of tax policy enamored with proposals like a value-added tax or a so-called "fair tax," or even a vision of government that includes a diminished role for the IRS. The IRS enraged and emboldened its critics when in May 2013 its employee Lois Lerner publicly admitted to having given harsher or slower handling to the applications for recognition of exemption of some section 501(c)(4) "social welfare" organizations whose names suggested conservative-leaning political agendas. Even in the calm of hindsight, it seems likely that some mishandling occurred that has not been fully acknowledged or explained, likely even skewed by the political biases of some IRS personnel. But the specter of a wide-ranging conspiracy orchestrated at the highest levels of government also seems unlikely. In a world of intense political polarization, however, the inability of those at the poles to accept the possibility that the truth may lie somewhere in between is not surprising.

The most strident IRS critics in Congress did not need encouragement to be critical, of course. The 501(c)(4) "scandal" did not make them skeptics. But it provided an irresistible occasion for expressing that skepticism, and thus an irresistible occasion for all polar views to be loudly heard. And one of the tangible effects has been perhaps even more aggressive reductions of the IRS budget. After all, who wants to give more money to finance more misconduct? The bold notion of the IRS as a profit center is lost in the rhetoric. In fact, the IRS's return-on-investment is over 200:1, while it estimates that every one dollar taken away from its enforcement budget reduces its collections by as much as seven dollars.

The fiscal 2015 IRS funding in the omnibus appropriation legislation approved by Congress in mid-December is not as austere as the Financial Services and General Government Appropriations Act (H.R. 5016) the House of Representatives passed on July 16, 2014. But it still reduces the IRS budget for fiscal 2015, compared to fiscal 2014, by about 3 percent, and the slightly less than $11 billion approved in December is $1.5 billion less than the IRS and the Administration requested. To be sure, the IRS request represented a significant increase over last year's funding, but that was in large part an attempt to make up for substantial reductions in both services and enforcement caused by funding cuts in recent years.

The damage to the administration of the tax system and the public interest from underfunding the IRS, while not

always intuitive, is grim. Personnel attrition is up, especially at senior levels, while hiring is down. Meanwhile, the IRS training budget has been reduced by 85 percent since fiscal 2009. While many of us tax lawyers frequently find ourselves facing the IRS as an adversary in a tax controversy, and in that context we want the IRS to "lose," there are no winners from dramatically reduced training that reduces the likelihood that our IRS counterparts will be up-to-date on the law and purposes and effects of common practices and techniques. The result is that audits take longer, are less satisfying, and leave less time for consideration by the Office of Appeals, while the same limitations apply at Appeals as well. Comparable sacrifices on the service side are also well documented, with longer waits for phone calls to be answered and more phone calls going unanswered altogether.

This degrading of both enforcement and service inevitably erodes public confidence and fosters the perception that tax collection is unfair or even arbitrary. That in turn creates frustration and cynicism that translates into complaints to members of Congress and more political pressure to punish the IRS by reducing its budget still further. In the long term, this vicious circle has the potential to be as significant as any case or ruling we have seen.

Number Six: Final Section 67(e) Regulations (2 Percent Floor for Trusts): Reg. §1.67-4, T.D. 9664, 79 Fed. Reg. 26616-20 (May 9, 2014)

On May 8, 2014, the IRS released Reg. §1.67-4, providing guidance in identifying the costs or expenses incurred by estates and non-grantor trusts that are not subject to the 2 percent floor for miscellaneous itemized deductions under section 67 because they are "costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate," as provided in section 67(e)(1). By an amendment dated July 17, 2014, the effective date of these regulations was changed from May 9, 2014, to January 1, 2015.

The regulations follow a string of IRS victories in cases subjecting the investment advice costs of trusts to the 2 percent floor. Mellon Bank v. United States, 265 F.3d 1275 (Fed. Cir. 2001); Scott v. United States, 328 F.3d 132 (4th Cir. 2003); William L. Rudkin Testamentary Trust v. Commissioner, 467 F.3d 149 (2d Cir. 2006), aff'd sub nom Michael J. Knight, Trustee v. Commissioner, 552 U.S. 181 (2008). The final regulations make only a few changes to the proposed regulations published in 2011.

