Hampton Roads Estate Planning Council

***Current Developments***

***An IRS Scouting Report***

Virginia Beach

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CURRENT DEVELOPMENTS[[1]](#footnote-1)

**LEGISLATIVE AND REGULATORY DEVELOPMENTS**

**For the 99.8 Percent Act, S. 309 (Introduced January 31, 2019) and H.R. 4857 (Introduced October 24, 2019)**

**Senator Sanders and Representative Gomez introduce identical bills to change the estate tax**

On January 31, 2019, Senator Bernie Sanders (I. Vt.) introduced the “For the 99.8 Percent Act” in the United States Senate. Almost nine months later, Representative Jimmy Gomez, D. Cal.) introduced the Act in the United States House of Representatives. These bills, if ever enacted, would greatly impact the estate, gift, and generation-skipping taxes.

The Act would have a non-indexed $3.5 million exemption for estate tax (and presumably generation-skipping) tax purposes. The non-indexed gift tax exemption would be $1 million. The Act includes anti-clawback rules. The proposed marginal rates are:

$3.5 million to $10 million 45%

$10 million to $50 million 50%

$50 million to $1 billion 55%

Over $1 billion 77%

The Section 2032A special valuation rule cap would be increased from $750,000 indexed for inflation since 1997 to $3 million indexed for inflation since 1997 or about $4.6 million in 2020. The Section 2031(c)(1) maximum exclusion for land subject to a conservation easement would be increased from the lesser of $500,000 or forty percent of the net value to the lesser of $2 million or sixty percent of the net value. The consistent basis reporting rules of Section 1014(f) for estates would be extended to gifts.

The Act restricts the availability of discounts for entities such as limited partnerships and limited liability companies. If an interest in an entity that is not actively traded is transferred for estate and gift tax purposes, the nonbusiness assets held by the entity would be valued as transferred directly from the transferor to the transferee. Also, no lack of control discount would be allowed if the transferor, the transferee, and members of their family or families control the entity or own a majority of the entity’s ownership interests by value.

A new Chapter 16 and a new Section 2901 would eliminate many of the benefits of planning with grantor trusts for third party beneficiaries by treating any distribution during the deemed grantor’s live as a gift, treating the cessation of grantor trust status as a gift, and including the value of the assets at the deemed grantor’s death in the deemed grantor’s estate.

The Act eliminates zero-out GRATs. GRATs would be subject to a ten year minimum term with no decrease permitted in the annual payment. The maximum term would be the grantor’s life expectancy plus ten years. The minimum value of the remainder interest in the GRAT would be the greater of twenty-five percent of the value transferred or $500,000 but not greater than one hundred percent of the value transferred.

The Act would impose an inclusion ratio of one for generations-skipping tax purposes for any trust that is not a “qualifying trust.” A qualifying trust is one that must terminated within fifty years after creation. A trust created before the date of enactment would receive an inclusion ratio of one for fifty years after the date of enactment and would be thereafter subject to generation-skipping tax.

The gift tax annual exclusion would be simplified to apply to transfers in trust, transfers of interests in pass-through entities, and transfers subject to prohibitions or other restrictions. These changes basically eliminate the current present interest requirement for annual exclusion gifts. There would be an annual $30,000 per donor limit. The Act retains the exclusion for the payment of tuition and medical expenses directly to the provider.

**H.R. 218 (January 3, 2019) and S. 215 (January 24, 2019)**

**Death Tax Repeal Acts Introduced in House and Senate in 2019**

Representative Jason Smith (R. Mo.) introduced H.R. 218, the “Death Tax Repeal Act,” in the House of Representatives on January 3, 2019 and Senator John Thune (R. S.D.) introduced the same as legislation in the Senate as S. 215, the “Death Tax Repeal Act of 2019,” on January 24, 2019.

The death tax repeal acts would repeal the estate and generation-skipping transfer taxes in their entirety. The gift tax would be retained with a $10 million exemption indexed for inflation and a 35 percent rate. The acts would also phase-out the taxation of qualified domestic trusts for non-citizen spouses existing on the effective date by eliminating the taxation of lifetime distributions from qualified domestic trusts ten years after the date of enactment and eliminating the taxation of the balance remaining in a qualified domestic trust at death.

**Revenue Procedure 2019-44 (November 6, 2019)**

**IRS announces inflation adjustments for 2020**

The following are some of the inflation adjustments for 2020.

1. Tax Rate Tables

TABLE 1 – Married Individuals Filing Joint Returns and Surviving Spouses

If Taxable Income is: The Tax is:

Not over $19,750 10% of the taxable income

Over $19,750 but $1,975 plus 12% of

not over $80,250 the excess over $19,750

Over $80,250 but $9,235 plus 22% of

not over $171,050 the excess over $80,250

Over $171,050 but $29,211 plus 24% of

not over $326,600 the excess over $171,050

Over $326,600 but $66,543 plus 32% of

not over $414,700 the excess over $326,600

Over $414,700 but $94,735 plus 35% of

not over $622,050 the excess over $414,700

Over $622,050 $167,307.50 plus 37% of

the excess over $622,050

TABLE 2 – Heads of Household

If Taxable Income is: The Tax is:

Not over $14,100 10% of the taxable income

Over $14,100 but $1,410 plus 12% of

not over $53,700 the excess over $14,100

Over $53,700 $6,162 plus 22% of

but not over $85,500 the excess over $53,700

Over $85,500 $13,158 plus 24% of

but not over $163,300 the excess over $85,500

Over $163,300 $31,830 plus 32% of

but not over $207,350 the excess over $163,300

Over $207,350 $45,926 plus 35% of

but not over $518,400 the excess over $207,350

Over $518,400 $154,793.50 plus 37% of

the excess over $518,400

TABLE 3 – Unmarried Individuals (other than Surviving Spouses and Heads of Household)

If Taxable Income is: The Tax is:

Not over $9,875 10% of the taxable income

Over $9,875 but $987.50 plus 12% of

not over $40,125 the excess over $9,875

Over $40,125 but $4,617.50 plus 22% of

not over $85,525 the excess over $40,125

Over $85,525 but $14,605.50 plus 24% of

not over $163,300 the excess over $85,525

Over $163,300 but $33,271.50 plus 32% of

not over $207,350 the excess over $163,300

Over $207,350 but $47,367.50 plus 35% of

not over $518,400 the excess over $207,350

Over $518,400 $156,235 plus 37% of

the excess over $518,400

TABLE 4 – Married Individuals Filing Separate Returns

If Taxable Income is: The Tax is:

Not over $9,875 10% of the taxable income

Over $9,875 but $987.50 plus 12% of

not over $40,125 the excess over $9,875

Over $40,125 but $4,617.50 plus 22% of

not over $85,525 the excess over $40,125

Over $85,525 but $14,605.50 plus 24% of

not over $163,300 the excess over $85,525

Over $163,300 but $33,271.50 plus 32% of

not over $207,350 the excess over $163,300

Over $207,350 but $47,367.50 plus 35% of

not over $311,025 the excess over $207,350

Over $311,025 $83,653.75 plus 37% of

the excess over $311,025

TABLE 5 – Estates and Trusts

If Taxable Income is: The Tax is:

Not over $2,600 10% of the taxable income

Over $2,600 $260 plus 24% of

but not over $9,450 the excess over $2,600

Over $9,450 $1,904 plus 35% of

but not over $12,950 the excess over $9,450

Over $12,950 $3,129 plus 37% of

the excess over $12,950

2. Standard Deductions

For taxable years beginning in 2020, the standard deduction amounts under Section 63(c)(2) are as follows:

Filing Status Standard Deduction

Married Individuals Filing $24,800

Joint Returns and Surviving

Spouses

Heads of Households $18,650

Unmarried Individuals (other $12,400

Than Surviving Spouses and

Heads of Households)

Married Individuals Filing $12,400

Separate Returns

3. Qualified Business Income Under Section 199A

For taxable years beginning in 2020, the threshold amount under Section 199(e)(2) is $326,600 for married filing joint returns, $163,300 for married filing separate returns, and $163,300 for single and head of household returns.

4. Basic Exclusion Amount

For an estate of any decedent dying in calendar year 2020, the basic exclusion amount is $11,580,000 for determining the amount of the unified credit against estate tax under Section 2010. The unified credit is $4,577,800.

5. Annual Exclusion for Gifts

(1) For calendar year 2020, the first $15,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts under Section 2503 made during that year.

(2) For calendar year 2020, the first $157,000 of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts under Section 2503 and 2523(i)(2) made during that year.

6. Interest on a Certain Portion of the Estate Tax Payable in Installments.

For an estate of a decedent dying in calendar year 2020, the dollar amount used to determine the "2-percent portion" (for purposes of calculating interest under Section 6601(j)) of the estate tax extended as provided in Section 6166 is $1,570,000.

**2019-2020 Priority Guidance Plan (October 9, 2019)**

**Treasury Department and Internal Revenue Service release their 2019-2020 Priority Guidance Plan**

On October 9, 2019, the Treasury Department and the Internal Revenue Service released their 2019-2020 Priority Guidance Plan which lists those projects which will be the focus of the IRS’s efforts during the twelve-month period from July 1, 2019 through June 30, 2020. The 2019-2020 Priority Guidance Plan contains 203 guidance projects of which guidance on 31 items had been released as of September 30, 2019. Each item listed below is identified by the number given in the different parts of the Priority Guidance Plan.

Part 1 of the Plan is titled “Implementation of Tax Cuts and Jobs Act (TCJA).” The estate and gift tax and related items in Part 1 are:

6. Regulations clarifying the deductibility of certain expenses described in §67(b) and (e) that are incurred by estates and non-grantor trusts. Notice 2018-61 was published on July 30, 2018.

17. Guidance on computational, definitional, and anti-avoidance rules under §199A and §643(f). Final and proposed regulations were published on February 8, 2019. Notice 2019-07 was published on February 25, 2019.

Part 3. Burden Reduction. This part contains the following items dealing with estate and gift tax and related areas:

9. Final regulations streamlining the §754 election statement. Proposed regulations were published on October 12, 2017.

13. Final regulations under §§1014(f) and 6035 regarding basis consistency between estate and person acquiring property from decedent. Proposed and temporary regulations were published on March 4, 2016.

17. Final regulations under §2642(g) describing the circumstances and procedures under which an extension of time will be granted to allocate GST exemption.

20. Guidance under Treas. Reg. §301.9100 regarding relief for late regulatory elections.

Part 6. General Guidance. The section on gifts and estates and trusts in Part 6 includes the following items:

1. Guidance on the basis of grantor trust assets at death under Section 1014.

2. Final regulations under Section 2032(a) regarding the imposition of restrictions on estate assets during the six-month alternate valuation period. Proposed regulations were published on November 18, 2011.

3. Regulations under Section 2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.

4. Regulations under Section 7520 regarding the use of actuarial tables in valuing annuities, interest for life or terms of years, and remainder or reversionary interests.

The first three items were carried over from the 2017-2018 priority guidance plan. The fourth item is new.

**Proposed Treasury Regulation § 20.2010-1(c) (November 20, 2018)**

**Treasury Department issues proposed anti-clawback regulations**

Proposed Regulations (REG-106706-18) were released on November 20, 2018, and published in the Federal Register on November 23, 2018 (83 Fed. Treas. Reg. 59343), to prevent the “clawback” of the benefits of the doubled federal gift tax exemption during 2018 through 2025 if the “sunset” of those benefits occurs in 2026 as currently scheduled and the donor dies in 2026 or later. Although neither the statute nor the proposed regulations use the word “clawback,” the regulations would carry out the mandate of the 2017 Tax Act in new Section 2001(g)(2), which provides that Treasury “shall prescribe such regulations as may be necessary or appropriate to carry out this Section with respect to any difference between (A) the basic exclusion amount under Section 2010(c)(3) applicable at the time of the decedent’s death, and (B) the basic exclusion amount under such Section applicable with respect to any gifts made by the decedent.”

The proposed regulations would add a new paragraph (c) to Treas. Reg. § 20.2010-1 (with the current paragraphs (c) through (e) redesignated as (d) through (f)), providing that if the total of the unified credits attributable to the basic exclusion amount that are taken into account in computing the gift tax payable on any post-1976 gift is greater than the unified credit attributable to the basic exclusion amount that is allowable in computing the estate tax on the donor’s estate, then the amount of the credit attributable to the basic exclusion amount that is allowable in computing that estate tax is not determined under Section 2010(c) but is deemed to be that greater total of gift tax unified credits attributable to the basic exclusion amount.

**Example.** Proposed Treas. Reg. § 20.2010-1(c)(2) provides the following Example:

“Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $10 million in basic exclusion amount allowable on the dates of the gifts. A dies after 2025 and the basic exclusion amount on A’s date of death is $5 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A’s post-1976 gifts (based on the $9 million basic exclusion amount used to determine those credits) exceeds the credit based on the $5 million basic exclusion amount applicable on the decedent’s date of death, under paragraph (c)(1) of this Section, the credit to be applied for purposes of computing the estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on the post-1976 gifts made by A.”

Viewed another way, if what would otherwise be the basic exclusion amount for estate tax purposes is less than the total of the basic exclusion amount applied to post-1976 taxable gifts, it is increased for estate tax purposes under this new regulation to equal that total. And if, in the example, the gift had been $12 million instead of $9 million, then the entire assumed $10 million basic exclusion amount would be used with still some gift tax payable (the donor having never married), and the estate tax credit would be computed as if the basic exclusion amount were $10 million.

Under Proposed Treas. Reg. § 20.2010-1(f)(2), the anti-clawback rule would take effect when it is adopted as a final regulation.

Contemporaneously with the release of the proposed regulations, the IRS issued a news release with the reassuring headline of “Treasury, IRS: Making large gifts now won’t harm estates after 2025.” The press release includes an even simpler explanation that “the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the BEA [basic exclusion amount] applicable to gifts made during life or the BEA applicable on the date of death.”

In their practical effect, the proposed regulations do what the statute asks – nothing more, nothing less. The statute compares a transfer at death after 2025 (subparagraph (A)) with a transfer by gift before 2026 (subparagraph (B)). And this is what the proposed regulation would address. For example, the proposed regulation would not address the similar scenario of gifts both before 2026 and after 2025. If large amounts of the increased credit attributable to the new doubled basic exclusion amount are used to shelter gifts from gift tax before 2026 (like the $9 million gift in the Example), then after 2025 the donor might have to wait for decades for the indexed $5 amount to catch up so there can be more credit available for gift tax purposes.

Likewise, the text of the regulation and the Example (and the description above in this Alert) are painstakingly limited in all cases to the amount of the credit that is attributable to the basic exclusion amount – that is, the amount (indexed since 2012) defined in Section 2010(c)(3). Regarding portability, for example, that approach makes it clear that the deceased spousal unused exclusion amount (DSUE amount) defined in Section 2010(c)(4) is not affected by this special rule and is still added under Section 2010(c)(2)(B), in effect thereby generating an additional credit of its own in cases in which the anti-clawback rule applies. But it still may be that the words “lesser of” in Section 2010(c)(4) will limit the DSUE amount available to the estate of a person who dies after 2025 (assuming no change in the law) to the sunsetted basic exclusion amount of $5,000,000 indexed for inflation in effect at the time of the death of the surviving spouse referred to in Section 2010(c)(4)(A), despite the assertion in Treas. Reg. § 20.2010-2(c)(1) that “the DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts – (i) The basic exclusion amount in effect in the year of the death of the decedent” (presumably the predeceased decedent), and despite the statement in the preamble to the June 2012 temporary regulations that “[t]he temporary regulations in Treas. Reg. § 20.2010-2T(c)(1)(i) confirm that the term ‘basic exclusion amount’ referred to in Section 2010(c)(4)(A) means the basic exclusion amount in effect in the year of the death of the decedent whose DSUE amount is being computed.” That limitation gives effect to the general notion held by congressional drafters that portability should, in effect, be allowed to no more than double what would otherwise be the survivor’s exemption.

But if the proposed regulations follow the statute very closely as to their practical effect, it is harder to say that they follow the context of the statute as to their approach and form. Before the proposed regulations were released, there was speculation that the regulations under Section 2001(g)(2) would mirror Section 2001(g)(1) with which their statutory authority is linked and provide, in effect, that in calculating the estate tax the basic exclusion amount in effect at the time of death will be used to calculate the hypothetical “total gift tax paid or payable” on pre-2026 adjusted taxable gifts that is deducted under Section 2001(b)(2) on line 7 of Part 2 of the estate tax return. And by increasing the amount on line 7, which is subtracted in line 8, the estate tax would be appropriately reduced to offset the clawback effect.

But the proposed regulations take a different approach. The preamble implies that other approaches were considered, but concludes that “in the view of the Treasury Department and the IRS, the most administrable solution would be to adjust the amount of the credit in Step 4 of the estate tax determination required to be applied against the net tentative estate tax.” In the context of the new regulation, “Step 4” in the preamble apparently most closely corresponds to line 9a of Part 2 of the estate tax return (“basic exclusion amount”); Step 2 corresponds to line 7.

By increasing the amount on line 9a, rather than the amount on line 7, the proposed regulations would achieve the same result, of course, because both line 7 and lines 9a through 9e produce subtractions in the estate tax calculation. But line 7 already requires three pages of instructions, including a 24-line worksheet, to complete, and an incremental increase of complexity in what already has a reputation for being a tangled morass might be easier to process than adding a new challenge to line 9, which now requires less than one-third of a page of instructions. But, needless to say, IRS personnel see more returns than we do, they see the mistakes, and they hear the complaints. Presumably – hopefully – they contributed to forming the assessment that the line 9 approach is “the most administrable solution.”

That approach should work fine if the law is not changed and sunset occurs January 1, 2026. But, although the example in Proposed Treas. Reg. § 20.2010-1(c)(2) mentions that the donor “dies after 2025,” the substantive rule in Proposed Treas. Reg. § 20.2010-1(c) applies by its terms whenever “changes in the basic exclusion amount … occur between the date of a donor’s gift and the date of the donor’s death.” It is not limited to 2026 or to any other particular time period. The 2010 statutory rule in Section 2001(g)(1) and the 2017 statutory rule in Section 2001(g)(2) are not limited to any time period either. Therefore, if Congress makes other changes in the law, particularly increases in rates or decreases in exemptions, and doesn’t focus on the potential clawback issue in the context of those changes, the generic anti-clawback regime of Section 2001(g)(1) and (2) and these regulations could produce a jigsaw puzzle of adjustments going different directions that may strain the notion of administrability cited in the preamble.

The Example in Proposed Treas. Reg. § 20.2010-1(c)(2) is generally helpful, mainly because it is simpler and more readable than the rule in Proposed Treas. Reg. § 20.2010-1(c)(1) itself. But, perhaps to help achieve that simplification, the drafters of the example used unindexed basic exclusion amounts of $10 million before 2026 and $5 million after 2025, thereby rendering it an example that could never occur under current law, and possibly causing concern that the proposed anti-clawback rule would apply only to the unindexed basic exclusion amount. Because the inflation adjustment is an integral part of the definition of “basic exclusion amount” in Section 2010(c)(3), there should be no question that it is the indexed amount that is contemplated and addressed by the regulation, despite the potential implication of the example.

In any event, the final regulations could benefit from more examples than just one, showing how the outcome would adapt to changes in the assumptions, including examples with indexed numbers, examples with numbers below $5 million (indexed) and above $10 million (indexed), examples with portability elections, and examples with allocations of GST exemption.

There had also been speculation that the regulations might address the option of making, for example, a $5 million gift during the 2018-2025 period (assuming no previous taxable gifts) and treating that gift as using only the temporary “bonus” exclusion resulting from the 2017 Tax Act, which is sometimes described as using the exclusion “off the top,” still leaving the exclusion of $5 million (indexed) to generate a credit to be used against the estate tax after 2025. But that type of relief would go beyond the objective of preserving the benefits of a 2018-2025 use of the increase in the basic exclusion amount and would, in effect, extend the availability of those benefits beyond 2025. Although the preamble to the proposed regulations does not refer directly to that issue, it appears that it would require a different regulatory analysis to achieve that result.

The Notice of Proposed Rulemaking asked for comments from the public by February 21, 2019, and announces a public hearing to be held, if requested, on March 13, 2019.

**IRS Issues Final** **Regulations on Section 199A (January 18, 2019)**

**IRS proposes final regulations on passthrough deduction under new Section 199A**

On January 18, 2019, the Internal Revenue Service (IRS) and the Department of the Treasury released regulations on new Section 199A, the 20 percent deduction for qualified business income, added to the Internal Revenue Code by the 2017 Tax Act. A revised version of the final regulations was issued on February 1, 2019 to make some corrections in the January 18th version of the final regulations.

Revenue Procedure 2019-11 was also issued on January 18, 2019. This revenue procedure provides methods for calculating W-2 wages for purposes of Section 199A. Notice 2019-07 was issued as well on January 18, 2019. This notice contains a proposed revenue procedure to provide a safe harbor permitting a rental real estate enterprise to be treated as a trade or business under Section 199A. Finally, proposed regulations were issued to address matters not addressed in either the August 8th proposed regulations or the January 18th final regulations.

While the proposed regulations issued on August 8, 2018 provided guidance to taxpayers and practitioners on significant issues that arose with the enactment of the new 20 percent deduction, they left many significant issues unaddressed, many of which have been addressed in the final regulations.

The final regulations under Section 199A provide definitional, computational, and anti-avoidance guidance helpful in determining the appropriate deductible amount. Additionally, the IRS and Treasury proposed regulations under Section 643(f) that contain anti-avoidance provisions with respect to the use of multiple nongrantor trusts to circumvent the purpose of Section 199A. The Section 199A proposed regulations contain six sections, each briefly summarized below.

**Background**

Section 199A provides generally that taxpayers other than corporations may claim a deduction for 20 percent of their qualified business income from a partnership, S corporation, or sole proprietorship. These passthrough entities are referred to as “Relevant Passthrough Entities” (RPEs). “Qualified business income” for purposes of Section 199A is defined generally as the net amount of income, gain, deduction, and loss with respect to the qualified trade or business, excluding certain investment-related income and guaranteed payments to partners in a partnership. A “qualified trade or business” is defined generally as any trade or business except the trade or business of performing services as an employee and any specified service trade or business (SSTB).

The deduction under Section 199A is limited generally to the greater of: (1) 50 percent of the W-2 wages of the trade or business for the taxable year, or (2) the sum of 25 percent of such wages and 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property for the taxable year (referred to awkwardly in the regulations as “UBIA of qualified property”). The W-2 wage and UBIA of qualified property limitations do not apply to taxpayers with a taxable income of less than $157,500 ($315,000 for married couples filing jointly) adjusted for inflation and is phased in for taxpayers with taxable income above that threshold amount. The thresholds for 2019 are $160,700 for single taxpayers and heads of household, $160,725 for married taxpayers filing separately, and $321,400 for married taxpayers filing joint returns. Finally, the Section 199A deduction cannot exceed the taxpayer’s taxable income over net capital gain for the tax year.

**Operational Rules**

The first Section of the regulations under Section 199A provides guidance on the determination of the Section 199A deduction generally. The regulations clarify that, for purposes of Section 199A, the term “trade or business” should be interpreted in a manner consistent with the guidance under Section 162, which provides a deduction for ordinary and necessary business expenses. The regulations under Section 199A, however, expand the traditional definition under Section 162 to include certain rental or licensing of property to related parties under common control.

This first Section also provides guidance on computing the deduction for a taxpayer that has taxable income above, at, or below the threshold amount for applying the W-2 wage and UBIA of qualified property limitations. In doing so, the IRS and Treasury prescribe computational rules, including rules for determining carryover losses and for the treatment of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income.

Finally, the first Section of the regulations provides that the Section 199A deduction is applied at the partner or shareholder level. The deduction does not affect the adjusted basis of a partner’s interest in a partnership, the adjusted basis of a shareholder’s stock in an S corporation, or an S corporation’s accumulated adjustments account.

**Determination of W-2 Wages and the UBIA of Qualified Property**

The second section of the regulations prescribes rules for determining W-2 wages and the UBIA of qualified property. The regulations provide that W-2 wages of a qualified trade or business are determined generally using the rules that applied under former Section 199 with respect to the domestic production activities deduction. The IRS and Treasury state in the preamble of the proposed Section 199A regulations that Notice 2018-64, issued concurrently with the regulations, provides three methods for calculating the W-2 wages of a qualified trade or business.

Additionally, the second section of the regulations addresses many issues concerning the UBIA of qualified property, including its allocation among relevant passthrough entities, subsequent improvements to the qualified property, and the effect of certain nonrecognition transactions (for example, like-kind exchanges). The regulations put in place guardrails to prevent taxpayers from gaming the system. For example, the regulations indicate that property is not qualified property if a taxpayer acquires and disposes of the property in a short period unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was not to increase the Section 199A deduction.

**Qualified REIT Dividends and Qualified Publicly Traded Partnership Income**

The third section of the regulations restates the definition of qualified business income (QBI) and provides additional guidance on the determination of QBI, qualified REIT dividends, and qualified PTP income. The regulations describe in further detail the exclusions from QBI, including capital gains, interest income, reasonable compensation, and guaranteed payments. With respect to qualified REIT dividends, the regulations contain an anti-abuse rule to prevent dividend-stripping and similar transactions aimed at increasing the qualified REIT dividends without having a corresponding economic exposure.

**Aggregation Rules**

The fourth section of the regulations addresses rules for aggregating multiple trades or businesses for the purposes of applying the computational rules of Section 199A. Commentators urged the IRS to apply the grouping rules for determining passive activity loss and credit limitation rules under Section 469. The IRS concluded that the rules under Section 469 were inappropriate for purposes of Section 199A, but did agree with commentators that aggregation should be permitted.

The regulations create a four-part test for aggregation. First, each trade or business a taxpayer proposes to aggregate must itself be a trade or business as defined by the regulations. Second, the same person, or group of persons, must own, directly or indirectly, a majority interest in each of the businesses for the majority of the taxable year. The regulations provide rules allowing for family attribution for this purpose. Third, none of the trades or businesses can be an SSTB. Finally, the trade or business must meet at least two of the three following characteristics:

(1) The businesses provide products and services that are the same or typically provided together.

(2) The businesses share facilities or significant centralized elements.

(3) The businesses are operated in coordination with each other.

Under the regulations, an individual taxpayer may aggregate trades or businesses operated through multiple passthrough entities; however, the taxpayer must determine the QBI, W-2 wages, and UBIA of qualified property for each trade or business separately before applying the aggregation rules. The regulations also permit a RPE to aggregate separate businesses that are operated either directly or through lower-tier RPEs.

**Specified Service Trade or Business and the Trade or Business of Performing Services as an Employee**

The fifth section of the regulations contains substantial guidance on the definition of an SSTB.  Under Section 199A, if a trade or business is an SSTB, none of its items are taken into account for determining a taxpayer’s QBI.  A taxpayer who owns an SSTB conducted through an entity, such as an S corporation or partnership, is treated as engaged in an SSTB for purposes of Section 199A, regardless of the taxpayer’s actual level of participation in the trade or business.

Notwithstanding the general rule, taxpayers with taxable income of less than $157,500 ($315,000 for married couples filing jointly) as adjusted for inflation may claim a deduction under Section 199A for QBI received from an SSTB.  The Section 199A deduction phases out for taxpayers with taxable incomes over this threshold amount. If a trade or business is conducted by a passthrough entity, the phase-out threshold is determined at the individual, trust, or estate level, not at the level of the passthrough entity.  Accordingly, a passthrough entity conducting an SSTB could have taxable income below the threshold amount but have no owners eligible for a Section 199A deduction because each of them has taxable income above the threshold amount (plus $50,000 or $100,000 in the case of a married couple filing jointly).

The regulations also attempt to combat what commentators have called the “crack and pack” strategy. Under this strategy, a business that would otherwise be an SSTB separates all its administrative functions into a separate entity to qualify that separate entity for the Section 199A deduction. To minimize the potential for this abuse, the regulations provide that an SSTB includes any trade or business with 50 percent or more common ownership. The final regulations deleted the 80 percent requirement (that the SSTB with 50 percent of more common ownership also provide 80 percent or more of its property or services to SSTB).  The Service agreed with commentators that this require was unnecessary.

The regulations contain a lengthy and detailed definition of an SSTB. Generally, the regulations state that the existing guidance defining a “qualified personal service corporation” under Sections 448 and 1202 informs the definition of an SSTB under Section 199A. Pursuant to Section 199A(d)(2)(A), which incorporates the rules of Section 1202(e)(3)(A), an SSTB is any trade or business in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, investment management, or trading or dealing in securities, or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners. The regulations limit “reputation or skill” to trades or businesses involving the receipt of income for endorsing products or services, licensing or receiving income for the use of an individual’s publicity rights, or receiving appearance fees.

The Service deleted the Business Incidental to an SSTB Test from the final regulations. As a result, the common control of an SSTB and a non SSTB will not causes to non SSTB to be treated as part of the SSTB. This differs from the situation in which an SSTB and a non SSTB are part of the same business

The common law and statutory rules used to determine whether an individual is an employee for federal employment tax purposes apply to determining whether an individual is engaged in the trade or business of performing services as an employee for purposes of Section 199A. The regulations also create a presumption that an individual who was treated as an employee for federal income tax purposes but is subsequently treated as other than an employee with respect to the same services is still engaged in the trade or business of performing services as an employee for purposes of Section 199A.  The presumption attempts to prevent taxpayers from reclassifying employees as independent contractors in order to claim a Section 199A deduction.

**Special Rules for Passthrough Entities, Publicly Traded Partnerships, Trusts, and Estates**

The sixth section of the regulations contains special rules for passthrough entities, PTPs, nongrantor trusts, and estates. Passthrough entities, including S corporations and entities taxable as partnerships for federal income tax purposes, cannot claim a deduction under Section 199A. Any passthrough entity conducting a trade or business, along with any PTP conducting a trade or business, must report all relevant information — including QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income — to its owners so they may determine the amount of their respective Section 199A deductions.

The regulations require that a nongrantor trust or estate conducting a trade or business allocate QBI, expenses properly allocable to the trade or business, W-2 wages, and UBIA of qualified property among the trust or estate and its beneficiaries. The allocation is based on the ratio that the distributable net income (DNI) distributed or deemed distributed to each beneficiary bears to the trust’s or estate’s total DNI for the taxable year. Any DNI not distributed is allocated to the nongrantor trust or estate itself. UBIA of qualified property is allocated without taking into account how depreciation deductions are allocated among the beneficiaries under Section 643(c). When calculating the threshold amount for purposes of applying the W-2 wage and UBIA limitations, unlike the proposed regulations, the final regulations provide that taxable income is computed at the trust or estate level taking into account any distributions of DNI.

For purposes of the Section 199A regulations, a qualified subchapter S trust (QSST) is treated as a grantor trust. The individual treated as the owner of the QSST is treated as having received QBI directly from the trade or business and not through the QSST.

The final regulations treat the S and non-S portions of an Electing Small Business Trust (ESBT) as a single trust when determining the threshold amount for the ESBT.

**Anti-avoidance Guidance for Multiple Nongrantor Trusts**

In addition to finalizing regulations under Section 199A, the IRS and Treasury finalized regulations under Section 643(f) designed to prevent taxpayers from manipulating the Section 199A deduction using multiple nongrantor trusts. Section 643(f) allows Treasury to prescribe regulations to prevent taxpayers from establishing multiple nongrantor trusts to avoid federal income tax. The regulations under Section 643(f) provide that when two or more trusts have the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a purpose of such trusts is to avoid federal income tax, all of such trusts will be treated as a single trust for federal income tax purposes. Absent this anti-abuse rule, taxpayers could own a trade or business through multiple nongrantor trusts such that each trust would have taxable income below the threshold amount for applying the W-2 wage and UBIA limitations on the Section 199A deduction.

**Notice 2018-54, 2018-24 IRB 750 (May 23, 2018**)

**IRS provides guidance on certain payments made in exchange for state and local tax credits**

The purpose of this notice is to inform taxpayers that the Treasury Department and the IRS intend to propose regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes.

The 2017 Tax Act limited an individual taxpayer’s deduction for the aggregate amount of state and local taxes paid during the calendar year to $10,000. State and local tax payments in excess of those amounts are not deductible. This new limitation applies to taxable years from 2018 through 2025. In response to this new limitation, some state legislatures are considering or have adopted proposals that would allow taxpayers the make transfers to funds controlled by state or local governments or other specified transfers in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of the proposals is to allow taxpayers to characterize such transfers as fully deductible charitable contributions for federal income tax purposes while using the same transfers to satisfy state or local tax liabilities.

The notice warns taxpayers that despite these state efforts to circumvent the new $10,000 limitation on the deduction of state and local taxes, they should be mindful that federal law controls the proper characterization of payments for federal income tax purposes. Proposed regulations will be issued to make it clear that the requirements of the Internal Revenue Code, informed by substance over form principles, will govern the federal income tax treatment of such transfers.

**Press Release: Treasury Issues Proposed Rule on Charitable Contributions and State and Local Tax Credits (August 23, 2018)**

**Department of Treasury issues proposed rule on federal income tax treatment of payments and property transfers under state and local tax credit programs**

The Treasury Department released this proposed rule to prevent charitable contributions from being used to circumvent the new limitation on state and local taxation under the 2017 Tax Act. The 2017 Tax Act limited the amount of state and local taxes that an individual could deduct to $10,000 per year. Several states have enacted or are considering tax credit programs to “circumvent” the $10,000 limit of the 2017 Tax Act.

The Treasury Department stated that the proposed rule is a straightforward application of a long-standing principal of tax law: when a taxpayer receives a valuable benefit in return for a donation to charity, the taxpayer can deduct only the net value of the donation of a charitable contribution. The rule applies that quid pro quo principle to state tax benefits provided to the donor in return for contributions.

The press release gives the following example: if a state grants a 50 percent credit and the taxpayer contributes $1,000, the allowable charitable contribution may not exceed $500. The proposed rule provides an exception for dollar-for-dollar state and local tax deductions and tax credits of no more than 15 percent of the payment amount of the fair market value of the property transferred. These guidelines will apply to both new and existing tax credit programs.

The press release also noted that because of the increase in the standard deduction of the 2017 Tax Act the Treasury Department projects that 90 percent of taxpayers will not itemize under the new tax law. It also estimates that approximately 5 percent of taxpayers will itemize and have state and local income tax deductions above the $10,000 cap. The Treasury Department also expects that only about 1 percent of taxpayers will see an effect on the tax benefits for donations to school choice tax credit programs.

**Letter Ruling 201924009 (Issued January 29, 2019; Released June 14, 2019)**

**Taxpayer is considered a “non-resident, not a citizen of the United States” for estate, gift and generation-skipping tax purposes when he acquired his United States citizenship solely by reason of residence within United States Possession**

This letter ruling concerns the determination of whether an individual would be taxed as a resident citizen or a nonresident not a citizen of the United States. Taxpayer was born in a foreign country. Neither of his parents were citizens, nationals, or residents of the United States or of any of its possessions or territories. Neither of taxpayer’s parents were born in the United States or any of its possessions or territories.

After taxpayer’s birth, taxpayer came to a Possession of the United States with a student visa. After graduating from college, taxpayer began to work in the United States Possession with a work visa and continuously resided in the Possession after he moved to the Possession. Subsequently, taxpayer became first a permanent resident of the United States Possession and subsequently a citizen of the United States through naturalization proceedings in the United States district court for the district of the Possession.

In making its determination of the status of taxpayer for purposes of the estate, gift, and generation-skipping taxes, the Internal Revenue Service first reviewed the Nationality Act of 1940, which was in effect at the time of taxpayer’s birth. This act governed whether taxpayer received derivative citizenship through his parents as of his birth. The Service determined that under the 1940 Act as in effect when taxpayer was born, the taxpayer would not have qualified as a citizen of the United States at birth through his parents.

The Service then examined the Immigration and Nationality Act of 1952, which was in effect when the taxpayer became a United States citizen. Taxpayer became a citizen of the United States solely based on his continuous residency in the United States Possession.

The Service then examined Sections 2208 and 2209 of the Internal Revenue Code. Section 2208 provides that a decedent who was a citizen of the United States and a resident of a possession at the time of his or her death is considered a “citizen” for federal estate, gift, and generation-skipping purposes unless he acquired his United States citizenship solely by reason of (1) his being a citizen of the possession or (2) his birth or residence within that possession. Section 2209 provides that a decedent who is a citizen of the United States and a resident of a possession at the time of his death shall for purposes of the estate tax be considered a “non-resident, not a citizen of the United States” if that decedent acquired his United States citizenship solely by reason of (1) his being a citizen of a possession of the United States or (2) his birth or residence within such possession of the United States. Since the taxpayer acquired his United States citizenship solely by reason of his residence within a United States possession, the taxpayer would be considered a “non-resident, not a citizen of the United States” for purposes of the estate, gift, and generation skipping taxes. As a result, the taxpayer would be subject to tax as a non-resident, not a citizen of the United States.

**Letter Rulings 201929013 (Issued April 4, 2019; Released July 19, 2019) and 201929017 (Issued April 8, 2019; Released July 19, 2019)**

**Decedent’s estate granted extension to make portability election**

Decedent died survived by spouse. Decedent’s estate was not required to file an estate tax return. Decedent had unused applicable exclusion and a portability election was necessary to allow the surviving spouse to take into account that unused applicable exclusion (DSUE amount). Since the availability of portability in 2011, the portability election is to be made on a timely filed complete and properly prepared estate tax return. Spouses’ tax advisor did not advise her about the portability election. Consequently, an estate tax return was not timely filed and the portability election was not made.

After the discovery of the missed portability election, decedent’s estate requested an extension of time under Treas. Reg. § 301.9100-3 to make the portability election. Treas. Reg. § 301.9100-3 provides that an extension of time to make an election when the due date is prescribed by a regulation (and not expressly provided by statute) will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. Because the time for filing the portability election is fixed by the regulations, the Internal Revenue Service had the discretionary authority under Treas. Reg. § 301.9100-3 to grant an extension of time.

Based on the information, affidavits, and representations submitted on behalf of the decedent’s estate, the Service granted the request for an extension of time. The Service did note that if it was later determined that decedent’s estate was large enough to require the filing of an estate tax return, the Service lacked the authority under Treas. Reg. § 301.9100-3 to grant an extension of time to elect portability. In that situation, the extension of time to elect portability would be deemed null and void.

**Setting Every Community Up for Retirement Enhancement (“SECURE”) Act (December 17, 2019)**

**Secure Act has large impact on retirement benefits**

The House of Representatives on December 17, 2019 and the Senate on December 19, 2019 passed the Setting Every Community Up for Retirement Enhancement (“SECURE”) Act as part of Division O of H.R. 1865, which was entitled “Further Consolidated Appropriations Act, 2020.” The SECURE Act was introduced by House Ways and Means Chair Richard Neal and Ranking Member Kevin Brady and was passed on a bipartisan basis. The SECURE Act includes the following changes to defined compensation plans, defined benefit plans, and IRAs:

* Making it easier for small businesses to set up 401(k) accounts;
* Providing a maximum tax credit of $500 per year to employers who create a 401(k) or simple IRA with automatic enrollment;
* Pushing back the age at which retirement plan participants need to take required minimum distributions from 70 ½ to 72;
* Removing the age limit at which an individual can contribute to a regular IRA and allowing anyone that is working and has earned income to contribute to a regular IRA regardless of age;
* Requiring most non-spousal IRA retirement plan beneficiaries to withdraw the amounts in inherited accounts within 10 years of the death of the participant;

This last change, which will be effective for anyone who inherited an IRA from the original IRA owner who passed away on or after January 1, 2020, basically eliminates the use of the “Stretch IRA” by most non-spousal individual beneficiaries. Far fewer beneficiaries will be able to extend distributions from an inherited IRA over their lifetimes. Instead, most beneficiaries of inherited IRAs will have to withdraw all of the assets from the inherited IRA within ten years following the death of the original owner. The exceptions to the ten-year distribution requirement include IRAs left to a surviving spouse, a minor child, a disabled or chronically ill individual, and beneficiaries who are less than 10 years younger than the decedent.

The new law also now permits tax-free distributions from a 529 plan to repay up to $10,000 in qualified student loans and the expenses of certain apprenticeship programs. This change to 529 plans is retroactively effective as of January 1, 2019.

**MARITAL DEDUCTION**

**Letter Ruling 201923004 (Issued December 17, 2018; Released June 7, 2019)**

**Estate granted extension of time to make QTIP election**

A marital trust was created for the benefit of the surviving spouse when the decedent died. Although the marital trust was identified on Schedule M to decedent’s federal estate tax return, the federal estate tax return failed to include the QTIP election for the property in the marital trust. The attorney who prepared the federal estate tax return described the value of the property passing to the marital trust as property other than QTIP property and for which no QTIP election was made.

The estate requested an extension of time under Treas. Reg. §§ 301.9100-1 and 301.9100-3 to make a QTIP election for the marital trust.

Treas. Reg. § 301.9100-1 gives the IRS the discretion to grant a reasonable extension of time to make a regulatory or statutory election. Under Treas. Reg. § 301.9100-3, an extension of time will be granted when the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional. Based on these standards, the Internal Revenue Service granted the estate an extension of time to make the QTIP election for the marital trust. The election was to be made on a supplemental federal estate tax return.

**GIFTS**

**Karen S. True v. Commissioner, Tax Court Docket No. 21896-16 (Petition filed October 11, 2016; Settled July 9, 2018) and H. A. True III v. Commissioner, Tax Court Docket No. 21897-16 (Petition filed October 11, 2016; Settled July 6, 2018)**

**IRS attacks use of Wandry clause in gift and sale of interests in a family business**

In the True v. Commissioner case, Husband gave interests in a family business to one of his daughters. At the same time, he sold interests in the family business to his three children and a trust. Husband obtained appraisals from FMV which the court noted is a recognized and reputable national appraisal firm. Since Husband and Wife split the gift, any gift was considered made one-half by each spouse.

When the gifts of the interests in the family business were made to the daughter, the transfer agreement provided that if the value of the interests transferred to the daughter were determined to be worth more than $34,044,838 for federal gift tax purposes, then the interests owned by the daughter would be adjusted so that the value of the gift remained at $34,044,838 and the daughter would be treated as having purchased the ownership interests that were removed from the gift. Thus, the transfer documents utilized adjustment provisions to fix the value of the interests given to the daughter at a specific dollar value similar to the adjustment clause upheld by the Tax Court in Wandry v. Commissioner, T.C. Memo 2012-88 and with which decision the Service disagrees.

