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QUARTERLY TAX UPDATE

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A sampling of recent tax developments, provided by an advisor, for advisors.

LEGISLATION AND TREASURY REGULATIONS

Tax Reform. As of going to press, there has not been a release of actual proposed legislation to debate and digest. The only official progress so far has been moving from President Trump's one-page summary of goals for changing the tax laws, issued last spring, to the roughly eight-page "Unified Framework for Fixing our Broken Tax Code", released last month by the Republican leaders of Congress and the Administration. Both were issued to a great degree of self-generated fanfare, relative to the actual substance of the documents. That would indicate it should be quite a show when the House Ways and Means Committee releases an actual draft of the legislation.

The federal budget for the 2017-2018 fiscal year must first be completed and agreed to by both the House and Senate. The Senate has now passed a budget, and breaking news is the House has adopted, by a very narrow vote losing some Republican members, the Senate budget version in its current form, thereby lessening the procedures and time needed to move forward with tax legislation. Ways and Means Chairman Brady intends to release a draft of the tax reform bill by November 1. Republican leaders are publicly committed to a New Year's Eve deadline for enactment of the tax reform law. It recalls the situation in 2012 when Congress and Vice President Biden spent New Year's Day negotiating the "fiscal cliff" legislation. Keep C-Span on your dial, seeking out other entertainment for New Year's Eve festivities might not be needed this year.

Section 2704(b) Regulations. Treasury Secretary Mnuchin recently issued his "Second Report to the President on Identifying and Reducing Tax Regulatory Burdens" This report was made necessary by President's Executive Order 13789 issued earlier in 2017, requiring Treasury to review all regulations issued by the Obama Administration after January 1, 2016 to determine if any of them imposed undue financial burden on U.S. taxpayers, increased complexity, or exceeded regulatory authority. In an interim report issued in June, Secretary Mnuchin identified eight sets of regulations in need of further study under these parameters.

The Second Report involves several tax regulation packages, but of particular interest to estate planners is the decision to rescind the proposed regulations under Section 2704(b), issued in 2016. The regulations attempted to impose new requirements on the ability to recognize well-known valuation discounts, such as lack of marketable interest or lack of control for minority shares, where there are transfers of ownership interests in family controlled entities. There had been uncertainty as to whether the regulations would be re-issued in final form as is, or revised substantially, following a high volume of public commentary critical of the regulations. Many thought that valuation discounts would become unavailable for estate and gift tax purposes.

With the decision by Treasury to withdraw the proposed 2704(b) regulations, taxpayers will continue to apply pre-existing law on determining and recognizing valuation discounts when transferring interests in family controlled entities by death, gift, sale or otherwise.

COURT CASES

RERI Holdings I LLC v. Commissioner, 149 T.C. No. 1 (7/3/2017). The case involved a large income tax charitable deduction recognized by the LLC taxpayer on the assignment to the University of Michigan of an interest in another LLC holding a real estate interest. The court case did not go well for the taxpayer or its members. It is a continuation of litigation between the taxpayer and the IRS going back to a couple of 2014 opinions, *RERI Holdings I, LLC v. Commissioner*, T.C. Memo. 2014-99 (5/22/2014); *RERI Holdings, I, LLC v. Commissioner*, 143 T.C. No. 3 (8/11/2014), both of which were rulings on summary judgment motions. The latest opinion is a full review of the case after development of facts and testimony.

The subject real estate has been land and a web hosting special purpose building in California, leased by AT&T. The long term lease was to end in 2015 with AT&T holding successive renewal options. A series of tiered LLCs held ownership of the underlying property. In early 2002, prior to RERI coming on the scene, there were transactions by Red Sea Tech I that split RS Hawthorne Holdings, LLC (the real estate LLC) into a term of years interest (TOYI) set to expire on December 31, 2020 after the first AT&T lease renewal, and a successor member interest (SMI). In March 2002, RERI acquired from Red Sea, for about $3 million, its SMI in Hawthorne Holdings. Piecing it all together, the SMI was a potentially valuable ownership interest in a real estate LLC that held a property that may or may not in the future be of high value, depending on AT&T's lease renewal or alternative uses of the special purpose building.