Not surprisingly, the regulations (Reg. §1.67-4(b)(5) & (6)) exempt from the 2 percent floor uniquely fiduciary expenses, such as for probate court fees and costs, fiduciary bond premiums, costs of legal publication of notices to creditors and heirs, costs related to fiduciary accounts, and appraisals needed to complete a tax return or to make distributions. Similarly, the regulations (Reg. §1.67-4(b)(3)) exempt the costs of preparing specified tax returns - namely estate and GST tax returns, fiduciary income tax returns, and the decedent's final income tax returns.

Costs that the regulations make subject to the 2 percent floor include "ownership costs" that in effect are in rem costs that follow the asset (Reg. §1.67-4(b)(2)), the costs of preparing all tax returns other than those specified (Reg. §1.67-4(b)(3)), and of course the regular costs of investment advice (Reg. §1.67-4(b)(4)).

"Bundled" or unitary fiduciary fees must be allocated between costs that are covered (that is, subject to the 2 percent floor unless de minimis) and those that are not covered, in one of two ways. The allocation must be done on a strict tracing basis if the fiduciary pays covered expenses to a third party or charges an extra fee with respect to covered costs (such as "ownership costs")(Reg. §1.67-4(c)(3) & (4)) or if the fiduciary fee is calculated on the basis of an hourly rate (Reg. §1.67-4(c)(2)). Otherwise, only investment advice subject to the 2 percent floor must be separated out, or "unbundled" (Reg. §1.67-4(c)(2)), and that may be done by "[a]ny reasonable method" (Reg. §1.67-4(c)(4)). The regulations (Reg. §1.67-4(c)(1)) also contemplate exceptions to unbundling "to the extent provided ... by guidance published in the Internal Revenue Bulletin," thus allowing the IRS to prescribe safe harbors and other exceptions without the formality of regulations (and ultimately that may be where the real law is made).

Initially, Reg. §1.67-4(d) would have applied "to taxable years beginning on or after May 9, 2014." That is, the regulations would have immediately applied to an irrevocable non-grantor trust created on or after May 9, 2014, and to the estate of an individual who died on or after May 9, 2014. In addition, the regulations would have applied prior to January 1, 2015, to an existing fiscal-year estate with a taxable year beginning between May 9, 2014, and

January 1, 2015. But as for existing trusts with calendar years, the typical case the writers of the regulations must have had in mind, the regulations would have taken effect exactly on January 1, 2015. Upon publication of those final regulations, the American Bankers Association and 14 state bankers associations requested a delay in the application of the regulations so their members could properly develop procedures to comply with the regulations, particularly procedures to unbundle their fiduciary fees in compliance with the regulations. By an amendment released as T.D. 9664 on July 16, 2014, the writers of the regulations agreed and changed the effective date to apply to taxable years beginning on or after January 1, 2015.

The story of these regulations is the story of mistakes. It would be one more mistake, however, not to disclose that I was counsel for the taxpayer in Scott, one of the IRS victories that led up to these regulations, and readers should judge the objectivity of the following remarks with that in view.

In hindsight, it may have been a mistake that the House-Senate conferees on the Tax Reform Act of 1986 added the words "would not have been incurred if the property were not held in such trust or estate," now found in the second clause of section 67(e)(1), without explaining what they intended those words to mean. Then the courts that decided the cases in the context of expenses for investment advice made the mistake of failing to reach an interpretation of those words that would serve the simplification objectives of the statute. This, however, was the most forgivable mistake, because such an interpretation, while it would fit the framework and theme of the statute, would be subtle and complex, not a result judges like, and Congress had said nothing to help the courts.

Then there is the anomaly that after working on this regulations project at least since 2006 (when it first appeared on the Treasury-IRS Priority Guidance Plan), the drafters, who apparently intended a January 1, 2015, effective date by the use of the words "taxable years beginning on or after," overlooked common exceptions like fiscal-year estates and new estates and trusts. But this was quickly corrected and proved harmless in the long run.