With respect to the interests that were sold to that daughter and the other two children and a trust, the transfer documents provided that if the interests sold were undervalued by FMV for federal gift tax purposes, the purchase price would be increased to reflect the fair market value as finally determined for gift tax purposes.

The IRS has alleged a gift tax deficiency of $16,591,418 by each of Husband and Wife. Husband and Wife have countered that the valuations are correct. However, if the transferred interests are determined to have a higher value, no gift should result because of the adjustment provisions contained in the transfer agreement. These two cases may help determine the future validity and usefulness of Wandry adjustment clauses.

These cases were settled in July 2018 with agreed gift tax deficiency of $2,004,322 in Karen S. True and $2,004,321 in H.A. True III.

**Letter Ruling 201803003 (Issued October 6, 2017; Released January 9, 2018)**

**Proposed trust modifications will not trigger gift or generation-skipping tax**

An irrevocable trust was created prior to October 22, 1942 by parents for the benefit of Daughter. The Daughter’s only right was to receive distributions of net earnings, but not principal, awarded to her by the trustee with the consent of the advisory board of the trust and to distribution of the trust estate made by the trustee at the termination of the trust. At Daughter’s death, her equitable interest was to pass to and vest in her heirs in accordance with the laws of descent and distribution then in force. The trust was to continue for Daughter’s life and for a period of 21 years after her death at which time the trust would terminate and the trust corpus would be distributed to the beneficiaries.

Because of a planned disclaimer, certain of the children and grandchildren of Daughter had sought a declaratory judgment concerning the impact of their planned disclaimers. The court ruled that Daughter and the successor beneficiaries all had a testamentary general power of appointment. A pre October 22, 1942 power of appointment only has adverse estate tax consequences if it is exercised. Upon the death of Daughter or successor beneficiary, the heirs at law of that beneficiary would succeed to the beneficiary’s interest in the trust. The court also ruled that after Daughter’s death, each successor beneficiary would have three separate beneficial interests:

An income interest for 21 years after Daughter’s death;

The remainder interest which vested in possession 21 years after Daughter’s death; and

A pre-1942 general power of appointment.

The court ruled that each of those interests could be disclaimed independently of others.

Several years later, Daughter proposed to partially release her general power of appointment to restrict the power in two respects. First, the power was to be exercisable only in favor of the Daughter’s estate. Second, the power could only be appointed to take effect after her death. The intention of Daughter was to allow her power of appointment over the trust to lapse at her death.

Subsequently, the trustee petitioned the supervising court, with the consent of the Daughter and other beneficiaries, to provide that when the trust terminated 21 years after the death of Daughter, any share distributed to a beneficiary under a specified age was to be held in a continuing trust until that beneficiary reached the specified age. If that beneficiary survived Daughter but died before reaching the specified age, the beneficiary would have a general testamentary power of appointment causing the property to be included in the beneficiary’s estate. The later petition also requested the court to modify the trust to allow for the administration of the separate trusts created after the Daughter’s death.

The taxpayer requested the following rulings:

The power of appointment granted to the great grandchildren who succeeded to the Daughter’s interest in the trust would be considered a pre-October 22, 1942 power of appointment and the complete release or lapse of that power of appointment would not have any adverse estate, gift, or GST tax purposes.

The proposed disclaimer by any one or more of the great grandchildren would be a qualified disclaimer under Section 2518 and would not have any adverse gift tax or estate tax consequences to the disclaimants and would not result in the loss of the GST exempt status of the trust.

The assets of a continuing trust created pursuant to proposed modification after Daughter’s death would be included in the estate of the beneficiary if the beneficiary died before the termination of the continuing trust.

The proposed construction of the trust would not cause the trust to be subject to GST tax.

The proposed construction of the trust would not result in a taxable gift by any of the beneficiaries of the trust.

With respect to the first ruling request, the Daughter had a pre-October 22, 1942 general power of appointment to which the grandchildren would succeed when the Daughter dies. To the extent that any grandchild disclaimed his or her interest in that power of appointment or died during the 21 year period following Daughter’s death, some great grandchildren might succeed to her power of appointment. Based on the regulations to Section 2041, the power of appointment held by the great grandchildren and more remote beneficiaries would be considered a power created before October 22, 1942 and consequently the release or lapse of such a power would not treated as the exercise of the power and would have no adverse estate or gift tax consequences.

With respect to the second ruling request, Daughter’s heirs cannot succeed to any interest in the trust until Daughter’s death pursuant to the terms of the trust. Consequently, Daughter’s great grandchildren could disclaim their interest and there would be no adverse estate or gift tax consequences.

With respect to the third and fourth ruling requests, the proposed modifications would not have any adverse generation-skipping tax consequences. The modification would fall within the scope of Treas. Reg. 26.2601-1(b)(4)(i)(D)(1) which provides that a modification of the governing instrument of an exempt trust is valid under applicable state law and will not have adverse GST consequences when the modification does not shift a beneficial interest to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification and the modification does not extend the time for the vesting of any beneficial interest in the trust beyond the period provided for in the original trust. That was the case here.

With respect to the fifth ruling request, because the proposed construction of the trust clarified ambiguous terms of the trust and reflected the rights of the party under applicable law, the proposed construction of the trust would not result in a taxable gift by any of the beneficiaries of the trust.

**Letter Ruling 201808002 (Issued November 16, 2017; Released February 23, 2018)**

**Service rules on gift tax consequences of gift of life estate interest in pre-October 9, 1990 transaction**

Prior to the enactment of Chapter 14 in 1990, husband, wife, and their six children purchased real estate from an unrelated party for the property’s fair market value. Husband, wife, and each of the children executed an agreement whereby husband, wife, and each of the children paid the actuarial value of their respective interests from their own resources and none of the six children used any funds acquired from their parents to acquire their respective interests. Under the agreement, wife acquired a life interest in the use of and income from the real property, husband acquired a life interest in the use of and income from the real property that became effective upon the death of the wife, and each of the children had a 1/6th undivided interest in the remainder.

The life tenants wished to give a geographically defined portion of the acreage of their life interest in the real property to the children. As a result, the six children would become the outright owners of that geographically defined real estate.

The taxpayers requested rulings that:

The remaining acreage of the real property after the transaction would continue to be treated as resulting from a pre-October 9, 1990 transfer for purposes of the application of Chapter 14.

The proposed gifts by the life tenants would be treated as gifts for federal gift tax purposes.

The proposed gifts by the life tenants would not result in any portion of the real property being included in the gross estate of either life tenant for estate tax purposes.

The Service first ruled that the conveyance of the real estate by the life tenants would be treated as gifts for federal gift tax purposes and that the gifts would be valued using the actuarial value of the individual life estate interests determined by the application of the appropriate Section 7520 rate. In addition, the life tenants would not be considered to retain any interest in, or any right to alter or revoke, or any reversion in the portion of the real estate that was conveyed to the remainder beneficiaries and that the transaction would not result in any adverse estate tax consequences to wife and husband. The Service held that the transaction would not be subject to the application of Chapter 14.

**Letter Ruling 201825003 (Issued March 9, 2018; Released June 22, 2018)**

**Transfer of the legal title, naked ownership, and remainder interest in and to artwork as defined by the deed of transfer is a completed gift for gift tax purposes**

Taxpayer and spouse owned an art collection. The taxpayer as a result of the spouse’s death, became the sole owner of the artwork. Prior to the spouse’s death, the taxpayer and the spouse entered into a deed of transfer with two museums outside of the United States under which they agreed to donate the artwork with the possession of the artwork by the museums to occur on the death of the second to die and spouse.

The deed of transfer provided that the taxpayers granted to the museums the legal title, naked ownership and remainder interest in and to the artwork. It also provided that the taxpayer expressly reserved a life interest and usufruct in and to the artwork which would automatically expire on the death of the taxpayers.

The deed provided the parties intended for the transfer not to qualify for gift tax purposes on the basis that the taxpayer was not releasing dominion and control over the artwork until death. If the taxpayer received a favorable ruling from the IRS of the gift tax treatment, the donation is deemed to take effect as of the day of the favorable ruling. Certain conditions were imposed in the deed of transfer. The museums were to comply with the requirements regarding the housing, display, and exhibition of the artwork. The museums must not become privately owned and the tax laws must not change to cause the taxpayer to become subject to taxation in the country, during the taxpayer’s life or upon death, in connection with the transfer of the artwork if the artwork was to be transferred to museums in a country other than the United States.

The IRS stated that upon the effective date of the deed of trust, the taxpayer would transfer legal title, naked ownership and the remainder interests of the artwork to the museums. During the period of the life interest and usufruct, the taxpayer would not sell or otherwise dispose of any of the artwork. The taxpayer retained no power to change the disposition of the artwork and was barred from doing so under the deed of trust. Even though the transfer of the artwork was subject to several conditions subsequent, the conditions that would cause a revocation of the transfer were not dependent on any act of the taxpayer. Consequently, the taxpayer’s grant to the museums of the legal title, naked ownership, and remainder interest to the artwork would be a completed gift for gift tax purposes.

**Letter Ruling 201836006 (Issued May 30, 2018; Released September 7, 2018)**

**Service rules on consequences of incomplete non-grantor trust**

This letter ruling is one of the most recent letter rulings on the tax consequences of an incomplete non‑grantor trust. In this letter ruling, grantor created an irrevocable trust. The beneficiaries were a class consisting of the grantor, the grantor’s parents, the grantor’s siblings, the grantor’s nephew and niece, any issue of the grantor born or adopted after a specified date and any mutual issue of grantor’s parents born or adopted after a specified date. A corporate trustee was the sole trustee of the trust.

The trust provided for a distribution committee consisting of the parents and the two siblings. The distribution committee had the power to appoint income and principal of the trust in a non‑fiduciary capacity to one or more beneficiaries by unanimous vote (unanimous member power) and to appoint principal and income in a non‑fiduciary capacity to one or more beneficiaries by a majority vote with the affirmative consent of the grantor (grantor’s consent power). If no members of the distribution committee were then serving, the trustee could distribute income and principal on a discretionary basis for health, education, maintenance and support. An independent trustee could distribute income and principal in its sole and absolute discretion for any purpose.

The grantor in a non‑fiduciary capacity could direct the trustee to distribute principal of the trust to or among the beneficiaries other than the grantor for health, education, support and maintenance (grantor’s sole power).

The grantor had a broad limited testamentary power of appointment over the property and the trust. To the extent that the grantor did not exercise the broad limited testamentary power of appointment, the property was to pass to grantor’s children, otherwise, to his parents and their descendants.

The following rulings were requested:

1. During the period that the distribution committee was serving during the life of the grantor, there would be no income tax consequences to the grantor or any member of the distribution committee.

2. The grantor’s contribution of property to the trust was not a completed gift, subject to federal gift tax.

3. Any appointment of trust property by the distribution committee to grantor would not be a completed gift by any member of the distribution committee.

4. Any appointment of trust property by the distribution committee to any beneficiary of the trust other than the grantor would not be a completed gift subject to federal gift tax by any member of the distribution committee.

5. No member of the distribution committee would be considered to have a Section 2041 general power of appointment over any property held in the trust.

The Service first ruled that none of the provisions of the trust would cause the grantor to be treated as the owner of the trust for income tax purposes as long as the distribution committee remained in existence and was serving under any of Sections 673, 674, 676, or 677. The Service then concluded that an examination of the trust revealed none of the circumstances that would cause administrative controls to be considered exercisable primarily for the benefit of the grantor under Section 675. A determination of whether Section 675 would cause the grantor to be treated as the owner of any portion of the trust for income tax purposes was deferred until the federal income tax returns of the parties were examined.

The Service next ruled that the contribution of property to the trust was not a completed gift. A distribution from the trust to grantor was merely a return of grantor’s property. Upon grantor’s death, the fair market value of the property in the trust was subject to tax in the grantor’s gross estate.

The Service finally ruled that any appointment of trust property by the distribution committee to any beneficiary of the trust, other than the grantor, would not be a completed gift subject to federal gift tax by any member of the distribution committee. Instead, any such appointment would be a completed gift by the grantor. In addition, the powers held by the distribution committee were not general powers of appointment under Section 2041 and accordingly, no property held in the trust would be includible in the gross estate of any member of the distribution committee upon his or her death under Section 2041.

**ESTATE INCLUSION**

**Badgley v. United States, \_\_\_\_\_ F.Supp.3d \_\_\_\_\_ (N.D. Cal 2018)**

**The assets of a GRAT are included in the settlor’s estate**

On February 1, 1998, Patricia Yoeder created a grantor retained annuity trust. Patricia was to receive annual annuity payments for the lesser of fifteen years or her prior death in the amount of 12.5 percent of the date of gift value of the property transferred to the GRAT. The GRAT paid Patricia an annuity of $302,259. Upon the end of the annuity term, the property was to pass to Patricia’s two living daughters. The GRAT also stated that, if the trustor failed to survive the trust term, the trustee was to pay all the remaining annuity amounts and the portion of the trust included in the trustor’s estate to the survivor’s trust created under Patricia’s revocable trust.

Patricia died on November 2, 2012 having received her last annuity payment from the GRAT on September 30, 2012, two months before the expiration of the annuity term.

The federal estate tax return reported a gross estate of $36,829,057, including the value of the assets held in the GRAT. The estate paid federal estate taxes of $11,187,457. On May 16, 2016 the estate filed a claim of refund seeking $3,810,004 in estate tax overpaid by the estate as a result of the inclusion of the full value of the GRAT. The case was before the court on cross-motions for summary judgment from the government and the estate.

The estate moved for summary judgment on two bases, asserting that Section 2036(a)(1) did not apply to Patricia’s GRAT and that Treas. Reg. § 20.2036-1(c)(2) was overly broad and invalid to the extent that it applied to the GRAT and that the transfer of property the GRAT was a bona fide sale for full and adequate consideration and Section 2036 did not apply to cause inclusion of the property in the GRAT in the estate. The government moved for summary judgment on the opposite grounds. The estate argued that a “fixed-term annuity” was not the same as a right to income or some other form of possession or enjoyment as required by Section 2036(a)(1). However, the government relied on three cases that took a broad approach to the operative language of Section 2036 and its predecessor: C. I. R. v. Church’s Estate; 335 U.S. 632 (1939); Spiegel’s Estate v. Commissioner, 335 U.S. 701 (1949); and Helvering v. Hallock, 309 U.S. 106 (1940). The court found that Section 2036 applied to the GRAT. Although plaintiff was correct that the government’s authorities did not expressly equate a fixed-term annuity with a right to income or some other possession or enjoyment, the Supreme Court had adopted a substance over form approach that favored a finding that the annuity comprised some form of possession, enjoyment, or right to income from the transferred property.

Treas. Reg. 20.2036-1(c)(2)(i) requires that transferred GRAT property be included in a decedent’s gross estate where the decedent retains an annuity interest and dies before the expiration of the annuity term. The court found that the regulation was valid even though Section 2036 does not equate “income” with a fixed term annuity in Section 2036. The silence did not mean that the interpretation of the Section is arbitrary or capricious. Instead the regulation is a permissible interpretation of Section 2036. The court also rejected the argument that the regulation was arbitrary because it would result in the inclusion of all private annuities in the decedent’s gross estate and was overly broad to the extent that the regulations subsequently included GRATs such as Patricia’s that “have no ordering rule, do not provide for income payments disguised as annuity payments, and at the time of grantor’s death can satisfy the annuity payments entirely out of principal.” The second argument failed once the court rejected the attempted distinction between an annuity and a right to income.

The court also rejected the argument that the creation of the GRAT was property transferred to the GRAT in a bona fide sale in exchange for an annuity. The court noted that the funding of the GRAT does not involve selling the transferred property to a third party in exchange for an annuity. There is no other owner of property engaging in the sale transaction other than the transferor.

Finally, the formula used to determine the included value of the GRAT was reasonable even though it assumed that the annuity was paid solely from income. The estate argued that an annuity can, in fact, be paid from either principal or income and thus the formula yielded a capriciously large amount to be included for tax.

As a result, Patricia’s GRAT was properly included in calculating the value of her gross estate.

**Letter Rulings 201920001, 201920002, and 201920003 (Issued November 26, 2018; Released May 17, 2019)**

**Judicial reformation and modification of powers of appointment have no adverse estate, gift, or generation-skipping tax consequences**

Grantor created separate irrevocable trusts for the benefit of each of his grandchildren. Each trust provided for the discretionary distribution of income and principal to the grandchild pursuant to an ascertainable standard. Upon termination of the trust at the grandchild’s death, each grandchild was given a testamentary power of appointment. If the power of appointment was not exercised, the property passed *per stirpes* to the then living descendants of the grandchild, otherwise to the then living descendants of the grandchild’s parent. The trusts also contained Crummey powers of withdrawal to permit gifts to the trusts to qualify as present interests for purposes of obtaining the gift tax annual exclusion.

The grantor and his spouse made gifts to the trusts for many years, which were treated as split gifts under Section 2513. When the grantor died, he bequeathed a portion of his estate to each trust. Grantor’s spouse continued to make gifts to each trust after the grantor’s death.

Several years after grantor’s death, the trustee became aware that the language of the trusts would not prevent the appointment of the trust property by a grandchild to non-family members and that the broad language describing the powers of appointment could be construed as granting a general power of appointment with adverse estate tax consequences to each grandchild. As a result, the trustee started a reformation proceeding to include the necessary limiting language to qualify each grandchild’s power of appointment as a limited power of appointment which expressly prohibited the appointment of trust assets to a grandchild, the grandchild’s estate, or the creditors of either. The petition was supported by affidavits, one each from the grantor’s accountant, the law firm which had drafted the trusts, and the trustee.

The court first issued an order limiting the power of appointment to exclude the grandchild, the grandchild’s estate, or the creditors of either. The court then issued an amended order that clarified that each trust would terminate upon the death of the grandchild and that the distributions at that time were outright distributions. The court also clarified that each grandchild’s power of appointment was limited to one or more of the lineal descendants of the child of the grantor who was the parent of the grandchild. A second amended order limited the grandchild’s Crummey powers of withdrawal to the greater of $5,000 or 5 percent of the value of the trust principal.

The trustee requested the following rulings:

1. The judicial reformation and modification of each trust would not cause the principal of the trust to be included in the spouse’s estate for estate tax purposes.

2. The trusts as modified and reformed did not give each grandchild a general power of appointment that would cause estate tax inclusion upon the death of the grandchild.

3. The judicial reformation and modification of the trusts would not be considered the exercise or release of a general power of appointment that would result in a gift under Section 2514.

4. The trust would be considered a “skip persons” for generation-skipping tax purposes and, as a result, the deemed allocation rules of Section 2632(b)(1) would apply to allocate the grantor’s and spouse’s GST exemption to the gifts and bequests to the trusts.

The Internal Revenue Service first ruled that because the spouse did not retain any right or interest in the trusts, the spouse did not retain any beneficial interest in the trusts, any right to alter, amend, revoke or terminate any of the trusts, or any right to designate who would possess or enjoy the property or the income derived from the trust that could have adverse estate or gift tax consequences to the spouse. In addition, the reformation and modification of the trusts were made pursuant to court order and not as a result of rights retained by the spouse. As a result, the judicial reformation and modification of the trusts would not cause the inclusion of the assets of the trusts in the spouse’s gross estate when the spouse died.

The Service next ruled that an examination of the relevant documents, affidavits, and representations of the parties indicated that the grantor and the spouse did not want the grandchildren to have either *inter vivos* or testamentary general powers of appointment. There was clear and convincing evidence that the language in the trusts as drafted that might give rise to testamentary and *inter vivos* general powers of appointment were scriveners errors and that the reformation and modification of the trusts was necessary and appropriate to carry out the objectives of the grantor and spouse and were not contrary to the intentions of grantor and spouse. As a result, the Service concluded that the judicial reformation and modification of the trusts did not constitute or exercise or release of a general power of appointment that would result in a gift under Section 2514 by the grandchildren and that the assets would not be included in a grandchild’s estate when the grandchild past away.

Finally, the Service ruled that the transfers to the trusts would be considered direct skips and that the deemed allocation rules of Section 2632(b) would apply to allocate the unused exemption of each of grantor and spouse to one-half of the gifts to the trusts when both grantor and spouse were alive, to allocate grantor’s unused GST exemption to the bequests to the trusts upon grantor’s death, and to allocated the spouse’s unused exemption to the gifts made by the spouse to the trusts in the years after grantor’s death. Section 2632(b)(1) provides that if an individual makes a lifetime direct skip gift, any unused portion of that individual’s GST exemption will be allocated to the direct skip.

**VALUATION**

**Letter Ruling 201819010 (Issued February 8, 2018; Released May 11, 2018)**

**IRS grants extension of time to make Section 754 election**

A general partnership was organized under state law. A and B owned a percentage interest in the partnership as community property. B died. The executor intended to make an election under Section 754 in connection with the death of B to step up the basis of partnership property. However, the executor failed to file a timely return to make the election. The executor represented that it had acted reasonably and in good faith and that granting the relief would not prejudice the interests of the government.

Treas. Reg. § 1.754-1(b)(1) provides that an election under Section 754 to adjust the basis of partnership property is to be made in a written statement filed with a partnership return for the taxable year in which the distribution or transfer occurs. For the election to be valid, the return must be filed not later than the time prescribed for filing the return for the taxable year. Under Treas. Reg. §§ 301.9100-1 and 301.9100-3, a request for an extension of time to make an election will be granted when a taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that the grant of the relief will not prejudice the interests of the government. In this situation, the Service found that the requirements of Treas. Reg. §§ 301.9100-1 and 301.9100-3 were satisfied and granted an extension of time to make the Section 754 election

**Letter Ruling 201814004 (Issued December 11, 2017; Released April 6, 2018)**

**IRS allows extension of time to make special use valuation election for farmland**

Upon decedent’s death, son and daughter were co-trustees of her revocable trust and co-executors of her estate which included farmland. Son and daughter retained an accountant to prepare and file the Form 706. The accountant failed to advise son and daughter to make the Section 2032A special use valuation election for the farmland. The son and daughter timely filed the Form 706.

After filing the Form 706, the son met with an attorney to discuss estate planning. The attorney discovered that the special use valuation election was never made on the Form 706. As a result of this discovery, the estate requested an extension of time to make the special use valuation election.

Under Treas. Reg. §§ 301.9100-1 and 301.9100-3, an extension of time to make an election will be granted if the IRS determines that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer relied on a qualified tax professional and the tax professional failed to advise the taxpayer to make the election.

The Service ruled that the requirements of Treas. Reg. §§ 301.9100-1 and 301.9100-3 had been satisfied and an extension of time to make the special use valuation election was granted.

**Letter Ruling 201820010 (Issued February 13, 2018; Released May 18, 2018)**

**IRS allows extension of time for estate to elect alternate valuation date**

The executor of decedent’s estate consulted an attorney to prepare the Form 706. The Form 706 was timely filed however, the attorney failed to make the alternate valuation election under Section 2032 on the initial Form 706. The executor now requested an extension of time to make the alternate valuation election and use the alternate valuation method in reporting the value of the gross estate on the return.

Under Treas. Reg. §§ 301.9100-1(c) and 301.9100-3, the IRS may grant an extension of time if the taxpayer shows that the taxpayer acted reasonably and in good faith and that the granting of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer failed to make the election because, after exercising reasonable diligence (taking into account the taxpayer’s experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election.

The IRS ruled that the requirements of regulations had been satisfied and granted an extension of time to make the alternate valuation election.

**Letter Ruling 201815001 (Issued December 11, 2017; Released April 13, 2018)**

**IRS allows extension to elect alternate valuation date**

Upon decedent’s death, the executor of the estate consulted CPA to prepare the Form 706 which was timely filed. CPA failed to make the alternate valuation election under Section 2032 on the Form 706. The CPA stated in an affidavit that he intended to make the alternate valuation election, but failed to check the box. The executor requested an extension of time to make the alternate valuation method election.

Under Treas. Reg. §§ 301.9100-1 and 301.9100-3, a reasonable extension of time may be granted if the taxpayer proves that the taxpayer acted reasonably and in good faith and the granting of relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make the election.

The Service ruled that the requirements of the regulations had been satisfied and granted an extension of time to make the alternate valuation date election.

**Letter Ruling 201825013 (Issued March 19, 2018; Released June 22, 2018)**

**IRS grants an extension of time to make the alternate valuation election**

After decedent’s death, the co-executors hired an attorney to prepare the estate tax return. The attorney prepared the estate tax return but failed to make the alternate valuation date election. The estate tax return was timely filed. Subsequently, after the due date of the estate tax return, the co-executors filed a supplemental estate tax return making the Section 2032 election. The Service then issued a letter to the estate stating that since the alternate valuation election was not made timely, the assets could only be valued using the alternate valuation date if an extension of time was granted under the relief provisions of Treas. Reg. §§ 301.9100-1 and 301-9100-3.

In this letter ruling, the IRS concluded that the standard of those treasury regulations were satisfied. Treas. Reg. § 301.9100-3 states that an extension of time for that relief will be granted if the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional.

**Estate of Clara M. Morrissette v. Commissioner, Tax Court Order, Docket No. 4415-14 (June 21, 2018)**

**Court denies partial summary judgment motion of estate that Section 2703 does not apply to split-dollar arrangement**

Split-dollar is a method of financing the purchase of insurance. It most typically takes the form of an arrangement between a closely held business and an owner-employee, or between a public corporation and its executives, in which the employer and employee agree to split the payment of premiums on an insurance policy on the life of the insured. In 2001, the IRS announced its intent in Notice 2001-10, 2001-1 C.B. 459, to change its tax treatment of split-dollar arrangements. Thereafter, it issued new regulations, in final form, on September 17, 2003. The new taxation scheme created under these regulations significantly altered the way in which split-dollar arrangements were used for estate planning purposes thereafter.

Under the regulatory scheme put in place in 2003, two mutually exclusive methods for taxing split-dollar life insurance arrangements now apply, the economic benefit regime and the loan regime. If the employer is the owner of the insurance policy, the split-dollar arrangement will be taxed as compensation related agreement under the economic benefit regime. The value of the current life insurance protection and any other benefits derived by the insured employee from the arrangement will be treated as taxable income to the employee under Section 61 of the Internal Revenue Code. The economic benefit rules apply to both arrangements where the policy is actually owned by the employer (endorsement method split-dollar arrangements) and to arrangements in which the employee owns the policy (collateral assignment split-dollar arrangements) but the employee’s only right is to the insurance protection. In this latter situation, the employer will be deemed to own the policy. Treas. Reg. § 1.61-2(c)(1)(ii)(A)(2).

Any split-dollar arrangement not described above in which the employee owns the policy will be governed under the loan regime by the Section 7872 below market loan rules. Transfers by the employer will be treated as loans and there will be deemed interest to the extent that the arrangement does not mandate adequate interest. The deemed interest will treated as compensation paid by the employer to the employee and then repaid as interest by the employee. The same rules will apply to split-dollar arrangements in all other contexts, such as shareholder-company and private donor-donee arrangements.

Morrissette involved a motion for partial summary judgment in a private donor-donee arrangement. The unique feature here is that the insureds were much younger than the donor. In Morrissette, Clara Morrisette established a revocable trust in 1994 to which she contributed all of her shares in Interstate Group Holdings which, in turn, held eleven moving and other companies. In September 2006, when Clara Morrissette was 93, her three sons became trustees of the revocable trust. Previously, on August 18, 2006, an employee of Interstate Group Holdings was appointed as a temporary conservator of Clara’s Morrisette’s estate through October 20, 2006. The conservator transferred additional assets into the revocable trust. In addition, the conservator established three perpetual dynasty trusts in 2006, one for each of her three sons and his family. The revocable trust was amended on September 19, 2006 to permit the trustees to pay premiums on life insurance and to make loans and to enter into split-dollar arrangements.

Next, on September 21, 2006, the dynasty trusts, the three brothers, the revocable trust, and other trusts holding interests in Interstate Group Holdings entered into a shareholders agreement providing that upon the death of each brother, the surviving brothers, and the dynasty trusts would purchase the Interstate Group Holdings stock held by or for the benefit of the deceased brother. To provide each dynasty trust with the funds to purchase the Interstate Group Holdings stock held by a deceased sibling, each dynasty trust on October 4, 2006 purchased a universal life policy on the life of each of the two other brothers.

Clara Morrissette’s revocable trust on October 31, 2006 entered into two split-dollar life insurance arrangements with the three dynasty trusts and then contributed $29.9 million in total to the three dynasty trusts in order to fund the purchase of the universal life insurance policies on each of Clara Morrissette’s three sons. The split-dollar life insurance arrangements provided that the revocable trust would receive the greater of the cash surrender value of the respective policy or the aggregate premium payments on that policy upon termination of the split-dollar life insurance arrangement or the death of the insured brother. The right to receive a portion of the death benefit would thus be a receivable of the revocable trust.

Each split-dollar agreement provided that the agreement would be taxed under the economic benefit regime and that the only economic benefit provided to each dynasty trust was the current life insurance protection. The dynasty trusts executed collateral assignments of the policies to the revocable trust to secure the payment of the amounts owed to the revocable trust. Neither the dynasty trusts nor the revocable trust retained the right to borrow against the policies.

In each of 2006 through 2009, Clara Morrissette reported gifts to the dynasty trusts under the economic benefit regime of the cost of the current life insurance protection determined under Table 2001 less the amount of the premiums paid by the dynasty trusts. Clara Morrissette died on September 25, 2009 and was survived by her three sons. After Mrs. Morrissette’s death, the estate retained Valuation Services, Inc. to value the receivables included in the gross estate as of the date of her death. Valuation Services, Inc. valued the receivables at $7,479,000.

The IRS in the audit of Clara Morrissette’s estate determined that the $29.9 million contribution was a gift in 2006 and assessed a gift tax deficiency against Clara Morrissette’s estate of $13,800,179 and a penalty of $2,760,036. The estate moved for partial summary judgment on the narrow issue of whether the split-dollar insurance arrangements were governed by the economic benefit regime under Treas. Reg. § 1.61-22.

In Estate of Clara M. Morrissette, 176. T.C. No. 11 (April 13, 2016), the Tax Court first noted that the 2003 final regulations governed the split-dollar arrangements since they were entered into after September 17, 2003. The court also noted that generally the person named is the owner in the insurance contract is treated as the owner of the contract. Under this general rule, the dynasty trusts would be considered the owners of the policies and the loan regime would apply. However, the final regulations included the special ownership rule that provided that, if the only economic benefit provided under the split-dollar life insurance arrangement to the donee is the current life insurance protection, then the donor will be deemed the owner of the life insurance contract, irrespective of actual policy ownership, and the economic benefit regime will apply.

To the court, the key question was whether the lump sum payment of premiums made directly made by the revocable trust on the policies in 2006 generated any additional economic benefit other than the life insurance protection to the dynasty trusts. If there was no additional economic benefit to the dynasty trusts, then the revocable trust would be deemed the owner of the policies by way of the special ownership rule and the split-dollar life insurance arrangements would be governed by the economic benefit regime. To determine whether any additional economic benefit was conferred, the relevant inquiry was whether the dynasty trusts had current access to the cash values of the respective policies under the split-dollar life insurance arrangement or whether any other economic benefit was provided. The court determined that the dynasty trusts did not have access to any part of the cash value of the insurance policies or to any other economic benefit except for the current life insurance protection. As a result, the economic benefit regime and not the loan regime applied.

The important issue yet to be determined with respect to Morrissette is the value of the receivables in Clara Morrissette’s estate for estate tax purposes and whether the receivables should only be valued at approximately $7,500,000. The resolution of this issue will determine the usefulness for estate and gift tax purposes of the split-dollar financing of the policies in this particular situation.

On December 5, 2016, the estate moved for partial summary judgment that Section 2703 does not apply for purposes of the valuation of Clara Morrissette property rights under the split-dollar arrangements estate tax. Section 2703(a) provides that for transfer tax purposes with respect to buy-sell and similar arrangements between family members, the value of properties are determined without regard to (1) any option, agreement, or other right to acquire or use property at less than fair market value, or (2) any restriction on the right to sell or use the property.

As noted above, the decedent entered into split-dollar arrangements through her revocable trust with the three dynasty trusts that had been established in the name of each of her three sons. The court held that the economic benefit regime applied and the cost of the current insurance protection was a transfer each year from the decedent to the son for gift tax purposes. The parties agreed that for estate tax purposes the estate must include the decedent’s rights under the split dollar arrangements in the gross estate. The parties disagreed over exactly what rights the decedent had over the split-dollar arrangements and whether those rights were subject to any restrictions pursuant to Section 2703(a)(2). The estate argued that the decedent’s only right under the split- dollar arrangement was the death benefit and that right was without restriction. The government argued that the decedent’s right also included the right to terminate the split-dollar agreements with the consent of the other party at any time and to receive a payout upon termination. It argued that the termination rights were restricted by the split-dollar arrangements and that Section 2703(a)(2) applied to disregard the termination restrictions. The IRS also argued that decedent had rights under the collateral assignment agreements and that those restrictions should be disregarded. As a result, summary judgment should be denied because there was a genuine issue of material fact.

Pursuant to Estate of Cahill v. Commissioner, T.C. Memo 2018-84, a restriction on a decedent’s termination rights is a restriction for purposes of Section 2703. In Estate of Cahill, the Tax Court denied the estate’s motion for partial summary judgment that Section 2703(a) did not apply to split-dollar arrangements with termination restrictions similar to those at issue in Morrissette where the parties to the agreements can mutually agree to terminate the arrangement but neither party could unilaterally terminate the arrangements. Here the decedent’s trust and the respective dynasty trusts could mutually agree to terminate the split-dollar arrangement but neither party could unilaterally terminate the agreement.

As a result, Judge Goeke denied the motion for partial summary judgment.

**Cahill v. Commissioner, T.C. Memo 2018-84; settled, Joint Stipulation of Settled Issues, Tax Court Docket 10451-16 (August 16, 2018)**

**Taxpayer’s motion for summary judgment with respect to split-dollar arrangement is denied**

Richard F. Cahill died on December 12, 2011. His son, Patrick Cahill, was named as executor. This case involves three split-dollar agreements that were executed in 2010 when Richard was 90 years old and unable to manage his own affairs.

Richard was the settlor of a revocable trust called the Survivor Trust. Patrick was the trustee of the Survivor Trust and was also decedent’s attorney-in-fact under a California Power of Attorney. Richard’s involvement in the three split dollar life insurance arrangements was effected solely through the Survivor Trust and was directed by Patrick Cahill either as decedent’s attorney in fact or as trustee of Survivor Trust. The parties agreed that everything in the Survivor Trust on decedent’s date of death was included in the decedent’s gross estate. Decedent was also settlor of the Morrison Brown (“MB”) Trust which was created in September 2010 by Patrick Cahill as decedent’s agent. William Cahill was trustee of the MB Trust and the primary beneficiaries of the MB Trust were Patrick and his issue. The MB Trust owned three whole life insurance policies. Two policies were on the life of Shannon Cahill, Patrick Cahill’s wife, and one policy was on the life of Patrick Cahill. The policy premiums were paid in lump sums as shown in the chart below.

|  |  |  |
| --- | --- | --- |
|  | **Policy Premium** | **Policy Amount** |
| New York Life on Patrick Cahill | $5,580,000 | $40,000,000 |
| SunLife on Shannon Cahill | $2,531,570 | $25,000,000 |
| New York Life on Shannon Cahill | $1,888,430 | $14,800,000 |
| **TOTAL** | **$10,000,000** | **$79,800,000** |

To fund these policies, three separate split-dollar agreements were executed by Patrick Cahill, as the trustee of the Survivor Trust, and William Cahill as trustee of the MB Trust. The Survivor Trust paid the premiums using funds from a $10 million loan from Northern Trust. The obligors on the loan were the decedent personally and Patrick Cahill as trustee of the Survivor Trust. Each split dollar arrangement was designed to take advantage of the economic benefit regime and avoid the loan regime. Upon the death of the insured, the Survivor Trust was to receive a portion of the death benefit equal to the greatest of the remaining balance on the loan, the total premiums paid with respect to the policy, or the cash surrender value. The MB Trust would retain any excess.

Each split-dollar agreement also provided that it could be terminated during the insured’s life by written agreement between the trustees of the Survivor Trust and the MB Trust. As of the date of Richard’s date in 2011, the aggregate cash surrender value of the policies was $9,611,624. The estate’s tax return reported the total value of decedent’s interest in the split-dollar agreements at $183,700. In the Notice of Deficiency, the IRS adjusted the total value of decedent’s rights in the split-dollar arrangements from $183,700 to $9,611,624, the cash surrender value of the policies.

The estate moved for partial summary judgment. A court may grant summary judgment when there is no genuine dispute as to any material facts and a decision may be granted as a matter of law. The court first found that Section 2036 and Section 2038 would apply in this situation. The estate tried to argue that neither Section applied because the decedent retained no rights with respect to the amounts transferred to justify application of those Sections. However, the court noted that the decedent retained the right to terminate and recover at least the cash surrender value held in conjunction with the MB Trust and that those constituted rights under Section 2036 and Section 2038. The court then noted that with respect to the requirements in Sections 2036 and 2038, questions remained as to whether decedent’s transfer of $10 million was part of a bona fide sale. It also noted that the issue of whether the transfer was for full and adequate consideration was a question of fact. It stated that the bona fide sale for adequate and full consideration exception was not satisfied because the value of what the decedent received was not even close to the value of what decedent paid.

The court also reviewed the argument of the government that Section 2703 would apply to the MB Trust’s ability to veto termination of split-dollar arrangements. It found that split dollar agreements, taken as a whole, clearly restricted decedent’s right to terminate the agreements and withdraw his investment from those arrangements. The court stated that the requirements of Sections 2703 were met and therefore denied the motion for summary judgment with respect to this. The court also noted that the parties had not addressed the exception in Section 2703(d) which provides for comparison with the terms of any similar arrangements entered into by persons in arms’ length transactions.

The court also rejected the estate’s contention that any part of the difference between the $183,700 that decedent allegedly received in return and the $10 million decedent paid would be accounted for as gifts and that to count the difference as part of the estate under Sections 2036, 2038 and 2703 would be double counting.

The estate also sought summary judgment that pursuant to Treas. Reg. § 1.61-22, the economic benefit regime would apply to split dollar arrangements. The IRS countered that the regulation did not apply for estate tax purposes and stated that the economic benefit regime rules only are gift tax rules. The court noted that to the extent that the regulations eliminated the gift tax treatment and that those transfers are relevant to the estate tax issues it would look at the regulations in deciding the case. The estate also argued that the court should modify the approach required by Sections 2036, 2038 and 2703 to avoid inconsistency between the statutes and the regulations. The court disagreed. First, it found no inconsistency between the estate tax statutes and the income tax regulations. It also disagreed with the estate’s argument, which was confusing to the court, that because Treas. Reg. § 1.61-22 did not deem the difference to be a gift, then the entire $10 million transferred must have been for full and adequate consideration. As a result, the estate’s motion for partial summary judgment was denied. The government did not move for summary judgment on any of the issues discussed.

The government and the estate settled on August 16, 2018. The estate conceded that the value of the decedent’s rights in the split dollar arrangements was $9,611,624, the cash surrender value of the policies, the amount asserted by the government. The estate was also liable for a Section 6662 20 percent accuracy related penalty.

**Streightoff v. Commissioner, T.C. Memo 2018 - 178**

**Court accepts government’s valuation of limited partnership interests in decedent’s estate**

Decedent, Frank Streightoff, was a resident of Texas when he died in 2011. During decedent’s lifetime, his daughter, Elizabeth Streightoff, held the decedent’s power of attorney.

On October 1, 2008, decedent through Elizabeth Streightoff, formed Streightoff Investments LP as a Texas Limited Partnership. Streightoff Investments during decedent’s life did not hold meetings or have votes.

The partnership agreement stated that the purpose of Streightoff Investments was to make a profit, increase wealth, and provide a means for decedent’s family to manage and preserve family assets.

Decedent funded Streightoff Investments with marketable securities, municipal bonds, mutual fund investments, other investments, and cash. As of January 31, 2009, 61.6 percent of Streightoff Investments ‘assets consisted of marketable securities, 23.6 percent consisted of fixed income investments in municipal bonds, and 13.3 percent was invested in mutual funds.

Streightoff Management LLC was the sole general partner of Streightoff Investments. Elizabeth Streightoff was the manager of Streightoff Management. The Streightoff Investments partnership agreement provided that the general partner was in charge of conducting the business of the partnership. Decedent, his daughters, his sons and his former daughter-in-law were the original limited partners under the partnership agreement. The limited partners other than decedent received their limited partnership interest as gifts. Upon formation, decedent and the other partners had the following interests:

|  |  |  |
| --- | --- | --- |
| Partner | Percentage | Type |
| Streightoff Investments | 1.00% | General |
| Decedent | 88.99% | Limited |
| Elizabeth Streightoff | 1.54% | Limited |
| Ann Fennell Brace | 1.54% | Limited |
| Camille Schuma | 1.54% | Limited |
| Jennifer Ketchurn Hodges | 1.54% | Limited |
| Hilary Dan Billingalea | 1.54% | Limited |
| Charles Franklin Streightoff | 1.54% | Limited |
| Frank Hatch Streightoff | 1.54% | Limited |
| Priscilla Streightoff | 1.54% | Limited |

Section 7.2 of the partnership agreement provided that a limited partner could not sell or assign an interest in Streightoff Investments without obtaining the written approval of the general partner, which approval would not be unreasonably withheld. Any partner who assigned his or her interest remained liable to the partnership for promised contributions or excessive distributions unless and until the assignee was admitted as a substitute limited partner.

On October 1, 2008, the same day that the decedent formed Streightoff Investments, he established the Frank D. Streightoff Revocable Living Trust and transferred his 88.99 percent interest in Streightoff Investments to the Revocable Trust. Frank Streightoff was the sole beneficiary and Elizabeth Streightoff was the trustee of the revocable trust. On October 1, 2008, decedent, through Elizabeth Streightoff executed an assignment of interest which designated the decedent as assignor and the revocable trust as assignee of the limited partnerships interests. Elizabeth Streightoff signed the transfer agreement in her capacities as the holder of the decedent’s power of attorney, trustee of the revocable trust, and managing member of Streightoff Management.