On August 27, 2003, RERI assigned the SMI to the University of Michigan as a charitable contribution. An appraisal of the fee interest in the real property came back with a value of $55 million. The appraiser than used IRS actuarial tables and rates under Code Section 7520. This led to a value of the SMI, after reduction for the value of the term of years interest, of $33 million. RERI filed Form 8283 with its 2003 income tax return,

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claiming a charitable deduction in the amount of $33 million for the remainder interest. The Form 8283 as filed did not contain an entry in the space for the taxpayer's basis in the donated property.

In the end, there was a great deal of discussion in the Tax Court opinion about the approaches used by the appraisers on both sides and whether the use of the Section 7520 tables was actuarially correct, but all of that only became relevant to determining whether the penalties assessed RERI should 20% or 40% based on the degree of valuation understatement. That is because regardless of the value of the SMI donated to Michigan, the charitable deduction was disallowed in full for failure to comply with the reporting rules under Section 170. Regulation Section 1.170A-13 contains the substantiation and reporting requirements for a donation over $5,000. The Tax Court has previously determined that strict compliance is not necessary to be allowed the deduction, but substantial compliance is necessary.

The court found here that the omission of the basis information caused the appraisal summary to not constitute substantial compliance with Code Section 170 or the 1.170A-13 regulations, and affirmed the IRS' denial of the charitable deduction. The court did not need to determine whether the omission of the basis information was intentional or unintentional.

Estate of Sower v. Commissioner, 149 T.C. No. 11 (9/11/2017). Issues involving "portability" (the use of estate and gift tax exemption left over from and unused by a prior deceased spouse) are making it into the courts. This recent case addressed the legalities of the IRS being able to assess estate and gift tax on the estate of surviving spouse, by lowering the deceased spousal unused exclusion (DSUE) that came from the prior spouse's estate.

Husband died in 2012 and an estate tax return was filed, satisfying the requirements for his DSUE to carry to his surviving spouse. Husband had made taxable gifts during his life totaling $945,000 (as did his wife), and they both filed gift tax returns with the IRS to report these gifts. Oddly with respect to the estate tax return, the court opinion states that the taxable gifts were included in a worksheet to calculate taxable gifts, but the Form 706 itself showed zero for taxable gifts. Thus, the combined estate and gift tax exemption was not reduced by those prior gifts.

The IRS issued a closing letter in 2013, accepting the estate tax return as filed without adjustment. The letter contained the standard language regarding the IRS not reopening or examining the estate tax return again except due to evidence of fraud, concealment, misrepresentation, etc. The surviving spouse later died in August 2013, and an estate tax return was filed utilizing $1.2 million of DSUE shown on the husband's prior return, lowering her taxable estate. After an amended return was filed to correct a math error, the estate had paid $750,000 in estate tax. Her estate tax return also did not include the effect of the lifetime taxable gifts she had made.

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The IRS audit of the surviving spouse's estate tax return included a review of the DSUE amount that had carried from the husband's prior return. The IRS notified the estate that it was reducing the DSUE amount from the husband's return from $1.2 million by the amount of the taxable gifts not included on that estate tax return. A similar adjustment was made to the available exemption for the surviving spouse's return. All of this caused a tax deficiency on her estate of an additional $788,000.

The estate pursued arguments in Tax Court that the IRS should not be able to assess the additional tax caused by the change to the DSUE, including that (1) the closing letter from the IRS precluded any changes to the amounts shown on the husband's estate tax return, (2) the review of the husband's estate tax return as to the DSUE amount was a second examination that is not allowed, (3) the effective date of the portability rules, specifically Code Section 2010(c)(5)(B), precluded adjusting the DSUE amount for taxable gifts made before that effective date, and (4) Section 2010(c)(5)(B) is unconstitutional, or at best the IRS adjustment here were not in accordance with Congressional intent in the statue, as it would override the statute of limitations that must apply to the prior estate tax return.

The court agreed with the IRS on all points raised. It found that the closing letter was not a closing agreement as that term is used under Code Section 7121. Regulations to the closing agreement usage require certain forms, IRS Form 866 or IRS Form 906, to be used to have a binding closing agreement on the parties. Those forms were not used in this case.

