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By **Charles A. Redd**

# Snoozers and Surprises Pave the Way to 2020

## An overview of recent developments

Estate planning and estate and trust administration professionals have seen an array of interesting developments in the past several months. Presented here are summaries of a few.

### No Clawback

In response to Internal Revenue Code Section 2001(g)(2), enacted as part of the 2017 Tax Act,[1] in which the Secretary of the Treasury was directed to prescribe regulations to carry out IRC Section 2001(g) with respect to the difference between the basic exclusion amount applicable at the time of a decedent's death and the basic exclusion amount applicable with respect to any gifts made by the decedent, the Secretary issued Proposed Regulations Section 20.2010-1(c).[2] The final version of this provision was released on Nov. 22, 2019 and published in the Federal Register on Nov. 26, 2019.[3]

Treasury Regulations Section 20.2010-1(c) ensures that, if a decedent uses the increased basic exclusion amount for gifts made while the 2017 Tax Act was in effect and dies after the sunset of the 2017 Tax Act (currently scheduled for Jan. 1, 2026), such decedent won't be treated, on such decedent's estate tax return, as having made adjusted taxable gifts solely because the increase in the basic exclusion amount effectuated by the 2017 Tax Act was eliminated.

The mechanism by which Treas. Regs. Section 20.2010-1(c) achieves this result is to provide that, if the total credits that were used in computing a decedent's gift tax on post-1976 gifts, within the meaning of IRC Section 2001(b)(2),[4] are greater than the applicable credit amount used, pursuant to IRC Section 2010(a), to compute the estate tax on the decedent's estate,[5] the credit that can in that circumstance be used to compute the estate tax is deemed to be the total credits that were used in computing the decedent's gift tax.

Unlike Prop. Regs. Section 20.2010-1(c), Treas. Regs. Section 20.2010-1(c) explains how the deceased spousal unused exclusion (DSUE) amount[6] interacts with the basic exclusion amount to produce the intended "no clawback" result. Treas. Regs. Section 20.2010-1(c)(1)(ii) and Example 4,[7] taken together, make several important points clear. First, when a surviving spouse makes taxable gifts, any DSUE amount that was available to him is deemed to have been applied to those gifts before his basic exclusion amount was so applied.[8] Second, if that surviving spouse dies after the sunset of the 2017 Tax Act, the DSUE amount applied to those gifts isn't reduced. Third, if both the DSUE amount and the surviving spouse's basic exclusion amount were applied to those gifts, in calculating the amount of the credit available in computing the surviving spouse's estate tax, the undiminished DSUE amount is removed. Fourth, the total credits that were used in computing the surviving spouse's gift tax based on that intact DSUE amount, plus the credit determined by applying the general "no clawback" rule of Treas. Regs. Section 20.2010-1(c), are available to offset the surviving spouse's estate tax liability.

Although, surprisingly, it took a year to bring this relatively small regulatory project to a conclusion, it's a welcome development. In particular, the Internal Revenue Service's treatment of the DSUE amount in the "no clawback" context is good news. It's somewhat disappointing that the IRS declined to address whether GST exemption[9] allocated before sunset of the 2017 Tax Act would, like the basic exclusion amount and the DSUE amount applied in computing the gift tax on post-1976 gifts, remain in place without reduction. It seems

**Charles A. Redd** is a partner at Stinson LLP in St. Louis and a fellow of The American College of Trust and Estate Counsel

significant, though, that, in the preamble to the final regulations, after observing that the GST exemption amount is defined by reference to the basic exclusion amount,[10] the IRS stated: "There is nothing in the statute that would indicate that the sunset of the increased [basic exclusion amount] would have any impact on allocations of the GST exemption available during the increased [basic exclusion amount] period."

## Gift Valuation

Chief Counsel Advice 201939002[11] addressed how properly to value for gift tax purposes publicly traded stock transferred to a grantor retained annuity trust (GRAT). This would seem to be a rather straightforward exercise, following the formula set out in Treasury Regulations Section 25.2512-2(b)(1),[12] but the IRS didn't see it that way.

> The *Kress* court accepted the concept of tax-affecting but rejected application of a "subchapter S premium."

The settlor of the GRAT was a founder and the chairman of the board of the company (Corporation A) whose stock he transferred to the GRAT. Before the transfer, Corporation A had been involved in exclusive merger negotiations with another company (Corporation B). Those negotiations were apparently successful. The merger of Corporation A and Corporation B was announced after the transfer, and, immediately after the announcement, the value of Corporation A's stock increased substantially.