After decedent’s death in 2011, on decedent’s federal estate tax return, Elizabeth Streightoff, as executor, elected the alternate valuation date. The net asset value of the 88.99 percent assets in the partnership on the alternate valuation date was $7,307,951. The estate used a combined 37.2 percent discount for lack of marketability, lack of control, and lack of liquidity, and reported the value of the limited partnerships interest as $4,588,000.

The court first had to determine whether the interest transferred to the revocable trust was a limited partnership interest or assignee interest. It noted that the federal tax effect of particular transactions is governed by the substance of the transaction rather than its form. The court concluded that the decedent transferred a limited partnership interest to the revocable trust and not an assignee interest. The economic realities underlying the decedent’s interest also support the court’s conclusion that the transferred interests should be treated as limited partnership interests for estate tax purposes. That was because, regardless of whether an assignee or limited partnership interest had been transferred, there would have been no substantial difference before or after the transfer of the limited partnership interests to the revocable trust. Also, even though an assignee could not vote, the partnership held no votes before decedent’s death.

The court then looked at the appropriate valuation of the limited partnership interests. The IRS used Juliana Vicelya and the estate used Howard Frazier Barker Elliot (HFBE). The court first determined that there was no discount for lack of control since the interest transferred was an 88.99 percent limited partnership interest which could control the partnership. It noted that limited partners with a 75 percent interest could remove general partners and a general partner’s removal terminated the partnership. This gave decedent’s interest control over the partnerships.

HFBE valued the interest as an assignee interest and concluded that a 13.4 percent discount for lack of control should be applied. Since the court determined that a limited partnership interest and not an assignee interest was transferred, a discount for lack of control was not appropriate. The IRS’s appraiser determined that an 18 percent discount for lack of marketability was appropriate. This was based on the highly liquid nature of the underlying assets of the partnership. In addition, the diversification of the underlying assets would make an interest in the partnership attractive to a hypothetical buyer, and the amount of control provided to an 88.99 percent limited partnership interest was a factor favoring a lower discount. Finally, the right of first refusal in the partnership agreement warranted a lower discount. HFBE concluded that a 27.5 percent discount for lack of a marketability was appropriate. However, one HFBE appraiser testified that his analysis of the lack of marketability discount would have included different considerations if the interest was a limited partnership interest with voting rights under the partnership agreement, as the court determined. Consequently, the court determined that the interest should be valued using an 18 percent discount rate for lack of marketability as the IRS’ appraiser proposed.

**Estate of Turner v. Commissioner, 151 T.C. No. 10 (2018) (Turner III)**

**Tax Court addresses tax issues arising from inclusion of family limited partnership interests in estate of first spouse to die**

In April 2002, Clyde W. Turner, Sr. (“Clyde Sr.) and his wife Jewell formed a limited partnership, each transferred $4,333,671 in cash, CDs, and publicly-traded securities to the partnership, and each took back a 0.5% general partner interest and a 49.5% limited partner interest. On December 31, 2002, and January 1, 2003, they gave limited partner interests to children and grandchildren and an irrevocable trust for one child. Clyde Sr. became seriously ill and was hospitalized in October 2003 and died on February 4, 2004.

In Estate of Turner v. Commissioner, T.C. Memo. 2011-209 (Aug. 30, 2011) (Turner I), the Tax Court (Judge Marvel) rejected Clyde Sr.’s executor’s claims of nontax purposes of asset management and protection and resolution of family disputes, viewed the creation of the partnership as “a part of a testamentary plan” in which Clyde Sr. retained both enjoyment and control, and thus found that the value of the assets he had transferred to the partnership was included in his gross estate under Section 2036(a)(1) and (2).

In [Estate of Turner v. Commissioner](https://www.ustaxcourt.gov/UstcDockInq/DocumentViewer.aspx?IndexID=5729349), 138 T.C. 306 (March 29, 2012) (Turner II), the executor returned to the court to seek reconsideration of its 2011 decision, which the court denied, and to claim in the alternative that a reduce-to-zero pecuniary bequest nevertheless protected the estate from estate tax by providing an increased marital deduction. The court held, in effect, that even though the value of the assets was pulled back into the gross estate, the transferred assets were out of Clyde Sr.’s control and therefore could not pass to Jewell or qualify for a marital deduction.

As clarified in Turner III, the result of Turner II was that “the only taxable portion of the estate is the portion attributable to the Section 2036 inclusion” (implying, although not explicitly saying, that the entire estate still within Clyde Sr.’s control and therefore disposable at his death was allocated to the marital bequest). Therefore, in the calculation of the estate tax liability following Turner II, the IRS asserted in Turner III that “the estate must reduce the marital deduction by the amounts of Federal estate and State death taxes the estate must pay because the only property available to fund the payments is property that would otherwise pass to Jewell and qualify for the marital deduction.”

In Turner III, the court rejected the IRS’ argument and held that the original marital deduction is still preserved because any payment by the executor out of assets allocated to the marital bequest (which were the only assets left) would entitle the executor to recovery under Section 2207B(a), which provides:

“(1) In general.—If any part of the gross estate on which tax has been paid consists of the value of property included in the gross estate by reason of Section 2036 (relating to transfers with retained life estate), the decedent’s estate shall be entitled to recover from the person receiving the property the amount which bears the same ratio to the total tax under this chapter which has been paid as—

“(A) the value of such property, bears to

“(B) the taxable estate.

“(2) Decedent may otherwise direct.—Paragraph (1) shall not apply with respect to any property to the extent that the decedent in his will (or a revocable trust) specifically indicates an intent to waive any right of recovery under this subchapter with respect to such property.”

The court noted (at p. 14) that Clyde Sr.’s will did not address the payment of taxes or their apportionment, which the court found “not surprising because Clyde Sr. did not know that the Court would apply Section 2036 to his lifetime transfers.” The court also noted, however, that Clyde Sr.’s will “clearly manifests his intention that the marital deduction not be reduced or diminished by the estate’s tax liabilities.” (In fact, the reduce-to-zero marital bequest, quoted in Turner II, includes the phrase “undiminished by any estate, inheritance, succession, death or similar taxes.”) The court concluded:

“Accordingly, we hold that the estate need not reduce the marital deduction by the amount of Federal estate and State death taxes it must pay because the tax liabilities are attributable to the Section 2036 assets, the estate has the right to recover the amount paid under Section 2207B, and the estate must exercise that right to recover to give effect to Clyde Sr.’s intention that Jewell receive her share of the estate undiminished by the estate’s tax obligations.”

The court also rejected the executor’s contention that the marital deduction should be increased by the amount of income generated after Clyde Sr.’s death by assets attributable to the marital share.

Turner III is not especially interesting because it tells us rules of law we did not know about. It is interesting because of the peculiar and questionable way in which it applies the rules we do know, and the implications we now see these rules might have beyond their customary context.

First, Turner I provided that the value of the assets Clyde Sr. transferred to the partnership in April 2002 was included in his gross estate, not the value of the gifts of partnership interests he made on December 31, 2002, and January 1, 2003. Who then is “the person receiving the property” from whom Section 2207B(a)(1) gives his executor a right of recovery? Is it not the partnership? If so, how is recovery obtained? And would not recovery from the partnership reduce the value of all interests in the partnership, including, after all, Jewell’s interests? Or was the “transfer” contemplated by Section 2207B(a)(1) not complete until and to the extent of Clyde Sr.’s gifts, so the recovery, if it comes from the partnership, must somehow come from the partnership interests of those transferees? Would not that be contrary to the recent application of Section 2036 in family limited partnership cases even to the assets represented by the partnership interests the partner retains until death?

Second, the recovery Turner III apparently contemplates, as quoted above, is “the amount of *Federal estate and State death taxes* [the estate] must pay because the tax liabilities are attributable to the Section 2036 assets” (emphasis added). In fact, the opinion uses the phrase “Federal estate and State death taxes” ten other times, including as the heading for its discussion of the right of recovery. But Section 2207B says nothing about state taxes. Clyde Sr. died domiciled in Georgia, a state with an estate tax coupled with the federal credit for state death taxes, and he died in 2004, when the federal state death tax credit had been phased down to 25% but not eliminated.

Third, footnote 2 of Turner III opinion states that Clyde Sr.’s wife Jewell had died on July 8, 2007, and that a related case for her estate (Docket No. 29411-11) was pending in the Tax Court. The petition was filed December 23, 2011, and the IRS’s motion of August 3, 2012, for continuance of the trial was granted August 29, 2012, and there are no entries in the docket since August 29, 2012. If Clyde Sr.’s executor does not seek and obtain the recovery contemplated by Section 2207B(a), or if he does anything else in a manner the IRS dislikes, Jewell’s estate’s pending matter gives the IRS one more setting in which to raise its concerns, for example by asserting that Jewell was deemed to make a gift or her gross estate is enhanced by the full marital deduction Clyde Sr.’s executor eventually takes into account.

Fourth, if every lifetime transfer potentially subject to Section 2036 now carries with it the potential for recovery from the transferee for additional estate taxes that might be paid, who can tell what use could be made of that potential in discounting the value of those transfers even further? A comparison could be made to Steinberg v. Commissioner, 145 T.C. 184 (2015), the “net net gift” case in which the court allowed a reduction in the value of a gift for the actuarially calculated value of the donee’s assumption of the obligation to pay the additional estate tax under Section 2035 if the donor died within three years of the gift. The problem is that in *Steinberg* the taxpayer conceded that there would be an increase in the gross estate under Section 2035 if the donor died within three years. It is hard to imagine any donor conceding a Section 2036 inclusion at the time of a transaction like the creation of the partnership in *Turner III*.

Fifth, Clyde Sr. died in February 2004. His executor filed the estate’s Tax Court petition in August 2008. There are a total of 82 entries in the Tax Court docket for the estate over the last ten years, although, curiously, none between February 2013 and April 2017. One could ask if this hassle and delay is worth it.

**Kress v. United States, 372 F.Supp.3d 731, (E.D. Wis. 2019)**

**Tax Court rejects IRS’s valuation of minority interests in closely held S Corporation stock given to family members over three years**

Kress involved gifts of stock in Green Bay Packaging, Inc., a closely held S Corporation based in Green Bay, Wisconsin (“GBP”) to family members. GBP was a vertically integrated manufacturer of corrugated packaging and related products. It employed approximately 3,400 people in fourteen states. In addition to the operating business, GBP had non-operating assets, including two aircraft, certain unrelated investments, and group life insurance policies. Approximately ninety percent of the common stock was owned by members of the Kress family and the remaining ten percent was owned by employees and directors.

When GBP sold shares to its employees and directors, the purchase price for those shares was 120% of the book value of each share. No price was established for shares that were transferred to members of the Kress family. Certain restrictions limited the ability to sell both family owned shares and non-family owned shares. A right of first refusal restriction in the GBP bylaws required that employee or director shareholder give GBP written notice of his or her intent to sell and offer to sell the shares back to GBP before selling to others. With respect to family-owned shares, a bylaw restriction required that Kress family members only give, bequeath or sell shares to other members of the Kress family.

Plaintiffs, James and Julie Kress, gave shares of GBP stock representing minority interests in the company to children and grandchildren in 2006, 2007, 2008 which gifts were reported on gift tax returns for 2007, 2008, and 2009 (and which the court referred to as the tax years in its analysis). The shares were valued as follows:

|  |  |
| --- | --- |
| **Gift Tax Year** | **Price Per Share** |
| 2007 | $28.00 |
| 2008 | $25.90 |
| 2009 | $21.60 |

Each of the two donors paid $1,219,241 in gift taxes with respect to the gifted shares for a combined total gift tax of $2,438,482.

The IRS challenged the values reported on their gift tax returns and said that the fair market value of the stock equaled the price used for actual share transactions between GBP and its employees and directors which were:

|  |  |
| --- | --- |
| **Gift Tax Year** | **Price Per Share** |
| 2007 | $45.97 |
| 2008 | $47.63 |
| 2009 | $50.85 |

The IRS issued a notice of deficiency,and the Kresses paid the additional gift tax totaling more than $2 million. The Kresses then filed amended gift tax returns seeking a refund for the additional gift taxes and accrued interest they paid. When the IRS failed to respond, the Kresses initiated the lawsuit in 2016 to recover the gift tax and interest assessed.

After ruling on procedural matters involving the admissibility of certain evidence, the district court determined that the Kresses successfully shifted the burden of proof with respect to the valuation of the gifted shares by introducing credible evidence to support their position (including the testimony of two experts), maintaining credible records, and cooperating with the government’s reasonable requests for documents and information. However, the court, citing Estate of Stuller v. United States, 55 F.Supp.3d 1091 (C.D. Ill. 2014) noted that if both parties had met their burdens of production by presenting some evidence, the party supported by the weight of the evidence will prevail regardless of which party bore the initial burden of production or persuasion.

The government used Francis Burns of Global Economics Group as its expert in the case. Burns determined the fair market value of the gifted shares using both a market approach and an income approach and ascribing a weight to each approach. Burns weighted the market approach 60 percent and the income approach 40 percent to determine the fair market value. This calculation resulted in the following valuations for the stock given to the children and grandchildren.

|  |  |
| --- | --- |
| **Gift Tax Year** | **Price Per Share** |
| 2007 | $38.40 |
| 2008 | $27.81 |
| 2009 | $40.05 |

Under the market approach, Burns identified nineteen to twenty companies that were in the same business as GBP, eliminated companies based on dissimilar characteristics, and identified four comparable companies for each year.

Under the income approach, Burns completed a capitalized cash flow analysis.

Burns’ marketability discounts were significantly below those of the expert witnesses of plaintiffs. Burns assessed marketability discounts of 10.8 percent, 11.0 percent and 11.2 percent nfor the respective tax years. The court found that Burns’ discounts for lack of marketability were “unreasonably low.”

The court also noted that Burns applied a separate subchapter S premium to his valuation. Both Burns’ and plaintiffs’ expert ,John Emory, applied C Corporation-level taxes to GBP’s earnings to compare GBP to other C Corporations. Burns then assessed a premium to account for the tax advantages associated with subchapter S status such as the elimination of the one level of taxes that GBP did not pay. Burns also noted that GBP did not pay C-corporation taxes in any of the valuation years and did not expect to in the future. Plaintiffs’ experts, John Emory and Nancy Czaplinski, did not consider subchapter S status to be a benefit that would add to the value of the minority shareholder’s stock because a minority shareholder could not change GBP’s corporate status. The court believed that GBP’s subchapter S status should have a neutral impact.

The court also found that Burns improperly treated the non-operating assets by adding back their full, undiscounted value after the discount analysis addressed above.

Plaintiffs’ first expert, John Emory, had his own valuation firm. Burns solely relied on a market approach and applied minority and marketability discounts to arrive at the value of minority shares in GBP. He determined the value per share of the stock as follows:

|  |  |
| --- | --- |
| **Gift Tax Year** | **Price Per Share** |
| 2007 | $28.00 |
| 2008 | $25.90 |
| 2009 | $21.60 |

The IRS criticized Emory’s valuation for ignoring the income approach to valuation, so plaintiffs retained Czaplinski who worked at Duff & Phelps. Using the income approach, Czaplinski calculated the value of the stock for the relevant years to be:

|  |  |
| --- | --- |
| **Gift Tax Year** | **Price Per Share** |
| 2007 | $30.87 |
| 2008 | $25.92 |
| 2009 | $25.06 |

The court found Emory’s valuation methodology the most sound, noting that he derived values through interviewing management at GBP, reviewing prior year reports, and analyzing the most relevant guideline companies and the multiples they yielded.

The IRS also asserted that the Kress’ experts erred in considering the restriction of transfers between family members in the bylaws in calculating the lack of marketability discount. Generally, the valuation of any stock is determined without considering restrictions to sell the stock under section 2708. Plaintiffs maintained that the restriction meant all three requirements under section 2703A because it:

1. was a bona fide business arrangement;

2. was not a device to transfer property to members of the decedent’s family for less than full and adequate consideration; and

3. included terms that are comparable to similar arrangements entered into by persons in arm’s-length transactions.

The court agreed that plaintiffs had shown that the restriction was a bona fide business arrangement and was not a device to transfer property to members of the decedent’s family for less than full and adequate consideration. However, the court found that the Kresses had not submitted specific evidence showing that the restriction was comparable to similar arrangements entered into by persons in an arm’s-length transaction. Though Kresses contended that restrictions like the GBP family restrictions were common to the commercial world, they did not produce any evidence that unrelated parties dealing at arm’s length would agree to such an arrangement.

The court did not fully accept Emory’s discounts for lack of marketability. Instead, the court held that a 27 percent discount for lack of marketability for 2006 and 2007 and a 25 percent discount for lack of marketability for 2008 were more fitting. It noted that Emory’s report only gave minimal consideration to the restrictions in the bylaws to transfers to family members, but that any consideration of that or other restriction was improper. As a result, a 3 percent downward adjustment was the appropriate. As a result, the value of the stock for give tax purposes was:

|  |  |
| --- | --- |
| **Gift Tax Year** | **Price Per Share** |
| 2007 | $29.20 |
| 2008 | $27.01 |
| 2009 | $22.50 |

**Carter v. United States \_\_\_\_\_ F. Supp. 3d \_\_\_ (N.D. Ala. 2019)**

**Court rejects attempt of estate to obtain refund for stock that it alleged was over-valued on the alternate valuation date as a result of fraud**

Elizabeth Carter was the personal representative of the Estate of Frances E. P. Roper. Frances Roper died on December 21, 2007. On the date of her death, Frances Roper owned 567,092 shares of Colonial BancGroup stock with a market value of $17,604,767. Frances Roper bequeathed the bulk of her estate, consisting primarily of Colonial BancGroup’s stock, to her niece, Elizabeth Carter, and her nephew, Randy Roper. Within six months after Frances Roper’s death, the market value of the stock decreased to $8,548,947.

The estate filed a federal estate tax return using the alternate valuation date and reported an estate tax of $6,261,530. On April 26, 2009, the estate filed an amended return reporting a slightly lower tax of $6,169,892. The Colonial stock represented 46.8 percent of the value of the gross estate. The IRS accepted the amended return and issued a refund.

Four years later, on September 13, 2013, the estate filed a refund claim with the IRS, alleging that it overpaid its estate tax by $3,731,616 due to a criminal fraud perpetrated against Colonial by one of its customers. Elizabeth Carter alleged that Colonial Bank and its executives urged them not to sell their shares as the price declined. Instead Elizabeth Carter and her brother, Randy Roper, obtained a loan from Colonial for which Colonial required personal guarantees (and on which they remained personally liable). As a result of the fraud, on August 14, 2009, the Alabama State Banking Department closed Colonial Bank and the FDIC assumed receivership over the bank. By December 17, 2010, Colonial’s stock closed at $ 0.07 per share and could no longer be publicly traded.

The estate asserted that it did not have to rely upon the stock’s publicly traded median price on the alternate valuation date due to the criminal fraud involving the bank. The IRS denied the claim. The estate then commenced an action seeking a refund of the overpaid estate tax. The government moved to dismiss on the basis of lack of subject matter jurisdiction and lack of merit. The estate sought the dismissal of this first action without prejudice which the government did not oppose in which the court granted without prejudice on May 12, 2016.

The estate filed a second refund claim on August 26, 2016 on the same grounds as the earlier refund claim. In addition, the claim was accompanied by the medical opinion of Elizabeth Carter’s treating physician in which the physician declared that Elizabeth Carter suffered from a medical impairment for over five years which had prevented her from managing the estate’s affairs.

The government opposed the second refund claim on two grounds. The first ground was that the court lacked subject matter jurisdiction. The second was that if subject matter jurisdiction existed, the estate’s claim lacked merit. The district court found that the court lacked subject matter jurisdiction. Section 6511(a) requires that a claim for refund must be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever period expires later. The court found that the estate had clearly missed the deadline for filing a refund claim and violated the provisions of Section 6511(a). The court noted that when the estate filed its claims in 2013 and 2016, the limitations period under Section 6511(a) for submitting such a claim had lapsed because the estate had filed its tax returns in 2008 and 2009. As a result, the court lacked jurisdiction.

However, the estate invoked the financial disability exception of Section 6511(h) to argue that the time to file the refund claim had been tolled. The court disagreed and held that the financial disability of the estate’s personal representative did not extend the filing deadline for the estate to seek a refund. Section 6511(h) permits the suspension of filing deadline while a taxpayer is unable to manage his or her financial affairs due to a disability. Elizabeth Carter asserted that from the fall of 2008 to the end of 2013, she suffered from moderate to severe mental and emotional abnormalities which rendered her incapable of managing the estate’s financial affairs. She provided the declaration of her treating physician to support this contention. Both Elizabeth Carter and the physician attested that the trauma from the complete devaluation of Colonial stock caused her ailments. The court however found that estates are not “individuals” subject to the provisions of Section 6511(h). Consequently, Elizabeth Carter could not invoke her financial disability to toll the time for the estate’s refund claim.

Then, the court addressed the valuation of the Colonial stock assuming that Section 6511(h) tolled the time for the estate to file its refund claim. The court held that the devaluation of the Colonial stock due to fraud established no entitlement to refund. The court noted that the value of the Colonial stock on both the date of Frances Roper’s death and the alternate valuation date could be determined based on the publicly traded value on a stock exchange. Elizabeth Carter, as executor, contended that the Colonial stock was worthless at the time of its valuation due to the fraud. However, the fraud did not become known and affect the value of the stock until more than one year after the alternate valuation date used by the estate. Until the fraud affected the exchange price, the fraud had no impact on the stock’s fair market value. Had the estate sold the stock on the alternate valuation date, the estate would have received the market price for the stock as of that date and that was the appropriate valuation. The court noted in conclusion that while it was sympathetic to the executor’s plight in these circumstances, it could not invoke its equitable powers to fashion relief against the “ravages wreaked by the criminal fraud.”

**Estate of Aaron U. Jones v. Commissioner, T.C. Memo 2019-101**

**Tax Court determines gift tax value of limited partnership units in voting and non-voting shares of stock in related timber land management and lumber entities**

This case involves the valuation for gift tax purposes of voting and non‑voting stock in the Seneca Sawmill Company, an S Corporation (SSC), and Seneca Jones Timber Company, a limited partnership (SJTC). Aaron Jones was the founder of both entities. SSC manufactured lumber. SJTC owned timber over 155,000 acres in western Oregon and supplied much of the timber for SSC’s milling operations. Jones had started SJTC when he became concerned that he would lose access to sufficient timber for SSC from federal lands. Aaron Jones owned the bulk of the shares or units in each entity and each of his three daughters owned a small interest.

SJTC and SSC, while separate legal entities, operated in tandem in furtherance of SSC’s sawmill business. SJTC’s management team was identical to that of SSC and was paid by SSC. SSC acted as the general partner for SJTC, made all management decisions for SJTC, and had full control over SJTC’s business. Under SJTC’s partnership agreement, the limited partners were restricted in their ability to transfer their interest in SJTC. The consent of all partners was required for the substitution of a transferee of SJTC partnership units as limited partner. Limited partners were also subject to a buy/sell agreement which restricted transfers of their interests in SJTC. Likewise, SSC’s shareholders could not sell, gift, or transfer their stock unless they did so in compliance with SSC’s buy/sell agreement.

As part of the succession plan that he began in 1996, Mr. Jones formed family and generation-skipping trusts on May 28, 2009, to which interest in the companies were to be transferred as gifts. He gave blocks of voting and non-voting stock in SSC to the different trusts. He also gave blocks of limited partner units in SJTC (and small interests with minimal value in another entity) to his daughters and to the different trusts. Jones signed net gift agreements with each of his daughters in which his daughters assumed liability for the gift and estate tax associated with the transfers.

Jones filed a gift tax return reporting the gifts. On the gift tax return, the SSC Class A (voting), the SSC Class B stock (nonvoting), and the SJTC units were valued respectively at $325, $207, and $320 per unit. The Internal Revenue Service issued a notice of deficiency in 2013 in which it determined additional gift tax owed of $44,986,416. Jones died in 2014 and his estate became responsible for handling the alleged gift deficiency with the Service.

The estate and the Service were unable to reach agreement and matter went to the Tax Court. In the course of this proceeding, the estate increased the fair market values of the SSC Class A stock, the SSC Class B stock, and SJTC interests tm $390, $380, and $380 per unit respectively. The IRS valued the SSC Class A voting shares at $1,395 per share, the SSC Class B non-voting shares at $1,325, per share and the SJTC limited partnership units at $2,511 per unit in its notice of deficiency. The IRS subsequently increased its valuation of the limited partnership units from $2,511 to $2,530 per unit.

The case boiled down to which expert’s opinion the court would accept. The court accepted the estate’s expert and not the government’s. The estate’s expert, Richard Reilly, used the discounted cash flow method and a market approach in valuing the shares and the units. Reilly found that SSC was worth $20,000,000 on a non-controlling, non-marketable basis after adjustments and discounts and calculated a value of $390 per share of Class A voting stock on the basis of the number of outstanding shares. He applied a three percent discount for the lack of voting rights and determined a $380 value per share for the Class B Non‑Voting Stock.

Reilly concluded that SJTC was worth $21,000,000 on a non-controlling, non-marketable basis after adjustments and discounts, and he calculated a value of $380 per unit on the basis of the number of outstanding partnership units. Using that valuation, the non-controllable market value of limited partnership units transferred was $3,901,715.

The IRS’ expert, Philip Schwab valued SJTC as a going concern and relied on a net asset value method approach and a market approach in valuing SJTC’s limited partnership units. After applying adjustments and discounts, Schwab determined the value of SJTC on a non-controlling, non‑marketable basis was a $140,398,000. He determined a value of $2,530 per limited partner unit.

John Ashbrook was the IRS’ rebuttal expert with respect to Reilly’s valuation of the SSC stock. The primary dispute between the parties was whether SJTC should be valued using the income approach or an asset based approach. In addition, the parties had other points of dispute: The reliability of revised projections in 2009; the propriety of taking tax affecting into account in the valuation of SSC; the proper treatment of intercompany loans from SSC to SJTC, the proper treatment of SSC’s ten percent general partner interest in SJTC: and the appropriate discount rate for lack of marketability.

The estate contended that SJTC was an operating company that sold a product and therefore should be valued as a going concern with primary consideration to its earnings. It also argued the SSC and SJTC were so closely connected that they should be treated as one entity for valuation purposes. The estate rejected an asset based valuation because there was no likelihood of SJTC selling the timber land. The government contended that SJTC was a natural resource holding company and that the value of its timber land should be given primary consideration in value. The government also argued that the SSC and SJTC were independent entities that should be valued separately.

The Tax Court, in its examination, relied upon Estate of Giustina v. Commissioner, 586 F .App’x 417 9t Cir. 2014). The court concluded that SJTC and SSC were so closely aligned and interdependent that it was appropriate to take into account its relationship with SSC and vice versa. This did not ignore the status of SJTC and SSC as separate legal entities, but recognized their economic relationship and its effect on their valuations. The court also accepted the argument of the estate that under the partnership agreement, holders of blocks of limited partnership units could not force the sale of its timber land and that SSC would never actually sell the timberland. The court concluded that an income based approach rather than a net asset valuation method approach should be used.

The court then noted that Reilly had relied upon revised projections from April 2009 in determining discounted cash flow and had tax affected the earnings before interest and taxes in projecting the earnings. While SSC normally did year-end projections, in the midst of the recession in early 2009, SSC’s management team completed revised financial projections for both SJTC and SSC to assess its ability to comply with loan covenants and operate in an increasingly challenging economic environment. The management team had used the same method to make the April 2009 projections that it used to complete its regular yearly financial projections. The April 2009 projection were more pessimistic results than the year-end projections. The government disagreed with the use of the more pessimistic April 2009 projections, but the court accepted the use since the April 2009 projections were the closest in time to the gifts that were made in May 2009. The court also accepted the use of tax affecting in determining SJTC’s earnings. Reilly used 38 percent as a proxy for the combined federal and state tax burdens that the owners of SJTC would bear (in effect treating SJTC as a C corporation. The court also noted that while the government “vociferously” objected to tax affecting, its experts were basically silent and referred to this as a fight between the lawyers and not between the valuation experts.

The court also looked at the market approach in which Reilly and Schwab both used the guideline public company method for valuing SJTC. The court thought that Reilly’s analysis was better than Schwab’s. As a result, the valuations of Reilly were accepted for gift tax purposes. The court rejected the government’s arguments that the intercompany debt should be added in as a non-operating asset since the interest income and expenses were accounted for in the discounted cash flow valuation method used by Reilly.

The court noted that the government did not submit a valuation of SSC and largely accepted the values of $390 for a Class A voting share and $380 for a Class B nonvoting share. The court almost summarily rejected the three criticisms of the government of Reilly’s valuation:

1. Improperly treating SSC’s $32.7 million receivable from SJTC as an operating asset;
2. Improperly treating SSC’s general partner interest in SJTC as an operating asset and thus improperly accounted for in the value of SSC; and
3. Tax-affecting the discounted cash flow method of valuing SSC.

The court noted that the advancements from SSC to SJTC were not investments. They were, instead, cash transfers between intercompany accounts of a single business enterprise to pay down debt to third party lenders. SSC’s controlling interest in SJTC ensured that SSC and SJTC could be operated as a single business enterprise which was an operating company and therefore Reilly’s use of expected distributions to represent the value of the general partner interest to SSC was reasonable. The court found that using tax affecting for valuing SSC was appropriate for that same reasons that the court found tax affecting appropriate for valuing SJTC.

Finally the court accepted Reilly’s 35 percent discount for lack of marketability which was based on SJTC’s unique characteristics including the buy-sell agreement, the lack of historic transfers, a potentially indefinite holding period, a reported loss in the twelve months before the gifts were made, and the unpredictability of partner distributions.

The court adopted the valuations in Reilly’s report thus giving the taxpayers a victory.

**CCA 201939002 (Issued May 28, 2019; Released September 27, 2019)**

**Determination of fair market value of publicly traded stock for gift tax purposes should take into account pending merger**

The donor was a co-founder and chairman of board of Corporation A, a publicly traded corporation. The donor transferred shares of Corporation A stock to a grantor retained annuity trust with a remainder to children. Subsequently, Corporation A announced a merger with Corporation B. The merger was the culmination of negotiations with multiple parties. Prior to the date of the gift of the stock to the GRAT, Corporation A held exclusive negotiations with Corporation B. On the day of trading after the announcement of the merger, the value of Corporation A’s stock increased substantially, although less than the agreed merger price. The merger price was subsequently consummated.

The memorandum did say that fair-market value is the price that a hypothetical willing buyer would pay a hypothetical willing seller, neither being under any compulsion to buy or to sell, both having reasonable knowledge of relevant facts. Treas. Reg. § 25.2512-1; Rev. Rul. 59-60, 1959-1 C.B. 237. Moreover, a valuation of property for estate and gift tax purposes is made as of the valuation date without taking account of subsequent events.

The IRS, in reviewing the transaction, found that the records supported a finding that, as of date of the gift, a hypothetical willing buyer of the stock could have reasonably foreseen the merger and anticipated that Corporation A’s stock would trade at a premium. While the sale price of stocks and bonds on the date of the gift is the usually the fair-market value, Treas. Reg. § 25.2512-2(e) provides that in cases in which the sale price of the stock or bond does not represent the fair-market value, then some reasonable modification to the sales price on the date of the gift or other relevant facts and elements of value shall be considered in determining the fair-market value.

The memorandum cited to Silverman v. Commissioner, T.C. Memo. 1974-285, aff’d., 538 F.2d. 927 (2d Cir. 1976), cert denied, 431 U.S. 938 (1937) in which taxpayers gifted shares of preferred stock while in the process of reorganizing with the intent to go public. The Tax Court rejected the expert testimony presented by the petitioners, because the expert failed to take into account the circumstances of the future public sale. The Tax Court also cited to Ferguson v. Commissioner, 174 F. 2d.997 (9th Cir. 1999), which affirmed the Tax Court’s prior decision, 108 T.C. 244 (1997). In Ferguson, the appellate court considered the issue of whether the taxpayers who gave stock in a publicly traded company to different charities shortly before the sale of the company were liable for the capital gains tax on the sale of the appreciated securities under the anticipatory assignment of income doctrine.

In Ferguson, the taxpayers owned 18 percent of a publicly traded company and served as officers and on the board of directors. The board of directors authorized an investment bank to find a purchaser and to assist in negotiations. By July 1989, the company entered into a merger agreement. On August 3, 1988 a tender offer was started. On August 15, taxpayers executed a donation-in-kind record with respect to their intention to donate stock to a charity and two foundations. On September 9, 1980, the charity and foundations tendered their stock. On September 12, 1980 the final shares were tendered. On October 14, 1988, the merger was completed. The court concluded that the transfers to the charity and the foundations occurred after the shares in the company had ripened from an interest in a viable corporation into a fixed right to receive cash. Consequently, the assignment of income doctrine applied and the taxpayer’s realized gain when the charity and the foundations disposed of the stock.

The memorandum states that the current situation was similar factually to Ferguson, especially on the issue as to whether the fair-market value of the stock should take into consideration the likelihood of the merger as of the date of the donor’s transfer of stock in Corporation A to the GRAT. The memorandum states that the Ferguson and Silverman opinions support the conclusion that the value of the stock in corporation must take in to consideration the pending merger. As a result, the value determined on the basis of the sales price on the date of the gift did not represent the fair-market value of the shares as of the valuation date. Relevant facts and elements other than the sales price must be considered in determining fair-market value. The memorandum also states that under the fair-market value standard, the hypothetical willing buyer and willing seller as of the transfer date would be reasonably informed during the course of negotiations over the purchase and sale of shares, and would have knowledge of all relevant facts, including the pending merger. It goes on to state that to ignore the facts and circumstances of the pending merger would undermine the basic tenants of fair market value, and yield a baseless valuation.

The government does not address in this memorandum the possibility that the market may already have built the possible merger into the price of the stock in Corporation A. Moreover, Silverman would appear to be less than relevant because it deals with stock in a closely held corporation, while Ferguson does not deal with a gift of stock, but with the issue of whether the donors of appreciated stock to charity were responsible for the payment of capital gains tax because a tender offer had ripened sufficiently to subject the gift to the anticipatory income doctrine. Finally, one might raise the question of why a third party purchaser would pay a premium when that purchaser could pay the market price of a publicly traded security.

**CHARITABLE GIFTS**

**Letter Ruling 201845014 (Issued August 9, 2018; Released November 9, 2018)**

**IRS issues favorable letter ruling with respect to two charitable remainder unitrusts**

X intended to form two charitable remainder unitrusts. CRUT 1 was an inter vivos CRUT with X’s life as the measuring life. CRUT 2 was an inter vivos CRUT with consecutive life interests in X and X’s spouse, subject to X’s right to revoke the spouse’s survivor remainder interest. Each CRUT provided that the unitrust amount would be a percentage of the net fair market value of the trust property determined as of the first business day of the taxable year. Each CRUT also provided that the trustee would distribute to the private beneficiary (i) a fixed percentage of the unitrust amount and (ii) such additional portion of the unitrust amount as the independent trustee determined was necessary to ensure that the total portion of the unitrust amount distributed to the private beneficiary in each taxable year was not de minimis under the facts and circumstances (the “minimum amount”).

After providing for the distribution of the minimum amount to X or X’s spouse, the trustee was to distribute the balance of the unitrust amount to such one or more of the private beneficiaries, and one or more charitable organizations in the “charitable class” as the independent trustee selected in equal or unequal portions in the independent trustee’s sole discretion without the approval or consent of any other person. The charitable class, which would contain the permissible charitable distributees, consisted of such of one or more charitable organizations that X, as an individual and not as a fiduciary, designated by an instrument delivered to the independent trustee. The power to designate the members of the charitable class lapsed each year. X also retained the testamentary power to appoint the charitable organizations that would receive the remainder at the end of the unitrust term. A default charity was named to the extent that X did not exercise the testamentary power of appointment.

X retained the power to remove and appoint an independent trustee. When X ceased to act, X’s wife was designated as the appointer and remover of the independent trustee.

The IRS was requested to give the following rulings:

1. The power of the independent trustee to allocate a portion of the unitrust amount between noncharitable and charitable beneficiaries would not prevent either CRUT from qualifying as a CRUT under Section 664.

2. The powers of X and X’s wife to replace the independent trustee would not prevent either CRUT from qualifying as a qualified CRUT under Section 664.

3. The power of X to designate the charitable class of each trust would not prevent either CRUT from qualifying as a qualified CRUT under Section 664.

4. X’s testamentary power to revoke the survivor remainder interest would not prevent CRUT 2 from qualifying as a qualified CRUT under Section 664.

5. X’s power to designate the charitable class of each CRUT would prevent completion of the gift of the net unitrust amount during X’s lifetime until the annual lapse of such power. Upon the annual lapse of X’s power to designate the charitable class and to the extent each year that the net unitrust amount was distributed to one or more charitable organizations, the distributions would be completed gifts that would qualify for the gift tax charitable deduction.

6. X’s testamentary power to revoke the survivor remainder interest in CRUT 2 would cause X’s gift of the survivor remainder interest to remain incomplete until X’s death.

7. With respect to CRUT 2, if X’s spouse survived X and if X did not revoke the survivor remainder interest at X’s death, the entire value of the assets of CRUT 2 included in X’s estate would be deductible because of the combined charitable and marital estate tax deductions.

The Service first ruled that the provisions in each CRUT giving the independent trustee the power to allocate a portion of the unitrust amount between charitable and noncharitable beneficiaries would not prevent either CRUT from qualifying as a valid CRUT under Section 664. The IRS noted that Section 674(c) provides an exception to the general rule of Section 674(a) under which the power of an independent trustee to allocate the unitrust amount among charitable and noncharitable beneficiaries on an annual basis is consistent with the provisions of the Internal Revenue Code governing charitable remainder trusts. The governing instrument must require that a portion of the unitrust amount be allocated and paid to the noncharitable beneficiaries each year and that amount must be not de minimis.

The Service next concluded that the retained powers of X and X’s wife to remove and appoint the independent trustee would not allow them to substitute any person who would be subordinate to X or X’s wife. Consequently, these powers to remove and replace the independent trustee would not prevent either CRUT from qualifying as a valid CRUT under Section 664.

The Service next ruled that X’s power to designate the charitable class of each CRUT would not prevent either CRUT from qualifying as a valid CRUT under Section 664. In addition, X’s testamentary power to revoke the survivor remainder in CRUT 2 would not prevent CRUT 2 from qualifying under Section 664.

The Service then ruled that X’s annual power to designate the charitable class would prevent completion of the gift of the net unitrust amount of each CRUT during X’s lifetime until the lapse of such power. Upon the annual lapse of X’s power to designate the charitable class and to the extent each year that the net unitrust amount was distributed to one or more charitable organizations, the distributions would be completed gifts and would qualify for the gift tax charitable deduction. In addition, the retention of the power to revoke the survivor remainder in CRUT 2 would cause X’s gift of the survivor remainder to remain incomplete until X’s death. At X’s death, the property remaining in CRUT 2 would not be subject to estate tax because it would qualify either for the marital deduction or the charitable deduction.

**Wendell Falls Development, LLC v. Commissioner, T.C. Memo 2018-45; motion for reconsideration denied, T.C. Memo 2018-193**

**No charitable contribution deduction is allowed for the donation of a conservation easement and no penalty is applicable**

The IRS disallowed an income tax charitable contribution deduction of $1,798,000 for the contribution of a conservation easement by Wendell Falls LLC. The IRS also sought to impose a 40 percent penalty for a gross valuation misstatement or, in the alternative, a 20 percent penalty for a substantial valuation misstatement. Wendell Falls, as part of a planned unit development in Wake County, North Carolina, intended to develop 1,280 acres. It also identified 125 acres of the 1,280 acres as the land upon which a park would be placed. In late 2006, the Wake County Board of Commissioners authorized the county to buy the 125 acres identified on the map as a park. Because of an incorrect reference in the planned unit development to the park having 160 acres as opposed to 125 acres, the purchase agreement inadvertently stated that the acreage of the planned park was 160 acres. The purchase agreement also stated that placing a mutually agreeable conservation easement on the land was a precondition to the sale. After realizing the mistake and having a new appraisal done, the land was valued at $3,020,000 unrestricted by any conservation easement and the Wake County Board of Commissioners reauthorized the purchase. On June 7, 2007, a conversation easement on the 125 acres was placed on the property and subsequently a general warranty deed was recorded transferring ownership of the 125 acres from Wendell Falls to Wake County.

On its partnership return for 2007, Wendell Falls claimed a charitable contribution deduction of $1,798,000 for the contribution of the conservation easement. The value of the conservation easement, according to the appraiser, was $4,818,000, and $1,798,000 represented the difference between the appraised value and the price paid by Wake County. The court denied the charitable contribution deduction for the easement for two reasons. The first was that Wendell Falls expected a substantial benefit from the conservation easement. The evidence showed that Wendell Falls would benefit from the increased value in the lots to be sold in the planned unit development from having the park as an amenity. Consequently, Wendell Falls donated the easement with the expectation of receiving a substantial benefit. The court held that the charitable contribution deduction was not allowable because of the expectation of the substantial benefit.

Alternatively, the value of the easement was zero. An easement must have value to generate a charitable contribution deduction. In order to determine the value because there were no sales of easements comparable to the easement contributed by Wendell Falls, the value of the easement would be equal to the value of the land before the easement minus the value of the land after the easement. In looking at the plan developed by Wendell Falls which had owned the entire 1,280 acres including the 125 acres, the best use of the 125 acres was as a park in the midst of a master planned community. The conservation easement did not diminish the value of the 125 acres because it was not prevented from being put to its best use. As a result, the value of the easement was zero.

After trial, the IRS conceded that the 40 percent penalty for gross valuation misstatement did not apply. The court rejected the imposition of the 20 percent penalty because Wendell Falls LLC had acted in good faith since it had hired two different state-certified real estate appraiser to value the conservation easement.