On the subject of a second impermissible tax audit, the court concluded that the second review of the husband's estate return did not amount to an examination under Section 7605(b). An examination must include a request for information, and no new information was sought by the IRS as to the husband's estate tax return. The taxable gifts were known due to the prior filed gift tax returns. The DSUE was known by its inclusion on the wife's later Form 706. As well, the two examinations were of two different taxpayers, the husband's estate, then later the wife's estate.

Finally, the court found the statute Congress implemented in Code Section 2010(c)(5)(B) is very clear as to legislative intent, and there was not improper elimination of statute of limitations. Any tax being assessed was done so on the surviving spouse's estate tax return. The court found technically there was no change to the husband's return. What was changed was the DSUE included in the later tax return still open under the relevant statutes for assessment of tax.

Estate of Powell v. Commissioner, 148 T.C. No. 18 (5/18/2017). The latest edition of IRS challenges to family limited partnerships, this case turned out adversely for the taxpayer. There are two general aspects to take away from the *Estate of Powell* case – the quite apparent bad facts that led to the IRS victory, and the unusual reasoning the court used to reach its decision. It is also an unusual case in that 17 Tax Court judges reviewed the decision, and there was no actual majority opinion, as some judges joined the opinion, some judges concurred in the result and participated in a concurring opinion, and a couple of judges concurred but did not join either opinion. In the end what mattered to the taxpayer was that every one of the 17 judges agreed that the plan followed by the family was a failure and all the family partnership value was includable in the taxable estate of the deceased.

The taxpayer had appointed her son as power of attorney with a springing power to act upon incapacity (the case does not indicate at what point in time the document was executed). The POA included powers granted to the attorney in fact, to hold and convey all property, and to make gifts on the principal's behalf to family members up to the annual exclusion from federal taxable gifts.

On August 6, 2008, a Delaware limited partnership called NHP was formed by the son as general partner. The partnership agreement gave the general partner sole authority over distributions, and provided the partnership could be liquidated by consent of all partners.

On August 7, 2008, two doctors issued a letter that the taxpayer was incompetent. The next day, on behalf of the taxpayer under the power of attorney, a great deal of activity occurred. The son, acting under the power of attorney, transferred cash and marketable securities worth $10 million from the taxpayer's revocable trust, of which the son was the trustee. In exchange the taxpayer received a 99% limited partner interest in NHP. The assets were managed by a wealth management firm founded by the son. Then the son transferred the 99% partnership interest to a charitable lead annuity trust. The terms of the CLAT provided that a family foundation would receive annual distributions for the taxpayer's life, with the remainder on her death paid out to her two children. She died on August 15.

On the taxpayer's gift tax return for 2008 was a taxable gift of $1.6 million reflecting the value of the remainder interest of the transfer to the CLAT using IRS actuarial tables. The value of the entire transfer to the CLAT was reported as $7.5 million. An outside appraisal was obtained that determined valuation discounts associated with the limited partnership interest of 25%.

The IRS audited both the gift tax return and the estate tax return, and issued assessments of tax. As to the gift tax, the IRS asserted the actuarial tables were not to be used since the taxpayer was terminally ill at the time of the transfer to the CLAT. For the estate tax return, the IRS included the entire assets of the partnership in her taxable estate under (1) Section 2036(a) [retained possession at death of the enjoyment or right to the income of, or the right to designate the persons who would possess or enjoy the property], or alternatively (2) under Section 2038(a) [retained power at death to alter, amend, revoke, or terminate a right to enjoy the property, or alternatively (3) under Section 2703(a) valuation rules, disregarding the value of liquidation restrictions in the partnership agreement.

As has been the case with past "death bed family partnerships", the court had little trouble agreeing with the IRS that the entire partnership assets were includable in the decedent's estate. The court chose Section 2036(a)(2) as the statute causing the inclusion, which provides that the gross estate includes the value of property where the decedent "retained for life…the right…in conjunction with another…to designate the persons who shall possess or enjoy the property." The "in conjunction" term is relevant since the court

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concluded that the decedent was acting in conjunction with the son as power of attorney and trustee. The transfer of those assets was not "a bona fide sale for an adequate and full consideration", as required under *Estate of Bongard v. Commissioner*, 124 T.C. 95 (2005), because there was no legitimate and significant nontax reason for the transfer to the family partnership.