As I have pointed out to the IRS in public comments on the proposed regulations, it was significant that the Supreme Court's Knight opinion found that its determination "may not be as easy in other cases, particularly *given the absence of regulatory guidance*, and that "Congress's decision to phrase the pertinent inquiry in terms of a prediction about a hypothetical situation inevitably entails some uncertainty." 552 U.S. at 194. Under the Supreme Court's jurisprudence of deference to regulations (see Mayo Foundation for Medical Education and Research v. United States, 562 U.S. 44 (2011)), this uncertainty in the absence of regulations would have permitted Treasury to find that administration expenses of a multi-beneficiary trust, other than perhaps the in rem expenses that follow the asset, were exempt from the 2 percent floor. Surely the drafters of the regulations were well aware of that option and their power to achieve it, unlike the courts. But Treasury and the IRS chose to trade that simple solution for a regime of incredible complexity, including unbundling, all under the flag of a statute originally conceived to relieve "significant complexity" and "extensive recordkeeping with regard to what commonly are small expenditures" (H.R. Rep. No. 99426, 99th Cong., 1st Sess. 109 (1985)), an obligation a fiduciary would have in any event.

Apparently the way this came about was that the regulations were drafted with an inexplicable compulsion to follow the case law. This was true of proposed regulations published in 2007 when the Second Circuit's Rudkin opinion was the most recent word, and it was true again of the new proposed regulations published in 2011 that followed Knight. The drafters refused what was virtually an invitation from the Supreme Court to provide "regulatory guidance" to the courts and instead crafted a codification of the cases that just happened to have been litigated. Thus, for example, only investment advice was the subject of the litigated cases, and only investment advice is subject to unbundling under the regulations in the absence of an hourly rate or a discrete third-party payment or incremental cost. Even the use of the expression "investment advice" in the context of a bundled fee where the fiduciary in effect is imagined to give "advice" to itself is hard to explain except with reference to the factual patterns of the cases. By deferring to the judges who were eager to defer to them, the drafters missed the opportunity to lead.

That, being most avoidable, was the chief mistake.

Number Five: Struggles of States with Tax Revenue and Uniformity

The federal credit for state death taxes, still set forth in section 2011 but not applicable since 2004 under section 2011(f), was not changed from 1926 to 2001. Initially simply 80 percent of the gross federal tax (which explains why the rates in section 2011(b) increase in increments of 0.8 percent), it was isolated from the increases in federal rates enacted during World War II and in 1954 was codified into its own independent table in section 2011(b). Throughout this remarkable 75-year period of stability, states were encouraged by their own citizens to conform, couple, or tie their death taxes to merely "soak up" the amount of the federal credit, thereby maximizing their own revenue without any incremental burden to their own citizens. Almost all states did so, with New York's legislation, tying its tax to the federal credit in effect in 1998, being the last before the phase-out of the federal credit enacted by Congress in 2001.

The 2001 Tax Act notoriously changed that landscape, and chaotic diversity among states ensued. Rates, exemptions (applicable exclusion/credit), QTIP elections, and the deduction for the state tax itself (the "circular calculation") were among the differences from state to state, not to mention the large number of states that remained "coupled" to the terminated federal credit and hence had no tax. Slowly, states have embarked on a new century of conforming. In 2014, we heard from New York, Maryland, Rhode Island, and Minnesota.

New York and Maryland increased their exemptions on a phased basis until 2019, when they will be equal to the federal exemption, but New York's exemption will be phased out for estates between 100 and 105 percent of the exemption amount. New York also added a New York-only QTIP election, added a provision for inclusion of gifts made between April 1, 2014, and January 1, 2019, if made within three years of death, and repealed the New York GST tax. Rhode Island increased its exemption from $921,655 to $1.5 million, indexed for inflation, and Minnesota increased its exemption in increments to $2 million by 2018- modest but in the right direction. Minnesota also retroactively repealed the gift tax it enacted in 2013. Meanwhile, the District of Columbia Council has passed legislation, currently under congressional review, to possibly increase its exemption to $2 million in 2016 and then to equal the federal exemption in 2018, but all subject to achieving revenue targets.