The IRS asserted that the general rule outlined in Treas. Regs. Section 25.2512-2(b)(1) didn't govern valuation of the stock for gift tax purposes but, rather, that the merger being negotiated on the date of the transfer had to be considered. As part of its support for this conclusion, the IRS cited and quoted from Treas. Regs. Section 25.2512-2(e), which states in relevant part that "[I]n cases in which it is established that the value per bond or share of any security determined on the basis of the selling or bid and asked prices … does not represent the fair market value thereof, then some reasonable modification of the value determined on that basis or other relevant facts and elements of value shall be considered in determining fair market value." After kicking Treas. Regs. Section 25.2512-2(b)(1) to the curb, the IRS opined that the willing buyer, willing seller standard[13] articulated in Treas. Regs. Section 25.2512-1 and Revenue Ruling 59-60 would control.

Application of the willing buyer, willing seller test in this case may have been inherently unfair. While the settlor (the "willing seller") presumably had full knowledge of the merger discussions on the date of the transfer, a "willing buyer" quite possibly wouldn't have had such knowledge. The settlor admittedly would have had an economic incentive to inform a prospective buyer about the merger that was in the works, but the settlor, as a corporate insider, may have been legally prohibited from so doing. Additionally, it's clear in CCA 201939002 that the IRS assumed that, on the date of the transfer, the merger was "practically certain to go through," but CCA 201939002 recites no facts to support that assumption.

## Tax on Trust Termination

Private Letter Ruling 201932001[14] responds to the request of the co-trustees of an irrevocable trust that the IRS rule on the gift, generation-skipping transfer (GST) and income tax consequences of a proposed premature termination of the trust. The IRS' conclusions regarding the gift and GST tax results that would flow from the proposed trust termination are as would be expected and wholly uninteresting. The income tax analysis is another story.

The trust instrument conferred on the settlor's son (Son) a mandatory income interest for his life. At his death, his descendants were to receive the remainder. No distributions of principal were allowed during Son's life. A relevant state statute allows termination of an irrevocable trust pursuant to a nonjudicial settlement agreement (NJSA), with court approval, if the court concludes continuance of the trust is no longer required to achieve any material purpose of the trust. Son, the then-living remainder beneficiaries who would take if the trust were then to terminate by its terms (the Current Remaindermen) and the then-living remainder beneficiaries who would take

if the trust were then to terminate by its terms and none of the Current Remaindermen were then living (the Successor Remaindermen) all entered into an NJSA, presumably compliant with the statute, providing for immediate termination of the trust and distribution of all trust property among Son, the Current Remaindermen and the Successor Remaindermen in accordance with their respective actuarial interests in the trust. Under the NJSA, the trustees were to effectuate distribution among the distributees, in their sole discretion, "on a pro rata or in kind basis."[15]

The IRS ruled that the termination distribution was, in substance, a sale of Son's and the Successor Remaindermen's beneficial interests to the Current Remaindermen. The IRS' approach and conclusion are seriously problematic on several levels.

The *Jones* court found important that the debtor had deposited the $20,000 back into his IRA prior to filing his bankruptcy case and within the 60-day rollover period under IRC Section 408(d)(3).

First, the IRS ignores the fact that Son, the Current Remaindermen and the Successor Remaindermen all received amounts equal to their actuarial interests in the trust. Son and the Successor Remaindermen didn't convey, by sale or otherwise, anything at all to the Current Remaindermen.[16] All the trust's beneficiaries received nothing more and nothing less than the true value of their respective interests. The possession of their interests was accelerated, but no value was shifted among them.

Second, to buttress its conclusion, the IRS cites Rev. Rul. 69-486. That ruling holds that a non-pro rata distribution of trust property, where neither the trust instrument nor local law allows the trustee to make a non-pro rata distribution, was equivalent to a pro rata distribution followed by an exchange between the beneficiaries, an exchange that required recognition of gain under IRC Section 1001. No facts are recited in PLR 201932001, however, that would bring it within the purview of Rev. Rul. 69-486. PLR 201932001 contains nothing to suggest that the trustees actually made non-pro rata distributions. The NJSA said the trustees had discretion to distribute "on a pro rata or in kind basis,"[17] but the trustees may well have made ratable distributions among all beneficiaries. To the extent ratable distributions were made, Rev. Rul. 69-486 has no application. In addition, the trust instrument and/or local law may have allowed for the making of non-pro rata distributions. If so, Rev. Rul. 69-486 is easily distinguishable on that ground alone.