The interesting aspect of the opinion that goes beyond the standard *Bongard* and Section 2036 analysis, was the court's use of Section 2043 to avoid what it perceived could be a double taxation problem. Section 2043 provides that if the taxpayer makes a transfer that is covered under any of Sections 2035 through 2038 for less than full consideration, the inclusion in the gross estate will only include the excess of the value of the property being included, less the consideration that was received.

The court was cognizant that technically what could happen is that the value of the partnership interest could be included in the estate under Section 2036(a) due to the retained power over transferred assets for less than full consideration, and the assets in the partnership could then as well be included in the estate under Section 2035 due to a transfer (subject to Section 2036) of the partnership interest within three years of death. Under the court's reasoning, the partnership interest received back by the decedent served as an offset to the value of the assets that were transferred to the partnership, so that not both of the items were includable in the estate tax calculation. It reasoned that Sections 2035 and 2036 are not mutually exclusive in this fact pattern, and Section 2043 is necessary to prevent double counting. The court admitted that the Tax Court had not regularly used Section 2043 in a family partnership context, and saw that the past results normally prevented such double inclusion by just ignoring the existence of the family partnership, but nevertheless felt compelled to be more exacting in its reasoning.

There was additional discussion of the transfer of the partnership interests to the CLAT. The court agreed with the estate that the son as power of attorney exceeded his authority under the power of attorney document under applicable state law (California) in making a transfer of all the partnership interests (the POA limiting gifts to the annual exclusion amount). Therefore, the gift was incomplete as either void or revocable, and no gift tax was due in addition to the estate tax.

Neither the taxpayer nor the IRS included the Section 2043 issue in their briefs, and the concurring judges found the whole analysis unnecessary. But the outcome of the case as to the estate being assessed additional estate taxes, was certain.

Estate of Sommers v. Commissioner, 149 T.C. No. 8 (8/22/2017). In the latest opinion of an ongoing saga involving a fight between a surviving spouse and nieces of the deceased, the Tax Court considered the effect of state law estate tax apportionment on federal estate taxes due, and the deduction against the taxable estate for gift taxes owed at death. This case follows a prior set of rulings by the Tax Court, *Estate of Sommers v. Commissioner*, T.C. Memo. 2013-8 (1/10/2013). That case was a summary judgment opinion involving gifts by the deceased of interests in Sommers Art Investors, LLC. Mr. Sommers had transferred title to valuable works of art to the LLC during his life in preparation of making gifts to his nieces. The nieces signed documents agreeing to pay the gift tax due on the transfers, but the agreements were silent as to estate tax due if the gifts and the tax were included in the taxable estate.

Family LLC interests were transferred in December 2001 and January 2002. The assignments did not include a formula clause that would adjust the interests given based on the appraisal in process, but stated the valuation would be done by the appraiser after the year end, and based on the appraisal the number of LLC units would be filled in the blank lines on the assignments by the law firm, who would release the transfer document. This was done in April 2002.

Mr. Sommers remarried his spouse in June 2002, and then later died in November 2002. By various probate and non-probate means his wife inherited all of his remaining property. The estate tax return did not include in the gross estate any gift taxes paid or due, it accordingly did not take a deduction for claims and expenses against the estate for gift taxes due, and it claimed a marital deduction for most of the balance of the estate. A gift tax return was filed for 2002 and the nieces paid the gift taxes based on the appraisal value of the LLC. The IRS audited the estate tax return, and under Section 2035(b) increased the estate by the gift taxes owed on the gifts within three years of death, and reduced the marital deduction reflecting assets actually passing to the spouse.

In the most recent opinion, the Tax Court determined that although the value of the gifts was included in the decedent's taxable estate, the New Jersey estate tax apportionment statute does not require apportioning estate tax against donees of lifetime gifts, and the terms of the decedent's Will caused the state apportionment statute to apply. The Tax Court also ruled that because the nieces committed to and did pay the gift tax, the estate was not entitled to deduct the gift tax due as a debt of the decedent.

Block Developers, LLC v. Commissioner, T.C. Memo. 2017-42 (7/18/2017). A successful entrepreneur was less successful in establishing a tax and estate plan that involved a family entity owned by Roth IRAs. The Tax Court agreed with the IRS that there was no economic substance to the arrangement and the taxpayers were liable for excise taxes on excessive contributions to Roth IRAs.