Despite the trend of this 2014 legislation and that of previous years, of course, there will never be the kind of estate tax uniformity there was before 2002, because in the absence of a state death tax credit a state's estate tax will always be an incremental burden on its citizens.

New York was also busy in 2014 on the income tax front, seeking to limit the loss of revenue from trusts that migrate out of New York or are created in other states by New York residents. For a trust with no New York trustees, no New York tangible personal property or real estate, and no New York source income, and thus exempt from New York income tax, there will now be a "throwback tax" (like California's) on income accumulated free of New York tax when it is later distributed to a New York resident beneficiary. And beginning in 2014 "incomplete gift non-grantor trusts" (e.g., "DING trusts" in Delaware and "NING trusts" in Nevada) created by New York residents will be deemed to be "grantor trusts" for New York income tax purposes, which will include the trust income in the New York grantor's income whether the income is distributed to the grantor or accumulated. These New York changes are the opposite of seeking conformity, bucking a recent trend of limiting a state's power to tax nonresident trusts. See Linn v. Department of Revenue, 2013 Ill. App. 4th 121055 (Dec. 18, 2013); Residuary Trust A v. Director, 27 N.J. Tax. 68 (N.J. Tax ct. 2013); McNeil v. Commonwealth of Pennsylvania, Pa. Comm. Court, No. 651 F.R. 2010, 173 F.R. 2011 (May 24, 2013).

Number Four: Continued Wave of Domestic Asset Protection Trust Statutes: Mississippi Qualified Disposition in Trust Act, Codified at Miss. Code §91-9-701 et seq.

Effective July 1, 2014, the Mississippi Qualified Disposition in Trust Act made Mississippi about the 15th state that permits a grantor to create an irrevocable trust, be a discretionary beneficiary of the trust, and receive spendthrift protection from creditors. Mississippi joins Alaska, Delaware, Hawaii, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, Wyoming, and to some extent Colorado in offering this type of protection.

A unique feature of the Mississippi Act is that before the transfer to the trust the grantor must have in place a general liability insurance policy and, if applicable, a professional liability policy with policy limits of at least $1

million for each policy. This might make Mississippi a less attractive jurisdiction than some of the other states. Indeed, it has even been suggested that the possible loss of protection against creditors if the insurance lapses may prevent a transfer to the Mississippi trust from being a completed gift. Other disadvantages of Mississippi compared to some other states include its common law Rule Against Perpetuities and its state income tax.

Probably neither the addition of Mississippi as a state with a domestic asset protection trust statute nor the fact that it is the 15th such state is really enough to call such legislation a "wave." But there have recently been such additions almost annually and no significant opposition or objection has appeared. It is true that asset protection trusts with "bad facts" have not fared well in the courts and that we are still waiting for the first case to affirm their use. But for those who have been waiting for a Full Faith and Credit showdown, in which a resident's use of the statute of another state is challenged as offensive to the public policy of the state of residence, each additional state with arguably the same policy makes that less likely. Not only is the body of statutory law affirming domestic asset protection trusts growing, but the universe of states in which such statutes could be challenged as offensive to public policy is shrinking.

Number Three: Sweeping IRS Attacks on Time-Honored Techniques: Estate of Donald Woelbing v. Commissioner (Tax Court Docket No. 30261-13, petition filed Dec. 26, 2013) and Estate of Marion Woelbing v. Commissioner (Tax Court Docket No. 30260-13, petition filed Dec. 26, 2013); Estate of Jack Williams v. Commissioner (Tax Court Docket No. 29735-13, petition filed Dec. 19, 2013)

Woelbing. In these two docketed cases widely discussed in 2014, the Tax Court has been asked to consider a sale by Donald Woelbing, who owned the majority of the voting and nonvoting stock of Carma Laboratories, Inc., of Franklin, Wisconsin, the maker of Carmex skin care products.