**Champions Retreat Golf Founders, LLC v. Commissioner, T.C. Memo 2018-146**

**Golf club development was not entitled to charitable deduction for donation to land trust of conservation easement operating across golf course**

Champions Retreat received a 463.3-acre tract to build a golf course in 2002. Champions Retreat raised an initial $13.2 million for construction of the golf club by selling 66 residential lots and borrowing heavily in order to complete construction of the golf club which occurred in June 2005. The golf club accounted for 363.56 acres of the 463.3-acre tract. After completion, Champions Retreat was not profitable. On December 16, 2010, Champions Retreat conveyed an easement that covered 348.51 acres to North American Land Trust. Champions Retreat claimed a $10,427,435 income tax charitable deduction on its partnership income tax return for 2010.

The easement identified three conservation purposes:

1. Preservation of the area as a relatively natural habitat of fish, wildlife, or plants or similar ecosystems;

2. Preservation of the area as an open space which provided scenic enjoyment to the general public and yielded a significant public benefit; and

3. Preservation of the area as an open space which, if preserved, would advance a clearly delineated federal, state, or local governmental conservation policy and would yield a significant public benefit.

The court observed that the easement area included 25 of the 27 holes in their entirety, most of the two remaining holes, and the driving range.

On audit, the IRS denied the income tax deduction on two alternative grounds. The first was that the conservation easement did not meet the requirements of Section 170. The second was that the easement did not have a value greater than zero.

The court only addressed the first ground advanced by the IRS. The court was unpersuaded that there was a sufficient presence of rare, unchanged, or threatened bird species in the easement area. In addition, the denseflower knotweed, which is a rare, endangered, or threatened species, only occupied a small fraction of the easement area.

Thus, a habitat for rare, endangered, or threatened species of animals, fish, or plants was not provided.

The court also concluded that the easement area was not a natural area that contributed to the ecological viability of the Sumter National Forest, which lies across the Savannah River from the easement area.

The easement area did not meet the test for providing open space because of the limited physical access of the public to view the easement area from the Little and Savannah Rivers which was further limited by three to ten foot river banks.

Finally, Champion Retreats’ preservation of open space was neither for the enjoyment of the general public nor pursuant to a clearly delineated government policy. Thus, it could not provide a significant public benefit.

**Belair Woods, LLC v. Commissioner, T.C. Memo 2018 - 159**

**On cross motions for partial summary judgment, court concludes that Belair did not comply, either strictly or substantially, with the requirements of the regulations with respect to obtaining an income tax charitable deduction; however, disputes of material fact existed as to whether Belair had reasonable cause for failure to supply a fully completed appraisal summary**

This case was decided on cross motions for partial summary judgment. Belair was formed in the late 2008 as a Georgia limited liability company. On December 18, 2008, HRH Investments LLC contributed 145.15 acres of real estate to Belair. On December 30, 2009, Belair entered into a deed of conservation easement with the Georgia Land Trust and the deed was recorded the next day. Belair delegated many details regarding this transaction to Forever Forests, LLC. Forever Forests was a consulting firm specializing in structuring conservation easements to maximize the tax benefits for donors. Forever Forests advised Belair on the terms of easement as well as the tax filings with respect thereto.

Belair timely filed the partnership return and claimed an income tax charitable contribution deduction of $4,778,000 for the donation of the easement. Belair included with the return a copy of an appraisal that relied on the “before and after” method to value the easement. Belair also included with its return a Form 8283 executed by the appraiser and the Georgia Land Trust. The instructions to Form 8283 directed the taxpayer to provide the IRS with certain information regarding non-cash charitable contributions. When a taxpayer donates property (other than publicly traded securities) valued in excess of $5,000, the taxpayer must provide:

1. A description of the donated property;

2. A brief summary of its physical condition;

3. Its appraised fair market value;

4. The date the property was acquired by the donor;

5. The manner of acquisition; and

6. The donor’s cost or adjusted basis.

The instructions to the Form 8283 also state that “[I]f you have reasonable cause for not providing the information. . .attach an explanation so your deduction will not automatically be disallowed.”

Belair contacted Forever Forests about preparing the Form 8283, specifically with reference to reporting its “cost or adjusted basis,” since it was using the “before and after” method to value the easement. Forever Forests relayed advice it had received in 2008 from the Baker Donelson law firm. At the request of Forever Forests, an attorney at that firm had reviewed the instructions to the Form 8283 and concluded that it should not be necessary to include the basis information if an explanation is attached to the Form 8283 providing reasonable cause why the basic information was not included. The attorney also stated that a reasonable cause for not including basis information should be that the basis of the property was not taken into consideration when computing the amount of the deduction.

When it filed the Form 8283, Belair appended a two-page letter which stated that a declaration of the taxpayer’s basis in the property was not included because the basis of the property was not taken into consideration in computing the amount of the deduction.

The IRS audited Belair’s 2009 return and issued a summary report explaining that Belair’s claimed deduction should be disallowed because Belair did not include information concerning the cost of the easement or adjusted basis on the Form 8283. About one month later, Belair’s CPA responded to the summary report and provided cost basis information concerning the easement.

On June 19, 2017, the IRS disallowed the deduction because the requirements of Section 170 had not been met. Alternatively, the IRS determined that no kind of deduction was allowable because Belair had not established the fair market value of the easement. The IRS also proposed a 40 percent gross valuation misstatement penalty or, in the alternative, a 20 percent accuracy related penalty. Both Belair and the IRS agreed that Treas. Reg. § 1.170A‑13(c)(2)(i)(B) requires a donor to attach a fully completed appraisal summary to the tax return on which the charitable contribution deduction is first claimed. The tax deduction will not be disallowed simply because of the inability (for reasonable cause) to provide certain information.

The Tax Court concluded that Belair did not strictly comply with the regulatory requirements because it did not report its cost basis as the regulation requires and as Form 8283 directed. Moreover, the explanation that Belair attached to that form, far from showing its inability to provide the information, simply asserted that the information was unnecessary. Belair contended that it had reasonable cause for omitting the basis information because it did not know what basis to report. The court noted that even if Belair’s premise was correct, the conclusion did not follow from its premise. The regulations exclude the admission of basis information only if a reasonable cause is established and the explanation is attached to the appraisal.

Belair alternatively contended that it cured its initial omission by supplying cost basis information during the audit with the IRS. Treas. Reg. § 1.170A-13 (c)(4)(iv)(H) provides that a deduction will not be disallowed for failure to attach an appraisal summary if the donor complies with IRS instructions to submit that document within 90 days of an IRS request therefor. Belair argued that this regulation entitled it to relief because its CPA provided basis information to the IRS in January 2013 shortly after being notified that Belair’s deduction would be denied for failure to submit a properly completed Form 8283. The court said that the regulation did not apply in this situation. Belair did not fail to attach an appraisal summary. Rather Belair intentionally included an incomplete Form 8283 with its return.

The court also rejected Belair’s argument that it had substantially complied with the regulation. Relying upon RERI Holdings 1, 149 T.C. \_\_\_ (July 3, 2017), the court concluded that a taxpayer did not substantially comply with a reporting requirements when it failed to disclose cost or adjusted basis on the Form 8283. However, Belair contended that when preparing its Form 8283, it reasonably relied on advice from Forever Forests, which in turn relied on advice from an outside law firm. The court concluded that the resolution of this issue could require it to address several questions as to which genuine disputes of material fact currently appeared to exist. These questions included whether Forever Forests was a tax professional, whether Forever Forests was a competent and independent advisor unburdened with a conflict of interest, whether Belair could reasonably rely on legal advice relayed to it indirectly and whether Belair actually relied in good faith on advice that the IRS seemed to regard as too good to be true. As a result, the court denied Belair’s motion for partial summary judgment and granted in part and denied in part the IRS’s motion for partial summary judgment.

**Blau v. Commissioner, \_\_\_ F. 3d\_\_\_\_ (D.C. Cir. 2019)**

**D.C. Circuit Court upholds decision of Tax Court finding that taxpayer was not entitled to income tax charitable deduction and imposition of 40 percent penalty for underpayment of tax was appropriate**

According to the court, the basic facts of the case are simple. RERI Holdings LLC acquired and then donated future interest in a piece of commercial property to the University of Michigan. RERI maintained that the donation was a bona fide donation that it valued reasonably at $33 million. The IRS found that RERI artificially inflated the value of the donated property to offset the tax liability of its owners.

In March 2002, RERI Holdings LLC purchased a successor member interest or SMI in a shell limited liability company for $2,000,950. The SMI represented the remainder interest (after a separate eighteen year term of years interest) in commercial real estate in California. In August 2003, Stephen Ross, one of RERI’s members, pledged $4 million to the University of Michigan and later increased the pledge to $5 million. In partial fulfillment of Ross’ pledge, RERI assigned the SMI to the University of Michigan. Under the gift agreement, the University of Michigan was to hold the SMI for a minimum of two years after which the University of Michigan was to sell the SMI in a manner and to a buyer of its choosing. In December 2005, the University of Michigan sold the SMI to HRK Real Estate Holdings, LLC for $1,000,940 (even though it had the property appraised at $6.5 million earlier that year). The parties stipulated that the sale price did not represent the fair market value of the SMI. The buyer was indirectly owned by one of RERI’s members.

On its 2003 informational income tax return RERI claimed an income tax charitable deduction of $33,019,000 for the transfer of a non-cash asset. $32,935,000 represented the purported value of the donated SMI and the remaining $84,000 was for appraisal and professional fees. RERI attached the appraisal to its return and a completed the Form 8283 for non-cash charitable contributions. However, RERI left blank the space for “Donor’s cost for adjusted basis” and failed to provide any explanation for this admission.

The Internal Revenue Service subsequently disallowed $29 million of RERI’s claimed charitable deduction based upon its determination that the SMI was worth only $3.9 million. It also imposed a penalty equal to 20 percent of the tax underpayment under §6662(e)(1) for a “substantial” underpayment.

RERI challenged the IRS’s determination of value and its imposition of an underpayment penalty in Tax Court. In its answer, the IRS revised its determinations and asserted that RERI was entitled to no charitable deduction on the ground that the transaction was a “sham for tax purposes that lacked economic substance.” The IRS argued in the alternative that RERI’s charitable deduction should be limited to $1,940,000, the amount that Michigan had realized from the sale of the SMI. The IRS finally claimed that the valuation misstatement was “gross” rather than merely “substantial,” which triggered a penalty equal to 40 percent of the tax underpayment.

The Tax Court issued a judgment sustaining both the IRS’s determination that RERI was not entitled to any charitable deduction and the assessment of the 40 percent penalty. However, the Tax Court did not base its decision on the “lack of economic substance” theory advanced by the IRS. Instead the Tax Court concluded that the RERI had failed to substantiate the value of the designated property as required by the Treasury Regulations. The Tax Court did find that the SMI was worth $3,462,886 on the date of the donation. The Tax Court also held the RERI did not qualify for the reasonable cause exception to the accuracy related penalties.

The circuit court first determined that the Tax Court properly determined that the RERI’s income tax charitable deduction failed due to RERI’s failure to strictly or substantially comply with the substantiation requirements found in Treas. Reg § 1.170A-13. The record showed that RERI fell short of substantial compliance by omitting the cost basis figure on the Form 8283 and its failure to provide an explanation. The circuit court noted that the alternative argument presented by RERI that the omission of the adjusted cost basis number provided the IRS with the same red flag as reporting the adjusted cost basis number on the Form 8283 was not appropriate.

The circuit court also found that the Tax Court properly upheld the 40 percent accuracy related valuation misstatement payments imposed by the IRS. The circuit court rejected RERI’s argument that the IRS had failed to meet the requirements of Section 675(1) for penalties, because RERI had failed to raise that argument in the Tax Court. As a result, this argument was forfeited.

The circuit court rejected RERI’s argument that, even if it misstated the value of the donated property, its underpayment was not “attributable to” that misstatement within the meaning of the penalty statute because the Tax Court’s stated reason for disallowing the deduction was RERI’s failure to properly substantiate the donation pursuant to Section 170. Instead, the penalty properly applied because the Tax Court determined that RERI made a gross valuation misstatement and that misstatement was an independent alternative ground for adjusting the deduction. The circuit court also rejected RERI’s claims that the Tax Court was required to determining the value of the SMI using actuarial tables and that, even if the Tax Court did not err in setting aside the actuarial tables, it applied too high a discount rate in calculating the fair market value of the donated property. The Tax Court had made an independent valuation of the SMI of $3.4 million based upon the evidence introduced at trial.

The circuit court then rejected RERI’s argument that it qualified for the Section 6664(c)(1) reasonable cause and good faith exception to the valuation misstatement penalty. Section 6664(c)(3) specifically provides the reasonable cause exception applies only if (1) the claimed value of the property was based on a qualified appraisal made by a qualitied appraiser and (2) in addition to obtaining such appraisal, the taxpayer made a good faith investigation into the value of the contributed property.

The circuit court agreed with the Tax Court’s decision not to excuse RERI’s gross valuation misstatement penalty under the reasonable cause and good faith exception. The Tax Court had assumed that RERI was correct and that the IRS bore the burden of proving the absence of reasonable cause. The Tax Court then held that the IRS carried this burden. The circuit court found that RERI bore the burden in proving it had met the requirements and had failed to do so. The circuit court found the RERI had failed to show that it conducted a good faith investigation into the value of the donated property. It noted that a good faith investigation calls for some action beside beyond simply accepting the result as a qualified appraisal. As a result, the circuit court did not need to address the other element of qualifying for the exception, which is the requirement of a qualified appraisal.

**I.R. – 2019-182 (November 12, 2019)**

**IRS increases enforcement action of Syndicated Conservation Easements**

The Internal Revenue Service announced what it called “a significant increase in enforcement actions for syndicated conservation easement transactions, a priority compliance area for the agency”, on November 12, 2019. It noted that coordinated examinations are being conducted across the IRS in the small business and self-employed division, the large business and international division, and the tax exempt and government entities division. Separate investigations have also been initiated by the IRS’s criminal investigation division. According to the IRS, these audits and investigations cover billions of dollars of potentially inflated deductions as well as hundreds of partnerships and thousands of investors.

As the IRS put it:

We will not stop in our pursuant of everyone involved in the creation, marketing, promotion and wrongful acquisition of artificial, highly inflated deductions based on these aggressive transactions. Every available enforcement auction will be considered, including civil penalties and, where appropriate, criminal investigations.

In Notice 2017-10 (December 2016) the IRS designated certain syndicated conservation easements as listed transactions. In specific, that notice listed transactions where investors and pass through entities received promotional material offering the possibility of charitable contribution deduction worth at least two and at one half times their investment. In many transactions, the deduction taken was significantly higher than 250 percent of the investment. These transactions are included on the IRS’s 2019 “dirty dozen” list of tax scams to avoid. The IRS recognized that there are many legitimate conservation easements and that its compliance efforts were focused on the abusive syndicated conservation easement transactions. The IRS noted that it is pursuing investigations not only of participants, but also of promoters, appraisers, tax return preparers and others and will develop and assert all appropriate penalties. Such penalties include accuracy related penalties for participants, penalties for substantial and gross valuation misstatements attributable to incorrect appraisals for appraisers, and promoters. The IRS also noted that it is litigating cases where necessary with more than 80 currently docketed cases in the Tax Court on the availability and amount of income tax charitable deductions with respect to conservation easements.

**Letter Ruling 201933007 (Issued April 22, 2019; Released August 16, 2019)**

**IRS permits the use of a formula to determine the term of years and termination date for charitable lead annuity trust**

This letter ruling concerns the proposed use of a formula to determine the term of years and termination date in a Charitable Lead Annuity Trust (CLAT) in order to meet the requirement under Section 2055(e)(2)(B) that a guaranteed annuity be paid for a specified term of years in order for a transfer at death to a CLAT to qualify for the estate tax charitable deduction.

Grantor’s revocable trust provided that at the death of the second to die of grantor and spouse, a CLAT would be established with the residue of the trust. The charitable annuity amount of the CLAT was to equal five percent of the fair market value of the initial trust estate.

The term of years and the termination date of the CLAT was to be determined through a formula pursuant to which the payment of the annuity amount would terminate at the end of that number of years, rounded up to the nearest whole year, starting on the date of death of the survivor of grantor and spouse, which, taking into account the following:

(i) the lowest federal midterm rate which may be elected under Section 7520;

(ii) the frequency of the payment of annuity amount;

(iii) the annuity amount; and

(iv) such valuation methods, tables, factors and applicable rates prescribed by the provisions of the Internal Revenue Code

would result in a federal estate tax charitable deduction in the estate of the survivor of grantor and spouse, equal to, or as close as possible to, 100 percent of the fair market value of the property transferred to the CLAT.

Grantor sought two rulings:

1. The use of the formula satisfied the requirement that a guaranteed annuity must be paid for a specific term of years; and

2. The estate of the survivor of the grantor and spouse would be entitled to a federal estate deduction under Section 2055(a) for the present value of the annuity interest.

The Internal Revenue Service ruled favorably on both requests. It noted that the annuity amount was a determinable amount, ascertainable as of the date of the death of the survivor of grantor and spouse, because it was equal to five percent of the fair market value of the initial trust estate. It then held that the provision for determining the term of years of the CLAT was permissible because the term, although not expressly stated in the instrument, was determinable as of the date of death of the survivor of grantor and spouse based on the formula in the trust instrument. This met the requirement that a CLAT have a specified term. As a result, the formula satisfied the requirement that a guaranteed annuity must be paid for a specified term of years under Section 2055(e)(2)(B). The Service also found that the survivor’s estate would be entitled to an estate tax charitable deduction because the amount of the estate tax charitable deduction was determinable as of the date of death of the survivor of grantor and spouse.

**Letter Rulings 201937003 and 201937004 (Issued March 13, 2019; Released September 13, 2019)**

**Payment of fee by foundation to disqualified person or to disregarded entity for services is not an act of self-dealing**

The founder of a foundation donated services through two wholly owned, disregarded entities to the foundation to enable the foundation to carry out its activities. The personnel providing the services were employees of entities disregarded with respect to the founder for tax purposes. One entity provided programmatic services, grant making services and charitable consulting services to the foundation. The second entity provided investment advisory services.

The Service ruled that the provisions of the services would not be an act of self-dealing as long as the services were reasonable and necessary to carrying out the exempt purposes of the foundation and the payments were not excessive. These payments fell within the exception under Section 4941(d)(2)(E) for the payment by a foundation of reasonable compensation for personal services that are reasonable and necessary for carrying out the exempt purpose of a private foundation to a disqualified person such as the founder.

**GENERATION-SKIPPING TRANSFER TAX**

**Letter Rulings 201820007 and 201820008 (Issued February 5, 2018; Released May 18, 2018)**

**Proposed distribution from one generation-skipping tax exempt trust to another exempt trust will not cause either trust to lose their exempt status**

These letter rulings concern irrevocable GST exempt trusts created after September 25, 1985. Separate trusts were established with identical terms for the benefit of the Settlor’s two sons. Trust A was an irrevocable trust for the benefit of one son and Trust B was an irrevocable trust for the benefit of a second son.

The trustee could currently distribute income and principal to each son for the son’s support, maintenance, education, and health. Upon the death of the son, the son had a limited testamentary power of appointment to the issue of the Settlor. Otherwise the property passed per stirpes to the son’s then living issue.

Trustee subsequently appointed all the principal and accumulated income of one of the trusts to a new trust, known as Trust C. During the son’s lifetime, the distribution standard and trustee were the same as the distribution standard and trustee in Trust A. The son continued to have a testamentary limited power of appointment to the settlor’s issue. However, Trust C expressly provided that the son could create a new trust for the benefit of permissible appointees. The beneficiary of each new trust was given a testamentary general power of appointment which would cause the assets of the trust to be included in the estate of the beneficiary at his or her death. Consequently, the distribution of property from Trust A to Trust C would not cause a shift to beneficial interest to lower generation or extend the time for vesting of any beneficial interest.

As a result, the proposed appointment from Trust A to Trust C would not cause the trust to lose its exempt status for GST purposes because the new trust satisfied the requirements of Treas. Reg. § 26.2601-1(b)(4)(i)(D) since the change would not shift any beneficial interest to a lower generation and would not extend the term of the trust beyond the period permitted in the original trust.

**Letter Ruling 201923022 (Issued February 7, 2019; Released June 7, 2019)**

**Husband and Wife granted extension of time to allocate GST exemption**

Husband and wife created two irrevocable trusts. Each trust was for the benefit of a child and her issue and each trust has GST tax potential. Husband and wife made lifetime gifts to each trust and relied upon an accounting firm to prepare the gift tax returns. Husband and wife split gifts for these transfers. The gift tax returns for the first year failed to allocate any part of either husband’s or wife’s exemption to the transfers to the two trusts. The failure to allocate GST exemption was discovered subsequently by a law firm. The husband and wife requested an extension of time to allocate their available GST exemptions.

Treas. Reg. § 301.9100-3 provides that requests for an extension of time will be granted when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional. The Internal Revenue Service found that the requirements of Treas. Reg. § 301.9100-3 had been satisfied and husband and wife were granted an extension of time to allocate their available GST exemptions to the trusts.

**Letter Ruling 201921001 (Issued December 10, 2018; Released May 24, 2019)**

**Donor and spouse granted extension of time to opt out of automatic allocation rules**

Donor created three irrevocable trusts for the primary benefit of his children and his children’s issue. In a subsequent year, spouse created three irrevocable trusts for the primary benefit of her sister and her nephews. Each of the six trusts had GST potential. Donor made gifts to the three trusts for the children in the year that they were created and spouse made gifts to the three trusts for the sister and nephews in the year in which they were created. Both the donor and the spouse split the gifts for all the transfers to the trusts. Although donor and spouse did not intend the GST exemption be allocated to five of the six trusts, the CPA who prepared the gift tax returns erroneously failed to opt out of the automatic allocation rules. These errors were discovered later by new legal counsel upon a review of the gift tax returns. The donor and the spouse requested an extension of time to opt out of the automatic allocation rules of Section 2632(c)(1).

Treas. Reg. § 301.9100-3 provides that requests for an extension of time to opt out of the automatic allocation rules will be granted when the taxpayer provides evidence that the taxpayer acted reasonably and in good faith and that the granting relief will not prejudice the interests of the government. A taxpayer is deemed to act reasonably and in good faith when the taxpayer reasonably relied on a qualified tax professional. The Service concluded that the requirements of Treas. Reg. § 301.9100-3 had been satisfied and the donor and the spouse were granted a 120 day extension of time to make the election to opt out of the automatic allocation rules.

**Letter Rulings 201849007 and 201849008 (Issued July 31, 2018; Released December 7, 2018)**

**IRS grants an extension of time for grantors to allocate GST exemption to trust**

Grantors created a trust for the benefit of their issue. An accountant prepared and filed the gift tax returns for Grantor 2’s gifts to Trust 1 and Trust 2 in which Grantor 2 and spouse elected to split the gift under Section 2513. Accountant failed to allocate Grantor 2 and spouse’s respective GST exemptions to the transfers to the trusts on two dates. Grantor 2 and spouse requested an extension of time pursuant to Treas. Reg. §§ 301.9100-1 and 301.9100-3 to allocate their GST exemptions to the transfers to the trusts on the two dates.

The Service granted the request for an extension of time because the requirements of Treas. Reg. § 301.9100-3 had been satisfied. Requests for relief will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional to make the election.

**Letter Ruling 201850010 (Issued September 17, 2018; Released December 14, 2018)**

**IRS grants extension of time to sever QTIP trust into exempt and non‑exempt QTIP trusts and to make a “reverse” QTIP election for the exempt QTIP trust and to apply the GST automatic allocation rules to allocate GST exemption to the exempt QTIP trust**

Decedent died survived by spouse. Decedent’s revocable trust, which contained the provisions for the disposition of decedent’s assets after his death, provided that if spouse survived decedent, the trustee was to divide the trust into a QTIP marital trust and a bypass trust. Moreover, if the property allocated to the QTIP martial trust exceeded decedent’s available GST tax exemption allocated to that trust, the trustee was to establish exempt and non‑exempt QTIP trusts.

Upon decedent’s death, decedent’s estate retained a law firm to prepare the estate tax return. The estate made the QTIP election for the QTIP trust to qualify it for the estate tax marital deduction. However, the Form 706 prepared by the law firm failed to indicate that the QTIP trust was to be severed into exempt and non‑exempt QTIP trusts and did not make a reverse QTIP election with respect to the exempt QTIP trust. As a result, none of decedent’s GST exemption was allocated to the QTIP trust.

The law firm did not advise the estate of the need to sever the QTIP trust, make a reverse QTIP election, or apply GST exemption to the exempt QTIP trust. These errors were only discovered after the spouse’s death.

The Service granted an extension of time to sever the QTIP trust into exempt and non‑exempt QTIP trusts and to make a reverse QTIP election with respect to the exempt trust. It also ruled that the automatic allocation rules would automatically allocate decedent’s unused GST exemption to the exempt QTIP trust as of the date of decedent’s death.

These rulings were issued pursuant to Treas. Reg. §§ 301.9100‑1 and 301.9100‑3 which provide that an extension of time will be granted when the taxpayer establishes that the taxpayers acted reasonably and in good faith and the grant of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer relied on a qualified tax professional and the tax professional failed to make or advise the taxpayer to make the election.

**Letter Rulings 201921004 and 201921012 (Issued December 11, 2018; Released May 24, 2019)**

**Transfers to trusts were direct skips and husband and wife did not opt out of automatic allocation rules when gift tax returns stated that husband and wife were opting out of automatic allocation rules for indirect skips**

Each of husband and wife created separate trusts for the benefit of each of their grandchildren. Each trust provided for the discretionary distribution of income and principal to the grandchild as the trustees in their sole discretion determined to be advisable. When a grandchild reached age 30, the trust would terminate and the principal would be paid to the grandchild. If the grandchild died before reaching the age of 30, the property in the trust was to be paid to the grandchild’s then living issue, otherwise to the then living issue of the grandchild’s most immediate ancestor who was a child of husband, otherwise to the grandparent’s then living grandchildren. These transfers did not qualify for the generation-skipping tax annual exclusion since the trust for each grandchild did not give the grandchild a vested interest in the trust. The transfers were direct skips since the only possible beneficiaries of the trusts were skip persons.

Husband and wife each filed a gift tax return for the transfers to the trusts on which they split gifts under Section 2513. The transfers to the trusts were incorrectly reported as indirect skips. Moreover, attached to each gift tax return was a statement that husband and wife elected out of the automatic allocation rules with respect to transfers to the trust. Husband and wife did not pay any GST tax with respect to the gifts to the trusts. The wife had died and husband was the executor of wife’s estate.

A ruling was requested that the grandparent’s unused GST exemption was automatically allocated to the transfers to the trust. The Internal Revenue Service stated that Section 2632(b)(1) provides that if an individual makes a lifetime direct skip, any unused portion of the individual’s GST exemption shall be allocated to that direct skip transaction. One cannot opt out of the automatic allocation of GST exemption to direct skips. The Service ruled that pursuant to Section 2632(b)(1) the unused portions of husband’s and wife’s GST exemptions were allocated to the trusts. As a result, husband and wife could not opt out of the automatic allocation to direct skips. Instead, they opted out of the automatic allocation to indirect skips but that the opt out on the gift tax returns was irrelevant since each transfers to the trusts was a direct skip.

**Letter Rulings 201927014 and 201927015 (Issued March 12, 2019; Released July 5, 2019)**

**Taxpayers granted extension of time to opt out of automatic allocation GST exemption**

In each of these two letter rulings, husband established three separate trusts for the benefit of husband’s and wife’s three children. Each of the separate trusts had GST potential. The terms of each trust provided that each trust would terminate and be distributed to the child on the later of the date on which the child reached age 38 and the death of the taxpayers.

An accountant prepared and filed the gift tax returns reporting husband’s transfers to the separate trusts for the children. The husband and the wife split their gifts on their gift tax return. As a result, each of husband and wife reported one-half of the transfers made to the separate trusts for the children on their respective returns. In preparing the gift tax returns, the accountant did not opt out of the automatic TST allocation rules.

The taxpayers requested an extension of time pursuant to Section 2642(g) and Treas. Reg. § 301.9100-3 to opt out of the automatic allocation rules. Treas. Reg. § 301.9100-3 provides that requests for relief, will be granted when a taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. The taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional.

Based on the facts submitted, the Internal Revenue Service determined that the taxpayers had acted reasonably and in good faith and granted an extension of time to opt out of the automatic allocations of GST exemption to the separate trusts.

**Letter Ruling 201929006 (Issued April 3, 2019; Released July 19, 2019)**

**Taxpayer granted extension of time to opt out of automatic allocation of GST exemption**

Parent created Trust A for the benefit of Taxpayer. Trust A gave Taxpayer a testamentary power of appointment to the creditors of Taxpayer’s estate. Trust A also gave the Taxpayer a lifetime and testamentary power to appoint the property in Trust A for the benefit of Taxpayer’s children.

Subsequently, Taxpayer created Trust 1, a Trust having GST tax potential. In the same year, Taxpayer exercised the limited power of appointment to decedents in Trust A direct the X amount be transferred to Trust 1. In subsequent years, Taxpayer exercised the limited power to make addition transfers to Trust 1. Trust 1 had GST potential. Subsequently Taxpayer created and funded four additional trusts having GST potential.

An attorney provided Taxpayer with legal and tax advice in connection with the creation and funding of the five trusts. An accounting firm prepared the necessary gift tax returns. In joint discussions with the attorney and the accounting firm, Taxpayer was advised of the potential GST tax implications of the transfers and directed that no GST exemption be allocated to the five trusts. In preparing the gift tax returns, the accounting firm failed to elect out of the automatic allocation of GST exemption that Taxpayer had directed.

Taxpayer requested an extension of time under Section 2642(g) and Treas. Reg. § 301.9100-3 to elect out of the automatic allocation of GST exemption. Treas. Reg. § 301.9100-3 provides that relief will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional.

The Internal Revenue Service ruled that the requirements of Treas. Reg. § 301.9100-3 had been satisfied and an extension of time to opt out of the automatic allocation of GST exemption was granted.

**Letter Rulings 201836004 and 201836007 (Issued June 5, 2018; Released September 7, 2018)**

**Spouse’s allocation of GST exemption to three trusts was void under Treas. Reg. § 26.2632-1(b)(4)(i) because trusts had no GST potential with respect to spouse**

Taxpayer established three irrevocable trusts for the primary benefit of his three children respectively. The terms of each trust provided for discretionary distributions of income for the health, education, and support of each child. Upon the death of the second to die of taxpayer and spouse, the trustee could make discretionary distributions of principal for the health, education, and support of the child. The child had the right to withdraw the principal of the trust at four different ages. Each trust granted the child a testamentary general power of appointment to the child’s estate, the creditors of the child’s estate, or to any person or corporation.

The taxpayer made gifts to the trust in year 1 and year 2. The taxpayer and spouse each filed a gift tax return. On each form, the taxpayer and spouse signified their consent to treat each transfer as having been made one-half by each spouse under section 2513. On each gift tax return, taxpayer and spouse erroneously allocated GST exemption to the transfers to the three trusts.

The taxpayer and the spouse requested rulings that the allocations of GST exemption made to the three trusts were void because there was no GST potential with respect to those transfers.

The Service found that the trust had no GST potential with respect to the taxpayer or the spouse. The child was the primary beneficiary of each trust. The trustee was only authorized to make distributions of income and principal to the child. The child could withdraw amounts of principal from the trust upon reaching different ages. None of the payments were payments to skip persons and therefore, none were generation-skipping transfers with respect to the taxpayer or the spouse. Upon the child’s death, the child had a testamentary general power of appointment, which would cause the property in the trust to be included in the child’s estate. As a consequence, the child would be the transferor of any payments made from the trust after the death of the child. Consequently, because there was no GST potential, the taxpayer and the spouse’s allocation of GST exemption to the trust was void under Treas. Reg. § 26.2632-1(b)(4)(i). This regulation provides that an allocation of GST exemption to a trust is void to the extent that the amount allocated exceeds the amount necessary to obtain an inclusion ratio of zero with respect to the trust. An allocation is also void if the allocation is made with respect to a trust that has no GST potential with respect to the transferor making the allocation at the time of the allocation.

**Letter Ruling 201825007 (Issued March 15, 2018; Released June 22, 2018)**

**Modification of GST grandfathered trust will not affect exempt status**

Decedent created a trust for the benefit of his daughter and her descendants through his will. Decedent died prior to December 26, 1985 and the trust was grandfathered from GST tax. The trust was initially administered in State A. The court in State A issued a final order modifying the method of determining the income of the trust. Under the modification, the trustees were to distribute an amount equal to the greater of the trust’s annual net income or X percent of the total value of the trust determined on the first date of each year. This was done pursuant to a statute in State A. This order was contingent on the receipt of a favorable ruling from the IRS.

Subsequently, the situs of the trust was moved to State B. The corporate trustee now sought to modify the method for determining the trust income. Under the proposal, the annual distribution amount to be paid by the trustees would be a unitrust amount. The trustee also sought an ordering rule for determining the character of the annual trust distributions for income tax purposes in accordance with the State B’s statute. In all other respects, the terms of the trust would be identical to the original trust.

In general, a modification of the governing instrument of an exempt trust will not cause an exempt trust to be subject to the GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who currently are the beneficiaries and the modification does not extend the time for vesting any beneficial interest in the trust beyond the period provided for in the original trust. See Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1). Based on examples in the treasury regulations, the IRS ruled that the proposed changes would not shift a beneficial interest to a beneficiary in a lower generation and would not extend the time for the vesting of any beneficial interest beyond the period provided for in the original trust. As a result, the modification of the method of determining trust income and the adoption of the ordering rule would not cause the trust to lose its GST exempt status.

**Letter Rulings 201932001 – 201932010 (Issued April 9, 2019; Released August 9, 2019)**

**Termination of grandfathered GST Trust has no GST or gift tax consequences but will cause recognition of long-term capital gain**

Settlor created an irrevocable trust prior to September 25, 1985 for the benefit of Son. The trust was thus grandfathered from GST tax. The trust provided for the support of Son during his life. The trust provided for the distribution of the income to Son, but for no distributions of principal during Son’s life. Upon Son’s death, the remaining property was to be distributed to Son’s descendants per stirpes.

Son and the remainder beneficiaries entered into an agreement that the continuance of the trust was no longer necessary to achieve any clear material purpose of such trust. As part of a settlement agreement, the trust property would be distributed among Son, the current remainder beneficiaries, and the successor remainder beneficiaries in accordance with the actuarial value of each beneficiary’s share. The settlement agreement was subject to both court approval and a favorable ruling from the Internal Revenue Service.

The Service first ruled that the court approved termination and proposed distribution would not cause the trust to be subject to GST tax since it would not cause a beneficial interest to be shifted to a beneficiary who occupied a generation lower than the beneficiaries who held the interest prior to the termination nor extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. This was true as long as the actuarial values of the trust accurately represented the actuarial value of each beneficiary’s interest. Thus, the trust would not become ungrandfathered and subject to GST tax. Secondly, because the beneficial interest, rights, and expectancies of the beneficiary would be substantially the same both before and after the termination and proposed distribution (as long as the actuarial values of the trust accurately represented the actuarial value of each beneficiary’s interest) there would be no adverse gift tax consequences.

The Service then ruled that the proposed transaction was in substance a sale of Son’s and the successor remaindermen’s interests to the current remaindermen. As a result, the entire amount realized by Son as a result of the early termination of the trust would be long-term capital gain under Section 1222(3). Son’s basis in the income interest of the trust was portion of the entire basis under Section 1015. Because the disposition of Son’s term interest was not part of a transaction in which the entire interest was transferred to a third party, Son’s adjusted basis in the trust was disregarded under Section 1001(e). Likewise, the successor remaindermen would realize long-term capital gain as a result of the early termination of the trust. The amount realized by each current remaindermen on the exchange of property for the trust interest held by Son and the successor remaindermen would be equal to the amount of cash and the fair market value of the trust interests received in exchange for transferred assets.

**Letter Ruling 201825023 (Issued March 9, 2018; Released June 22, 2018)**

**IRS grants decedent’s estate an extension of time to sever a residuary trust into an exempt and non-exempt residuary trust**

Upon decedent’s death, the residue of decedent’s revocable trust was to be held in a residuary trust that had GST tax potential. In addition, one paragraph of the trust directed the trustee to divide any trust into two separate sub trusts of equal or unequal value whenever the division was necessary or desirable to minimize transfer or other taxes. Finally, the trust provided that the trust should be construed in a matter consistent with decedent’s objective of using all available GST tax exemptions and to have trusts that were either entirely exempt or entirely non-exempt.

The executors engaged a law firm to prepare a Form 706. An accounting firm was retained to advise the estate on income tax issues arising as a result of decedent’s death. Neither the law firm nor the accounting firm advised decedent’s estate of any gifts or distributions to grandchildren that would have a GST impact. Moreover decedent’s estate was not advised to divide the residuary trust into separate exempt and non-exempt trusts to effect decedent’s GST planning. The estate tax return was timely filed but did not evidence any attempt to divide the residuary trusts into exempt or non-exempt trusts. The executors requested an extension of time to sever the residuary trust into exempt and non-exempt trusts and a ruling that the automatic allocation rules would cause any unused portion of decedent’s GST exemption to be allocated to the exempt residuary trust.

Treas. Reg. § 26.2654-1(b)(1)(ii) provides that the severance of a trust that is included in the transferor’s gross estate into two or more trusts will be recognized for generation-skipping tax purposes if the trust is severed pursuant to discretionary authority granted either under the governing instrument or under local law. The terms of the new trust must provide for the same succession of interests and beneficiaries as provided in the original trust. The severance needs to occur prior to the date prescribed for filing the federal estate tax return for the estate of the transferor. The severance must occur on either a fractional basis or if a pecuniary basis severance is required, it meets the requirements for payments to individuals.

Based upon the facts submitted, the IRS concluded that the requirements of Treas. Reg. § 301.9100-3 were satisfied. This regulation provides that requests for relief will be granted when the taxpayer provides evidence to show that the taxpayer acted reasonably and in good faith and that granting the relief will not prejudice the interests of government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer.

**FIDUCIARY INCOME TAX**

**Letter Ruling 201807001 (Issued November 13, 2017; Released February 16, 2018)**

**IRS recognizes reformation of trust to qualify as a grantor trust for income tax purposes**

Donor created a trust which he intended to be a grantor trust prior to August 20, 1996. The Donor was not a citizen of the United States. At the time Donor executed the trust, he was not married and had no issue. Subsequently, Donor married and had issue. None of Donor, Donor’s spouse, and Donor’s issue were ever United States citizens.

The trust, as originally drafted, provided that the independent trustee during the lifetime of Donor, could distribute the income and principal of the trust to or for the benefit of Donor and Donor’s issue.

Prior to August 20, 1996, the trust was treated as a grantor trust for income tax purposes; however, as a result of the Small Business Job Protection Act in 1996, which became effective on August 20, 1996, the grantor trust rules only apply in computing the income of a citizen or resident of the United States. There was an exception that provides that a trust would be treated as a grantor trust if during the lifetime of the grantor distributions could only be made to a non-citizen grantor or the non-citizen spouse. As a result of the Small Business Job Protection Act, after August 20, 1996, the trust was no longer a grantor trust.

The grantor filed a reformation suit to eliminate the issue as beneficiaries of the trust so that the trust could be treated as a grantor trust for income tax purposes. The grantor and the attorney who drafted the trust testified that Donor always intended the trust to be a grantor trust from its inception and the court granted the request for reformation and the issue were eliminated as beneficiaries.

The IRS held that the transcripts and representations of the party showed that Donor intended that the trust be a grantor trust with respect to Donor and that this intent was not carried out in the trust agreement as a result of a mistake of fact or law. As a result, the trust reformation was to be taken into account as of the initial date of the trust, so that the exception would permit the trust to be a grantor trust for income tax purposes from inception.

**Letter Ruling 201803004 (Issued September 28, 2017; Released January 19, 2018)**

**IRS grants extension to trust for charitable contribution election**

The trustees of a trust made charitable contributions during Year 2. The trust filed a return for Year 1 treating the charitable contributions made in Year 2 as paid in Year 1. An exception in Section 642(c) permits a charitable contribution paid after the close of the taxable year and on or before the last day of the year following the close of that taxable year to be treated as paid during such taxable year if an election is made. This is permitted if an election is filed under Section 642(c). However, due to inadvertence, the Section 642(c) election was not included with the Year 1 Form 1041 return for the trust. The income tax return filed for Year 2 did not take a deduction for the charitable contributions made in Year 2.

In this letter ruling, the Service applied the provisions of Treas. Reg. § 301.9100-3, which states that a request for relief will be granted when a taxpayer shows that the taxpayer acted reasonably and in good faith and that grant of relief will not prejudice the interests of the government. The IRS found that these requirements were met without much discussion, and the trust could take the Section 642(c) deduction in Year 1.

**Green v. United States, 880 F.3d 519 (10th Cir. 2018)**

**Income tax charitable deduction for non-grantor trust limited to trust’s adjusted basis in properties donated to charity**

David M. Green and Barbara A. Green created an irrevocable dynasty trust in 1993. The beneficiaries of the dynasty trust were the children and descendants and charity. The trust stated that a distribution could be made from the trust to charity, but only to the extent that the distributiobn would not prevent the trust from qualifying as an electing small business trust or an S corporation. The trust owned a single member limited liability company called GDT which was disregarded for income tax purposes.

Hob-Lob Limited Partnership (“Hob-Lob”) owns and operates most of the Hobby Lobby retail stores located nationwide. The trust was a 99% limited partner in Hob-Lob. In 2003, GDT purchased 109 acres of land in two industrial buildings in Lynchburg, Virginia for $10.3 million. GDT obtained the money to purchase the property through a distribution from Hob-Lob to the trust in 2003.

On March 19, 2004, GDT donated 73 of the 109 acres of land and the two industrial buildings to the National Christian Foundation Real Property, Inc. The National Christian Foundation is a recognized charity. The trust reported that its adjusted basis in Virginia property was $10,368,113 on the date of the donation.

In 2002, GDT purchased a church building and several out buildings in Ardmore, Oklahoma for $150,000. Subsequently in 2004, GDT donated the Ardmore property to the Church of the Nazarene. Its adjusted basis in the property is $160,477 and the property had a fair market value of $355,000.