The taxpayer had established a highly successful concrete wall business, based on developing a type of interlocking concrete blocks for use in retention walls in hilly areas to preserve development, particularly in California. He sold and licensed the concrete block system in his company, Soil Retention Systems, Inc. He was fully engaged in marketing his retention wall system personally and in the name of SRS. The taxpayer later formed several separate companies for asset protection purposes, and SR Products was created to succeed SRS. SR Products employed over 30 people and was the manufacturer and distributor of the concrete blocks.

The taxpayer then pursued tax and estate planning measures to further preserve his income and wealth. Through a series of meetings and consultations with an outside financial advisor, a convoluted plan was created involving a family entity mostly owned by Roth IRAs created by the taxpayer, his spouse, and two of his children. The planning involved the financial advisor being granted an option to purchase two of the taxpayer's patents for a note to be paid at a later time, and the advisor also agreeing to pay SR Products 10% of the sales he realized on the use of the patents, if the option was exercised. Four family members of the taxpayer then formed self-directed Roth IRA accounts, and contributed $1,900 each to form Block Developers, LLC. The financial advisor became a 5% owner of the LLC.

The linchpin of the plan was then, the advisor sold the patents he had purchased from the taxpayer to Block Developers LLC for a note and deferred payment. When all of the parts of the plan were condensed, SR Products was paying a royalty to Block Developers equal to 10% of sales. Thus, a steady flow of cash started to go into the Roth IRAs, as distributions from Block Developers LLC that was taxed as a flow-through entity partnership. For the period 2001 through 2007, about $800,000 was distributed into the Roth IRA accounts.

There was a great deal of confusion in the case regarding procedural matters and what taxpayers the IRS could actually pursue in assessing tax. In the end, the party to the case was the LLC itself as a partnership level proceeding, not the individual taxpayers. Reviewing the whole plan and the substance of what happened, the court concluded that in economic substance, Block Developers had no employees, no assets, little expenses, and no business purpose other than holdings the royalty rights.

The court agreed that the individuals were liable for the Code Section 4973 excise tax on excess Roth IRA contributions (the limit on contributions in the case years under Code Section 408A was generally $4,000). The court reviewed prior cases involving family business ventures being owned by Roth IRAs, particularly *Polowniak v. Commissioner*, T.C. Memo. 2016-31 (2/25/2016), and adopted its reasoning and similar conclusions that (1) the taxpayer already had a successful business, (2) the services performed were the same and the new entity owned by the Roth IRAs added no activity or value, (3) contracts were not strictly followed and recordkeeping was inconsistent, (4) employee work and equipment used by one company were not reimbursed by the company owned by the Roth IRA, and (5) there was no legitimate business purpose.

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McGaugh v. Commissioner, No. 13665-14 (7th Cir. 6/26/2017), *affg*. T.C. Memo. 2016-28 (2/24/2016). The Seventh Circuit recently affirmed a Tax Court decision in favor of a taxpayer who was assessed tax for an early distribution from an IRA. The case is interesting in that it was the IRS that appealed an adverse Tax Court ruling (and still lost at the appellate level), and illustrated how an assessment of a large amount of income tax can turn on a few key facts.

The taxpayer had an IRA at Merrill Lynch, and wanted $50,000 of the IRA to be invested in the stock of a company not traded on the public markets. He instructed Merrill Lynch to send the funds to First Personal Financial Corporation (FPFC) to purchase 7,500 shares from the company. Merrill declined to do so. After that refusal the taxpayer initiated, by a phone call, a wire transfer from his IRA account at Merrill to FPFC. The company issued the stock certificate in the name of "Raymond McGaugh IRA FBO Raymond McGaugh", and sent the certificate to Merrill Lynch.

On the basis that it believed the taxpayer had initiated a taxable distribution from the IRA account, Merrill did not retain the stock certificate and forwarded it to the taxpayer by mail. Twice the mails were attempted and twice the envelope came back undelivered, the second time marked "refused". The taxpayer testified that Merrill sent the envelope to an incorrect address. Merrill tried again for delivery using FedEx and this time it was not returned. The exact whereabouts of that stock certificate remained unknown.