According to the Tax Court petitions, Mr. Woelbing sold all of his Carma nonvoting stock in 2006 to a grantor trust in exchange for an interest-bearing promissory note in the amount of $59 million, the fair market value of the stock determined by independent appraiser. The installment sale agreement provided that if the value of a share of stock were determined to be higher or lower than that set forth in the appraisal, whether by the Internal Revenue Service or a court, then the number of shares of stock purchased would automatically adjust so that the fair market value of the stock purchased equaled the amount of the note. The trust's financial capability to repay the promissory note without using the stock itself or its proceeds exceeded 10 percent of the face value of the promissory note, including three life insurance policies on Mr. and Mrs. Woelbing's lives that were the subject of a split-dollar insurance arrangement with the company. The policies had an aggregate cash value of about $12.6 million, which could be pledged as collateral for a loan or directly accessed through a policy loan or the surrender of paid-up additions to the policies. At the time of the sale transaction, two sons of the Woelbings executed personal guarantees in the amount of 10 percent of the purchase price.

Mr. Woelbing died in 2009, and the IRS challenged the 2006 sale in connection with its audit of his estate tax return. The IRS basically ignored the note, doubled the value of the stock at the time of the gift to $117 million, again increased the value of the stock at the time of Mr. Woelbing's death to $162 million and included that value in his gross estate, and asserted gift and estate tax negligence and substantial underpayment penalties. For gift tax purposes, the notices of deficiency asserted that the entire value of the stock was a gift at the time of the sale, either because section 2702 applied to ignore the note or because the note in fact had no value anyway. For estate tax purposes, the IRS asserted that Mr. Woelbing retained for his life the possession or enjoyment of the stock or the right to designate the persons who shall possess or enjoy the stock under section 2036 and the right to alter, amend, revoke, or terminate the enjoyment of the stock under section 2038.

Thus, besides simple valuation, the Tax Court might be obliged to address the adjustment clause, the possible reliance on the life insurance policies and guarantees to provide "equity" in the trust to support the purchase, and the applications of section 2702 to the sale and sections 2036 and 2038 after the sale.

Williams. Similarly, in Williams the IRS challenged a partnership owning real estate and business and investment assets with a wide variety of arguments, including disregarding the existence of the partnership and treating transfers to the partnership as a testamentary transaction at the decedent's death, undervaluation of the partnership

assets, lack of a valid business purpose or economic substance for the partnership, the decedent's retained enjoyment of the partnership assets, restrictions on the right to use or sell the partnership interest ignored under section 2703(a), liquidation restrictions ignored under sections 2703, 2704(a), and 2704(b), and any lapse of voting or liquidation rights in the partnership treated as a transfer under section 2704(a).

Comment. The everything-but-the-kitchen-sink approach reflected in these late-2013 Tax Court petitions, especially the Woelbing petitions, has chilled transactions that had been commonplace in estate planning, including installment sales to grantor trusts. Recent Administration proposals for legislation to reduce the benefits of sales to grantor trusts, even though they may not gain traction in Congress, serve to reinforce the perception of increased animus toward these transactions.

This comes as IRS review of gift tax returns filed for 2012 is hitting top speed. Most of those gift tax returns will be entering the third year of the three-year statute of limitations in 2015. With the lifetime gift tax exemption of $5.12 million headed for a return to $1 million if Congress failed to act, we know that many of these 2012 gifts were large, leveraged, imaginative, often done in haste, often accompanied with some form of defined value provision, and sometimes edging close to the boundaries of the reciprocal trust doctrine in the case of married donors. The public discussions of the 2012 gift tax landscape were interesting. The gift structures and related transactions we heard discussed were interesting. The gift tax returns -nearly 370,000 of them according to IRS statistics- must be interesting- the last thing we want a tax return to be. It is very possible that 2015 will bring word of more aggressive audits and that 2016 will see Tax Court petitions for which the Woelbing and Williams petitions were just a warm-up.

Number Two: Valuation Under Scrutiny and Suspense: Estate of Elkins v. Commissioner, 767 F.3d 443 (5th Cir. 2014), aff'g in part and rev'g in part 140 T.C. 86 (2013); Estate of Natalie B. Giustina v. Commissioner, No. 12-71747 (5th Cir. Dec. 5, 2014), rev'g and rem'g T.C. Memo 2011-141

Elkins. The Tax Court decided Estate of Elkins v. Commissioner on March 11, 2013, but it did not make last year's Top Ten. On September 15, 2014, the Court of Appeals for the Fifth Circuit technically affirmed in part and reversed in part, but largely reversed. Maybe it's the slow year, but now it's gotten interesting.