In June 2003, GDT purchased 3.8 acres of land in Texas for $145,000. On October 5, 2004, GDT donated the Texas property to Lighthouse Baptist Church. The trust reported that its adjusted basis in the Texas property was $145,180 and the fair market value of the property was $150,000 on the date of the donation.

In October 2005, the trust filed its income tax return for 2004. The return claimed a charitable deduction totaling $20,526,383. This included the donations of real property as well as a $1,851,502.42 donation to Reach the Children Foundation, Inc. The return reported the trust’s total adjusted basis in the three donated real properties as approximately $10.7 million, and that the properties’ fair market value at the time of the donation was approximately $30.3 million. At no point in 2004 or any other tax year did the trust report as its income the properties’ unrealized appreciation of approximately $19.6 million. On October 15, 2008, the trust filed an amended Form 1041 claiming a refund from the Internal Revenue Service for $3,194,748 in income tax and increasing the trust’s reportable charitable deduction from $20,526,383 to $29,654,233.

The IRS denied the refund claim by the trust. It stated that the charitable deduction for the real property donated in 2004 was limited to the basis of the property contributed. The Western District of Oklahoma granted partial summary judgment in favor of the trust, concluding the trust was statutorily authorized to take a deduction equivalent to the fair market value of the properties as of the time of the donation.

On appeal, the Circuit Court first looked at the language of Section 642(c)(1). It stated that the Section applies only to estates and trusts. The deduction is limited to any amount of gross income which pursuant to the terms of the governing instrument paid for a charitable purpose. The Circuit Court then said that the central issue in this appeal is the amount of the deduction is under Section 642(c)(1).

The Circuit Court stated that there were four possible interpretations of the statutory language. One possible interpretation of the statutory phrase is that a charitable contribution must be made out of the gross income earned by the trust during the year in question.

A second possible interpretation is that a charitable contribution must be made exclusively out of gross income earned by the trust at some point in time, so long as that gross income is kept separate from the trust principal from the time it is earned until it is donated.

The third possible interpretation, and the one that both parties in the case appeared to urge, is that a charitable contribution need not be made directly from, but must instead simply be traceable to, current or accumulated gross income. If applied to contributions of real property, that would mean that the real property must have been purchased with, i.e. sourced from, the trust’s current or accumulated gross income.

The fourth and final possible interpretation is that the amount of the charitable deduction is capped or limited by the amount of gross income earned by the taxpayer in the tax year in question.

Consequently, the statutory phrase “any amount of the gross income” was viewed by the Circuit Court as ambiguous.

The Circuit Court disagreed with the District Court’s finding that the deduction should extend to the full amount of the fair market value of the donated property. Instead, it agreed with the IRS that the amount of the deduction should be limited to the adjusted basis in the property. The Circuit Court noted that because the trust never sold or exchanged the properties at issue and never realized the gains associated with their increases in market value, the trust was never subject to being taxed from those gains. Consequently, construing the Section 642(c)(1) charitable deduction to extend to unrealized gains would be inconsistent with the Internal Revenue Code’s general treatment of gross income.

The Circuit Court found that until Congress acted to make clear that it intended for the Section 642(c)(1) deduction to extend to unrealized gains associated with real property originally purchased with gross income, that it cannot construe the deduction in that manner. It also noted that its interpretation found support in Mertens Law of Federal Income Taxation, which states that where appreciated property purchased from accumulated gross income is donated, the amount of the deduction is limited to the adjusted basis of the property rather than based on the fair market value of the donated property as well as, in part, in a decision dealing with the predecessor statute to Section 642(c)(1), W. K. Frank Trust of 1931 v. the Commissioner, 145 F.2d 411 (3d Cir. 1944). The Circuit Court also stated that if Congress had intended for the concept of “gross income” to extend to unrealized gains on property purchased with gross income, it would have said so.

The court finally rejected the argument of the trust that Section 512(b)(11) provided an alternative path for a deduction for charitable contributions by trusts that are sourced from unrelated business income. The trust argued that through the operation of Section 512(b)(11), its contribution of donated properties was deductible under Section 170. The Circuit Court rejected this theory, because the trust’s claim for a refund made no mention of its Section 512(b)(11) legal theory, and this theory was never clearly raised and/or resolved by the District Court. The case was remanded to the District Court with directions to enter summary judgment in favor of the government.

**Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue, \_\_\_\_\_\_\_ U.S. \_\_\_\_\_\_\_\_ (2019)**

**U. S. Supreme Court unanimously holds that the income taxation of out-of-state trust is unconstitutional**

On June 8, 2018, the North Carolina Supreme Court affirmed the Court of Appeals’ 2016 decision in Kimberly Rice Kaestner 1992 Family Trust v. North Carolina Department of Revenue, \_\_\_\_\_ N.C. \_\_\_\_\_ (2018), upholding the Court of Appeals’ (and Business Court’s) finding that North Carolina General Statute Section 105-160.2 is unconstitutional as applied to the Kimberly Rice Kaestner 1992 Family Trust (the “Trust”). The Trust challenged the state of North Carolina’s imposition of income tax on the basis that the Trust’s sole tie to the state is the residency of the Trust’s beneficiary, which connection is insufficient to allow taxation under the due process and commerce clauses of the U.S. Constitution.

The Trust sought a refund of over $1.3 million in income taxes paid to the state of North Carolina for tax years 2005 – 2008. Upon denial of the claim, the Trust brought suit challenging the constitutionality of the statute, both on its face and as applied to the taxpayer (the Trust). Each of the Business Court, Court of Appeals, and North Carolina Supreme Court focused on the unique facts of the case in finding that the statute is unconstitutional as applied to the Trust.

The trustee, during the period taxes were assessed, was a resident of Connecticut, the Trust was governed by New York law, and North Carolina’s only connection to the Trust was the residence of the beneficiary. Further, all custodians of the Trust’s assets were located in Massachusetts, while all documents related to the Trust, such as ownership documents and financial and legal records, were kept in New York. Finally, distributions from the Trust were in the discretion of the trustee, and no distributions were made to the beneficiary in North Carolina during the relevant period.

The North Carolina Supreme Court emphasized that its opinion is limited to an “as applied” standard, meaning the court considered only whether the statute is constitutional as applied to the Trust. In responding to the Trust’s continued challenge to the constitutionality of the statute, on its face, the North Carolina Supreme Court noted the presumption that “any act passed by the legislature is constitutional” and “any individual challenging the facial constitutionality of a legislative act must establish that ***no*** set of circumstances exists under which the [a]ct would be valid” (emphasis added). Because the Trust presented only facts and evidence relevant to it, the North Carolina Supreme Court did not (and could not) consider whether the statute is unconstitutional on its face.

It has long been settled that a trust has a separate existence from its beneficiary, and therefore income to the trust is separately attributed. In determining whether the statute is constitutional, as applied to the Trust, the North Carolina Supreme Court evaluated the requirements of the due process clause, specifically that the entity being taxed must “purposefully direct its activities” at the state, and the activities must be sufficiently abundant that the entity invokes the benefits and protections of that state’s laws. Therefore, in order to withstand this challenge, the presence of the trust beneficiary in the state must satisfy the “purposeful” requirement to allow taxation of the Trust. The North Carolina Supreme Court concluded that the unilateral activity of the beneficiary did not satisfy this requirement.

Interestingly, Justice Sam Ervin, in dissent, noted the advancements of modern technology related to online and telephone communications, rather than in person. He opined a traditional analysis of physical presence in a state may need to be amended to reflect those changes in determining whether a taxpayer purposefully directs its activities to a state.

The United States Supreme Court granted the North Carolina Department of Revenue’s petition for a writ of certiorari on January 11, 2019. It has been set for argument on Tuesday, April 15.

On June 21, 2019 the U.S. Supreme Court issued a unanimous opinion, delivered by Justice Sotomayor, holding that as applied to the Trust, the North Carolina statute subjecting the Trust to state income taxation, which is based solely on the trust beneficiary’s residence in the state, violates the Due Process Clause. Clearly the decision is a taxpayer victory. But, does the Court’s decision shed any further guidance on the broader issue: in what circumstances does the state taxation of trust accumulated income satisfy the Due Process Clause?

As discussed above, the opinions of the State courts have been based solely on the facts and circumstances of this Trust and the contacts of the trustee to North Carolina and the rights of the beneficiary, who resident in North Carolina. The opinions of the State courts have been narrowly framed, and the U.S. Supreme Court’s opinion is similarly constructed. Justice Sotomayor reinforces that the Court’s holding is limited “to the specific facts presented” and that the Court’s decision does not “imply approval or disapproval of trust taxes that are premised in the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here.” Specifically, footnote 8 states that the Court does not “decide what degree of possession, control, or enjoyment would be sufficient to support taxation.”

In evaluating the relationship of between the trust assets and the party to the trust the state seeks to tax, the Court focused on possession, control and enjoyment as critical in supporting state taxation under the Due Process Clause. In the context of the Trust, the Court specifically noted the beneficiaries’ inability to compel distribution, which were solely in the trustee’s discretion. In addition, during the years at issue, the beneficiaries never received a distribution from the Trust, and had no right to “otherwise control, possess, or enjoy the trust assets.”

Many were hoping the Opinion would be broader so as to provide guidance in the context of other state statutes subjecting trusts to income taxation. But there are a few highlights in the opinion that shed light on the Court’s analysis that ***may*** have broader implications to the state taxation of trusts. In its opinion, the Court evaluated prior decisions on the issue, noting that the relationship between the relevant trust constituents (settlor, trustee, or beneficiary) and the trust assets is critical in the Due Process analysis. “Due Process Clause demands attention to the particular relationship between the resident and the trust assets that the state seeks to tax. Because each individual fulfills different functions in the creation and continuation of the trust, the specific features of that relationship sufficient to sustain a tax may vary depending on whether the resident is a settlor, beneficiary or trustee.”

In its analysis, the Court reviewed its precedent of the sufficiency of possession and control of the trust property as to the settlor to justify taxation under the Due Process Clause. A significant number of states define a resident trust, for state income tax purposes, as a trust whose grantor was resident of the state. The State of Minnesota has filed a writ with the U.S. Supreme Court, seeking the Court’s review of the Minnesota Supreme Court’s decision holding its statue on income taxation, which is based on the settlor’s residence, unconstitutional. In this opinion, the Court analyzed is precedent in the context of statutes based on the in-state residence of settlors, and again focused on the possession and control of the trust assets as related to the settlor. Citing to both Curry v. McCanless and Graves v. Elliott, which upheld the state income taxation of trusts based on the residence of the settlor, the Court pointed to the fact that settlors of the trusts at issue in these cases retained the right to dispose of the trust property (Curry*)* and the power to revoke the trust (Graves*)*.

While the opinion does not provide guidance on what circumstances would support state taxation of trusts based on the residence of a trust beneficiary, in reading between the lines, possession, control and enjoyment are the critical factors. Where the trust beneficiary has no right to compel distributions, has no expectation regarding distributions, nor the power to appoint or control the trust property, taxation is not supported.

**Fielding v. Commissioner, 916 N.W.2d 323 (Minn. 2018); Petition for Writ of Certiorari to United States Supreme Court denied, Docket No. 18-664 (June 28, 2019) under name Bauerly v. Fielding**

**Attempt of Minnesota to tax irrevocable non-grantor trusts as resident trusts for state income tax purposes is unconstitutional under the due process clauses of United States and Minnesota Constitutions**

Reid MacDonald, who was then domiciled in Minnesota, created four GST trusts on June 25, 2009. Each trust was initially funded with shares of nonvoting common stock in Faribault Foods, Inc. a Minnesota S Corporation. The original trustee for all four trusts was Edmund MacDonald, a California domiciliary. Reid MacDonald retained the power to substitute assets in the trusts. Consequently for the first thirty months of their existence, the trusts were “grantor type trusts”. On December 31, 2011, Reid MacDonald relinquished his power to substitute assets in the trusts and the trusts ceased to be “grantor type trusts” and became irrevocable on December 31, 2011 (according to the court). Reid MacDonald was a resident of Minnesota at the time the trusts became irrevocable. As a result, each trust was then classified as a “resident trust” under Minn. Stat. § 290.01, subd. 7b(a)(2). Katherine Boone, a Colorado domiciliary, became the sole trustee for each trust on January 1, 2012.

Subsequently, the trusts filed Minnesota income tax returns as resident trusts, without protest, in 2012 and 2013. On July 24, 2014, William Fielding, a Texas domiciliary, became trustee of the trusts. Shortly thereafter, all of the shareholders, including the trusts, sold their shares in Faribault Foods, Inc. Because the trusts were defined to be Minnesota residents as a result of Reid MacDonald’s Minnesota domicile in 2011, the trusts were subject to tax on the full amount of the gain from the 2014 sale of the stock as well as the full amount of income from other investments. The trusts filed their 2014 Minnesota income tax returns under protest, asserting that the Minnesota statute classifying them as resident trusts was unconstitutional as applied to them. The trusts then filed amended tax returns claiming refunds for the difference between the tax owed as resident trusts and the tax owed as non-resident trusts – a tax savings of more than $250,000 for each trust.

The Minnesota Commissioner of Revenue denied the refund claims and the Commissioner’s decision was appealed to the Minnesota Tax Court on the grounds that the Minnesota statute violated the due process and commerce clauses of the United States and Minnesota constitutions. The trusts and the Commissioner each moved for summary judgment. The Minnesota Tax Court ultimately concluded that defining the trust as a resident trust based upon Reid MacDonald’s Minnesota residency at the time the trusts became irrevocable violated the due process provisions of the Minnesota and United States constitutions. The Minnesota Tax Court stated that the grantor’s domicile at the time the trust becomes irrevocable was not “a connection of sufficient substance” to support taxing the trusts. Having decided the case on due process grounds, the Minnesota Tax Court did not reach the Commerce Clause.

The Minnesota Tax Court noted that a state’s tax will satisfy the due process clause if there is some minimum connection between the state and the entity subject to the tax and a “rational relationship” between the income that the state seeks to tax and the protections and benefits conferred by the state citing Luther v. Commissioner of Revenue, 588 N.W. 2d 502 (Minn. 1999).

The Minnesota Supreme Court framed the issue as whether Minnesota may permissibly tax all sources of income to the irrevocable trusts simply because it had classified the trusts as residents based on events that predated the tax year at issue.

The Minnesota Tax Commissioner cited the following as factors requiring taxation:

1. Reid MacDonald was a Minnesota resident when the trusts were created;

2. Reid MacDonald was domiciled in Minnesota when the trusts became irrevocable and was still domiciled in Minnesota in 2014;

3. The trusts were created in Minnesota with the assistance of a Minnesota law firm which drafted the trust documents and until 2014 retained the trust documents;

4. The trusts held stock in a Minnesota S Corporation;

5. The trust documents provided that questions of law arising out of the trust documents were to be determined in accordance with Minnesota law; and

6. One beneficiary had been a Minnesota resident through the tax years in question.

The trusts, on the other hand, noted that:

1. No trustee had been a Minnesota resident;

2. The trusts had not been administered in Minnesota;

3. The records of the trust assets and income were maintained outside of Minnesota;

4. Some of the trusts’ income was derived from investments with no direct connection to Minnesota; and

5. Three of the four beneficiaries of the trusts lived outside of Minnesota.

The Minnesota Supreme Court concluded that the contacts on which the Tax Commissioner relied were either irrelevant or too attenuated to establish that Minnesota’s tax on the trusts income from all sources complied with due process requirements. It first noted the grantor’s connections to Minnesota were irrelevant. The relevant connections were Minnesota’s connection with the trustee and not the grantor who established the trusts years earlier.

It noted also that the stock was an intangible asset and cited cases holding that states cannot impose an income tax on trust property because possession or control of these assets was held by trusts that were not residents of or domiciled in a state. In addition, the Minnesota residency of one beneficiary did not establish the necessary minimum connection to justify taxing the trusts income. The grantor’s decision to use a Minnesota law firm and the contacts with Minnesota predating 2014 were irrelevant.

As a result, the contacts between the trusts and Minnesota from 2014 on were tenuous. The trusts had no contact with Minnesota during the applicable tax year. All trust administration activities by the trustees occurred outside Minnesota.

The Court also noted that these trusts were inter vivos trusts that had not been probated in Minnesota courts and had no existing relationship to the Minnesota courts distinct from that of the trusts and the trust assets unlike other cases which involved testamentary trusts such as District of Columbia v. Chase Manhattan Bank, 689 A. 2d. 539 (DC 1997).

Attributing all income, regardless of source, to Minnesota for tax purposes would not bear a rational relationship with the limited benefits received by the trusts from Minnesota during 2014.

On November 15, 2018, the Minnesota Department of Revenue filed a petition for a writ of certiorari to the United States Supreme Court under the case name Bauerly v. Fielding. The Supreme Court denied the petition for a writ of certiorari on June 28, 2019.

**South Dakota v. Wayfair, Inc., \_\_\_ U.S. \_\_\_ (2018)**

**Supreme Court overrules Quill Corp. v. North Dakota**

South Dakota, as many states, taxes the retail sales of goods and services in the state. Sellers are required to collect and remit the tax to the state, but if they do not, then in-state consumers are responsible for paying a use tax at the same rate. Under National Bellas Hess, Inc. v. Department of Revenue of Ill. 386 U.S. 753 (1967) and Quill Corp, Inc. v. North Dakota, 504 U.S. 289 (1992), South Dakota could not require a business that has no physical presence in South Dakota to collect its sales tax. Consumer compliance rates are notoriously low, however, and it is estimated that Bellas Hess and Quill caused South Dakota to lose between $48 and $58 million in tax revenue, annually. Out of a concern about the erosion of its sales tax base and the corresponding loss of funding for state and local services, the South Dakota legislature enacted a law requiring out of state sellers to collect and remit sales tax “as if the seller had a physical presence in the state.” The act covers only sellers that, on an annual basis, deliver more than $100,000 of goods or services into South Dakota or engage in 200 or more separate transactions for delivery of goods or services into South Dakota.

Respondents were top online retailers with no employees or real estate in South Dakota, each meeting the minimum sales or transactions requirement. They did not collect the sales tax imposed by South Dakota. South Dakota filed suit in state court seeking a declaration that the requirements of the act were valid and applicable to the respondents and an injunction requiring respondents to register for licenses to collect and remit the sales tax. Respondents sought summary judgment, arguing that the act is unconstitutional. The trial court granted their motion. The South Dakota Supreme Court affirmed on the ground that Quill is controlling precedent.

In a five to four opinion, the Supreme Court held that the physical presence rule of Quill is unsound and incorrect and overruled Quill and National Bellas Hess. The Court noted that the physical presence rule has long been criticized as giving out of state sellers an advantage. It also noted that each year, the physical presence rule becomes further removed from economic reality and results in significant revenue losses to the states. The Court felt that the physical presence rule is not a necessary requirement to satisfy due process concerns that there be some definite link or some minimum connection between a state and the person, property, or transaction it seeks to tax. In addition, Quill created resolved market distortions rather than resolving them. The Court observed that Quill was a judicially created tax shelter for businesses that limited their physical presence in a state, but sold their goods and services to consumers in a state, something that had become easier and more prevalent with the advancement of technology. Finally, Quill imposed the sort of arbitrary, formalistic distinction that the court’s modern commerce clause precedents disavowed in favor of a case-by-case analysis of the purposes and effects.

**Notice 2018-61, 2018-31 IRB (July 13, 2018)**

**IRS to issue regulations on effect of Section 67(g) on certain deductions for estates and nongrantor trusts**

The U.S. Treasury Department and the IRS announced on Friday, July 13, 2018, that they intend to issue regulations on the impact of new Section 67(g) of the Internal Revenue Code of 1986 on certain deductions for estates and nongrantor trusts. Section 67(g) was added to the Code by the 2017 Tax Act (P.L. 115-97) and suspends temporarily miscellaneous itemized deductions.

Tax practitioners expressed concern that Section 67(g) might inadvertently eliminate the deduction for costs of estate and trust administration. Practitioners have also requested guidance on whether the suspension of miscellaneous itemized deductions prohibits trust and estate beneficiaries from deducting on their individual returns the excess deductions of the trust or estate incurred during the trust’s or estate’s final taxable year.

Treasury and the IRS have stated that forthcoming regulations will clarify that the costs of trust or estate administration are not miscellaneous itemized deductions suspended by Section 67(g). Treasury and the IRS have also stated that new regulations will address the impact of Section 67(g) on the ability of beneficiaries to deduct an estate’s or trusts excess deductions upon termination of the estate or trust.

Under Section 67(e) of the Code, the adjusted gross income of an estate or nongrantor trust is computed in the same manner as that of an individual, with two exceptions. Section 67(e)(1) permits an estate or nongrantor trust to deduct in computing adjusted gross income the costs incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in the estate or trust. Such expenses generally include, for example, fiduciary compensation and court accounting costs. Section 67(e)(2) provides an exception for deductions allowable under Section 642(b) (relating to the personal exemption of an estate or nongrantor trust), Section 651 (relating to distributions of income to beneficiaries of simple trusts), and Section 661 (relating to distributions of income and principal to beneficiaries of complex trusts).

New Section 67(g) of the Code suspends the deduction for miscellaneous itemized deductions for any taxable year beginning after December 31, 2017, and before January 1, 2026. Some practitioners expressed concern that Section 67(g) may inadvertently eliminate the ability of an estate or nongrantor trust to deduct the administration expenses described in Section 67(e)(1).

On the termination of a nongrantor trust or estate, Section 642(h) of the Code allows the beneficiaries succeeding to the property of the nongrantor trust or estate to deduct the trust’s or estate’s unused net operating loss carryovers under Section 172 of the Code and unused capital loss carryovers under Section 1212 of the Code. If an estate or nongrantor trust has deductions (other than deductions for personal exemptions or charitable contributions) in excess of gross income in its final taxable year, then Section 642(h) allows the beneficiaries succeeding to the property of the estate or trust to deduct such excess on their individual returns. Capital loss carryovers and net operating loss carryovers are taken into account in calculating adjusted gross income and are not miscellaneous itemized deductions. Section 67(g) therefore does not affect the ability of a beneficiary to make use of a capital loss carryover or net operating loss carryover received from an estate or nongrantor trust.

The excess deductions of an estate or nongrantor trust, however, are allowable only in computing taxable income and are not covered by an exception from miscellaneous itemized deductions in Section 67(b). Absent guidance to the contrary, the excess deductions of an estate or nongrantor trust are now disallowed by Section 67(g) for taxable years beginning after December 31, 2017, and before January 1, 2026. The inability of beneficiaries to claim excess deductions may create unwelcome and unanticipated consequences. For example, it could artificially affect timing of distributions, delay closing of estates, and create incongruity in the treatment of administration expenses — permitting them as deductions to an estate or trust but denying them when passed-out to beneficiaries.

Notice 2018-61 announces that Treasury and the IRS intend to issue regulations “clarifying that estates and nongrantor trusts may continue to deduct expenses described in Section 67(e)(1)” for taxable years during which Section 67(g) suspends miscellaneous itemized deductions. Estates and nongrantor trusts may rely on Notice 2018-61 in continuing to deduct expenses under Section 67(e)(1).

Notice 2018-61 includes a reminder that Section 67(g) does not affect the determination of administration costs defined in Section 67(e)(1) of the Code. Pre-existing law continues to apply to the identification of administration expenses under Section 67(e)(1), including the treatment of “bundled” trustee’s fees.

Notice 2018-61 also notes that Treasury and the IRS are studying whether Section 67(e) deductions and other deductions that would not be considered miscellaneous itemized deductions to an estate or nongrantor trust should continue to be regarded as miscellaneous itemized deductions when included by a beneficiary as an excess deduction under Section 642(h)(2). Treasury and the IRS intend to issue regulations addressing whether a beneficiary may claim the excess deductions of a terminating estate or trust notwithstanding the suspension of miscellaneous itemized deductions under Section 67(g). In connection with the drafting of new regulations, Treasury and the IRS are seeking public comments on whether amounts deductible under Section 642(h)(2) of the Code should be analyzed separately from other miscellaneous itemized deductions when applying Section 67 of the Code. Notice 2018-61 does not provide a timeframe for when Treasury and the IRS may issue new regulations.

**Letter Ruling 201921007 (Issued February 12, 2019; Released May 24, 2019)**

**Corporation will continue to be treated as an S Corporation despite inadvertent termination for failure of two trusts to make small business trust election**

Corporation was an S Corporation. Trust 1, a revocable trust created by A, and Trust 2, a revocable trust created by B, each owned stock in X Corporation. Both A and B died and both trusts became irrevocable trusts that were eligible to elect electing small business trust (ESBT) status. X Corporation represented that Trust 1in tended to elect ESBT treatment effective as of the date two years after the date of A’s death and that Trust 2 intended to elect ESBT treatment effective as the date two years after the date of B’s death when the two years after death eligibility period of Section 1361(c)(2)(A)(ii) for each trust ended. However, the trustees of Trust 1 and Trust 2 failed to make timely ESBT elections and X Corporation’s Selection terminated. X Corporation represented that the failures to file the ESBT elections for Trust 1 and Trust 2 were inadvertent and were not motivated by tax avoidance or retroactive tax planning. X Corporation filed all returns consistent with X’s status as a S Corporation and X Corporation and its shareholders agreed to make any adjustments required as a condition of obtaining relief under the inadvertent termination rule provided in Section 1362(f).

Section 1362(f) provides that if an S election was ineffective for a taxable year for failure to meet the requirements for an S Corporation and the S Corporation status was terminated, and the Internal Revenue Service determines that the circumstances resulting in the termination were inadvertent, the corporation will continue to be treated as an S Corporation. The continued treatment of the corporation as an S Corporation requires that no later than a reasonable period of time after the discovery of the circumstances resulting in a termination of S Corporation status, steps were taken so that the corporation met the requirements of an S Corporation and the corporation and each shareholder agreed to make the necessary adjustments as be required by the Service. If these requirements were met, a corporation would be treated as an S Corporation during the period specified by the Service.

In this letter ruling, the Service held that the requirements of Section 1362(f) had been met by X Corporation and Trust 1 and that Trust 2 would be treated as ESBTs. In addition, the shareholders of X Corporation had to include the prorated share of the separately stated and nonseparately computed items of X Corporation income, make any necessary adjustments to basis, and take into account any distributions made by S Corporation. The ruling was also conditioned upon Trust 1 and Trust 2 filing completed ESBT elections and the beneficiaries of each trust filing timely amended federal income tax returns consistent with the treatment of Trust 1 and Trust 2 as ESBTs.

**Letter Ruling 201922021 (Issued December 6, 2018; Released May 31, 2019)**

**Corporation will continue to be treated as S Corporation when termination of corporation’s S status was inadvertent under Section 1362(f) due to failure of trustees to timely file ESBT election**

X Corporation was an S Corporation for federal income tax purposes. Prior to her death, A, an eligible shareholder owned shares in X. Upon A’s death, A’s shares were transferred to Trust 1, Trust 2, and Trust 3. Each trust was an eligible shareholder from the date of transfer of shares to the date that was two years after the date of death pursuant to Section 1361(c)(2)(A)(ii). Each trust was eligible to make an Electing Small Business Trust (ESBT) election as of the date two years after the date of death; however, the trustees of each trust failed to make the ESBT election. As a result X Corporation’s S Corporation election terminated.

X Corporation represented that the circumstances resulting in the termination of X Corporation’s S Corporation election and the failure to make the timely ESBT elections were inadvertent and not motivated by tax avoidance or retroactive tax planning. Section 1362(f) provides that if an S Corporation election was terminated because of inadvertent circumstances, the corporation can continue to be treated as an S Corporation during the period of termination if certain requirements are met. Based on the facts submitted, the Internal Revenue Service concluded the failure of each trust to file ESBT elections caused an inadvertent termination of X Corporation’s S Corporation election within the meaning of §1362(f) and that X Corporation would be treated as continuing to be an S Corporation.

The ruling was contingent upon the filing of ESBT elections by each trust. X Corporation and its shareholders agreed to make any adjustments required as a condition of obtaining relief under §1362(f) that the IRS might require.

**Letter Ruling 201928010 (Issued March 26, 2019; Released July 12, 2019)**

**Estate granted the extension of time to make Section 663 election to treat distribution as paid or credited on last day of fiscal year**

An estate filed its federal income tax return on a fiscal year basis. The estate made a distribution within the first 65 days of the fiscal year and intended to have the distribution considered paid or credited on the last day of the prior fiscal year as permitted under Section 663(b). Due to inadvertence, the Section 663(b) election was not timely filed.

The Section 663(b) election is to be made on the income tax return of a trust filed for the taxable year of the trust for which the election is made. Treas. Reg. § 301.9100-3 provides that relief will be granted when the taxpayer shows that the taxpayer acted reasonably and in good faith and the grant of the relief will not prejudice the interests of the government.

The Internal Revenue Service concluded that the estate had acted reasonably and in good faith and granted the extension of time to make the Section 663(b) election.

**ASSET PROTECTION**

**Indiana Senate Bill 265 (May 5, 2019)**

**Indiana enacts self-settled asset protection trust legislation**

On April 9, 2019, the Indiana legislature enacted S.B. 265, the purpose of which was to amend the Indiana Code concerning trusts and fiduciaries. The Indiana governor signed the act on May 5, 2019. One important provision of the act was the addition of a new Section 30-4-8 to the Indiana Code to permit the establishment of “Legacy Trusts” which are a form of self-settled domestic asset protection trusts (“DAPTs”) and provide spendthrift creditor protection to the settlors of Legacy Trusts. As of the effective date of July 1, 2019, Indiana will become the eighteenth state to have DAPT-enabling legislation. The other seventeen states are Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming.

The Indiana Legacy Trust law is similar to the statutes of the other states that permit DAPTs. Either the owner of property or the holder of general power of appointment can transfer assets to a Legacy Trust. The transfer of assets to the Legacy Trust must be a “qualified disposition.” To be a qualified disposition, the Legacy Trust must be irrevocable, have a “qualified trustee” as one of the trustees, incorporate Indiana law to govern the validity, construction, and administration of the Legacy Trust, and have a spendthrift clause.

The transferor of assets to a Legacy Trust must sign a “qualified affidavit” which affirms that:

1. The transferor has full right to transfer property to the trust;
2. The transfer will not cause the transferor to be insolvent;
3. The transferor does not intend to defraud creditors with the transfer;
4. There are no pending or threatened court actions against the transferor other than those identified by the transferor in the affidavit;
5. The transferor is involved in no administrative proceedings other than those identified in the affidavit;
6. The transferor does not contemplate filing for bankruptcy; and
7. The property being transferred to the trust is not derived from unlawful activities.

A married transferor must provide a copy of the qualified affidavit to his or her spouse.

The Legacy Trust must have a “qualified trustee,” which is either an individual residing in Indiana or an entity authorized by Indiana law to act as a trustee. Qualified trustees must:

1. Maintain or arrange for the custody of the property in the trust;
2. Maintain records of the trust on an exclusive or nonexclusive basis;
3. Prepare or arrange for the preparation of all tax returns; and
4. Materially participate in the administration of the trust.

The act addresses the consequences if a non-Indiana court seeks to assert jurisdiction over a Legacy Trust or apply the law of a state other than Indiana. The act provides that if a court declines to apply Indiana law in determining the effect of a spendthrift provision in a Legacy Trust, the trustee must immediately resign and thereafter can only transfer the trust property to another trustee. The act also provides that an Indiana court “to the maximum extent permitted by the United States Constitution and the Indiana Constitution,” must exercise jurisdiction over the trust even if a court of another jurisdiction has or may have proper jurisdiction of a matter involving the trust.

The only claims of creditors that can be enforced against the assets in a Legacy Trust are:

1. Fraudulent transfer claims under the Indiana Uniform Fraudulent Transfer Act;
2. Child support obligations; and
3. Marital obligations incurred in a divorce (when the transfer of assets to the trust occurs after the marriage or within thirty days of the marriage).

Claims are subject to a two year statute of limitations period.

Transferors can have certain rights and powers with respect to the Legacy Trust. A transferor to a Legacy Trust may serve as investment advisor to the trust. The following provisions can be included in a Legacy Trust for a transferor:

1. The transferor can have the power to veto a distribution from the trust;
2. The transferor can have a testamentary limited power of appointment;
3. The transferor can have a power to take out principal under an ascertainable standard: and
4. The transferor can have the right to remove a trustee or trust director and appoint a new trustee or trust director who is not a related or subordinate party under Section 672(c) of the Internal Revenue Code.

With Indiana becoming the eighteenth DAPT state, other states are likely to at least consider DAPT legislation, if not join the states that have DAPT legislation. Connecticut is currently considering DAPT legislation.

**Connecticut House Bill 7104 (June 24, 2019)**

**Connecticut enacts self-settled asset protection trust legislation as part of its adoption of the Uniform Trust Code**

On June 24, 2019, Connecticut enacted HB 7104 by which Connecticut adopted the Uniform Trust Act. One important provision of the act was the “Connecticut Qualified Dispositions in Trust Act” to permit the establishment self-settled domestic asset protection trusts (“DAPTs”) which provide spendthrift creditor protection to the settlors of such trusts. As of the effective date of January 1, 2020, Connecticut will become the nineteenth state to have DAPT-enabling legislation. The other seventeen states are Alaska, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming.

The Connecticut DAPT law is similar to the statutes of the other states that permit DAPTs. Either the owner of property or the holder of general power of appointment can transfer assets to a Connecticut DAPT. The transfer of assets to the Connecticut DAPT must be a “qualified disposition.” To be a qualified disposition, the Connecticut DAPT must be irrevocable, have a “qualified trustee” as one of the trustees, incorporate Connecticut law to govern the validity, construction, and administration of the Connecticut DAPT, and have a spendthrift clause.

The Connecticut DAPT must have a “qualified trustee,” which is either an individual residing in Connecticut or an entity authorized by Connecticut law to act as a trustee. Qualified trustees must:

1. Maintain or arrange for the custody of the property in the trust;
2. Maintain records of the trust on an exclusive or nonexclusive basis;
3. Prepare or arrange for the preparation of all tax returns; and
4. Materially participate in the administration of the trust.

The act addresses the consequences if a non-Connecticut court seeks to assert jurisdiction over a Connecticut DAPT or apply the law of a state other than Connecticut. The act provides that if a court declines to apply Connecticut law in determining the effect of a spendthrift provision in a Connecticut DAPT, the trustee must immediately resign and thereafter can only transfer the trust property to another trustee.

The only claims of creditors that can be enforced against the assets in a Connecticut DAPT are:

1. Fraudulent transfer claims under the Connecticut Uniform Fraudulent Transfer Act;
2. Child support obligations;
3. Marital support obligations; and
4. Tort claims arising prior to the transfer of assets to the Connecticut DAPT.

Claims are subject to a four-year statute of limitations period.

Transferors can have certain rights and powers with respect to the Connecticut DAPT. The following provisions can be included in a Connecticut DAPT for a transferor:

1. The transferor can have the power to veto a distribution from the trust;
2. The transferor can have a testamentary limited power of appointment; and
3. The transferor can have the right to remove a trustee or trust director and appoint a new trustee or trust director who is not a related or subordinate party under Section 672(c) of the Internal Revenue Code.

With Connecticut becoming the nineteenth DAPT state and Indiana having also adopted DAPT legislation in 2019 which is effective July 1, 2019, additional states are likely to at least consider DAPT legislation, if not join the states that have DAPT legislation.

**Toni 1 Trust v. Wacker, 413 P.2d 1199 (AK 2018)**

**Alaska Supreme Court determines that Alaska state courts do not have exclusive jurisdiction over fraudulent transfer actions under AS 34.40.110(k)**

Donald Tangwall sued William and Barbara Wacker in Montana state court in 2007. The Wackers counterclaimed against Tangwall, his wife, Barbara Tangwall, his mother-in-law, Margaret “Toni” Bertran, and several trusts and businesses owned or run by the Tangwall family. As a result, several default judgments were entered against Donald Tangwall and his family.

In 2010, before the issuance of the last of the default judgments, Toni Bertran and Barbara Tangwall transferred parcels of real property to an Alaskan trust called the “Toni 1 Trust” which was an Alaska self-settled domestic asset protection trust.” The Wackers filed a fraudulent transfer action under Montana law in Montanan state court alleging that the transfers were fraudulent and default judgments were entered against Barbara Tangwall, the Toni 1 Trust, and Toni Bertran.

After the issuance of the fraudulent transfer judgments by the Montana court, the Wackers purchased Barbara Tangwall’s one half interest in one of the parcels at a sheriff’s sale in partial satisfaction of their judgment against Donald Tangwall and the family. Before the Wackers could purchase the remaining half interest, Toni Bertran filed for Chapter 7 bankruptcy in Alaska. As a result, her interest in the property in the Toni 1 Trust was subject to the jurisdiction of the federal bankruptcy court.

In December 2012, Donald Tangwall, as trustee of the Toni 1 Trust, filed a complaint in the bankruptcy court alleging that the service on the trust in the Montana fraudulent transfer action was defective, which rendered the judgment against the trust void. However, rather than litigate the issue of service in Montana, the bankruptcy trustee brought a fraudulent transfer claim against Tangwall under the federal bankruptcy fraudulent transfer statute. The bankruptcy court entered a default judgment against Tangwall, which judgment was sustained upon appeal.

Tangwall then sought relief in Alaska state court in which he argued that AS 34.40.110 granted Alaska courts exclusive jurisdiction over any fraudulent transfer actions against the trust. On this basis, Tangwall sought a declaratory judgment stating that all judgments against the trust from other jurisdictions were void and that no future actions could be maintained against the trust because the statute of limitations had run.

The Alaska Superior Court dismissed this complaint and Tangwall appealed. The Alaska Supreme Court found that AS 34.40.110(k) could not limit the scope of the jurisdiction of other states. Citing Tennessee Coal, Iron and Railroad Company v. George, 233 U.S. 354 (1914), the Court held that states are not constitutionally compelled to acquiesce to sister states’ attempts to circumscribe their jurisdictions over actions. It stated that Tennessee Coal held that the Full Faith and Credit Clause of the United States Constitution does not compel states to follow another state’s statutes claiming exclusive jurisdiction over suits based on a cause of action “even though the other state created the right of action.” The Court did acknowledge that the Alaska legislature attempted to grant Alaska courts exclusive jurisdiction over claims against an Alaska self-settled domestic asset protection trust. It also acknowledged that several other states had similar statutes and that similar statutes do restrict their jurisdiction. However, the court found that under Tennessee Co, the assertion of exclusive jurisdiction did not render a fraudulent transfer judgment against an Alaskan trust from a Montana court void for lack of subject matter jurisdiction.

In addition, the court found that it could not grant Tangwall relief under federal judgment. It noted that Tennessee Coal only addressed the state’s ability to restrict the jurisdiction of sister states. However, Marshall v. Marshall, 547 U.S. 293 (2006), concluded that state efforts to limit federal jurisdiction were invalid even though the state created the right of action that gave rise to the suit. It noted that AK 34.40-110(k) purported to grant Alaska courts exclusive jurisdiction over all fraudulent transfer claims against Alaska self-settled domestic asset protection trusts. Because 28 U.S.C. § 1334(a) gives federal courts’ jurisdiction over some of these claims, the Alaska law conflicted with federal law to the extent that it was impossible to comply simultaneously with both. Consequently, under the Supremacy Clause of the Constitution, state courts are precluded from limiting federal jurisdiction. Therefore, relief could not be granted to Tangwall from the federal judgment.

**Olson v. Marshack, \_\_\_ F. Supp. 3d \_\_\_ (C.D. Cal. 2018)**

**U.S. District Court declines to approve settlement of bankruptcy trustee with respect to offshore trust**

In 2010, Jana W. Olson was sued in California Superior Court by Passport Management LLC. Within a month of the service of the lawsuit, Olson transferred her beneficial interest in a self-settled Cook Islands offshore asset protection trust from herself to her two minor children for no consideration. This transfer had the appearance of a fraudulent transfer. Subsequently, Olson filed a petition for bankruptcy. Passport Management LLC became the primary creditor of the bankruptcy estate.

At some point, Olson agreed to repatriate the money in the self-settled Cook Islands trust and a stipulated order was entered by the bankruptcy court directing Olson to do so. The bankruptcy court’s order specifically required repatriation but did not decide if the money was the property of the bankruptcy estate.

Olson then, according to the district court, proceeded to disobey the bankruptcy court’s order by sabotaging the repatriation effort with a letter designed to convince the Cook Islands trustee that her request to repatriate the money was made under duress. As a result, apparently, the Cook Islands trustee refused to repatriate the money. The bankruptcy court then jailed Olson for more than a year for civil contempt. Eventually, the bankruptcy trustee decided that jail was not going to convince Olson to repatriate the funds in the trust from the Cook Islands. The bankruptcy trustee then negotiated an agreement with Olson and Olson’s father and Olson’s brother, as trustee of a new California trust with the two minor children as beneficiaries, under which the money would be returned to California with approximately 80 percent going to the bankruptcy estate and 20 percent to the California trust.

After the repatriation of the funds to California, the bankruptcy trustee moved for approval of the compromise agreement before the bankruptcy court. Passport Management opposed the motion claiming that there was no authority to disburse property of the bankruptcy estate in contravention of the priority rules and that, in any event, there was no reason to allow Olson effectively to be rewarded for her contempt. Passport Management LLC also argued that other pressure could have been brought to bear before a compromise was struck that allowed Olson or her family to retain part of the funds.

The bankruptcy trustee argued that the agreement was the only way to get property back into the reach of the United States court and that 80 percent was better than getting nothing at all. The trustee also believed that the fraudulent transfer claim could have been easily won, but that subsequent collection would have been virtually impossible because of the difficulty of seeking collection in the Cook Islands. As a result, the bankruptcy court granted the motion to approve the compromise, but declined to determine whether the trust funds held in the Cook Islands were always the property of the bankruptcy estate.