Merrill Lynch issued a Form 1099-R to the taxpayer in the amount of $50,000. The taxpayer testified he never received the 1099. The IRS assessed tax on the unreported amount on the 1099, and argued that the taxpayer was in constructive receipt of $50,000 from his IRA. The IRS equated the situation to direct an IRA custodian to pay a bill on behalf of the taxpayer, or make a personal investment with a direct payment to a third party. The Seventh Circuit, as had the Tax Court, disagreed and found no evidence had been introduced that the taxpayer was in constructive receipt of IRA funds or assets. The court also observed that the Form 1099 was issued for the 2011 tax year, but Merrill Lynch did not attempt to mail the stock certificate to the taxpayer until February 2012.

Hurford Investments No. 2, Ltd. v. Commissioner, Order on Motion for Summary Judgment, U.S. Tax Court Docket No. 23017-11 (4/17/2017). This current Tax Court action is an outgrowth of the estate tax case *Estate of Hurford v. Commissioner*, T.C. Memo. 2008-278 (12/11/2008), where the Tax Court had held that certain phantom stock in Hunt Oil Company, which had been contributed to a family limited partnership, was includable in a surviving spouse's taxable estate after she had inherited it from her pre-deceased husband. The underlying estate tax case was of a garden variety failed FLP nature, but the current case is more unusual.

This associated case dealt with the aftermath of that estate tax inclusion case, i.e. the income tax consequences of Hunt Oil redeeming the phantom stock from the family partnership for cash. It is not a typical scenario faced by many estate planners, but is a useful review of what tax effects can be experienced by clients after estate planning techniques are put in place.

Gary Hurford was a long time employee of Hunt Oil, and was awarded a deferred compensation benefit termed "phantom stock", in that the value of the award was tied to the stock value of the company. After Gary's death, the phantom stock was included on his estate tax return. Under the terms of the phantom stock plan, his death triggered a five year countdown period where the phantom stock would adjust with the company value, and a mandatory redemption of the phantom stock account would occur after five years. Upon his death, his surviving spouse Thelma inherited the plan benefits. As part of a comprehensive estate plan she later transferred the phantom stock rights to Hurford Investments No. 2, the family partnership that was party to this case. Hunt Oil adjusted its books and records to reflect Hurford Investments No. 2 as the owner of the rights.

Making the case more complicated, and for reasons not fully explained to the court or added to the record, the partnership reported a short term capital gain upon its receipt of the phantom stock from Thelma. At the time of the transfer in 2000, the phantom stock was worth $6.4 million, and upon Thelma's death in 2001 it was worth $9.6 million. After the end of the five year countdown, Hunt Oil redeemed the phantom stock, and in 2006 distributed about $13 million to the family partnership. The partnership filed its 2006 tax return recognizing $6.5 million of ordinary income (the gross proceeds received, less basis equal to what the partnership previously included in income as capital gain upon Thelma's contribution to capital of the partnership).

The IRS and the taxpayer argued before the Tax Court with differing positions on the effect of the 2006 redemption for income tax purposes. The IRS argued that as a result of the estate tax case in Tax Court (that the FLP was not a valid partnership), Thelma really owned the phantom stock at death, and since the phantom stock is deferred compensation, not a capital asset, it can only produce ordinary income with no cost basis.

The partnership argued that in its hands the phantom stock became a capital asset, regardless of its prior deferred compensation nature, and also asserted that since the phantom stock was included in Thelma's taxable estate by virtue of the estate tax litigation, basis in the asset should adjust up her date of death value. The Tax Court agreed with the taxpayer on an unpublished summary judgment order, that under Code Section 1221 the phantom stock became a capital asset after it was transferred by Thelma to the partnership, that the redemption by Hunt Oil was a sale or exchange by the partnership of that capital asset, and the inclusion of it in Thelma's taxable estate caused a basis step up to her date of death value. While the docketed case produced an unpublished opinion, the court's discussion is an interesting look at how an ordinary income item can become a capital asset, and a tax planning and reporting issue to consider when assessing the post-death treatment of family partnership assets.

IRS RULINGS AND ANNOUNCEMENTS

Annual Gift Exclusion, IRS Revenue Procedure 2017-58, IR-2017-178 (10/19/2017). The IRS issued inflation adjusted rates, brackets and limitations for 2018. Notably for estate planning, the annual exclusion from taxable gifts will increase to $15,000 (depending on tax reform).