The case involved a family that co-owned valuable artwork subject to a cotenancy agreement that required unanimous consent to sell any of the artwork and waived each cotenant's unilateral right to partition. On the decedent's estate tax return, the executors claimed a 44.75 percent discount reflecting the lack of marketability under the cotenancy agreement, and the time and expense of a partition action even if the agreement were unenforceable. In the Tax Court litigation, the estate claimed a valuation discount of nearly 67 percent, based on the views of art experts that no one would want a partial interest in the art without a very substantial discount.

The Tax Court (Judge Halpern) held that section 2703(a)(2) required that the restrictions on partitioning in the cotenancy agreement be disregarded. The executors had argued that the cotenancy agreement restricted the sale of each item of art, but did not restrict the sale of fractional interests owned by the cotenants, and thus should not be subject to section 2703(a). The court concluded that the cotenancy agreement had the effect of waiving the right of partition, and as such was a restriction "on the right to sell or use ... property" within the meaning of section 2703(a)(2). Nevertheless, the court rejected the IRS assertion that there should be no discount and held that a 10 percent discount was available to reflect the lessened marketability of a tenancy-in common interest in art. But it viewed the discounts claimed by the executors as unrealistically high because it viewed it as "false or at least highly dubious" that the Elkins children would endure such economic loss just to stand by the cotenancy agreement.

The Court of Appeals for the Fifth Circuit reversed and rendered, ordering a refund of $14.4 million plus interest. It agreed with the Tax Court's rejection of the IRS's "no discount" position and emphasized that the IRS offered no evidence of the proper amount of discount if any discount is allowed. With regard to the estate's evidence of discounts at trial, larger than the discounts on the estate tax return, the court stated that "[w]e repeat for emphasis that the Estate's uncontradicted, unimpeached, and eminently credible evidence in support of its proffered fractional-ownership discounts is not just a 'preponderance' of such evidence; it is the only such evidence." The

court repudiated the Tax Court's assumption about the Elkins children, stating:

> It is principally within the last few pages of its opinion that the Tax Court's reversible error lies. While continuing to advocate the willing buyer/willing seller test that controls this case, the Tax Court inexplicably veers off course, focusing almost exclusively on its perception of the role of "the Elkins children" as owners of the remaining fractional interests in the works of art and giving short shrift to the time and expense that a successful willing buyer would face in litigating the restraints on alienation and possession and otherwise outwaiting those particular co-owners. Moreover the Elkins heirs are neither *hypothetical* willing buyers nor *hypothetical* willing sellers, any more than the Estate is deemed to be the hypothetical willing seller.

In a footnote, the court suggested that it was not concerned with the fact that the estate tax return had employed a smaller discount, because "the IRS disallowed that discount." It did not mention section 2703.

Giustina. The Tax Court decision in Estate of Giustina v. Commissioner was featured in Number Seven in the 2011 Top Ten. Judge Morrison had valued a 41.128 percent limited partnership interest in a partnership conducting forestry operations by giving a 75 percent weight to a value of $52 million determined by a cash flow (going concern) method and a 25 percent weight to a value of $151 million determined by an asset value method. The court did this even though there was no evidence that a sale or liquidation was anticipated and, indeed, as the court summarized, "[t]he Giustina family had a long history of acquiring and retaining timberlands." The court assumed that although the owner of a 41.128 percent limited partnership interest "could not alone cause the partnership to sell the timberlands," it could join with other limited partners to compile the two-thirds vote necessary to replace the general partners or to dissolve the partnership.