The district court rejected the compromise. First, the court said that without a judgment avoiding the transfers, the Cook Islands funds were not a part of the bankruptcy estate at the time of the petition. The transfers would have to be formally avoided through a fraudulent transfer claim to make the funds part of the bankruptcy estate. In addition, the bankruptcy court had no equitable duty to approve the compromise after Olson and her family arranged for the repatriation money in reliance on the settlement. This effectively minimized the independent role of the bankruptcy court in the process. The court also agreed with Passport Management that a benefit to Olson’s minor children was an indirect benefit to Olson herself as the money set aside in trust was money that Olson did not have to pay for her children’s welfare. The court then rejected the argument of the bankruptcy trustee that the minor children might be individually liable for their mother’s debt as beneficiaries of the trust. The court noted that the normal rule is that beneficiaries are not liable for the wrongful acts of the trust. As a result, the district court rejected the settlement agreement.

**FIDUCIARY CASES**

**Ajemian v. Yahoo!, Inc., 84 N.E. 3d 766 (Mass. 2017), petition for cert. docketed sub nom. Oath Holdings, Inc. v. Ajemain (U.S. Jan. 19, 2018 (No. 17-1005**)

**The Stored Communications Act (the “SCA”) does not prevent Yahoo!, Inc. (“Yahoo”) from voluntarily disclosing emails from a decedent’s account to the decedent’s personal representatives at the request of the personal representatives; it remains to be settled whether the SCA compels Yahoo to do the same**

John Ajemian died intestate, and his siblings, Robert Ajemian and Marianne Ajemian, were appointed as his personal representatives. Robert and Marianne asked Yahoo to provide access to the contents of John’s e-mail account. Yahoo refused to release the contents of the account, although they did provide “subscriber information” upon Robert and Marianne obtaining a court order mandating disclosure to the account holder’s personal representatives.

Robert and Marianne filed a complaint in the Probate and Family Court seeking a judgment that they were entitled to unfettered access to the messages in the account. Yahoo filed a cross motion for summary judgment arguing that the SCA prohibited the requested disclosure, and, even if it did not, Yahoo was permitted to deny access to, or even delete the contents of, the account at its sole discretion based on the service contract entered into at the time the e-mail account was created.

The judge granted Yahoo’s motion for summary judgment solely on the basis that the SCA barred Yahoo from complying with the requested disclosure. Robert and Marianne appealed to the Massachusetts Appeals Court, and the Supreme Judicial Court of Massachusetts transferred the case to themselves as a matter of first impression.

The SCA prohibits entities that provide “service[s] to the public” from voluntarily disclosing the “contents” of stored communications unless certain statutory exceptions apply. The “agency exception” allows a service provider to disclose the contents of stored communications “to an addressee or intended recipient of such communications or an agent of such addressee or intended recipient.” The “lawful consent exception” allows disclosure “with the lawful consent of the originator or an addressee or intended recipient of such communication.”

The Supreme Judicial Court of Massachusetts ruled that the SCA does not prohibit Yahoo from voluntarily disclosing the contents of an e-mail account to the personal representatives of the account holder’s estate, because the lawful consent exception applies.

The Court found that the agent exception does not apply because personal representatives are not agents of the decedent, as they cannot be controlled by the decedent. However, the lawful consent exception does apply such that the personal representatives of a decedent can give lawful consent to release of the content of the account. The Court reasoned that to find otherwise would result in a class of digital assets—stored communications—that could not be marshalled by personal representatives. The Court found that this was not the intent of the SCA. Therefore, based on the Court’s statutory interpretation analysis, personal representatives are capable of giving “lawful consent” to the disclosure on behalf of the account holder, and “actual consent” by the decedent is not required to qualify for the “lawful consent exception” under the SCA.

Because the lawful consent exception applies, Yahoo is not prevented by the SCA from releasing the contents of the account to the personal representatives. The Supreme Judicial Court of Massachusetts remanded the issue of whether Yahoo was compelled to release the contents of the account to the Probate and Family Court, but strongly signaled that if the lower court were to find that Yahoo was not compelled to release the contents, the Supreme Judicial Court of Massachusetts would overturn that ruling and compel Yahoo to release the contents of the account.

**Laborers’ Pension Fund v. Miscevic, No. 17-2022 (7th Cir. Jan. 29, 2018)**

**ERISA does not preempt the Illinois slayer statue, and the Illinois slayer statute applies where the deceased was killed by an individual found not guilty by reason of insanity**

Evidence produced at her criminal trial showed that Anka Miscevic killed her husband, Zeljko Miscevic, in January 2014; however, she was found not guilty by reason of insanity. Despite the finding that she was responsible for her husband’s death, Anka then claimed she was entitled to her deceased husband’s pension plan, which was governed by federal ERISA law. A claim was also made on behalf of their minor son for the benefits. Their minor son was awarded the benefits from the pension plan. Anka appealed.

Illinois has a “slayer statute,” which provides that “a person who intentionally and unjustifiably causes the death of another shall not receive any property, benefit, or other interest by reason of the death.” However, neither federal ERISA law nor the pension’s governing documents contains an express slayer provision; therefore, if federal law governs, the named beneficiary would receive the assets, despite the operation of a slayer statute under state law.

On appeal, the Court of Appeals for the Seventh Circuit upheld the interpretation that a slayer is precluded from obtaining the benefits payable under the decedent’s pension plan even if they were found not guilty by reason of insanity. The Court reasoned that slayer statutes are traditionally an area of state regulation, and it rejected Anka’s argument that Congress intended to preempt the slayer statutes through ERISA. ERISA was enacted after it was well established that an individual who kills another individual cannot benefit as a result of that death. Therefore, Congress could have clearly stated that it intended to change that result in certain situations, but their failure to explicitly state that intent results in a determination that it was not their intent.

Further, the Court held that Illinois’ statute that provides that “a person who intentionally and unjustifiably causes the death of another” is broad enough to encompass a situation where an individual is found not guilty by reason of insanity. They deferred to state law decisions to interpret the statute. Anka argued that the killing was justifiable because she was found not guilty. The Court rejected this argument on the grounds that an insanity defense is an “excuse” defense, not a “justification” defense. The decision rests on lower court decisions interpreting the statute, and therefore the Court does acknowledge that the interpretation may be different in other states.

**Lynch v. Barba, 2018 WL 1613834, C.A. No. 12083-MG (Del. Ch. Ct. 2018)**

**Trustee is entitled to summary judgment when beneficiary cannot substantiate his breach of fiduciary duty allegations and has waited too long to file his lawsuit against the trustee**

Ethel M. Lynch died in August of 2010. She named her daughter, Rhonda Barba as executor of her estate and trustee of two testamentary trusts. Rhonda predeceased Mrs. Lynch, so Rhonda’s husband, Francis Barba, qualified as the named successor executor and trustee.

Mrs. Lynch had transferred her property to a Revocable Trust which was to be distributed at her death, one-half to a Special Needs Trust for her husband, Mr. Lynch, and the remainder was to remain in the Revocable Trust for the benefit of Rhonda. Upon Rhonda’s death, the Revocable Trust provided the principal of the Special Needs Trust would be distributed in accordance with Rhonda’s testamentary power of appointment or to her surviving issue per stirpes. The beneficiaries after Mrs. Lynch’s death are Mr. Lynch and Rhonda’s two sons, Matthew and Eric Barba.

Mr. Barba and Mr. Lynch did not have a good relationship prior to Mr. Barba serving as Trustee for Mr. Lynch’s Trust, and this additional relationship only exacerbated their disagreements. Mr. Lynch filed a 78 count Complaint alleging Mr. Barba did not act in good faith while serving as executor for Mrs. Lynch’s estate and as trustee of the Special Needs Trust.

Among his many complaints, Mr. Lynch claimed Mr. Barba breached the fiduciary duties he owed Mr. Lynch as trustee of the Special Needs Trust by selling trust/estate property for less than its fair market value, refusing to change the name of the trust to remove “special needs,” improperly moving and converting trust assets for personal use, failing to communicate with the beneficiary, failing to make distributions when requested, wasting trust assets and failing to provide accountings or other required reports as requested.

Mr. Barba filed a Motion for Summary Judgment requesting the trial court dismiss Mr. Lynch’s Complaint, as there were no disputed facts to support the allegations that Mr. Barba had failed to meet his fiduciary obligations. Mr. Barba also asserted Mr. Lynch’s claims were time barred and that the doctrine of laches prevented Mr. Lynch from asserting them. Both Mr. Barba and Mr. Lynch requested that the Special Needs Trust be terminated and all remaining assets be distributed to Mr. Lynch.

A plaintiff has the burden of proving his allegations. A plaintiff who fails to present specific evidence of a breach of duties owed by a trustee will not be successful.

Patricia Griffin, a Master in the Court of Chancery of Delaware, submitted a report to the Chancery Court containing her recommendations for action on the pending Motion for Summary Judgment. Overall, the Master found that Mr. Barba did not violate his fiduciary duties as trustee.

The Will granted the executor and trustee of the Special Needs Trust broad fiduciary powers along with the ability to hold or dispose of property in the trustee’s discretion. When assessing the appropriateness of Mr. Barba’s actions as trustee, Delaware applies a prudent investor standard. When the trustee acts with skill, care, diligence and prudence in light of the circumstances, they will not be found to violate their fiduciary duty to the beneficiary as a result of their actions.

In reviewing Mr. Barba’s actions, the Master found that Mr. Lynch presented insufficient evidence to support any of his claims for breach of fiduciary duty. Mr. Barba sold the real property held in the estate for their appraised values and Mr. Lynch did not provide any factual support that the properties were sold for less than their fair market value. The Master also found that the Special Needs Trust expressly authorized employing and compensating advisors for the proper administration of the trust. Mr. Barba also demonstrated his compliance with the Trustee’s duty to keep accurate records contrary to the assertion of Mr. Lynch.

With respect to the exercise of Mr. Barba’s discretion, the Master held that to determine if Mr. Barba breached his duties to Mr. Lynch, she had to determine whether the funds distributed to the beneficiary were consistent with the authority provided by the Special Needs Trust and Delaware law, not whether Mr. Lynch received all of the payments he requested. Because Mr. Barba was granted the sole and uncontrolled discretion to make payments from the trust to Mr. Lynch, the Master found that his failure to agree to every request from Mr. Lynch did not itself constitute a breach of the trustee’s duty.

The Master further found that even if Mr. Lynch had one or more valid claims, laches would bar his claims. To support the affirmative defense of laches, the defendant must prove the claimant had knowledge of the claim, the claimant unreasonably delayed in bringing the claim and that delay resulted in prejudice to the defendant.

The Master found that Mr. Lynch knew in September 2011 about the transfers of property and actions he complained of during the administration of Mrs. Lynch’s Estate. The inventory for Mrs. Lynch’s Estate was filed in March 2011 and the final accounting was filed in September 2011, a copy of which was sent to Mr. Lynch. Mrs. Lynch’s estate closed in December, 2011.

Mr. Lynch did not assert his claims until March 2016, over four and a half years after the claim arose. By that time the Estate was closed and all property had been distributed. Therefore, if Mr. Lynch were allowed to proceed, the Estate would have to be reopened and beneficiaries would have to find a way to reimburse the Estate to satisfy Mr. Lynch’s claims. On these facts, the Master found that all three requirements for laches were satisfied, barring Mr. Lynch’s claims.

Lastly, the Master addressed Mr. Lynch’s and Mr. Barba’s request to terminate the Special Needs Trust and to allow distribution of the assets to Mr. Lynch. Delaware law allows a court to terminate a trust if all beneficiaries consent and the court determines the settlor’s objectives or purpose for the trust has become impossible to achieve, administration is difficult or impractical, and/or continuing the trust is not in the best interest of the beneficiaries.

The Master found that termination of the Special Needs Trust was appropriate because of the broad trust purposes to benefit Mr. Lynch and because of the unlikelihood of locating a successor trustee willing to serve. Mr. Barba was not willing to continue to serve as trustee and the successor trustee named in the trust instrument also had declined to serve.

**Bullard v. Hoffman (In re Mayette E. Hoffman Living Trust U/A dated August 4, 1997), 812 S.E.2d 401 (N.C. Ct. App. 2018)**

**A trustee’s egregious conduct is not a prerequisite to awarding attorney’s fees under the UTC in a judicial proceeding involving the administration of a trust**

Kimberli Bullard and James Hoffman were co-trustees of a trust for the benefit of their father. The primary asset of the trust was the father’s residence. When their father was moved to a nursing home, the father’s attorneys notified Kimberli and James of their responsibility as fiduciaries to co-manage the property, including dealing with repair and maintenance of the residence. Kimberli and James could not agree on management of the property and the residence was left vacant, bills were unpaid, insurance lapsed and the property generally deteriorated.

After approximately two years, Kimberli sent James a letter alleging James’ various breaches of fiduciary duty and requesting that he voluntarily resign as co-trustee. James acknowledged receipt of the letter but took no other action. Kimberli then petitioned the Guilford County Superior Court to remove James as co-trustee. While the removal case was pending, there was a tenant interested in leasing the property but James refused to sign the lease. Upon petition by Kimberli, the Clerk of the Superior Court entered an order approving the lease.

After the Clerk removed James as co-trustee, Kimberli filed a petition for attorney’s fees in the amount of $26,096.70. The Clerk awarded $7,243 in attorney’s fees as reflective of the fees incurred during the time that the petition to remove James as co-trustee was pending. The Clerk found that James’ actions during that period were “egregious and obstructionist” in a manner that warranted an award of attorney’s fees. However, the attorney’s fees incurred outside of that period were denied as being irrelevant to James’ “egregious and obstruction behavior.” James’ appeal of this fees award to the Guilford County Superior Court was denied. James appealed this decision to the North Carolina Court of Appeals.

Under the North Carolina Uniform Trust Code a court may award costs and expenses, including reasonable attorney’s fees, as provided in the General Statutes. In turn, the General Statutes permit the court to apportion costs amongst the parties in the court’s discretion. At common law, litigation expenses were generally only chargeable against the other party in the case of egregious conduct, such as bad faith or fraud.

The North Carolina Court of Appeals denied James’ appeal and upheld the award of attorney’s fees. The Court of Appeals reasoned that the common law principle requiring egregious conduct for an award of attorney’s fees is not required by the applicable statutes, which leave the award to the court’s discretion. The Court of Appeals further held that even if egregious conduct were a prerequisite to an award of attorney’s fees, James’ conduct while the removal action was pending was, in fact, egregious. James was aware that the trust property was continuing to lose value while vacant, but he refused to take corrective action. Therefore, the Clerk did not abuse her discretion in her award of attorneys’ fees to Kimberli.

**In re Estate of Forgey, 298 Neb. 865 (2018)**

**Nebraska Supreme Court awards damages and legal fees for trustee’s failure to inform and report**

This dispute involved, among other related matters, the proper measure of damages for failing to provide an accounting for the Glenn G. Forgey Revocable Trust (“Trust”). The grantor of the trust, Glenn G. Forgery (“Grantor”) died in 1993.

Under the terms of the Trust, following the Grantor’s death and payment of the Grantor’s debts, funeral expenses, estate expenses, and federal estate taxes, the remaining assets of the Trust were to be divided into separate trusts for the benefit of each of the Grantor’s surviving children and the descendants of the Grantor’s children who did not survive him. The Grantor had three surviving children: Lyle A. Forgey (“Lyle”), Bessie I. Forgery-McCoy (“Bessie”), and Wayne Forgey (“Wayne”). Wayne died before the lawsuit commenced.

The trust instrument named Lyle sole trustee and gave him broad discretion to manage the Trust. The Trust instrument also required Lyle to provide an annual accounting to the beneficiaries.

Lyle failed to file timely the Grantor’s federal estate tax return, resulting in the assessment of interest and penalties. Because the Trust owned mostly illiquid assets and none of the family members wanted to sell Trust assets, Lyle made an election under the Internal Revenue Code to pay estate taxes on an installment basis. The installment payment of estate taxes contributed to a significant delay in terminating the Trust.

The Trust’s primary assets consisted of agricultural land, stock in a small local bank, and cash. The Trust instrument required allocation of all the bank stock to Lyle’s share. Before the Grantor’s death, the Grantor, Lyle, and Wayne conducted jointly a cattle ranching business on the land and divided the profits 20 percent to the Grantor, 45 percent to Lyle, and 35 percent to Wayne. Although the Grantor owned the land, Lyle and Wayne did not pay rent to the Grantor. Lyle and Wayne continued operating the ranching business in the same manner after the Grantor’s death, but paid the Grantor’s 20 percent profit share to the Trust.

In 2013, Wayne’s surviving spouse Marvel Forgey (“Marvel”) and her children brought suit against Lyle because after 20 years the Trust still had not been divided into separate shares. These plaintiffs also alleged various breaches of fiduciary duty and sought to remove Lyle as trustee. Among other claims, Marvel and Bessie contended that Lyle breached his fiduciary duties by failing to charge rent to himself and Wayne for use of the land in the ranching business. They also contended that Lyle breached his fiduciary duties by failing to timely file the federal estate tax return and by failing to render accounts as required by the Trust instrument.

The trial court ultimately dismissed most of the breach of fiduciary duty claims, but ordered the termination and division of the Trust. The court determined what the values of the Trust assets were at the time of the Grantor’s death. The court assigned assets to each of the shares based on their values in 1993. Under this method, Lyle’s share received all the bank stock and Wayne’s and Bessie’s shares each received one-half the land. The court used cash and other assets to equalize the value of the shares. The court then allocated income and expenses to each share over the 20-year period based on the asset to which the income and expenses related. For instance, Lyle’s share received the benefit of all the bank stock dividends.

Marvel appealed the trial court’s order, contending, among other things, that the trial court should have awarded Marvel and Bessie attorneys’ fees and that the trial court erred in failing to assess damages against Lyle for failing to render an accounting.

Nebraska law before 2005 required a trustee to keep the beneficiaries reasonably informed of the trust and its administration. After the enactment of the Uniform Trust Code in 2005, Nebraska law required a trustee to send the beneficiaries, at least annually, a report of the trust property, liabilities, receipts, and disbursements. The Trust instrument also required the trustee to account to the beneficiaries. Normally, an accounting is the appropriate remedy for failing to inform and report to the beneficiaries.

Typically, a trustee who successfully defends against claims for breach of fiduciary duty may reimburse himself for the attorneys’ fees from the trust. When the trustee creates the circumstances that permit the beneficiaries to question the trustee’s actions, the trustee should bear his own attorneys’ fees.

The Nebraska Supreme Court held that because Lyle’s failure to keep the beneficiaries informed caused the misunderstandings and complications that led to the litigation, an accounting was not a complete remedy. In the Court’s opinion, Bessie failed to raise with Lyle the issue of rent for the agricultural land because she had no information about the ranching business or the value of the land. The Court therefore ordered that Lyle transfer to Bessie’s share an amount equal to one-half the rent he should have collected from himself and Wayne.

The Court also ordered Lyle to transfer an amount equal to the assessed penalties and interest resulting from the failure to timely file the estate tax return equally to Bessie’s and Wayne’s shares. Finally, the Court found that the trial court should have awarded the plaintiffs their attorneys’ fees. Without an award of attorneys’ fees, there would be no consequence for Lyle failure to inform and report. Furthermore, Bessie and Marvel had expended considerable funds enforcing their statutory right to an accounting. In the Court’s opinion, failing to reimburse Bessie and Marvel would produce an inequitable result.

**Morgan v. Superior Court of Orange County, 23 Cal. Rptr. 3d 647 (Cal. App. 2018)**

**California court holds that predecessor trustee cannot assert the attorney-client privilege against a successor trustee and that any provision of a trust instrument seeking to do so violates public policy**

This case arose during litigation between Thomas Edward Morgan, III (“Morgan”), the trustee and a beneficiary of the Amended and Completed Restated Beverly C. Morgan Family Trust dated November 6, 2013 (“Trust”), and Nancy Morgan Shurtleff, John Evans Morgan, and Nancy Morgan Shurtleff’s daughters Kathleen Shurtleff and Jessica Shurtleff (collectively, the “Shurtleffs”), who are beneficiaries of the Trust. Morgan became sole trustee of the Trust following the death of the settlor, Beverly C. Morgan, in January 2014. Shortly after Morgan became trustee, the Shurtleffs filed a petition in the Probate Court for Orange County, California (“Probate Court”), seeking reformation of the Trust and removal of Morgan as trustee. The litigation continued for three years.

In April 2017, the Probate Court removed Morgan as trustee of the Trust and named Bruce and Lee Ann Hitchman (the “Hitchmans”) as successor co-trustees. The Probate Court ordered Morgan to turn over to the Hitchmans all communications he made in his capacity as trustee of the Trust. Morgan objected to disclosing certain communications with his attorney, contending that both the attorney-client privilege and the terms of the Trust instrument barred their disclosure. The section of the Trust instrument in question provided that all communications with legal counsel “shall be absolutely protected and free from any duty or right of disclosure to any successor Trustee or any beneficiary and any duty to account.”

The Probate Court held that the terms of the Trust prohibiting disclosure of all communications with legal counsel violated California public policy and entered an order compelling Morgan to disclose the privileged communications to the Hitchmans. The Probate Court’s order explicitly prohibited the Hitchmans from disclosing these communications to the Shurtleffs. Morgan sought a writ of mandamus from the Fourth District Court of Appeal (“Court”) stating that the Probate Court judge exceeded his authority in issuing the order.

Under California law, a trustee who seeks legal advice on behalf of a trust may assert the attorney-client privilege against a beneficiary or any third person with respect to any communications with the trustee’s legal counsel. This privilege, however, vests in the office of trustee and not in the individual or entity serving as trustee. Accordingly, a former trustee must turn over all communications, including privileged communications, to a successor trustee upon request. The successor trustee can continue to assert the attorney-client privilege against the beneficiaries of the trust. A trustee who seeks legal advice regarding a charge of breach of fiduciary duty may hire a separate lawyer and pay the lawyer out of the trustee’s personal funds.

Under California law, a trust instrument cannot absolve a trustee from liability for intentional misconduct, gross negligence, or reckless indifference. Privileged communications may bear on a successor trustee’s determination of whether a predecessor trustee acted with intentional misconduct, gross negligence, or reckless indifference. Accordingly, a trust provision barring a predecessor trustee from disclosing privileged communications to a successor trustee is unenforceable.

The Court upheld the Probate Court’s order requiring Morgan to turn over the privileged communications to the Hitchmans. The provisions of the Trust instrument barring disclosure of privileged communications to successor trustees violated California public policy and were unenforceable. Because Morgan did not distinguish between communications with his attorney on behalf of the Trust and communications with his attorney to protect himself from liability, and because Morgan paid his attorney using Trust funds, California law required him to turn over the privileged communications to the Hitchmans. Furthermore, the Probate Court correctly applied California law in barring the Hitchmans from disclosing any privileged communications to the Shurtleffs.

**Carberry v. Kaltschmid, 2018 WL 2731898 (Cal. 2018)**

**Trust protectors do not have a general right to information allowing them to compel trust accountings**

The terms of a trust provided for a “trust protector” who held certain powers in a “fiduciary capacity.” The trust protector was not a beneficiary, and the trust instrument did not explicitly grant the trust protector the right to compel an accounting. The trust protector filed a probate “Petition for Order Compelling Co-Trustees to Account and to Provide Information” in the wake of a dispute between the trustees and beneficiaries that, at the time of the trust protector’s petition, was in the process of being settled. No trustee or beneficiary joined or supported the trust protector’s petition.

The California Probate Code requires trustees to provide accountings to the beneficiaries of a trust with a present interest in either principal or income (§ 16062(a)). Further, a trustee or beneficiary may seek a court order to compel a trustee to account to a beneficiary (§ 17200(a) & (b)(7)(C)). The California Probate Code does not grant such rights to trust protectors.

The Probate Division of the San Mateo County Superior Court denied the trust protector’s petition for an accounting, ruling that the trust protector lacked standing. The trust protector appealed. The California Court of Appeal, First District, Division 5, affirmed and awarded appellate costs, but not sanctions, to the respondents.

Although California law provides trust beneficiaries with the right to compel an accounting, the trust protector was not a beneficiary of the trust. Further, the terms of the trust did not give the trust protector the right to compel an accounting. Therefore, the trust protector did not have a right to compel an accounting and lacked standing to bring his “Petition for Order Compelling Co-Trustees to Account and to Provide Information”.

**Doermer v. Oxford Fin. Grp., Ltd., 884 F.3d 643, 647 (7th Cir. 2018)**

**When there are multiple co-trustees, a single trustee does not have capacity to bring an action on behalf of a trust, and a beneficiary cannot sue on behalf of the trust**

Richard Doermer and Kathryn Doermer Callen are the only children of Richard T. and Mary Louise Doermer. They are the beneficiaries of a multi-million dollar trust that their parents established for their benefit and the benefit of their children (the “Trust”). The Trust currently has three trustees, Richard, Kathryn, and Bankers Trust, a corporate trustee. In 2010, Richard and Kathryn had an “irreconcilable” dispute regarding how to manage and invest the Trust assets. Kathryn hired Oxford Financial Group (“Oxford”), to advise her in handling the Trust and to help resolve the problems with her brother. The Trust paid Oxford’s fees.

In 2012, Oxford recommended that the co-trustees divide the Trust into two, one trust for Kathryn and her descendants and one trust for Richard and his descendants. As part of this plan, the Trust’s situs was moved from Indiana to South Dakota. The siblings could not agree on how to divide the assets and Kathryn refused to sign the agreement. Richard petitioned a South Dakota state court to divide the Trust; however, the court denied the request.

In July 2016, Richard sued Oxford in Illinois state court on behalf of the Trust for breach of fiduciary duty, negligence, gross negligence and willful and wanton misconduct. Richard states that the reason Kathryn refused to sign the agreement was the negligent advice she received from Oxford. Because the Trust was not divided, Richard was unable to pursue his high-risk, high reward investment strategy. If the Trust had been divided, Richard believes his half would have earned an additional $2 million in reasonable investments opportunities. Richard sued Oxford in his capacity as both a co-trustee and a beneficiary of the Trust. The complaint identified Kathryn as an “involuntary plaintiff”; however, besides sending her a letter and a copy of the complaint, she was not joined as a party.

Oxford removed the case to federal court based on diversity jurisdiction and filed a Motion to Dismiss the Complaint. The District Court granted the Motion to Dismiss, as Richard could not sue in his capacity as co-trustee, because both state law and the trust agreement required a majority of the co-trustees to consent to the lawsuit. Additionally, Richard could not sue Oxford as a beneficiary, because state law prohibits a trust’s beneficiary from suing a third party on behalf of the trust.

Richard appealed challenging both rulings and additionally arguing that the removal of the case to federal court was improper. Richard claimed the District Court lacked subject matter jurisdiction, arguing that Kathryn’s presence in the case as an “involuntary plaintiff” destroyed the diversity jurisdiction that would make the removal proper.

Illinois law requires consent of a majority of the trustees to act on behalf of the trust, including filing litigation. A trust’s beneficiary may not sue a third party on behalf of a trust unless the trustee could maintain an action against a third party but improperly refuses to sue.

On appeal, the United States Court of Appeals, Seventh Circuit, upheld the dismissal of the case. The Seventh Circuit first affirmed that the District Court did have valid subject matter jurisdiction because there was diversity between the plaintiff and the defendant. The Seventh Circuit evaluated the use of “involuntary plaintiff” in both Illinois (where the lawsuit was filed) and South Dakota (where the situs of the trust was located). If Kathryn was an “involuntary plaintiff” then diversity jurisdiction was destroyed, as she and Oxford are both citizens of Indiana. The Seventh Circuit stated that there is no such thing as an “involuntary plaintiff” in Illinois, and even if the case was decided under South Dakota law, an involuntary plaintiff can only arise when that person’s presence is essential for proper adjudication of the case.

Richard also argued that the Trust was the real party in interest and the Trust had the citizenship of every co-trustee including Kathryn. The Court rejected this argument because when a trustee “files a lawsuit or is sued in her own name, her citizenship is all that matters for diversity purposes.”

In evaluating the claims, the Seventh Circuit stated that a plaintiff’s capacity to sue on behalf of a trust is determined by the state where the federal district court is located. While the Seventh Circuit used Illinois law, it stated that the outcome would not change if South Dakota law applied. The Seventh Circuit confirmed that Illinois law barred Richard from suing Oxford in his capacity as co-trustee, because state law required the consent of a majority of trustees to act on behalf of the Trust. Additionally, the Trust agreement also required a majority of co-trustees to act on behalf of the Trust and because neither the corporate trustee nor Kathryn consented to the lawsuit, Richard did not have standing to sue as a trustee.

Additionally, the Court affirmed that Richard could not sue as a beneficiary because a beneficiary may not sue a third party on behalf of a trust unless the trustee improperly refuses to file suit. An improper refusal only occurs when there is a breach of the trustee’s fiduciary duties to bring the claim. Richard’s Complaint did not state that either Kathryn or the corporate trustee breached any fiduciary obligation by not joining the suit and therefore failed to establish a basis allowing him to bring this suit rather than the trustees. The Seventh Circuit accordingly affirmed the dismissal of the case.

**Estate of Lee, 2018 WL 2374116 (Texas 2018)**

**The spendthrift provisions of a testamentary trust rendered invalid, for the purposes of a standing analysis, the terms of an agreement between former beneficiaries of the trust**

Testatrix Lucy Lee (“Lucy”) established a testamentary trust (the “Trust”) under the terms of her will (the “Will”) for the lifetime benefit of her son, Jack O’Guinn (“O’Guinn”), and upon his death for the benefit of her step-grandson, Michael Douglas Lee (“Lee”), and grandson Jack Lindsay O’Guinn (“Jack”). Lucy modified her Will by a first codicil (the “First Codicil”), which named Lucy’s niece, Mary Elizabeth Whitten (“Whitten”) as the Trust’s sole remainder beneficiary in place of Lee and Jack. Lucy later executed a second codicil (the “Second Codicil”), changing her plan and leaving her entire estate to O’Guinn outright and free of trust.

After Lucy’s death, Whitten and Lee entered into an agreement (the “Agreement”) pursuant to which Lee would contest probate of the Second Codicil in exchange for Whitten’s promise to share 40% of her share under the First Codicil should Lee’s contest of the Second Codicil be successful. The terms of the Will, republished by the First Codicil, provided that the beneficiaries held their interests subject to a spendthrift trust.

To have standing to contest a will or codicil, a party must be an “interested person,” defined under Texas law as an “heir, devisee, spouse, creditor, or any other having a property right in or claim against an estate being administered” (Tex. Estates Code Ann. § 22.018(1)). Status as a former remainder beneficiary under the terms of a testamentary trust does not satisfy this definition. Further, because the spendthrift provisions of a trust may invalidate, for the purposes of a standing analysis, contractual agreements made between a trust’s beneficiaries, being a party to an agreement with a trust beneficiary does not necessarily cause someone to be an “interested person” with respect to the trust or to the will that created the trust.

The County Court of Gregg County, Texas, denied Lee’s petition contesting probate of the Second Codicil, ruling that Lee lacked standing. Lee appealed. The Court of Appeals of Texas, Texarkana, affirmed.

Although Lee was a former remainder beneficiary under the Trust created by the Will, this was not sufficient to give him standing to contest probate of the Second Codicil. To have standing to contest probate of the Second Codicil Lee needed an interest under either the Second Codicil, which he was contesting, or the First Codicil, which he hoped would be operative. However, Lee held no express interest under the terms of either the First Codicil or the Second Codicil. Further, Lee held no interest under the Agreement, which was invalidated by the spendthrift terms prohibiting alienation of trust assets of the Trust as outlined in the Will and as republished by the First Codicil. Therefore, Lee did not have standing to contest the Second Codicil.

**Rachins v. Minassian, 2018 WL 3387236 (Florida 2018)**

**The remainder beneficiaries of a family trust were qualified beneficiaries under Florida law with standing to challenge a trust’s administration, even though they would receive their interests through newly created trusts**

The settlor (the “Settlor”) established a trust which, at his death in 2010, when the federal estate tax was not in effect, funded a family trust (the “Family Trust”) with the Settlor’s entire residuary estate. The Settlor’s wife (the “Wife”), who was not the mother of the settlor’s children (the “Children”), had absolute discretion to make distributions from the Family Trust during her lifetime to herself for health, education, and maintenance. Upon the death of the Wife the Family Trust would terminate and the trust would be divided into separate trusts for the benefit of each of the Children. Soon after the death of the Settlor, the Children challenged the Wife’s administration of the Trust for a number of reasons, including the Wife’s alleged gambling habit.

The wife successfully sought dismissal of the Children’s suit, claiming the Children were neither beneficiaries nor Qualified Beneficiaries of the Family Trust. The Children appealed, claiming they are Qualified Beneficiaries under the provisions of the Florida Trust Code and, therefore, had standing to question whether the wife is properly administering the trust corpus.

Section 736.0103(16) of the Florida Trust Code states that a Qualified Beneficiary “means a living beneficiary who, on the date the beneficiary’s qualification is determined:

* + - 1. Is a distributee or permissible distributee of trust income or principal;
      2. Would be a distributee or permissible distributee of trust income or principal if the interests of the distributees described in paragraph (a) terminated on that date without causing the trust to terminate; or
      3. Would be a distributee or permissible distributee of trust income or principal if the trust terminated in accordance with its terms on that date.

Under Florida case law, Qualified Beneficiaries have standing to challenge the administration of a trust.

The District Court of Appeals of Florida, Fourth District, reversed holding that the Children were Qualified Beneficiaries of the Family Trust. The Children were Qualified Beneficiaries of the Family Trust with standing to challenge the administration of the Family Trust during the Wife’s lifetime, even though the Family Trust would terminate at the death of the Wife, and even though the remaining principal of the Family Trust would flow to the Children via newly created trusts rather than via outright distributions from the terminated Family Trust.

The Children are beneficiaries because they have future beneficial interest in any property remaining in the Family Trust after the Wife’s death, since any remaining property remaining in the Family Trust will be disbursed to a new trust for the Children’s benefit under the terms of the original trust document. That means because any remaining property in the Family Trust would be distributed to a new trust created for the benefit of the Children upon the Wife’s death, the Children will, at a minimum, have an equitable interest in any property in the Family Trust at that time.

The fact that any remaining principal of the Family Trust would flow into a new trust created for the Children, as opposed to being distributed to the Children outright, did not preclude the Children from being beneficiaries of the Family Trust under the statutory definition.

Similarly, the fact that the Family Trust terminated upon the Wife’s death does not preclude the Children from having a beneficial interest in the Family Trust as, by definition, a remainder interest in a trust refers to the right to receive trust property upon the termination of the trust.

The Children are also Qualified Beneficiaries of the Family Trust because the term “qualified beneficiary” includes a living beneficiary who “[w]ould be a distributee or permissible distributee of trust income or principal if the trust terminated in accordance with its terms on that date. Here, the children are qualified beneficiaries under section 736.0103(16)(c), because they would be distributes of trust principal if the Family Trust terminated in accordance with its terms (i.e., the wife died).

The District Court of Appeals found the definition of “qualified beneficiary” under subsection (16)(c) includes the Children in this situation, even though the Family Trust terminates at the wife’s death and even though the Children would be distributes of any remaining trust principal in the Family Trust only through a newly-created trust for their benefit.

The District Court of Appeals concluded that the Wife’s unlimited power to invade the Family Trust was subject to implied limitations to protect beneficiaries with an interest in any property that might remain in the Family upon the Wife’s death which gave the Children standing to challenge the Wife’s administration of the Family Trust.

**Trudel v. SunTrust Bank, 288 F. Supp. 3d 239 (D.D.C. 2018)**

**Bank did not owe fiduciary duties to a deceased savings account owner. Therefore, the court denied request from the customer’s children for an equitable accounting**

In 1994, Ukrainian businessman Yevgenyi Scherban opened a savings account at SunTrust Bank and funded it with $1 million. Although the bank records were unclear, it appeared that Scherban named his wife, Nadejda Nikitina, and his son, Ruslan, as the beneficiaries of the account. In 1996, Scherban and Nikitina were murdered. At the time of their deaths, over $1 million remained in the account.

In December 1996, after Scherban and Nikitina’s deaths, an individual posing as Nikitina asked SunTrust to wire $282,000 to an entity in the Czech Republic. Although Nikitina was deceased, the bank approved the transfer.

In 2003, the account had a zero balance and SunTrust closed the account. Neither the bank nor Scherban’s children could locate withdrawal records for the remaining $812,215. Although he was a beneficiary of the account, Ruslan stated that his father’s personal assistant oversaw the family’s American assets, and Ruslan never received account statements.

Scherban’s children suggested that SunTrust had converted the money for itself. They produced a June 2002 letter purportedly from the bank to lawyers for Nikitina’s estate, which stated that there had been no customer-initiated activity on the account since Scherban opened it. However, the children also produced a statement showing an unexplained debit of $50,000 in 1997.

SunTrust, meanwhile, claimed it had no record of the letter. The Bank blamed Scherban’s personal assistant for the missing funds, but it could not produce definitive evidence to support its theory.

Scherban’s children sued SunTrust for an equitable accounting. After discovery, both sides moved for summary judgment.

An accounting is a general investigation of the transactions between parties. A court will grant a request for an accounting only if (1) the transaction is complex or the parties shared a fiduciary relationship and (2) the remedy at law is inadequate. Banks generally do not have a fiduciary relationship with their depositors, but one can arise if there is an established relationship of trust and confidence. A bank can create such a fiduciary relationship if it takes on additional responsibilities, receives greater compensation than from a typical transaction or exercises excessive control.

The District Court for the District of Columbia held that the children were not entitled to an accounting for the savings account. The Bank did not provide special services nor did the children rely on SunTrust to manage or control the assets. Therefore, the Bank did not owe fiduciary duties to Scherban or the children. The District Court accordingly dismissed the children’s claim for an accounting.

**EGW v. First Federal Savings Bank of Sheridan, 413 P.3d 106 (2018)**

**Wyoming strongly adheres to the notion that a testator has the absolute right to dispose of his property as he sees fit at his death assuming he is legally competent to do so, and therefore *in terrorem* clauses do not violate public policy even when an action challenging such a clause is brought in good faith or is based on probable cause**

Allen Willey created the Allen F. Willey Trust in 2001 (the “2001 Trust”) as a revocable trust to manage his assets during his lifetime and dispose of them at his death. Mr. Willey served as trustee during his life and initially named his son, Spencer, as successor trustee. The beneficiaries of the 2001 Trust were Spencer’s minor children, E.W. and A.W.

Mr. Willey amended the trust several times between 2006 and 2010 to add his wife’s daughter and granddaughter as beneficiaries and to remove Spencer as a beneficiary. In 2014 another amendment to the 2001 Trust was made to remove Spencer from his role as successor trustee and to replace him with First Interstate Bank of Sheridan. Further, an *in terrorem*, or “no-contest clause”, was also added to the 2001 Trust. The no-contest clause specifically stated a challenge by Spencer, Mr. Willey’s grandchildren, his sisters or their children, or anyone purportedly acting on behalf of any of them shall terminate any interest they had in the 2001 Trust.

Mr. Willey entered into a listing agreement with a real estate broker in 2013 to sell the Willey Ranch, an asset of the 2001 Trust. In an attempt to prevent the sale of the ranch, Spencer filed a Complaint for Injunction and Declaratory Judgment against (1) Mr. Willey in his individual capacity and as the Trustee of the Allen F. Willey Trust, and (2) Mr. Willey’s wife, Bertha. The Complaint sought to set aside the listing agreement for the ranch and remove Mr. Willey from the role of Trustee on the basis of incapacity. Spencer also alleged Bertha exercised undue influence over Mr. Willey. Spencer further asserted an oral agreement existed between his father and himself that Spencer was to inherit the Willey Ranch and therefore sale of the ranch would constitute a breach of that agreement.

Mr. Willey passed away during the proceedings. The trial court allowed Spencer’s claims to proceed to trial where the jury found the trust amendments were not a product of undue influence; this verdict was appealed and affirmed by the Supreme Court of Wyoming.

In 2016, while his first action was pending, Spencer filed the current action on behalf of his two minor children, E.W. and A.W. (the “Minors”). The Minors’ action sought an injunction preventing the sale of the Willey Ranch, a declaratory judgment that the *in terrorem* clause did not apply to them, removal of First Federal as Trustee and damages for First Federal’s alleged breach of fiduciary duties.

First Federal Savings Bank of Sheridan, Wyoming, in its capacity as the Successor Trustee of the 2001 Trust, as amended, and Irma Bertha Willey, Susan Williams, Martin Martinez, Leslie Lube, and Brittany Phillips (the “Defendants”) opposed the requested relief and moved for summary judgment on the grounds that the *in terrorem* clause voided the beneficial interests of the minors as a result of Spencer’s prior lawsuit.

The Minors argued that due to Spencer’s lack of standing, as determined by the trial court in the prior litigation, the *in terrorem* clause was not triggered. They also argued that the *in terrorem* clause should be declared void as a violation of public policy.

The trial court granted the Defendants’ Motion for Summary Judgment. The trial court rejected the Minors’ claims that Spencer had lacked standing to bring in the prior lawsuit. The trial court determined Spencer did have standing to challenge the 2010 Trust in the prior action and that challenge terminated the interests of E.W. and A.W. in the 2010 Trust. Further, the trial court determined *in terrorem* clauses do not violate Wyoming public policy.

Wyoming public policy favors an absolute right of an individual to dispose of their property as they see fit at their death. *In terrorem* clauses are enforceable regardless of the good faith or probable cause reasoning for instituting the action. The plain and unambiguous language of the document governs the interpretation of a trust agreement.

After de novo review, the Supreme Court of Wyoming affirmed the rulings of the trial court. The Supreme Court reviewed the findings of the 2014 action to confirm the trial court’s decision that Spencer no longer had an interest in the 2010 Trust after the jury held there was no undue influence. There was not a decision stating Spencer lacked standing to assert that challenge.

The Wyoming Supreme Court reviewed, in depth, the public policy argument advanced by the appellants. The opinion pointed out that Wyoming courts, including the Wyoming Supreme Court, have well established precedent that states it is “the absolute right of the testator to dispose of his property after death as he sees fit, provided he is legally qualified so to do and acts as the law directs.” The intent of the testator, as determined from the language of his will, controls the disposition of his property.

The Wyoming Supreme Court rejected the Minors’ argument that using the action of a parent to deprive the minor child of a property right violates constitutional provisions protecting minors and providing for due process and access to courts. The Wyoming Supreme Court, relying on decisions from other jurisdictions, found that beneficiaries do not have a right to testamentary bequests and are only granted those bequests subject to the testator’s conditions. Where the testator clearly states the conditions in his will, it is not up to the court to alter those conditions based on what it deems “fair”.