Extension of Time for Portability Election, Rev. Proc. 2017-34, 2017-24 IRB 1282 (6/9/2017). To address the high volume of private letter ruling requests the IRS is receiving for relief on late “portability” elections, a simplified method has been developed for obtaining an extended time to preserve the unused estate and gift tax exemption of the first spouse to die. The Revenue Procedure outlines the requirements for this extended grant of time, and is essentially an extension of the simplified method that was in place under Revenue Procedure 2014-18.

The portability election is made by the timely filing of a federal estate tax return for the first spouse to die, where that deceased spouse did not utilize all of the exemption. This unused exemption (the DSUE) is calculated on that federal estate tax return. The IRS has experienced many requests for relief from this timely filing requirement, especially where the tax return was not otherwise required when the gross estate was under the exempt amount.

Under the Revenue Procedure, the late estate tax return for deceased persons who died after 2010, have not already filed a timely estate tax return, and must be filed by the later of (1) January 2, 2018, or (2) the second anniversary of the death of the deceased spouse. The estate tax return must not have been otherwise required to be filed, such as a large estate with marital and/or charitable deductions that caused no tax to be due.

GST Exemption Allocation, PLR 201731005 (8/4/2017). The IRS showed flexibility in granting a ruling request to treat a trust as having received an intended allocation of generation skipping transfer tax exemption, after the taxpayer filed a gift tax return without a Notice of GST Exemption Allocation attached. The Forms 709 were filed by husband and wife on a gift-spitting basis. Husband had elected out of the automatic GST exemption allocation rules with respect to gifts made to an irrevocable trust. The gifts were correctly reported as indirect skip gifts on Schedule A, Part 3. The preparer also included an amount of GST exemption allocation on Schedule D, Part 2, Line 6. However, the additional Notice of Allocation, required under the instructions to Form 709 following the regulations under Section 26.2632-1(b), was not attached.

The IRS granted the ruling request that the allocation of GST exemption was considered made as the taxpayer substantially complied with the essential elements of the regulation and instructions, and the 709 had enough information to demonstrate the taxpayer intent.

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Conversion from Non-Grantor Trust to Grantor Trust, PLR 201730018 (7/28/2017). In a series of private letter rulings, the IRS considered a proposed amendment to a trust that converted an existing charitable lead annuity trust from a nongrantor trust to a grantor trust. The trust amendment would give authority, in a nonfiduciary capacity, to the grantor's sibling, who is not a trustee, to substitute trust property for other property having equivalent value.

The IRS ruled that the amendment and the resulting conversion from nongrantor trust status to grantor trust status (1) is not a taxable transfer of property for income tax purposes; (2) is not self-dealing because the grantor's sibling is not a disqualified person pursuant to Code Section 4941; and (3) does not result in an income tax charitable deduction for the grantor in the year of the amendment, because of the finding that there is no transfer. While the first ruling was not new territory for the IRS to consider, the second and third rulings became issues to address because a CLAT was involved.

Also of interest is the application of the substitution power under Code Section 675(4)(C) as the basis for grantor trust status. The introductory language of Section 675(4) and the particular provision of clause (C) have seemingly conflicting terms, where the trust power can be held "by any person", but then states that the person would "reacquire" the trust property If the grantor is the only person funding the trust, it is interesting how another person could reacquire trust property. In this ruling, the IRS followed the "by any person" wording to allow grantor trust status where the sibling held the power. In the trust instrument the person was called the "Substitutor". The Substitutor was not the Grantor under the trust in question.

CLATs are subject to at least some of the excise taxes and restrictions as are private foundations. But the Substitutor was the grantor's sibling, is not a "family member" under Code Section 4946(d), and so is not a disqualified person under the self-dealing rules.

The third ruling was adverse to the request of the taxpayer, who sought an income tax deduction on the conversion. In assessing this request, the IRS referred to its prior Revenue Procedure 2007-45, which states that the donor is entitled to claim a charitable deduction on funding a CLAT in the year that the assets are irrevocably transferred to the trust. The IRS concluded here that the conversion from nongrantor to grantor status is not a transfer of property for income tax purposes.