Third, the IRS cites Rev. Rul. 72-243 to support its conclusion that the amounts received by Son in the termination are amounts received from the sale or exchange of a capital asset to the Current Remaindermen. Rev. Rul. 72-243, however, bears no resemblance to PLR 201932001. Rev. Rul. 72-243 says that proceeds received by the life tenant of a trust in exchange for the transfer of his beneficial interest to the remainder beneficiary are treated as an amount realized from the sale or exchange of a capital asset. As explained above, in PLR 201932001, Son, the "life tenant," transferred nothing to any remainder beneficiary.

## Tax-Affecting

In *Kress v. United States*,[18] the taxpayers were shareholders in Green Bay Packaging, Inc. (GBP), a family-owned subchapter S corporation (S corp), and they gifted minority interests in GBP stock to their children and grandchildren in 2006, 2007 and 2008. The taxpayers filed gift tax returns for those years, and the IRS challenged the amounts reported on those returns. The taxpayers paid the gift tax deficiencies and filed amended gift tax returns seeking refunds for the additional taxes and interest they paid. The IRS denied the taxpayers' requests for refunds, and the taxpayers sued for the refunds in District Court in Wisconsin.

The sole issue before the District Court was the fair market value of the GBP stock the taxpayers gifted to their children and grandchildren in 2007, 2008 and 2009. Part of the analysis made by the taxpayers' valuation experts involved valuing GBP shares in relation to comparable C corporation stock and then adjusting the values of the GBP shares to account for the fact that GBP's earnings, while not subject to income tax at the

corporate level, aren't tax-free but, rather, are taxable at the shareholder level. This adjustment is commonly referred to among valuation experts as "tax-affecting." The government's valuation expert also engaged in tax-affecting, but, in addition, he applied an adjustment, a "subchapter S premium," to account for the tax characteristics associated with subchapter S status.

The court accepted the concept of tax-affecting but rejected application of a "subchapter S premium." In so doing, the court stated:

> The court finds GBP's subchapter S status is a neutral consideration with respect to the valuation of its stock. Notwithstanding the tax advantages associated with subchapter S status, there are also noted disadvantages, including the limited ability to reinvest in the company and the limited access to credit markets. It is therefore unclear if a minority shareholder enjoys those benefits.

The *Kress* court's willingness to adopt tax-affecting in valuing equity in an S corp (the form in which countless family businesses exist) is significant. Taxpayers have been striving for many years to validate use of tax-affecting in the valuation of equity in pass-through entities, and the battle has at times seemed almost useless.[19] The taxpayers in *Kress* are to be congratulated for their perseverance.[20]

In addition to tax-affecting, the court addressed whether certain provisions contained in GBP's bylaws restricting the ability of GBP shareholders to transfer their shares could be taken into account for purposes of valuing the gifted stock. The court first observed that the general rule embodied in IRC Section 2703(a)[21] applied, and so resolution of this issue would turn on the applicability of Section 2703(b).[22] All three exceptions set out in Section 2703(b) must apply to supersede Section 2703(a). The court had no difficulty concluding that the bylaws provisions in question constituted a "bona fide business arrangement" and that they weren't a "device" within the meaning of Section 2703(b)(2). Unfortunately for the taxpayers, the court wasn't convinced that the restrictions' terms were "comparable to similar arrangements entered into by persons in an arms' length transaction." The good news for the taxpayers is that their failure to prevail under Section 2703 caused them to forfeit a mere 3% lack of marketability valuation discount.

## IRA in Bankruptcy

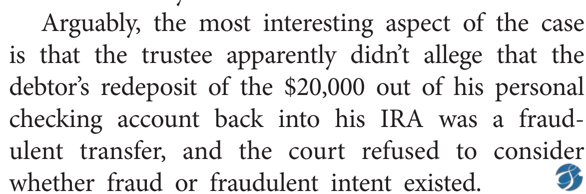
The U.S. Bankruptcy Court, in *Jones*,[23] considered whether a debtor may deprive his bankruptcy trustee of funds the debtor withdrew from an individual retirement account, deposited into a checking account and then redeposited into the IRA.

On or about April 16, 2018, the debtor withdrew $50,000 from his IRA and deposited $49,000 into his personal checking account. He retained $1,000 to purchase lottery tickets. The debtor subsequently used the funds in his checking account to purchase additional lottery tickets. His "strategy" was to win money and pay off his debts to avoid filing for bankruptcy. This strategy didn't work out so well. He lost $30,000.