The Wyoming Supreme Court also rejected the Minors’ argument that Mr. Willey was alive at the time of the prior suit and therefore could have removed them as beneficiaries, but his failure to do so indicated he did not intend for them to be disinherited. The Wyoming Supreme Court distinguished all the cases the Minors cited to support this argument and therefore they were not persuasive to the court.

**In the Matter of the Will of E. Warren Bradway, 2018 WL 3097060 (N.J. Sup. Ct. App. Div., June 25, 2018)**

**New Jersey court admits to probate a codicil written entirely in the purported testator’s blood**

From 1997 to 2004, E. Warren Bradway and Marc Coleman were in a long-term relationship. Bradway and Coleman also operated a bed and breakfast together in Philadelphia. In 2001, Bradway executed a will naming Coleman as the primary beneficiary and executor of his estate.

In 2004, Bradway and Coleman ended their relationship. Bradway also won a judgment against Coleman related to the winding up of the bed and breakfast. Later that year, Bradway began a relationship with Kirston Baylock and eventually moved into Baylock’s New Jersey home.

In 2006, using his own blood as ink, Bradway drafted a codicil to his 2001 will. This codicil named Baylock as primary beneficiary and executor of his estate by directing that all references to Coleman in the 2001 will be replaced with Blaylock’s name. The codicil also referenced the 2001 will and partially forgave the judgment against Coleman.

Bradway died in April 2016. The next month, Bradway’s estate filed a petition to admit the 2001 will and the codicil to probate in the Chancery Division of the New Jersey Superior Court. Coleman filed an answer, claiming that the codicil was invalid.

At trial, DNA experts agreed that the blood used to write the codicil came from a full sibling of Bradway’s brothers. Handwriting experts testified that the signature on the codicil matched Bradway’s handwriting. However, Coleman’s handwriting expert testified that the signature could have been inserted later using manual or digital “cut-and-paste” techniques.

After the expert witnesses testified, the estate moved for a directed verdict to admit the codicil to probate. Coleman opposed the motion and promised to call two witnesses who would testify that the codicil was unsigned at Bradway’s death. Nonetheless, the trial court granted the estate’s motion and admitted the codicil to probate. Coleman appealed.

New Jersey law recognizes traditional wills executed in accordance with testamentary formalities and holographic wills where the document is signed and the material portions are in the testator’s handwriting. An unsigned document may also be admitted to probate if the proponent shows, by clear and convincing evidence, that the decedent intended the document to constitute his will, a codicil to his will, or a revocation or revival of his will or codicil.

The Appellate Division affirmed the trial court’s decision to admit the codicil to probate. The appellate court first concluded, because all the handwriting experts agreed the body of the codicil was written in Bradway’s handwriting, that there was clear and convincing evidence that Bradway wrote the codicil. The question then became whether there was clear and convincing evidence that Bradway intended the codicil to alter his 2001 will. On this point, the appellate court agreed that the trial court had correctly ruled there was

The appellate court ruled that the codicil’s references to the 2001 will, Coleman, and the bed and breakfast debt all established that Bradway intended to amend his will. Although Bradway’s use of his own blood was “eccentric”, that too evidenced that Bradway intended the document to be a codicil. Therefore, the trial court did not err by admitting the codicil to probate.

**Horgan v. Cosden, 2018 WL 2374443 (Fla. Dist. Ct. App. May 25, 2018), review denied, No. SC18-1112, 2018 WL 3650268 (Fla. July 30, 2018)**

**Early termination of a trust can only occur for the best interest of the beneficiaries when viewed in the light of the settlor’s intentions**

Yvonne S. Cosden created a revocable trust in 1993. This trust was amended and restated in 1998 and on January 24, 2004, as the Second Amendment to and Restatement of The Yvonne S. Cosden Revocable Trust Dated 7/29/93 (the “Trust”). Mrs. Cosden died in 2010, and the Trust became irrevocable. Joseph J. Horgan, Mrs. Cosden’s personal assistant and friend, and Christopher E. Cosden, her only child, are the successor co-trustees. The Trust provides Mr. Cosden the net income for life, and upon his death, three higher educational institutions receive the principal. The Trust did not include a provision about early termination but did include a spendthrift provision.

In August 2015, Mr. Cosden and the remainder beneficiaries entered into an agreement to terminate the trust early and divide the $3 million in trust assets between them based on the actuarial value of their interests. Mr. Horgan, as co-trustee, did not agree with the early termination. In October 2015, Mr. Cosden filed a suit against Mr. Horgan, as co-trustee, seeking to terminate the Trust and a court order directing the distribution of assets in accordance with the beneficiaries’ agreement. Mr. Horgan responded stating that the termination of the Trust was against the settlor’s wishes to provide for her son for the rest of his life.

Both Mr. Cosden and Mr. Horgan moved for summary judgment in their favor. The Florida trial court granted summary judgment in favor of Mr. Cosden. The trial court directed termination of the Trust as provided in the agreement relying on Florida statutes that allow a court to terminate a trust if termination is not inconsistent with the settlor’s purpose and is in the best interests of the beneficiaries. Mr. Horgan appealed.

Florida law allows termination of a trust when the modification or termination is not inconsistent with the settlor’s purpose and the trust’s purpose no longer exists, has been fulfilled, or has become illegal, impossible, wasteful, or impracticable to fulfill. A trust can also be terminated if such termination is in the best interest of the beneficiaries. However, it is not enough for the beneficiaries to all agree, rather, there must be evidence that the termination would not violate the settlor’s intent.

On appeal, the Second District Court of Appeals reversed and remanded the case, directing the trial court to enter a final order of summary judgement denying the termination of the Trust.

The Second District Court of Appeals held that the plain language of the Trust determines the settlor’s intent. The plain language showed Mrs. Cosden wanted to provide for her son financially via incremental distributions of income until he died and then give the remainder to the three educational institutions. The District Court found that early termination of the Trust would frustrate these purposes of the Trust. Here, the facts did not support a finding that Trust assets were being wasted, that the purposes of the Trust had been fulfilled or that an early termination was in the best interest of the beneficiaries when considered in view of the settlor’s intent.

**In Estate of Burkhalter, 806 S.E.2d 875 (Ga. Ct. App. 2017)**

**The probate court finding that the petitioners’ proposed declaratory judgment actions would not violate a will’s terrorem clause was wrongfully decided because (1) a question regarding the validity of an *in terrorem* clause must be raised and resolved in the first declaratory judgment action raising that issue, and (2) the request for a declaration that a future petition to remove the executors would not violate the *in terrorem* clause lacked sufficient specificity for the trial court to make the required analysis that such a request would not be a violation of the *in terrorem* clause**

The will of Louise Ray Burkhalter contained an *in terrorem* clause that read, in part, “[a]ny person … who attacks in any court of law any provision of my [will], or the administration of my estate … shall be specifically disinherited from any portion of my estate that would go to them.” Louise’s sons, William and John, were the executors of Louise’s estate, which was probated in the Bibb County Probate Court. Two of Louise’s other children, Nancy and George, filed a petition for declaratory judgement requesting a ruling that they could, without triggering the *in terrorem* clause of the will, file additional declaratory judgment actions regarding (i) the substantive provisions of the will, (ii) the *in terrorem* clause of the will, and (iii) removal of William and John as executors.

The probate court denied the declaratory judgment regarding the substantive provisions of the will, but entered a declaratory judgment permitting Nancy and George to file subsequent petitions regarding the *in terrorem* clause and to remove the executors, without triggering the *in terrorem* clause. The executors appealed.

As interpreted by case law, the Georgia Declaratory Judgment Act permits an interested party to seek a declaration concerning the validity of an *in terrorem* clause without triggering the *in terrorem* clause. Additionally, Georgia courts previously held that a declaratory judgment can be used, without triggering the *in terrorem* clause, to determine whether the proposed actions would violate the *in terrorem* clause.

On appeal, the Court of Appeals of Georgia overruled the Probate Court’s decision granting the petitioners’ declaratory judgment request. The Court of Appeals found no authority to support “a procedure by which an interested party may file one declaratory judgment action to determine whether it may file a second declaratory judgment action to determine the validity of an *in terrorem* clause. Rather, a question regarding the validity of an *in terrorem* clause should be resolved in the first declaratory judgment action raising that issue.”

The Court of Appeals also found that the probate court improperly granted the declaratory judgment request regarding the validity of an action to remove the executors.

The Court of Appeals explained that, although an action to remove executors is not necessarily a violation of an *in terrorem* clause, the petitioners did not provide the probate court with sufficient detail regarding their proposed removal action for the probate court to properly determine whether such action would be a violation of the *in terrorem* clause. The petition did not attach a proposed complaint seeking the executors’ removal or otherwise stating the basis for a suit to remove them. “Absent such allegations,” the Court of Appeals held that the record was insufficient to support the conclusion of the probate court that the “… proposed Petition to remove the executors [would] not violate the *in terrorem* clause.” Therefore, the Court of Appeals remanded the decision to the probate court to undertake the proper analysis.

**Smith v. Szeyller, 31 Cal. App. 5th 450 (2019)**

**A beneficiary who received notice but did not participate in litigation between another beneficiary and the trustees found herself with no recourse to object to the settlement reached between the litigating beneficiary and the trustees, even where the settlement agreement provided that a portion of the litigating beneficiary’s legal fees be paid out of the non-participating beneficiary’s trust share**

Mr. and Mrs. Smith created a trust naming their five children as beneficiaries. At Mr. Smith’s death, Mrs. Smith became the sole trustee of the trust. Mrs. Smith named her daughter, Joann, as her co-trustee, and Joann’s husband, Edward, as her successor trustee. After Mrs. Smith’s death, Joann and Edward served as co-trustees of the trust (the trustees).

One of Joann’s brothers, Don, objected to an accounting the trustees provided and filed a verified petition questioning trust expenditures and gifts made to Joann and Edward from the trust before Mrs. Smith’s death. Don’s petition requested that the court freeze the trust assets, remove the trustees and pay Don’s attorney’s fees from the trust assets. The trustees agreed to freeze trust assets, make a distribution of $200,000 to each of the beneficiaries before trial and revised their accountings. The trustees petitioned the court for approval of their revised accountings. Don filed objections and a petition for financial elder abuse. The other three siblings — Donna (through her conservator), Dave and Dee — were all notified of the petitions but did not respond. Additionally, Don specifically asked Donna (through her conservator) if she wanted to join the litigation and she declined.

After three days of trial, the trustees advised that they had revised their accountings again to address Don’s concerns. The trustees and Don then reached a settlement agreement that the court approved. The agreement provided, in part, for the payment of Don’s attorney’s fees from the trust assets. Donna (through her conservator) filed post-trial motions for a new trial and to vacate the judgment on the grounds that she had been denied due process and challenging the award of attorney’s fees.

In general, the “American rule” requires successful litigants, including a beneficiary challenging the actions of a trustee, to pay their own attorney’s fees. An exception to this rule is the “common fund doctrine,” which permits the court to require that non-litigants who receive a pecuniary benefit as a result of the litigation bear a portion of the legal fees. The substantial benefit doctrine extends the common fund doctrine to permit a court to require passive parties who receive non-pecuniary benefits as a result of litigation to bear a portion of the legal fees.

On appeal, the California Court of Appeals affirmed the trial court’s ruling and upheld the settlement agreement, including the award of attorney’s fees from trust assets. The Court of Appeals rejected Donna’s due process argument because Donna had been notified about the litigation and chose not to participate. Because Donna chose not to participate in the litigation, the California Court of Appeals determined that she was not entitled to additional notice regarding the proposed settlement agreement, which addressed matters already before the court. Additionally, the Court of Appeals found that the award of attorney’s fees and the application of the substantial benefit doctrine were appropriate in this case because the non-participating beneficiaries received the benefit of more accurate trust accountings, refunds to the trust from the trustees and a stop to further inappropriate depletion of the trust assets by the trustees, all of which benefitted all of the beneficiaries, not just the litigating party.

The substantial benefit theory has rarely, if ever, been applied in the trust context before. Further application of the substantial benefit theory in the trust context may lead more disgruntled beneficiaries to act unilaterally to initiate litigation if there is a possibility to spread their legal fees amongst all the beneficiaries even without their consent. At the same time, beneficiaries who previously may have been disinclined to join in litigation may be more likely to do so based on this case. As Donna learned the hard way in this case, by failing to participate in the litigation, a beneficiary may lose her seat at the negotiating table and miss the chance to object to settlement terms with which she disagrees, such as payment of fees out of her trust share.

**Matter of Fund for Encouragement of Self Reliance, 440 P. 3d 30 (2019) (4th Dist., April 25, 2019)**

**Where the terms of a charitable trust appointed multiple trustees and did not explicitly provide that the trustees could act alone, consent by all of the co-trustees was required to decant the trust, despite the reference in the decanting statute to “a Trustee,” in the singular**

The terms of a charitable trust appointed co-trustees. The trust did not include provisions giving any one trustee the ability to act unilaterally. When a dispute arose among the co-trustees, the 8th Judicial District Court, Clark County, Nevada, ordered that half of the property be decanted into a new trust with the same purpose as the original trust, but to be administered by only one of the original trustees, against the objection of the co-trustees. The co-trustees appealed on the grounds that consent of all of the co-trustees was required to decant the trust.

The Nevada decanting statute provides that “unless the terms of … [the] irrevocable trust provide otherwise, a trustee with discretion or authority to distribute trust income or principal to or for a beneficiary of the trust may exercise such discretion or authority by appointing the property subject to such discretion or authority in favor of a second trust as provided in this section.” NRS 163.556(1). The term “trustee” is defined by NRS 163.500 to mean “a trustee, trustees, person or persons possessing a power or powers referred to in [the Charitable Trust Act].” The governor of Nevada amended that law on June 5, 2019, but not in a way that substantively changed the law relied on in this case.

The Nevada Supreme Court overruled the lower court and held that the decanting statute does not permit decanting of the trust without the consent of all of the trustees. In reaching its decision, the Nevada Supreme Court noted that, in relevant part, the trust provided that the “*Trustees* … may, in *their* discretion” manage trust property and income (emphasis added by the Nevada Supreme Court). Quoting Bogert’s *Law of Trusts and Trustees*, the Nevada Supreme Court explained, “In the absence of statute or contrary direction in the trust instrument, the trustees are regarded as a unit.”

Because neither the statutory definition of trustee, nor the terms of the trust contradicted that presumption, the Nevada Supreme Court found that the unanimous consent of all of the co-trustees was required to exercise a discretionary power, including the statutory decanting power. However, because the Nevada Supreme Court found consent from all of the co-trustees was required, they did not need to address the issue of whether the Nevada decanting statute even applies to charitable trusts.

This case is a reminder to practitioners to be deliberate in drafting and to be aware of statutory default rules regarding the ability or inability of trustees to take unilateral action.

**In re Deborah Dereede Living Trust dated December 18, 2013, 2019 WL 1549157 (S.C. App. April 10, 2019)**

**A trustee’s reasonable, good-faith departure from the express terms of a trust nevertheless constituted a breach of fiduciary duty**

Courtney Feely Karp was the personal representative of the estate of her mother, Deborah Dereede (the decedent), and the successor trustee of the decedent’s revocable trust agreement, which became irrevocable at the decedent’s death. The decedent’s revocable trust agreement provided that “as soon as practicable” after the decedent’s death, the trustee should sell certain real property, discharge the mortgage secured by the property and distribute one-half of the net proceeds of sale to Karp’s stepfather, Hugh Dereede.

Because she was also serving as personal representative of the decedent’s estate, Karp believed that she could not sell the real property and distribute the proceeds until the time for creditor’s claims against the estate expired. Hugh Dereede disagreed and brought an action in the applicable South Carolina Circuit Court. In response, Karp claimed Dereede violated a no-contest clause in the decedent’s revocable trust by initiating the lawsuit. The Circuit Court ruled that Karp breached her fiduciary duties by failing to sell the real property and distribute the property to Dereede as soon as possible. Karp appealed.

A trustee is obligated to administer a trust in accordance with its express terms. In particular, a trustee must adhere strictly to express directions as to how and when to dispose of trust property. While personal representatives often must delay the distribution of assets until the personal representative determines that the estate has sufficient liquidity to satisfy all creditors’ claims, that rule does not apply in the case of trustees. According to the Court of Appeals, a trustee breaches her fiduciary duties by failing to act in strict compliance with the terms of the trust agreement, even if the trustee does so reasonably and in good faith. Furthermore, according to the appellate court, a no-contest clause in a will or trust agreement cannot be enforced against an interested person who has probable cause to contest the validity of the document or the actions of the fiduciary.

The Court of Appeals upheld the Circuit Court’s decision, finding that Karp breached her fiduciary duties by failing to take any action to sell the real estate within six months of the decedent’s death. The Court of Appeals also held that Dereede did not trigger the no-contest clause in the trust agreement because he had probable cause for bringing his action against Karp.

A trustee’s bad faith nearly always constitutes a breach of fiduciary duty. This case is a reminder that even a trustee’s reasonable, good-faith actions can still constitute a breach of trust when the trustee’s actions violate the express terms of the trust.

**Campbell v. Commissioner, T.C. Memo 2019-4 (2019)**

**U.S. Tax Court respected a foreign asset protection trust and held that the IRS could not consider the trust assets in determining the taxpayer’s assets for purposes of collecting a tax liability**

In 2002 and while a resident of Connecticut, John F. Campbell filed his personal income tax return for 2001. Campbell’s return reported taxable income of just over $20,000 and a tax liability of about $60,000.

Near the end of 2002, Campbell and his family moved to the island of St. Thomas in the U.S. Virgin Islands. In 2004, while a resident of St. Thomas, Campbell created the First Aeolian Islands Trust pursuant to the law of Nevis, West Indies. Campbell named Meridian Trust Co. Ltd. as the initial trustee, although the trust protector, who held the power to remove and replace the trustee, later replaced Meridian Trust with Southpac Trust Nevis Ltd. The trust was structured as an irrevocable foreign asset protection trust. Campbell funded the trust with $5 million in cash and marketable securities.

At the time he created the trust, Campbell had a net worth of approximately $25 million. Campbell and members of his family could receive distributions from the trust in the sole discretion of the trustee, but Campbell never received any distributions of trust assets. Campbell could not appoint or remove the trustee nor direct the trustee to make any distributions or investments. The trust was a grantor trust as to Campbell for federal income tax purposes.

During 2001, Campbell had engaged in a tax shelter transaction (a custom adjustable-rate debt structure, or CARDS transaction). In 2004, the IRS initiated an examination of Campbell’s 2001 income tax return. In 2006, Campbell made a $27 million investment in the “GO-Zone” initiative in the U.S. Gulf Coast Region. Campbell’s investments consisted of commercial and residential real estate. In 2009, about half of the residential real estate was declared uninhabitable because it had been built using toxic drywall.

As a result of the drywall issues and the 2008 housing crash, Campbell’s investments generated an approximately $10.5 million net operating loss. Through a series of transactions in 2009, Antilles Offshore Investors Ltd., which was a subsidiary of Antilles Master Fund, a foreign entity the trust created, loaned money to one of Campbell’s business entities in the Gulf Coast Region. Because of personal guarantees on a number of other loans, Campbell effectively became insolvent by 2010.

In 2007, the IRS completed its examination of Campbell’s 2001 return and issued a notice of deficiency for approximately $13.9 million. Campbell filed a petition with the U.S. Tax Court contesting the deficiency. Campbell and the IRS ultimately settled and Campbell was able to deduct his net operating loss carryback against his 2001 deficiency. The settlement left Campbell with an approximately $1 million deficiency and a $100,000 accuracy-related penalty.

In 2010, the IRS issued a notice of intent to levy against Campbell’s assets, to which Campbell objected. In 2012, Campbell filed a petition with the Tax Court seeking to bar the levy. The Tax Court remanded the petition to the IRS Appeals Office.

At the Appeals Office hearings, Campbell submitted an offer in compromise on the basis of doubt of collectability and offered to settle all his outstanding debts for $12,603. The IRS stated that Campbell was ineligible for doubt of collectability status because he had “net realizable equity” of approximately $1.5 million in the trust. As negotiations collapsed, the IRS increased Campbell’s reasonable collection potential to more than $19.5 million by including the $5 million Campbell placed in the trust as dissipated assets. In 2018, the IRS formally rejected Campbell’s offer in compromise. Campbell appealed to the Tax Court.

The Tax Court reviews the IRS’ administrative determinations for abuse of discretion. Section 7122(a) of the Internal Revenue Code permits the IRS to compromise civil cases arising under the Internal Revenue Code. Regulations promulgated under Section 7122 list three grounds for compromise: (1) doubt as to liability, (2) doubt as to collectability and (3) promotion of effective tax administration.

Doubt as to collectability exists when the taxpayer’s income and assets are less than the amount of the tax liability. Doubt as to collectability is assessed on the basis of the taxpayer’s reasonable collection potential. A taxpayer’s reasonable collection potential is based on (1) assets, including dissipated assets; (2) future income; (3) assets collectible from third parties; and (4) assets available to the taxpayer but beyond the reach of the government.

Dissipated assets include assets that the taxpayer sold, transferred, encumbered or disposed of in an attempt to avoid the tax liability after the tax was assessed or for up to a period of six months before the assessment. According to the U.S. Supreme Court, assets collectible from third parties include assets that a third party is holding as a nominee or alter ego of the taxpayer.

The “nominee theory” focuses on whether the taxpayer is the true beneficial owner of the property. The “alter ego” theory focuses on whether the taxpayer has pierced the corporate veil. According to the Supreme Court, both theories look first at what rights the taxpayer has in the property under state law and then at federal tax law to determine whether the taxpayer’s rights constitute a property right for collectability purposes.

The Tax Court ultimately found that the IRS abused its discretion in considering the trust an asset for purposes of Campbell’s reasonable collection potential. The Tax Court held that the $5 million Campbell placed in the trust were not dissipated assets. Campbell placed the assets in the trust in 2002, three years before the IRS informed Campbell his 2001 return was under examination, six years before the assessment of the deficiency and 10 years before his offer in compromise. Accordingly, the transfer to the trust was beyond the permissible period for inclusion as a dissipated asset. Furthermore, even if the transfer to the trust took place within the permitted periods, Campbell had a net worth of over $25 million at the time he funded the trust.

The Tax Court also held that the trust was not considered an asset Campbell could collect from a third party. In making this finding, the Tax Court focused on two facts. First, Campbell had no control over the trustee and could not force the trustee to make distributions or investments. Second, Connecticut law, which governed Campbell’s state law rights in the trust at the time the tax deficiency arose in 2001, did not have a developed body of law as to whether Campbell had any property rights in a foreign asset protection trust. Because the IRS could not defend its position that Campbell had a property right in the trust under state law, the Tax Court held that the IRS’ position that the trust was available to Campbell was an abuse of discretion.

Finally, because Campbell did not have sufficient control over the trustee or the trust to compel a distribution or investment, the Tax Court held that the trust was not an asset of Campbell’s beyond the reach of the government. The Tax Court made this finding despite the IRS’ argument that Campbell had the de facto right to remove and replace the trustee through the trust protector and that the trustee loaned money to Campbell’s business at Campbell’s effective direction.

This case demonstrates that the Tax Court will respect a properly structured foreign asset protection trust. Most reported decisions involving asset protection trusts have held that the transfers to the trusts were fraudulent transfers or voluntary conveyances. Recently, however, cases with facts favorable to grantors have resulted in findings that respect asset protection trusts. In this case, the Tax Court respected a foreign asset protection trust when the trustee was fully independent of the grantor, the grantor could not remove or replace the trustee, the trustee had total discretion over distributions and investments, the grantor created the trust while the grantor was solvent, and the grantor had received no distributions from the trust.

**Gibbons v. Anderson, 2019 Ark. App. 193 (April 3, 2019)**

**Arkansas Court of Appeals held that the arbitration provision in a trust agreement was unenforceable in a suit challenging the validity of the trust on grounds of undue influence**

Woodrow W. Anderson Jr. executed a trust agreement on April 1, 2014, with himself as initial trustee, and his children, Woodrow Anderson III and Kandice Gibbons, as successor trustees. The trust provided that the trust would pay for the college educations of all grandchildren of the grantor up to $100,000 total, and no more than $25,000 each. Each grandchild was to receive a car, not to exceed $30,000, after completing one semester or two terms in college. The trust further provided that each grandchild was to receive $500 per month for expenses.

On Nov. 7, 2014, Woodrow Jr., Woodrow III and Gibbons executed the first amendment to the trust, making several significant changes to the terms of the trust. Woodrow Jr. was in poor health and under the influence of narcotics at the time. He died 17 days later.

On Jan. 4, 2017, Seth Anderson and Trevor Anderson, grandchildren of Woodrow Jr., filed a complaint for breach of trust, alleging that the amendment was executed as a result of undue influence and that the changes to the terms of the trust were not in the best interests of the beneficiaries. Specifically, the amendment gave the trustees the sole discretion to make distributions for education, and removed the specific provisions originally included. Seth and Trevor further alleged that the trustees had breached the trust and acted in bad faith by failing to provide $500 per month for expenses and a vehicle as set forth by the original terms of the trust.

The complaint sought to set aside the amendment, to remove the trustees, to appoint new trustees, to obtain an accounting of the trust, to restore any funds improperly distributed under the amendment and to impose a constructive trust against any property improperly removed from the trust. They also requested a judgement against the trustees and the trust for the value of the vehicles that should have been purchased, the payment of $500 per month that should have been paid pursuant to the trust, and to recover the amounts the trustees had expended on educational expenses.

The trustees filed a motion to dismiss, or in the alternative, to compel arbitration in accordance with the arbitration clauses contained in the trust and the amendment. Seth and Trevor filed a response to the motion, alleging that the arbitration clause in the trust did not purport to bind the beneficiaries, and the arbitration clause in the amendment was not valid because the grantor was not competent at the time of execution of the amendment.

The trial court held that the question went to the integrity of the amendment and whether the grantor was under undue influence at the time of execution of the amendment, and that was a question for the court to decide, not an arbitrator. The trial court denied the motion to compel arbitration. The trustees appealed.

Arkansas law is silent on whether a trust may contain any arbitration provision, and Arkansas has not enacted a law addressing the applicability of an arbitration clause to a dispute concerning the validity of a trust.

The Court of Appeals stated that the dispute concerned the testamentary capacity of the grantor and the validity of the trust and the amendment, and that where there is an allegation of undue influence or incompetency of the grantor, arbitration cannot determine the validity of the trust. The Court of Appeals held that the validity of the trust and the amendment were within the jurisdiction of the trial court, irrespective of the arbitration provisions contained in both.

In holding that the question of trust validity was one for the court rather than arbitration, the Court of Appeals looked to statutes enacted in Florida and Arizona concerning arbitration clauses in trusts, both of which exclude disputes over the validity of a trust from arbitration. The court also looked to case law in California, where in *McArthur v. McArthur*, 224 Cal. App. 4th, 651 (2014), the California Court of Appeals denied a motion to compel arbitration as to the validity of a trust where a trust instrument contained an arbitration clause, thus indirectly holding that the validity of a trust agreement is not subject to arbitration.

Because Seth and Trevor sought to set aside the amendment on grounds of undue influence, this constituted a challenge to the validity of the instrument and therefore not an issue to be resolved through arbitration.

Practitioners should be cognizant of the enforceability of arbitration clauses contained in testamentary instruments under applicable state law, as well as the applicability of such clauses to questions of validity of the instrument. State laws on this issue continue to develop, and practitioners should review applicable state law developments before advising clients on the validity and enforceability of arbitration clauses in this context.

**In re Antonia Gualtieri Living Trust, 2019 WL 1265167 (Mich. Ct. App. March 19, 2019)**

**The court could not compel income distributions for payment of child support from a discretionary trust**

Charles Anton is the beneficiary of the Antonia Gualtieri Living Trust. Petitioner Linda Anton sought to compel the trustees of the trust to make income payments to Charles so Linda might seek payment of child support and alimony arrearages from Charles. The trial court denied Linda’s petition for distribution based on the fact that the trust is a purely discretionary trust, and that Linda was not entitled to compensation for the outstanding arrearages out of income distributions made to Charles from the trust. Linda appealed. On appeal, Linda and the trustees disagreed as to whether the trust at issue is a support or spendthrift trust, or a discretionary trust.

Pursuant to Michigan law, a discretionary trust allows the trustee to pay to the beneficiary as much of the income and principal as the trustee determines appropriate in his discretion, whereas a support trust allows a trustee to pay income and principal of the trust to the beneficiary for support, maintenance and welfare. A spendthrift trust provides that the beneficiary’s interest shall not be transferable or subject to the claims of creditors. Creditors cannot compel the trustee of a discretionary trust to pay any part of income or principal in order that the creditors be paid.

The Court of Appeals held that the trust at issue is a discretionary trust, not a spendthrift trust, and therefore Linda cannot compel income distributions in order to obtain compensation for unpaid child support and alimony.

The terms of the trust provided that the trustee “in its sole and absolute discretion, shall apply to, or for the benefit of Charles Anton as much of the principal from the trust as the Trustee deems advisable for his education, health, maintenance, and support.” Linda argued that the use of the term “shall” indicates mandatory distributions and therefore a support or spendthrift trust; the trustees argued that the use of the words “sole and absolute discretion” indicates a discretionary trust. The Court of Appeals held that while the term “shall” typically indicates a mandatory provision, the fact that the word “shall” is immediately preceded by the words “sole and absolute discretion” renders the trust discretionary.

The appellate court noted that, in attempting to construe a trust instrument, a court must ascertain and give effect to the settlor’s intent. Here, the trust document states multiple times that the trustees are permitted to use their “sole and absolute discretion.” The trust document also contains provisions providing guidelines for discretionary distributions, including: (1) conservative exercise of discretion, (2) consideration of other income and resources available to the beneficiary, and (3) preservation of assets as the primary purpose. Taken together, it was clear to the court that the trust does not mandate distributions to Charles, regardless of the use of the term “shall.”

The Court of Appeals also noted that the Michigan Trust Code provides further support for the holding that the trust is discretionary, citing MCL 700.7102(D). That statutory provision defines “discretionary trust provision” to mean “a provision in a trust . . . that provides that the trustee has discretion . . . to determine,” among other decisions, whether to make distributions, in what amount, when and to whom.

Lastly, the Court of Appeals addressed Linda’s argument that public policy supports the argument that she be compensated for the arrearages via income distributions from the trust. The case law Linda cited in support of such argument applied specifically to spendthrift trusts. Because the trust at issue is a discretionary trust, the court rejected Linda’s public policy argument.

State law determines the type of trust and the access rights of creditors. Practitioners should carefully review the distribution language of a trust and applicable state law to determine whether a trust is considered a discretionary trust, support trust or spendthrift trust, and be cognizant of the rights of creditors to access the assets of each such trust.

**Ray v. Ready, 296 Va. 553 (Dec. 20, 2018)**

**Supreme Court of Virginia affirmed the dismissal of a lawsuit that named the estate of the decedent rather than the personal representative as a party. The court further held that the plaintiff could not amend her complaint under the “safe harbor”**

Keith Ready executed a holographic will that excluded his wife, Patricia Ray. After Ready’s death, the will was admitted to probate on Aug. 25, 2016, and Katherine Ready qualified as administratrix of the estate. Ray filed a lawsuit to claim her elective share of the augmented estate.

In her complaint, Ray styled the lawsuit “Patricia L. Ray v. Estate of Keith F. Ready.” But Ray directed the summons to Katherine Ready as administratrix of the estate. Katherine answered the complaint and signed it “Katherine E. Ready, Administratrix c.t.a. of the Estate of Keith F. Ready.”

At an evidentiary hearing on March 3, 2017, Katherine pointed out that Ray had failed to name Katherine in her capacity as administratrix. Therefore, Katherine argued that the lawsuit was a nullity and the only remedy was dismissal. Furthermore, because the statute of limitations period had passed, Katherine argued that Ray could not be allowed to amend her complaint.

Ray responded that Katherine had in fact appeared before the court in her capacity as administratrix. Ray noted that Katherine signed her answer to the complaint in a fiduciary capacity, and that the summons named Katherine as administratrix of the estate. Ray asked the court to add Katherine, as administratrix of the estate, as a defendant in the case rather than dismiss the case.

The Circuit Court for Henrico County agreed with Katherine that the complaint was styled incorrectly. It also held that the only remedy was dismissal of the case. The court dismissed the case and held that the statute of limitations barred Ray from amending her complaint. Ray appealed.

Lawsuits in Virginia must be prosecuted by and against living parties, either in their individual or representative capacity. A lawsuit in the name of a fiduciary must identify the fiduciary’s name, the nature of the fiduciary relationship and the name of the subject of the fiduciary relationship.

Virginia law provides a “safe harbor” which allows a party to retroactively amend its pleading if the pleading otherwise identifies the proper parties in the case. This safe harbor allows a party to correct its pleadings and maintain a lawsuit even after the statute of limitations period has passed.

The Supreme Court of Virginia agreed that Ray should have named Katherine, as administratrix, as the defendant. Ray’s complaint did not identify a party in either her individual or fiduciary capacity. Therefore, the Supreme Court affirmed the trial court’s ruling that dismissal was the only remedy. Because the statute of limitations period had passed, the Supreme Court also upheld the trial court’s decision to dismiss the case with prejudice.

Furthermore, the Supreme Court noted that Ray did not identify Katherine as administratrix in the caption or the body of her complaint. Accordingly, the Supreme Court held that Ray’s complaint failed to identify the proper party and that Ray could not retroactively amend her complaint under the safe harbor provision.

Attorneys must pay careful attention to the rules for captioning cases brought by or against fiduciaries. In Virginia, it is critical that the fiduciary itself be named in the pleadings, rather than the subject of the fiduciary relationship (such as an estate or trust). While certain safe harbors exist, these safe harbors may be strictly applied.

**In re Estate of Rabin, 2018 WL 6801812**

**Colorado Court of Appeals held that the personal representative was entitled to the decedent’s file with the decedent’s former attorney**

Mark Freirich represented Louis Rabin in several matters over Louis’ lifetime, including the preparation of promissory notes payable to Louis’ former spouse, Suyue Rabin.

After Louis died, his surviving spouse, Claudine, qualified as personal representative of Louis’ estate. During the administration of the estate, Claudine issued a subpoena to Freirich for Louis’ file. Freirich responded with a motion to quash the subpoena on the grounds that disclosure would violate the attorney-client privilege. Claudine later identified the files related to the promissory notes as being particularly relevant. Freirich produced those files, but he refused to produce Louis’ other files.

The trial court ruled in favor of Freirich and awarded him attorney’s fees. While Claudine’s motion to reconsider was pending, Claudine and Suyue settled the claims related to the promissory notes. In denying Claudine’s motion to reconsider, the trial court found that the controversy would soon be resolved and the files were not necessary to evaluate the claims against Louis’ estate. Claudine appealed.

The personal representative of an estate is entitled to take control or possession of the decedent’s probate estate. Furthermore, the personal representative succeeds the decedent as the client and the holder of the attorney-client privilege established during the decedent’s lifetime.

The Colorado Court of Appeals held that Claudine was entitled to Louis’ entire file. As the personal representative of Louis’ estate, Claudine was entitled to take possession of Louis’ entire probate estate. A deceased client’s file with his prior attorney is not an asset that can be inherited or transferred. However, it is still the property of the client during his lifetime and the property of the estate after the client’s death. Therefore, the personal representative has a right to take possession or control over it.

Furthermore, the court held that a decedent’s estate includes intangible personal property, such as legal claims against third parties. Claudine, as personal representative, was responsible for bringing those claims on behalf of the estate. Information contained in Louis’ file may have been necessary for her to recognize and prosecute those claims. Claudine could not effectively perform her duties as personal representative without access to the file.

The Court of Appeals also held that Claudine, as personal representative, stepped into Louis’ shoes as Freirich’s client. Therefore, Freirich could produce Louis’ file to Claudine without violating the attorney-client privilege.

The personal representative of an estate steps into the shoes of the decedent. Accordingly, the personal representative has the right to take possession or control of the decedent’s property, including files in the custody of the decedent’s former attorney. A decedent’s attorney should be aware of this right and so advise the client when drafting estate planning documents for the client.

**Ali v. Smith, 554 S.W.3d 755 (Tx. Ct. App. 2018)**

**Texas Court of Appeals affirms trial court order holding that arbitration was not compelled under will or Texas Arbitration Act**

Shafqat Ali was named as an executor under the will of Amjad Sultan. Following Sultan’s death, Ali qualified as executor of Sultan’s estate. Ali resigned as executor after a beneficiary filed an action alleging several breaches of fiduciary duty. After Ali’s resignation, no other executors were named in the will. Therefore, Darlene Smith was appointed as administrator of the estate.

As administrator, Smith sued Ali. In response, Ali filed a motion to compel arbitration. Ali relied on the Texas Arbitration Act and a term of the will which provided that, if a dispute arose under the will, the dispute must be resolved by arbitration. Although the Texas Arbitration Act generally requires the parties to be signatories to an agreement, Ali argued that Smith’s claims were made under the auspices of the will. Ali also argued that Smith received benefits under the will in the form of fiduciary compensation.

The trial court denied Ali’s motion to compel arbitration. Ali appealed.

The Texas Arbitration Act generally applies only to agreements between two or more parties. However, an arbitration clause may be enforced against a party who did not sign the agreement if the party receives substantial benefits under the agreement.

The Texas Court of Appeals, 14th District, affirmed the trial court’s denial of Ali’s motion to compel. Smith’s lawsuit did not allege Ali had violated the terms of the will. Instead, Smith alleged that Ali had violated state law. Therefore, Smith’s claim was not grounded in the terms of the will. The court contrasted Ali’s argument against a case where a beneficiary alleged the trustee had violated the terms of the trust. In that case, the arbitration clause was enforceable because the beneficiary’s argument was grounded in the trust instrument.

The Court of Appeals also rejected Ali’s argument that Smith’s fiduciary compensation was a substantial benefit under the will. Texas law authorizes an administrator to receive compensation even if there is no will. Because Smith was entitled to compensation under state law, her compensation did not amount to a substantial benefit under the will.

An arbitration clause may be enforceable against a beneficiary or fiduciary who did not negotiate the instrument containing the arbitration agreement if he or she obtains substantial benefits under the agreement. However, attorneys should distinguish between claims arising under state law and claims arising under the terms of the instrument.

Attorneys should also consider whether the claim implicitly recognizes the validity of the instrument. For example, in a 2014 case, a California court held that a beneficiary was not bound by an arbitration clause because she claimed that the trust amendment that created the arbitration requirement was produced by undue influence. The McGuireWoods Fiduciary Advisory Services summary of that case is available [here](https://www.mcguirewoods.com/client-resources/Alerts/2014/6/Recent-Cases-of-Interest-to-Fiduciaries).

**In re the Macy Lynne Quintalla Trust, 2018 WL 4903068 (Tex. App. 2018)**

**Failure to provide a means to remove and replace trust protector leads to litigation; trust protector not an “interested person” in the trust with the authority to request trust accountings**

In 2014, Oscar Leo Quintanilla (“Grantor”) created three substantially similar trusts for the benefit of his three children (“2014 Trusts”). He named Paul Perry (“Perry”) as trustee and Andrew Bradford West (“West”) as trust protector. Under the governing instruments of the 2014 Trusts, the trust protector’s sole power was to remove and replace the trustee. The governing instruments did not specify how to remove or replace the trust protector. The governing instruments, however, gave the trustee “in its discretion” the power to merge each of the 2014 Trusts with any similar trust created for the benefit of the same beneficiaries.

Shortly after the Grantor created the trusts, he and West had a falling-out. West, however, remained trust protector of the Trusts because no mechanism existed for his removal. West attempted to exercise his right to remove Perry as trustee and replace him with a corporate fiduciary. To prevent Perry’s removal as trustee, the Grantor in 2016 created three new trusts substantially similar to the earlier 2014 Trusts (“2016 Trusts”). Perry then exercised his authority under the governing instruments of the 2014 Trusts to merge each of the 2014 Trusts with its respective 2016 Trust. Perry provided notice to all the trust beneficiaries, who ratified the merger.

Perry then filed a declaratory judgment action in the Probate Court of Bexar County, Texas, asking the court to declare that the merger was valid and that West was not an “interested person” entitled to notice of the merger. West counterclaimed, asking the court to hold that Perry could not merge the 2014 Trusts with the 2016 Trusts or, alternatively, that West was an “interested person” and therefore entitled to an accounting of the 2014 Trusts up through the date of the merger. The trial court held that the trust mergers were valid and that West was not an interested person. West appealed.

The Texas Trust Code gives a trustee the power to combine two or more trusts “without a judicial proceeding if the result does not impair the rights of any beneficiary or adversely affect achievement of the purposes” of the trusts. Before merging trusts, a trustee must first give notice to “each beneficiary who might be then entitled to receive distributions from the separate trusts being combined.” Under Texas law, an “interested person” in a trust is a trustee, beneficiary, or “any other person having an interest in or a claim against the trust or any person who is affected by the administration of the trust.” A person is “affected by the administration of the trust” when that person is involved in managing aspects of the trust or could receive any of the trust assets.

The Texas Court of Appeals affirmed the trial court’s judgement. The Court of Appeals held that Perry was entitled to merge the 2014 Trusts with the 2016 Trusts pursuant to both the Texas Trust Code and the terms of the governing instruments of the 2014 Trusts. Texas law obligated Perry to give notice only to the current income beneficiaries. Perry gave the proper notice and obtained a release for the merger.

The Court of Appeals also held that West was not an “interested person” entitled to an accounting of the 2014 Trusts. The Court of Appeals stated that settlors and other persons who do not manage trust property are not “affected by the administration of the trust.” In the Court’s view, the power to appoint fiduciaries does not affect management of trust property, and therefore does not implicate the administration of the trust that might otherwise require notice to the trust protector.