In a brief unpublished memorandum opinion on December 5, 2014, the Court of Appeals for the Ninth Circuit reversed and remanded to the Tax Court "to recalculate the value of the Estate based on the partnership's value as a going concern." Rejecting the 25 percent probability of a liquidation that would justify an asset value approach to valuation, the court stated:

> In order for liquidation to occur, we must assume that (1) a hypothetical buyer would somehow obtain admission as a limited partner from the general partners, who have repeatedly emphasized the importance that they place upon continued operation of the partnership; (2) the buyer would then turn around and seek dissolution of the partnership or removal of the general partners who just approved his admission to the partnership; and (3) the buyer would manage to convince at least two (or possibly more) other limited partners to go along, despite the fact that "no limited partner ever asked or ever discussed the sale of an interest." Alternatively, we must assume that the existing limited partners, or their heirs or assigns, owning two-thirds of the partnership, would seek dissolution. We conclude that it was clear error to assign a 25% likelihood to these hypothetical events. As in Estate of Simplot v. Commissioner, 249 F.3d 1191, 1195 (9th Cir. 2001), the Tax Court engaged in "imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect" with the existing partners.

Simply changing the numbers in the section of the Tax Court opinion entitled "Value of the 41.128-Percent Limited Partner Interest" suggests that the reduction in value of the gross estate ordered by the Ninth Circuit will be about $11.5 million. The Ninth Circuit also found fault with the Tax Court's decision to cut in half the estate's expert's proffered company-specific risk premium, but left the door open slightly for the Tax Court to confirm its initial finding if it explained better.

The discussion of Giustina and another case in Number Seven in the 2011 Top Ten concluded by stating: "Together these cases illustrate that, probably on a judge-specific basis, an executor or donor who takes an estate or gift tax valuation case to the Tax Court, even involving an interest in an active business, can be in for a tedious and unpredictable time." Indeed. This case now goes back to Judge Morrison for recalculation by a going concern method. Meanwhile, August 13, 2015, will be the tenth anniversary of Mr. Giustina's death.

Comment. What is striking about these two cases is not as much that the courts of appeals reversed the Tax Court,

or even that the Fifth Circuit and the Ninth Circuit are otherwise viewed as quite different in their friendliness to taxpayers. It is the way these opinions demolish these Tax Court judges' efforts to find a compromise result in the face of what may have been a very muddled record. The appellate courts treat the Tax Court judges as if they were making stuff up. The Tax Court, as the Fifth Circuit says, "inexplicably veers off course," or, as the Ninth Circuit put it, "engaged in 'imaginary scenarios.'" Harsh rebukes.

Regarding the appellate courts' concerns that the Tax Court had no evidence on which to base its conclusions, the clear implication is that the IRS is going to have to do more than just attack the taxpayer's witnesses; it will have to offer expert testimony of its own. Of course, as noted previously (in Number Seven), the IRS budget is being cut. But the stakes in these cases show why, as estate planners often remind their clients, the cost of a thorough competent appraisal is almost always justified. The refund in Elkins is about $14.4 million and the reduction in the gross estate in Giustina is about $11.5 million.

The principal issue in Giustina was the valuation of a family timber business; discounts were a much less prominent issue. Discounts were the only issue in Elkins; the undiscounted value of the art was stipulated. A discussion of even these disparate valuation cases, however, brings to mind the fact that valuation discounts, like sales to grantor trusts, have been on Treasury's radar screen for some time.

The Obama Administration's first four General Explanations of the revenue measures accompanying its budget proposals ("Greenbooks") included a proposal to "Modify Rules on Valuation Discounts" by bulking up Treasury's authority to promulgate "disregarded restrictions" that would be ignored in valuing interests in entities. That proposal was dropped from the 2013 and 2014 Greenbooks. Since 2003, the Treasury-IRS Priority Guidance Plan has included a project to prepare "Regulations under §2704 [presumably §2704(b)(4)] regarding restrictions on the liquidation of an interest in certain corporations and partnerships."

That project has not been dropped, although other projects - decanting, charitable remainder trust forms, and private trust companies - have recently been dropped from the Plan. That fuels speculation about what Treasury is up to. Does dropping valuation from the Greenbooks indicate that Treasury has given up on the subject? Or does it mean that it has merely dropped the idea of expanding its statutory authority and will concentrate on completing the regulations project on the Priority Guidance Plan that it did not drop? Indeed, the very fine-tuned revenue estimates in the Greenbooks that contained this subject- expressed to the nearest million dollars over ten years with variations (downward) from year to year of $371 million, $501 million, and $87 million- could be viewed as clues that the desired regulations are already drafted or at least very tightly outlined. And that means that the release of the proposed regulations could be soon (although the same thing could have been said, and has been said, since 2003).