On June 15, 2018, the debtor redeposited into his IRA $20,000 of the funds he had withdrawn 60 days earlier. On Oct. 22, 2018, the debtor filed for bankruptcy under Chapter 7 of the Bankruptcy Code and claimed a $40,000 exemption in the IRA under 735 ILCS §5/12-1006, which allows exemption of a retirement plan (specifically including an IRA) from "judgment, attachment, execution, distress for rent, and seizure for the satisfaction of debts." The Chapter 7 trustee objected to the debtor's claimed exemption to the extent of $20,000, arguing that the funds he withdrew from his IRA lost their exempt status when he made the withdrawal.

The court overruled the trustee's objection. The court found important that the debtor had deposited the $20,000 back into his IRA prior to filing his bankruptcy case and within the 60-day rollover period under IRC Section 408(d)(3). The trustee cited various cases in support of his objection, but in all those cases, the withdrawn funds hadn't been repaid to a retirement account at the time of the bankruptcy filing. Further, the court noted that any commingling of retirement plan funds with monies in a personal checking account didn't imperil the exempt status of the funds and that any use whatsoever of the withdrawn funds during the 60-day period prior to repayment is similarly irrelevant.

Arguably, the most interesting aspect of the case is that the trustee apparently didn't allege that the debtor's redeposit of the $20,000 out of his personal checking account back into his IRA was a fraudulent transfer, and the court refused to consider whether fraud or fraudulent intent existed.



## Endnotes

1. An Act To Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97.
2. Proposed Regulations Section 20.2010-1(c), REG-106706-18, 83 Fed. Reg. 59343 (Nov. 23, 2018).
3. Treasury Regulations Section 20.2010-1(c), T.D. 9884, 84 Fed. Reg. 64995 (Nov. 26, 2019).
4. To the extent based solely on the basic exclusion amount. *See* Internal Revenue Code Section 2010(c)(3).
5. *Ibid.*
6. IRC Section 2010(c)(4).
7. Treas. Regs. Section 20.2010-1(c)(2)(iv).
8. This conclusion isn't at all surprising. It's entirely consistent with Treas. Regs. Sections 20.2010-3(b) and 25.2505-2(b).
9. The term "GST exemption" refers to the exemption from generation-skipping transfer tax allowed by IRC Section 2631(a).
10. IRC Section 2631(c).
11. Chief Counsel Advice 201939002 (released Sept. 27, 2019).
12. The general rule of Treas. Regs. Section 25.2512-2(b)(1) is that the fair market value (FMV) of stock traded on a stock exchange is the mean between the highest and the lowest quoted selling prices on the date of the gift.
13. FMV is the price that a hypothetical willing buyer would pay a hypothetical willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.
14. Private Letter Ruling 201932001 (released Aug. 9, 2019).
15. A distribution of trust assets "pro rata" is generally understood to entail division and distribution of each asset, insofar as possible, on a percentage basis among the recipients based on the relative values of their respective interests in the trust.
16. The IRS explicitly acknowledged this fact in the gift tax ruling portion of PLR 201932001: "[W]e conclude that no transfer of property will be deemed to occur as a result of the termination and Proposed Distribution."
17. The meaning of this phrase is indecipherable. A distribution of trust assets "in kind" is a distribution of trust assets themselves as opposed to a distribution of proceeds from a pre-distribution sale of assets. Thus, "in kind" isn't an alternative to or the opposite of "pro rata." In fact, the only way to make pro rata distributions is to make in-kind distributions.
18. *Kress v. United States*, 372 F. Supp.3d 731 (E.D. Wis. 2019).
19. *See Gross v. Commissioner,* T.C. Memo. 1999-254, *aff'd* 272 F.3d 333 (6th Cir. 2001).
20. *See also Estate of Aaron U. Jones v. Comm'r,* T.C. Memo. 2019-101 (Aug. 19, 2019).
21. Internal Revenue Code Section 2703(a) provides: (a) GENERAL RULE.—For purposes of this subtitle, the value of any property shall be determined without regard to—(1) any option, agreement, or other right to acquire or use the property at a price less than the fair market value of the property (without regard to such option, agreement, or right), or (2) any restriction on the right to sell or use such property.
22. IRC Section 2703(b) provides: (b) EXCEPTIONS.—Subsection (a) shall not apply to any option, agreement, right, or restriction which meets each of the following requirements: (1) It is a bona fide business arrangement. (2) It is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth. (3) Its terms are comparable to similar arrangements entered into by persons in an arms' length transaction.
23. *In Re Jones,* 2019 WL 1749219 (Bkrtcy.S.D.Ill. April 15, 2019).

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