S Corporation Held by Grantor Trust at Death of Grantor, PLR 201730002 (7/28/2017). In this private letter ruling the IRS considered a situation involving S corporation stock owned by a single member LLC. During the individual's life, he transferred the S corporation stock to his single member LLC. The LLC was taxed as a disregarded entity for income tax purposes and thus, not an ineligible S corporation shareholder. The individual then transferred some of the LLC units to a grantor trust. For income tax purposes the income and assets of the grantor trust are treated as the property of the grantor, so the individual was still deemed to own all the S corporation stock by way of both the single member LLC and the grantor trust.

Then the individual died. The grantor trust ceased to be such on the date of death. By becoming a nongrantor trust, the LLC became a partnership for tax purposes, with units owned by the estate of the deceased, and the

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nongrantor trust. A partnership cannot be an S corporation shareholder. This caused a technical termination of the S corporation election as of the date of death.

At a later date, the LLC redeemed the units held by the estate, thus returning the LLC to single member status, and an eligible S corporation shareholder (assuming the trust became an eligible shareholder such as a qualified subchapter S trust (QSST) or an electing small business trust (ESBT)).

The S corporation requested a ruling that the termination of the S election was inadvertent, that it was not intended and not motivated by tax avoidance or retroactive planning. The IRS has authority under Code Section 1362(f) to grant relief and allow the S corporation election to continue depending on the facts and if steps were taken in a reasonable amount of time after the termination to rectify the disqualifying event. Here, the IRS granted the relief and ruled favorably for the taxpayer that the termination was inadvertent.

While the ruling does not give details that would prove illustrative to estate planners, it can be reasonably concluded that some estate planning was what led to the structure of the entities. As is known in settings such as installment sales to defective trusts, the grantor trust rules are income tax rules, not transfer tax rules. It is possible that the grantor trust involved here was an irrevocable trust designed to receive LLC units by gift, sale, or otherwise, and be outside of the individual's taxable estate. This was all good during the individual's life, but became an issue upon death, when the single member LLC no longer was an eligible shareholder owned in part by a grantor trust. The ruling is positive toward the proposition of the IRS being agreeable to fixing this issue after death of the grantor, but estate planners should take steps prior to the client's death to ensure continued S corporation status rather than pursue the uncertainty of an IRS letter ruling.

Trust Division, PLR 201709020 (3/3/2017). The private letter ruling involved a desired division of an irrevocable trust holding S corporation stock, among other assets. The taxpayer sought favorable rulings on estate, gift, GST and income tax consequences on the change.

When the trust was funded, GST exemption was applied to achieve an inclusion ratio of zero. The trustee has full discretion to distribute income and principal among the grantor's living descendants (currently seven children as well as grandchildren) and a Family Trust. Upon the grantor's death, separate trusts would be created for the descendants, and each separate trust would be further divided into a subtrust holding the S corporation stock allocated to that descendant, and another holding all other assets allocate to that descendant. The S corporation trust share would be a QSST with all income distributed to the beneficiary. The other trust provides for discretionary distributions of income.

The trust and the beneficiaries filed a petition with the local court to be allowed to alter the trust instrument and split the non-S corporation share of the current trust into eight separate trusts now before the grantor's death, one for the benefit of each child and one for the benefit of the Family Trust. The grantor's spouse is the initial trustee of each separate trust. Each trust would receive a pro rata share of each asset (except the S corporation stock). The requested rulings, each of which the IRS granted, were:

1. The eight trusts would not be includable in the grantor's or the spouse's taxable estate. They represented that the spouse would not transfer any assets to the trust, and the trust would not acquire insurance on the spouse's life.
2. The transfers into each of the new separate trusts would not cause a taxable gift. The beneficiaries have substantially the same beneficiary interest, rights and expectations after the trust division.
3. The GST inclusion ratio of zero will not be altered as a result of the current trust being divided into eight separate trusts. Here, as provided in Regulation Section 26.2601-1(b)(4), the reformation of the trust would not change the inclusion ratio since the modification is not shifting the beneficial interest of any beneficiary skip person, and did not extend the time for vesting beyond the original trust.
4. The pro rata transfer of each asset will not cause an income realization event under Code Sections 61 or 1001, and each asset will have carryover basis.

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