The most recent ten-year revenue estimate, in the 2012 Greenbook, was $18.079 billion, or $1.8 billion per year, or $4.5 billion of value taxed at a 40 percent rate. For rough comparison purposes, in 2012, the last year for which statistics are available, there were about 9,400 estate tax returns filed and about $8.5 billion of tax reported. On that basis, the proposal would increase estate tax revenues by about 21 percent or about $190,000 per return. These numbers are unreliable because they compare estimates for future years derived from the Treasury economists' models with actual numbers from 2012, and they ignore gift tax returns. But, as far as they go, they portray a significant, but not staggering revenue effect. And regulations issued without the expanded legislative authority requested in the Greenbooks might have a lesser effect.

Again in the context of having just read about valuation cases, one must wonder if clearer and more objective rules in regulations would produce a more efficient and maybe even less expensive estate and gift tax return preparation and audit experience than the seemingly haphazard outcomes of the published cases. The results could be even more satisfying if, as the Greenbook descriptions stated, the contemplated regulations would "create safe harbors to permit taxpayers to draft the governing documents of a family-controlled entity so as to avoid the application of section 2704 if certain standards are met" and "make conforming clarifications with regard to the interaction of this proposal with the transfer tax marital and charitable deductions." The latter reference appears to contemplate overriding the harsh "reverse-Chenoweth" result seen in Technical Advice Memoranda 9050004 and 9403005 (wherein all stock owned by the decedent is valued as a control block in the gross estate, but the marital bequest is valued separately as a minority block for purposes of the marital deduction), relying on Estate of Chenoweth v.

Commissioner, 88 T.C. 1577 (1987). Such a result would reinforce the fairness of the proposal and should be very welcome. Only regulations refined through a public comment process, not case law, can produce such holistic and evenhanded outcomes.

On the other hand, if new valuation regulations reflect no more courage and imagination than the section 67(e) regulations previously described (Number Six) and, like those regulations, attempt only to codify, not influence, case law, then they could be very disappointing indeed.

Number One: Renewed Talk of Repeal of the Estate Tax and Speculation about What the Republican Congress Will Do

It is impossible to complete this list without looking at what everyone is looking at, without talking about what everyone is talking about- the political landscape after the 2014 elections. The election resulted in 54 Republican Senators (a pick-up of 9) and 247 Republicans in the House of Representatives (a pick-up of 14), the largest number of Republicans in the House since Herbert Hoover was President. It is possible that a majority of both the House and the Senate would favor the complete repeal of the estate tax.

In recent years, repeal discussions have been tempered by the fact that many who favored estate tax repeal (mostly Republicans but also some Democrats) appeared reluctant to put the estate tax in play, for fear of losing some of the gains of recent years, including the 40 percent rate and the high exemption indexed annually for inflation. With the Republican gains from the 2014 elections, that may not be as true anymore. Meanwhile, those who favor a more robust estate tax, returning to a variation of 2009 or even 2001 law, simply don't have the votes to gain traction. And while the Obama Administration has called basically for a return to 2009 law, the President has not pushed that. But the President might be inclined to veto a repeal of the estate tax, unless it was packaged with other sufficiently important measures that he favors.

Initial public indications of 2015 Republican priorities have not referred to the estate tax, and the estate tax is not included in the fundamental reform outlines and drafts that have originated largely with outgoing House Ways and Means Committee Chairman Dave Camp (R-MI) and incoming Finance Committee Chairman Orrin Hatch (R-UT), although many Republican leaders in both the House and Senate have voiced their support for repeal. This subject could be the most watched subject within the scope of these Top Ten observations as the congressional leadership forges its agenda in 2015. This commentary sees the odds against estate tax changes in the near future. But if that proves wrong, the subject is very likely to be Number One again in 2015.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Ron Aucutt

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