Grantors of dynasty trusts are increasingly appointing trust protectors, trust advisors, and other third-persons who have the power to supervise trustees, amend the trust, appoint fiduciaries, and exercise similar oversight powers. These trust “watchmen” often serve a useful function in adapting a trust to unforeseen circumstances and providing a more cost-efficient means of overseeing the trustee than relying on the beneficiaries to vindicate their rights in court. However, the trust protectors named in the governing document may not remain the best individuals to fulfill this role forever. Drafters of estate planning documents should include provisions in trust instruments governing the removal and designation of trust protectors and similar power holders in case irreconcilable conflict arises between the trust protectors and the other parties interested in the trust. Additionally, if part of the trust protector’s role is to supervise the trustee’s performance, then estate-planners should make sure that the trust protector has the requisite authority to demand information and accountings from the trustee.

**Walker v. Ryker, 2018 Cal. App. Unpub. LEXIS 6664 (2018)**

**A trust which provided for California law to apply to its interpretation and largely disinherited the testator’s daughter was valid under California law and did not violate California public policy, even where the grantor was purportedly domiciled in Chile or Argentina**

Douglas R. Tompkins founded The North Face and Esprit apparel lines. Before his death, he placed his assets in the Douglas R. Tompkins Revocable Trust with himself and Debra B. Ryker as the initial Co-Trustees (the “Trust”). Tompkins was survived by his wife, Kristin, and two daughters from a previous marriage, including Summer Tompkins Walker. Following Tompkins’s death in 2015, Kristin became successor Co-Trustee.

The trust provided that upon Tompkins’s death, Summer is only to receive selected items of Tompkins’s personal property. The trust document explicitly stated that Tompkins “intentionally and with full knowledge made no provision for any person, whether claiming to be an heir of the Trustor or not, except as specifically provided” in the trust agreement.

Six months after Tompkins’s death, Summer filed a petition in the Los Angeles Superior Court asking the court the determine the validity of the trust and its choice-of-law provisions (the Trust was governed by California law), alleging that Tompkins lived in South America at the time of his death and that the forced heirship laws applicable in Argentina and/or Chile should be applied to remove a portion of Tompkins’s assets from the trust and distribute them to her.

The Co-Trustees moved for summary judgment arguing that Section 21103 of the California Probate Code and the choice of law provision in the Trust required the application of California law to construe the Trust. Summer asserted that the laws of the decedent’s domicile should govern the distribution of his estate. The Superior Court granted the Co-Trustees’ motion for summary judgment and dismissed the case. Summer appealed.

Section 21103 of the California Probate Code provides: “The meaning and legal effect of a disposition in an instrument is determined by the local law of a particular state selected by the transferor in the instrument unless the application of that law is contrary to the rights of the surviving spouse to community and quasi-community property, or to any other public policy of this state applicable to the disposition.”

The Court of Appeals confirmed the ruling of the Superior Court holding that California law applied and that the choice-of-law provision was enforceable under Section 21103 of the California Probate Code. In the context of probate matters, California law specifically recognizes that a person may choose the law of any state to govern the disposition of their assets following their death and the courts will generally apply the selected law. This ruling is supported by the well-established precedent regarding testamentary intent and the duty of the court to ascertain and give effect to the intent of the maker.

The Court of Appeals noted that the trust contained a clear choice-of-law provision, directing that the trust be construed in accordance with California law. The Court of Appeals further emphasized that Summer’s argument that Tompkins was domiciled in Chile at the time of his death and that the trust’s choice-of-law provision should be disregarded accordingly, were without merit. Section 21103 of the California Probate Code is unambiguous and the plain meaning controls.

The Court of Appeals further held that Tompkins’s decision not to leave Summer any assets of significant value was not contrary to the public policy of California. California courts have long recognized the right of a parent to disinherit his or her children. California law presumes that the omission of a child from a will is intentional unless the child was born or adopted after the execution of the will. Accordingly, the Court of Appeals concluded that Tomkins’s failure to provide Summer with a portion of his estate at his death did not violate California’s public policy.

Lastly, the Court of Appeals addressed Summer’s assertion that Tompkins created the trust to evade Chilean law and that enforcing the trust would violate California’s public policy in favor of comity. The Court of Appeals applied an exception to the concept of comity, which precludes the application of foreign laws that are contrary to public policy of the forum state. The evidence offered by Summer to support the assertion that Tompkins structured his affairs in order to evade Chilean law failed to establish or even suggest that Tompkins’s trust was illegal under Chilean law. The Court of Appeals noted that the use of corporations and trusts is a common and legitimate means of avoiding taxation and avoiding forced heirships where applicable. The Court of Appeals therefore concluded that the principles of comity did not outweigh Tompkins’s directives and California’s public policy in favor of a testator’s freedom to dispose of his estate in the way he sees fit.

Practitioners should be cognizant of the effect of choosing a governing law other than that of the state of domicile of the grantor and should understand the potential challenges that may arise based on state legislature and public policy in determining the proper interpretation of the will or trust.

**Estate of Luce, No. 02-17-00097-CV (Ct. App. Texas 2018)**

**A testator who suffered physical injuries rendering him unable to speak and paralyzed from the chest down, but who suffered no head or brain injuries, validly executed a new will by communicating his preferences through a “blinking system” and directing the notary to sign on his behalf in the presence of a witness in accordance with Texas law**

Michael and Gayelynne met in 1987 and married in 1989. Both had children from prior marriages. In 1998, Michael executed a will (the “1998 Will”) naming Gayelynne as executor and giving his entire estate to her if she survived him. Michael had a distant relationship with his two daughters, and later adopted two of Gayelynne’s adult sons. Over the course of their 26-year marriage, Michael and Gayelynne separated four times, and Gayelynne filed for divorce three times. She filed for divorce for the last time in June 2015.

On October 11, 2015, Michael was in an ATV accident that left him paralyzed from the chest down, but the accident did not cause any head or brain injuries, and Michael continued to be alert and oriented as to person, time, and place. Before being intubated, he clearly communicated to hospital staff that he wanted his daughters, not his estranged wife, to make his decisions for him. Michael was subsequently intubated and left unable to speak.

On October 18, 2015, attorney Kevin Ferrier met with Michael and determined Michael’s wishes through a series of leading questions that Michael answered by blinking his eyes to indicated “yes” or “no.” Based on Michael’s answers, the attorney determined that Michael wanted to revoke all prior wills and leave his estate to his daughters. The attorney drafted the will and read it to Michael privately and then in the presence of a notary and two witnesses. The notary signed the will on Michael’s behalf, in the presence of the witnesses, the witnesses signed in Michael’s presence, and the will was notarized (the “2015 Will”). No one else was present in the hospital room.

Michael died on November 26, 2015. Gayelynne offered the 1998 Will for probate, and Michael’s daughters offered the 2015 Will for probate. Gayelynne contested the 2015 Will.

At trial a jury found that: (1) the 2015 Will was validly executed in accordance with statutory execution requirements, (2) Michael had testamentary capacity, (3) the 2015 Will was not a product of undue influence, (4) the 2015 Will revoked the 1998 Will, and (5) Gayelynne did not bring her suit in good faith. The 2015 Will was admitted to probate by a trial judge who subsequently lost reelection. The replacement judge vacated the lack of good faith ruling and awarded attorneys’ fees to Gayelynne to be paid by the estate. Both sides appealed.

Pursuant to Texas Estates Code Section 251.001, a person must be of sound mind to execute a valid will. Testamentary capacity requires that the person understand that he is making a will, the effect of the will, and the general nature and extent of his property. Texas Estates Code Section 251.051(2) allows a notary to sign for a person who is physically unable to sign or make a mark if directed to do so by that person, in the presence of a witness who has no legal or equitable interest in any real or personal property that is the subject of, or is affected by, the document being signed.

On appeal, the Court of Appeals affirmed the validity of the 2015 Will, but reversed the decision to vacate the finding that Gayelynne had brought her suit in bad faith. With respect to the validity of the 2015 Will, the Court of Appeals held that there was sufficient evidence to support the jury’s finding that the 2015 Will was properly and validly executed.

The attorney, the notary, and both witnesses testified that the attorney and Michael established a blinking system to communicate, that through the blinking system Michael confirmed that he understood the execution process, that the notary was signing the will for him, and that he was requesting the notary to sign for him. The notary further testified that she signed the will at Michael’s direction. Therefore, the Court of Appeals held that there was some evidence to support the jury’s finding that Michael directed another person to sign the 2015 Will for him.

Gayelynne challenged Michael’s capacity to make the 2015 Will, specifically his ability to understand the contents of the 2015 Will and that he knew the “natural objects of his bounty and their claim on him.” Medical records confirmed that Michael did not suffer head or brain injuries as a result of the accident. The attorney testified that Michael had testamentary capacity, and was awake, alert, and lucid. A doctor who examined Michael two days after the execution of the 2015 Will testified that Michael was competent and able to make his own decisions, financial and medical, and that Michael had sufficient mental ability to make the 2015 Will two days before. Based on this evidence, the Court of Appeals held that there was some evidence to support the jury’s finding that Michael had testamentary capacity to sign the 2015 Will.

Gayelynne also challenged the finding that Michael’s sister, Tina, did not unduly influence Michael. The Court of Appeals held that exertion of undue influence cannot be inferred by opportunity alone and there must be some evidence that the influence was not only present but was in fact exerted in connection with the making of the will. The Court of Appeals stated that “although weakness of mind and body caused by infirmities of disease, age, or otherwise may be considered as material in establishing the testator’s physical incapacity to resist or the susceptibility of his mind to an influence exerted, such weakness does not establish that his mind was in fact overpowered or subverted at the time the will was executed . . . Influence is not undue unless it destroys the testator’s free agency and the testament produced expresses the will of the person exerting the influence.” The Court of Appeals held that while Michael was in physical distress, he was not experiencing mental distress which would render him susceptible to undue influence.

Lastly, the Court of Appeals held that the replacement judge erred in vacating the jury’s finding that Gayelynne brought her suit in bad faith and awarding her attorneys’ fees because there was sufficient evidence to support the jury finding. Gayelynne was aware before the trial that Michael told hospital staff he was getting divorced and didn’t want Gayelynne involved in his care in any way.

Practitioners drafting and overseeing the execution of wills and trusts by alternative communication means should be aware of the specific execution requirements of the state whose laws apply, take precautionary steps to ensure that the testator or grantor is competent and has a full and complete understanding of the communication means utilized to dictate their wishes, and direct the execution of such documents. Videotaping of the execution ceremony in unique or unusual circumstances may be beneficial and thwart later challenges on the basis of lack of capacity or undue influence.

**In re Wilson, 300 Neb. 455, 915 N.W.2d 50 (2018)**

**Supreme Court of Nebraska holds that trial court order removing siblings as trustees of revocable trust did not also remove the siblings as trustees of a sub-trust created under the revocable trust agreement**

Henry B. Wilson Jr. created the Henry B. Wilson Jr. Revocable Trust (the “Revocable Trust”) under agreement dated as of June 27, 2002 (the “Trust Agreement”). Henry died on December 23, 2010, survived by his three adult children, Lou Ann, Roseann, and Roger.

Under the terms of the Revocable Trust, upon Henry’s death, three separate sub-trusts were created for each of Lou Ann, Roseann, and Roger. Roseann and Roger were named as successor trustees of the Revocable Trust and as trustees of each child’s separate trust.

Roseann and Roger, as trustees of the Revocable Trust, transferred real estate interests from the Revocable Trust to the children’s separate trusts, but otherwise neglected to administer the separate trusts. Lou Ann filed a petition alleging Roseann and Roger had breached their fiduciary duties and asking the trial court to remove Roseann and Roger as trustees of the Revocable Trust.

The trial court agreed that Roseann and Roger had breached their fiduciary duties as trustees of the Revocable Trust and entered an order removing Roseann and Roger as trustees of the Revocable Trust. Lou Ann’s petition did not ask the trial court to remove Roseann and Roger as trustees of her separate trust nor did the trial court remove them as trustees of that trust.

Lou Ann appealed the trial court’s decision not to remove her siblings as trustees of her separate trust. The Nebraska Court of Appeals held that the trial court’s order had, in fact, removed Roseann and Roger as trustees of Lou Ann’s trust. Therefore, the Court of Appeals concluded that the trial court had not erred.

Roseann and Roger appealed the Court of Appeals’ decision to the Supreme Court of Nebraska.

A court will generally only consider issues addressed in the pleadings. Therefore, if a trust agreement creates multiple trusts, a court will typically only grant relief with respect to the trusts addressed in the pleadings.

The Supreme Court of Nebraska held that the trial court’s order did not remove Roseann and Roger as trustees of Lou Ann’s trust.

The Court noted that Lou Ann’s pleadings named Roseann and Roger as trustees of the Revocable Trust. Furthermore, Lou Ann only asked the court to remove Roseann and Roger as trustees of the Revocable Trust. The trial court proceedings also showed that the trial court had only considered whether Roseann and Roger had breached their fiduciary duty as trustees of the Revocable Trust.

Revocable trust agreements often create separate sub-trusts for children and grandchildren upon the grantor’s death. Attorneys, advisors, and fiduciaries must distinguish between the revocable trust and sub-trusts created under the trust agreement. If an attorney prepares documents (such as a court filings or non-judicial settlement agreements) for a trust, the documents should clearly identify the trust in question.

**In re Estate of Duane Frances Horton, 325 Mich. App. 325 (July 17, 2018)**

**An unsigned and undated electronic note on decedent’s phone was ruled a valid will where the proponents of the will could show, by clear and convincing evidence, that the decedent intended the electronic note to be his will**

Decedent’s handwritten suicide note stated that his “final note, my farewell” could be found on his phone. The suicide note provided instructions for accessing the final note. The suicide note was handwritten and unsigned. The final note was completely type written and existed only in electronic format (the “Electronic Note”). Decedent typed out his full name at the end of the Electronic Note, but did not otherwise sign the Electronic Note.

The Electronic Note contained farewell messages, funeral instructions and directions regarding the disposition of the Decedent’s possessions. The Electronic Note distributed assets to individuals other than the Decedent’s mother, who was the Decedent’s sole legal heir. During Decedent’s lifetime, Guardianship and Alternatives, Inc. (“GAI”) had served as Decedent’s court-appointed conservator.

GAI submitted the Electronic Note to the probate court as the Decedent’s will. The decedent’s mother filed a competing petition for probate alleging that Decedent died intestate. After an evidentiary hearing, the probate court concluded that the Decedent meant for the Electronic Note to constitute his will, and that the probate court would therefore honor the Electronic Note as a valid will. The Decedent’s mother appealed.

Michigan law allows for three types of valid wills: (i) formal wills; (ii) a document that qualifies as a holographic will; and (iii) a document or writing that the decedent intended to constitute his will (an “intended will”). *See* MCL 700.2502. A formal will must be in writing and signed by the testator and two witnesses. MCL 700.2502(1). A holographic will need not be witnessed, but must be dated, and the testator’s signature and the material portions of the will must be in the testator’s handwriting. MCL 700.2502(2).

The standard for proving an intended will is clear and convincing evidence of the testator’s intent that the document constitute his will. MCL 700.2503. Intent can be demonstrated by extrinsic evidence. MCL 700.2502. Pursuant to case law, the determination of whether the decedent intended a document to constitute his will turns on the question of whether the person intended the document to be a final statement of the posthumous distribution of his property.

On appeal, the Court of Appeals of Michigan affirmed the probate court’s decision to admit the Electronic Note to probate as the Decedent’s will. The Court of Appeals specifically rejected Decedent’s mother’s attempt to argue that an intended will must also meet the requirements of a holographic will. Instead, the Court of Appeals reviewed the extrinsic evidence of the decedent’s intent and ruled that the clear and convincing evidence standard had been met even though the Electronic Note did not meet the requirements for a formal will or a holographic will.

In reaching its decision, the Court of Appeals reasoned that the Electronic Note was clearly intended to be read after the decedent’s death based on the apologies and explanations for his suicide, funeral requests, final farewells and reflections on the afterlife. Further, the Court of Appeals found that the Electronic Note provided clear instructions for distribution of the decedent’s property upon his death. The Court of Appeals also considered the Decedent’s strained relationship with his mother and concluded that he specifically intended to direct assets away from his mother, who would otherwise have inherited his property. Given these facts, the Court of Appeals agreed with the probate court that the Decedent intended the Electronic Note to be his will, and therefore the Electronic Note should be considered a valid will. The Court of Appeals also awarded costs to GAI as the prevailing party.

Under the Michigan Court of Appeals ruling, the universe of viable claims against a will may be greatly expanded as litigants will face no bar of formalities other than production of a document that clearly evidences an intent that it constitute the decedent’s final will.

As of March 20, 2019, GAI had filed an answer to the Decedent’s mother’s application for appeal to the Supreme Court of Michigan. If the Court of Appeals ruling stands, fiduciaries, at least in Michigan, should consider whether they have a duty to confirm that no other writings - including in an email, on a tablet, or in the cloud - exist that a decedent might have “intended to be a will.”

**O’Connor v. O’Connor, 26 Cal. App. 5th 871 (4th Dist., Aug. 29, 2018)**

**A requirement that a power of appointment can only be exercised by a specific reference to that power in a will did not require the beneficiary to name the trust itself in his will**

John was a beneficiary of Sub-Trust A and Sub-Trust B governed by a trust created by John’s parents. John had no power of appointment over Sub-Trust A. Sub-Trust B granted John a general power of appointment over the trust property. The trust language specified that the power was exercisable “by a will specifically referring to and exercising this general testamentary power of appointment.”

Two weeks before his death, John executed a will that said “I exercise any Power of Appointment which I may have over that portion of the trust or trusts established by my parents for my benefit or any other trusts for which I have Power of Appointment I exercise [sic] in favor of my brother [Kevin].” John had two other siblings, Astrid and Brian, who would be beneficiaries with Kevin if John’s exercise of the power of appointment was not valid.

Kevin petitioned the probate court to establish the validity of the exercise power of appointment. Astrid and Brian objected and argued that the language in John’s will was not a specific reference and was therefore not a valid exercise of the power. The parties stipulated to having a judicial referee hear the matter.

After four days of trial, the referee issued a statement of decision finding that John’s exercise of the power of appointment over Sub-Trust B was valid. The probate court adopted the referee’s ruling as its own decision and declared Kevin the prevailing party. Brian and Astrid appealed.

By statute in California, a power of appointment can be exercised only by complying with any requirements as to the manner, time and conditions of the exercise specified in the creating instrument. The statute expressly prevents courts from excusing compliance with a donor’s specific reference requirement. Case law has found that a blanket statement exercising any power of appointment that may or may not exist to be insufficient to satisfy the specific reference requirement.

The California Fourth District Court of Appeals affirmed the probate court’s decision and held that the language of the will contained sufficient detail to constitute a specific reference to the power of appointment granted by Sub-Trust B. The Court of Appeals determined that John was not required to specifically reference Sub-Trust B by name because the specific reference requirement in the trust referred to the power itself and not the trust instrument.

Through statutory interpretation, the Court of Appeals concluded that where the reference required is only to the power and not to the instrument, the determining factor is whether the language exercising the power contains sufficient detail “such that it is reasonable to conclude… that [the decedent] made an intentional and deliberate, not inadvertent, exercise of the *particular* power … granted to him.” Further, the Court of Appeals found that the language John used, particularly the reference to trusts created by his parents, made it sufficiently clear that he was referring to the power that Sub-Trust B granted to him. The Court of Appeals agreed with the judicial referee’s statement that the additional phrase “or any other trusts for which I have Power of Appointment” did not invalidate the preceding specific reference to John’s power of appointment over Sub-Trust B.

A reminder to practitioners to be careful in drafting, both when creating a power of appointment and when attempting to exercise one. In exercising a power, one should be as specific as possible.

**In the Matter of Cleopatra Cameron Gift Trust Dated May 26, 1998**

**The Supreme Court of South Dakota held that a California court’s order requiring payment of child support from a trust was not entitled to full faith and credit, and that the father’s child support rights were not enforceable against the trust**

Cleopatra Cameron was the beneficiary of three trusts created by her father. Each trust contained spendthrift provisions that prohibited the trustee from making direct payments to Cleopatra’s creditors. The trust provisions also granted the trustee sole discretion to make distributions from the trusts to Cleopatra. Cleopatra and Wells Fargo served as initial co-trustees of the trusts.

In 2005, Cleopatra married Christopher Pallanck. The couple lived in California with their two minor children until Christopher filed for divorce in Santa Barbara, California, in 2009. In March 2009, the California family court held Cleopatra and Wells Fargo in civil contempt for failure to pay Cleopatra’s child support obligations from the trusts.

In July 2012, Cleopatra exercised her authority as trustee to transfer the trust situs from California to South Dakota. Wells Fargo and several subsequent corporate trustees resigned as co-trustees; ultimately, Trident Trust Company was appointed as successor co-trustee of the trusts.

In May 2017, Cleopatra petitioned the South Dakota trial court to declare that the trustees were prohibited from making her child support payments from the trusts. The trial court agreed. In addition, the trial court held that, although Cleopatra’s obligation to pay child support was determined under California law, the enforcement of those obligations against the trusts was governed by South Dakota law. South Dakota does not recognize a public policy exception for the enforcement of child support orders against trusts. Therefore, the trial court held that the California court’s order directing the trustees to make payments to Christopher for child support was not entitled to full faith and credit. Christopher appealed.

The full faith and credit clause of the U.S. Constitution provides that states must recognize other states’ laws and judicial proceedings. However, the Constitution does not require states to adopt other states’ practices regarding the manner and mechanisms for enforcing judgments.

The Supreme Court of South Dakota held that Christopher could not enforce Cleopatra’s child support obligations against the trusts. Although California law allows a child support creditor to enforce claims against a trust, this is an enforcement mechanism rather than a substantive legal obligation. Therefore, the California court’s order was not entitled to full faith and credit. Instead, South Dakota law governed the question of whether Christopher could compel support payments from the trusts.

Under South Dakota law, a creditor may not compel a trustee to use trust assets to pay the beneficiary’s child support obligations. The Court noted that South Dakota’s legislature specifically rejected provisions in the Third Restatement of Trusts that would allow a creditor to enforce a beneficiary’s child support obligations against a trust.

Trustees often use their authority to transfer the situs of a trust to another jurisdiction to avail themselves of the new forum state’s favorable laws. For example, a trustee might transfer the trust’s situs to a state that allows the trustee to decant to a new trust. In this case, Cleopatra effectively used her authority to move the trusts’ situs to South Dakota, which has more trust-friendly asset protection rules.

**Alexander v. Harris, 2019 WL 2147281 (Fla. Dist. Ct. App. May 17, 2019)**

**A Florida appellate court held that a father’s special needs trust, which contained a spendthrift provision, is subject to garnishment to pay his child support obligations**

Clifford Harris was involved in a serious car accident as a minor. As part of the settlement, a special needs trust under 42 U.S.C. Section 1396p was created for Harris’ sole benefit. Each month, $3,035 was paid to the trust. As of December 2016, the trust had a value of $141,997.

Under the terms of the trust, the trustee had sole discretion to distribute trust assets to Harris; Harris had no legal authority to compel distributions. The trust also contained a spendthrift provision. Spendthrift provisions generally prevent a beneficiary’s creditors from seeking payment of the beneficiary’s debts from the trust assets.

In May 2009, Christina Alexander obtained a child support order against Harris. After Harris failed to pay the child support obligations, Alexander asked the court to hold Harris in civil contempt. The trial court granted Alexander’s first motion to hold Harris in contempt. Eventually, Harris once again failed to make child support payments, and his arrearages totaled $91,780. Alexander again moved to hold Harris in civil contempt. But the trial court denied Alexander’s subsequent motions. Instead, the trial court found that Harris had no ability to pay the child support arrearages or his ongoing support obligations, despite the trust assets.

Alexander appealed the trial court’s denial of her motion to hold Harris in civil contempt.

Under Florida law, discretionary distributions from a spendthrift trust are not protected from garnishment for the payment of child support, though Florida courts have found that enforcement against such a trust is a remedy of last resort.

The Florida District Court of Appeals held that Harris’ trust could be garnished to enforce his child support obligations. The court found that Alexander had exhausted all other sources from which she might satisfy Harris’ child support obligations. Furthermore, the court noted that although Florida law has long recognized the validity of spendthrift trusts, the state’s public policy gives primacy to enforcing child support orders. Therefore, the court held that Alexander was entitled to enforce Harris’ child support obligations against the trust.

Trusts often contain spendthrift provisions that are intended to protect the trust assets from the beneficiary’s creditors. Those provisions are often valid when properly drafted. However, state law may create exceptions under which a creditor may enforce the debt against the trust. Child support obligations are often enforceable even against trusts with spendthrift provisions.

**In re Ignacio G., 2019 WL 2376184, 2019 Tex. App. LEXIS 4648 (Tex. App. – Texarkana, June 6, 2019)**

**Summary judgment on how to interpret a trust was inappropriate where the intent of the settlors was not shown by sufficiently clear and convincing evidence**

A husband and wife created a revocable trust, which named their daughter, Esperanza, as trustee. In addition to Esperanza, the husband and wife had a son, Ignacio. The wife had a daughter, Edna, prior to meeting her husband. The husband adopted Edna. The trust agreement defined “children” as Esperanza and Ignacio specifically, and the summary attached to the trust described the trust assets as passing in equal shares to Esperanza and Ignacio after the deaths of the husband and wife. Descendants were defined in the trust to include adopted persons. The term “children” did not appear in the trust except in the identification paragraph. Edna did not appear anywhere in the trust or the summary.

The trust provided that after the death of the surviving grantor, “all of the remaining trust property shall be distributed to the Grantor’s [\_\_\_\_\_\_\_\_\_\_\_]. If none of the Grantors’ descendants survives the surviving Grantor, one-half of the property of the trust … shall be distributed to the Husband’s heirs and the other half … to the Wife’s heirs.”

After the husband and wife’s deaths, Esperanza, as trustee, filed a petition for declaratory judgment in Travis County asking the probate court to fill in the blank in the document with the word “descendants” and to determine whether Edna was a beneficiary of the trust. The attorney who drafted the trust testified that although he did not remember husband and wife personally, he assumed, based on the trust summary and the clear definition of “children,” that Edna was not an intended beneficiary of the trust. The probate court granted Esperanza’s request for summary judgment, reformed all of the relevant trust termination provisions to provide for distribution of trust assets to the “children” rather than “descendants” and ruled that Edna was not a child and thus not a beneficiary of the trust. Edna appealed.

In construing a will, the court focuses on the testator’s intent and Texas applies the same rules to interpreting a trust. In Texas, the meaning of a trust is a question of law when there is no ambiguity as to its terms. However, when the trust instrument’s language is uncertain or reasonably susceptible to more than one meaning, the trust is deemed ambiguous such that its interpretation presents fact issues, which precludes summary judgment. Alternatively, Texas Property Code Section 112.054 provides that a court may order modification of terms of an unambiguous trust if such reformation is necessary to correct a scrivener’s error and enact the settlor’s intent as established by clear and convincing evidence.

The Court of Appeals of Texas overturned the trial court’s award of summary judgment and remanded the case, ruling that there were genuine issues of material fact that precluded summary judgment. The Court of Appeals explained that the trial court must not have found the terms of the trust to be ambiguous, because otherwise the law would have precluded summary judgment. Accordingly, the Court of Appeals reasoned, the trial court must have been operating under the theory of a scrivener’s error, which would permit summary judgment to reform the trust if the settlor’s intent was shown by clear and convincing evidence as permitted by Texas Property Code Section 112.054. This section of the code did not exist when the trust was created, but the Court of Appeals reasoned that it was a codification of common law which did exist at the time of the creation of the trust and was therefore applicable.

The Court of Appeals found that under that standard, the trial court should not have issued summary judgment. The Court of Appeals explained that although the trust contained multiple scrivener’s errors, the evidence presented was insufficient to determine the settlor’s clear and convincing intent as a matter of law. For example, one of the scrivener’s errors was a mistake in fact that the settlors had only two children, when in fact they had three, and the evidence reviewed in the light most favorable to Edna (as required on appeal of summary judgment against her) could mean that the error was not in failing to use the word “children” instead of “descendants” but instead failing to include Edna in the definition of the settlor’s children. Therefore, there was a genuine issue of fact to be determined by the trier of facts before the trust could be reformed.

On Aug. 21, 2019, Ignacio and Esperanza filed a petition for review with the Supreme Court of Texas alleging that the Court of Appeals relied on the wrong standard of proof. As of this publication, the Supreme Court of Texas has not issued a ruling or indicated whether it intends to review the case.

For drafters, this case is another good reminder of the importance of careful drafting and review. The drafting attorney here explained that his paralegals drafted documents based on a form which he would then review. Here, his review was clearly insufficient as there was a least one blank left in the document, and the document summary did not necessarily match the terms of the trust. This is also an example of why it is helpful to specifically exclude children or other beneficiaries a client wishes to disinherit rather than relying on their omission to imply the client’s intent. For trustees, this case demonstrates the importance of reading and analyzing the exact terms of the trust rather than relying on a summary of the provisions, even if generated by the drafting attorney.

**Levitan v. Rosen, 95 Mass. App. Ct. 248, 124 N.E. 3d 148 (2019)**

**Interest in an irrevocable spendthrift trust created by a third party was deemed part of the marital estate to be considered in the division of property during a divorce, where the wife was the sole trust beneficiary**

Upon his death, a father created a lifetime trust, governed by Florida law, for the benefit of his daughter. The daughter and an independent trustee served as co-trustees of the trust. The independent trustee had unlimited discretion to make distributions of income and principal to the daughter as the independent trustee deemed advisable. Additionally, the daughter had the right to withdraw five percent of the trust principal each year. The withdrawal provision specifically provided that if the daughter exercised her right of withdrawal, the trustee “shall make such distribution to [her].” The trust contained a spendthrift provision that specifically included a spouse as a potential creditor who could not reach trust assets. The daughter had a limited power of appointment at her death exercisable in favor of her father’s descendants.

In the daughter’s divorce, the trial court held that the annual right of withdrawal was includable in the marital estate to be divided in the divorce, but the remainder of the trust was not part of the marital estate because it was protected by the spendthrift clause. In dividing the marital property, the trial court included the value of the trust withdrawal right (but not the full value of the trust) in the daughter’s share of the marital estate and also included the value of the withdrawal right in the daughter’s income for purposes of awarding support. The daughter appealed.

In Massachusetts, a divorce court must divide the divorcing parties’ property equitably; the size of each parties’ estate for the purposes of equitable distribution includes all property to which a party holds title, however acquired. Further, in Massachusetts, a beneficial interest in a trust may, depending on the terms of the trust, be considered part of an individual beneficiary’s estate even though the trustee, not the beneficiary, holds legal title. If a beneficial interest in a trust is not presently enforceable, Massachusetts courts have previously held that a divorcing beneficiary’s interest should not be classified as property subject to equitable division but should be considered by the court under the statutory criteria of G.L. c. 208 § 34 as an “opportunity for each [spouse] for future acquisition of capital assets and income.”

The Massachusetts Court of Appeals overturned the trial court’s ruling, but in an unfortunate surprise for the daughter, did so on the basis that the full value of the trust, not just the value of the withdrawal right, should have been included in the marital estate, and remanded the case for further consideration of equitable division of property and appropriate support on the basis of the expanded marital estate. The Court of Appeals did not agree that only the value of the withdrawal right should be included in the daughter’s income for purposes of determining support. The Court of Appeals reached this surprising result based on the fact that the daughter was the sole beneficiary of the trust and the settlor’s primary intent was to provide for the daughter rather than subsequent generations. The Court of Appeals also stated that the annual right of withdrawal built a “degree of predictability” into the trust distributions, despite the fully discretionary nature of the trustee’s distributions, which made the trust more than a “mere expectancy.” The Court of Appeals held that because of the spendthrift provision, the trust property could be assigned only to the daughter in the equitable distribution of marital property, and that the trial court should determine on remand how to distribute the remaining marital estate in light of that assignment.

**In re Estate of Victor J. Mueller Irrevocable Trust Number One and Number Two, Stephanie Mueller v. Krohn, 2019 WL 3210857 (Wis. Ct. App. July 17, 2019)**

**A trustee’s report adequately disclosed the existence of a claim so as to shorten the statute of limitations period to one year for matters disclosed in the report**

Victor Mueller established two separate, interrelated trusts during his lifetime, referred to as “trust one” and “trust two.” Trust one contained two working farm properties. Stephanie is the sole income beneficiary **of** trust one. Upon her death, the residue will go to UW Foundation for scholarships. All of Victor’s other assets were placed in trust two. Upon Victor’s death, trust two provided for the payment of certain specific bequests, directed the trustee to liquidate the gemstones, and pour the remainder into trust one. Stephanie was bequeathed $500,000 and all of Victor’s tangible personal property from trust two. Krohn was appointed as trustee of both trusts.

Following Victor’s death, Krohn liquidated most of the assets of trust two and paid 50 percent of the specific bequests; Stephanie received $250,000. Krohn retained a reserve of assets to pay any additional estate taxes. Krohn continued Victor’s contracts with farm operators and hunters who had farmed and hunted on the two properties in prior years. Stephanie received between $58,000 and $69,700 in the years 2014 through 2016. Stephanie filed a petition for judicial intervention, alleging that Krohn owed damages, had improperly charged a trustee’s fee and should be removed as trustee for breach of fiduciary duty. Krohn and UW Foundation filed motions for summary judgment seeking to dismiss the petition. The Circuit Court dismissed Stephanie’s claims on summary judgment and awarded attorneys’ fees to Krohn and UW Foundation. Stephanie appealed.

A claim must be brought within one year of the date the beneficiary “was sent a report that adequately disclosed the existence of a potential claim for breach of trust,” under Wisconsin law. “[A] report adequately discloses the existence of a potential claim for breach of trust if it provides sufficient information so that the beneficiary or representative knows of the potential claim or should have inquired into its existence.”

The Court of Appeals addressed several issues and claims for breach of fiduciary duty. With respect to Krohn’s statute of limitations defense, the court held that Krohn’s acceptance of the trustee fee was not a breach of fiduciary duty. Both trust documents provided for “reasonable compensation,” as agreed upon with the settlor or with the majority of living adult beneficiaries. Less than three months after Victor’s death, Victor’s attorney, Louise Andrew, sent Stephanie a “notice regarding trust” describing the trustee fee in detail. The notice specifically stated Krohn’s compensation and included terms concerning an increase in compensation for 2014. Stephanie did not object to the compensation until she filed the petition underlying this appeal in April 2016. The court held that Stephanie’s objection was barred by the statute of limitations and that, contrary to Stephanie’s claim, it is not necessary that a report contain the contents of an annual report in order to trigger the one-year period.

The court held that Krohn did not otherwise breach her fiduciary duty by (1) continuing the farm contracts previously entered into by Victor with Krohn’s brother and nephew, (2) employing her family members to clean and sell Victor’s property, and (3) continuing the hunting leases granted by Victor to Krohn’s family members. The court found that Stephanie had received a letter and a copy of the estate tax return, which adequately disclosed the existence of a potential claim for breach of trust with respect to the farming contracts and compensation of Krohn’s family members helping with the estate. Therefore, her claims were time-barred by the one-year statute of limitations. As to the hunting leases, the agreements were entered into prior to Victor’s death, and even so, the transaction was authorized by the terms of the trusts.

Trustees should take care to ensure that communications sent to a beneficiary contain sufficient information to constitute a “report” adequately disclosing the existence of a potential claim for breach of trust and any required statutory language so as to trigger the running of the applicable statute of limitations.

**Vander Boegh v. Bank of Oklahoma, N.A., 2019 WL 1495712 (Ky. Ct. App. Apr. 5, 2019)**

**Beneficiaries’ rights against a trustee are purely equitable, and a “letter of understanding” does not transform them into contract claims**

This consolidated case involved two trusts, the Charles R. Jones Sr. inter vivos trust dated May 1, 1973, and the Eula Kathleen Jones testamentary trust dated Oct. 24, 1967, whose sole asset was a 100 percent ownership interest in the Three Rivers limestone quarry in Livingston County, Kentucky. Bank of Oklahoma, N.A., as the sole trustee of the trusts, had entered into a 99-year lease agreement with Martin Marietta Materials Inc., granting Martin Marietta the right to conduct mining operations at Three Rivers.

During an audit, an accounting firm engaged by the trustee uncovered an approximately $100,000 shortfall in royalties paid from Martin Marietta to Three Rivers over a 15-year period. After learning of the royalty shortfall, a group of beneficiaries from the Vander Boegh family, who collectively held approximately 3/16 of the beneficial interests in the trusts, requested that the trustee cease accepting royalty payments from Martin Marietta and issue Martin Marietta a notice of default pursuant to the lease. The remainder of the beneficiaries objected to the Vander Boeghs’ request, prompting the trustee to file a declaratory judgment action seeking instructions from the McCraken Circuit Court. The Vander Boeghs filed numerous counterclaims against the trustee alleging breach of contract, breach of fiduciary duty and negligence.

The trial court issued a declaratory judgment directing the trustee to continue accepting royalty payments from Martin Marietta and to resolve the royalty dispute using all remedies available at law other than terminating the lease. The court then proceeded to trial on the Vander Boeghs’ counterclaims. After trial, the court issued findings of fact and conclusions of law holding that (1) the Vander Boeghs’ breach of contract and negligence claims failed because, subject to only minor exceptions, beneficiaries may bring only equitable actions against a trustee, and (2) the Vander Boeghs failed to establish any basis showing that the trustee breached its fiduciary duties. The trial court also awarded over $2 million in attorneys’ fees and costs to the trustee. The Vander Boeghs appealed.

With only minimal exceptions, a beneficiary’s rights against a trustee are purely equitable. A claim for breach of contract is an action at law and cannot be sustained by a beneficiary against a trustee. Furthermore, a beneficiary’s allegations that a trustee acted negligently cannot transform an equitable action (breach of fiduciary duty) into an action at law, even if the applicable standard for a trustee’s misconduct includes elements of a claim for negligence. A trustee is liable to the beneficiaries for breach of fiduciary duty only if the trustee failed to act reasonably (often referred to as the “duty of care” or the “duty of prudence”) and in the best interests of the beneficiaries (often referred to as the “duty of loyalty”). The fact that some beneficiaries disagree with the trustee’s decision, or that a different trustee would have acted differently, does not make a trustee liable for breach of fiduciary duty.

The Court of Appeals of Kentucky affirmed the trial court’s judgment regarding the Vander Boeghs’ counterclaims but remanded the trial court’s award of attorneys’ fees. The Vander Boeghs attempted to argue that a “letter of understanding” between the trustee and the beneficiaries amounted to a contract. The court disagreed, stating that the letter of understanding and all of the Vander Boeghs’ counterclaims concerned how the trustee carried out its fiduciary duties. The court declined to hold the trustee liable for failing to follow the Vander Boeghs’ request to terminate the lease because it recognized that the trustee had good reasons for not terminating the lease, including certain unusual market features about the lease and the loss of royalty payments while the trustee searched for a new operator for the quarry. Accordingly, the court affirmed the trial court’s judgment that the trustee did not breach its fiduciary duties. The court, however, found that the trustee’s legal invoices, which it submitted to support its award of attorneys’ fees, contained too many redactions to provide sufficient factual support for the $2 million award. Accordingly, the court remanded the attorney fee issue back to the trial court.

The relationship between a trustee and beneficiaries arises from equity. Any efforts by a beneficiary to transform the relationship into a contractual one are not likely to find success. When facing a conflict between beneficiaries, a trustee acts prudently by asking a court for advice and guidance. A court likely will not find a trustee’s past actions as a breach of fiduciary duty when those actions were consistent with the court’s advice and guidance.

**OTHER ITEMS OF INTEREST**

**Schermer v. Commissioner, T.C. Memo 2019-28**

**Taxpayer failed to meet burden of showing entitlement to deduction for federal estate tax attributable to income in respect of a decedent**

Jill Schermer’s husband, Robert Schermer, passed away on August 2, 2002. Robert Schermer’s father, Albert Schermer, passed away on January 17, 1999. Federal estate tax returns were filed for the estates of both Robert Schermer and Albert Schermer.

In 2014, Jill Schermer received the following distributions:

1. $174,832 annuity from National Financial Services;

2. $44,705 from a UBS Individual Retirement Account (IRA); and

3. $50,000 from a First Clearing LLC IRA.

Jill Schermer reported these amounts on her 2014 federal income tax return. Moreover, on Schedule A of her 2014 federal income tax return, Jill Schermer claimed a miscellaneous deduction for federal estate tax of $156,781 attributable to the inclusion of items of Income in Respect of a Decedent (IRD) in the estates of her husband and father-in-law. Jill Schemer provided no evidence that the accounts were part of her husband’s estate and that estate tax was paid by her husband’s estate. The Internal Revenue Service denied the deduction.

The Tax Court upheld the disallowance of the deduction for estate tax caused by the inclusion of items of IRD in an estate. Jill Schermer contended that she was entitled to the deduction for estate tax attributable to her father-in-law as she was the beneficiary of her husband’s accounts from UBS and First Clearing; however, her husband’s federal estate tax return did not include income for these accounts and, as noted above, Jill Schermer provided no evidence that these accounts were part of her husband’s estate and that estate tax was paid for these accounts. The income tax deduction for estate tax caused by the inclusion of items of IRD in an estate may only be taken if estate tax is paid.

Jill Schermer also contended that her deduction was for federal estate tax paid on IRD attributable to her father-in-law, which transferred to her upon the death of her husband. However, Albert Schermer’s federal estate tax return did not include the three distributions that Jill Schermer received. As a result, Jill Schermer failed to meet her burden of showing her entitlement to the income tax deduction.

**United States v. Johnson, \_\_\_ F. 3d \_\_\_\_ (10th Cir. 2019)**

**Four children held responsible for unpaid federal estate taxes on stock received from mother’s trust following mother’s death**

Anna Smith created the Anna Smith Family Trust during life and funded it with shares of stock in State Line Hotel Inc. The trust was governed by Utah law. The hotel was a closely-held corporation and the holder of a Nevada Gaming License. Anna died on September 2, 1991. Upon Anna’s death, two of her children, Mary Johnson and James Smith, were named as successor trustees of the trust and as personal representatives of the estate. Her four children were the beneficiaries of the trust.

Consistent with the terms of the trust, the successor trustees filed a federal estate tax return with the Internal Revenue Service. The return calculated the estate’s federal estate tax liability at $6,631,448. Of that total, only $4 million was paid to the IRS upon the filing of the return. The successor trustees elected to defer the payment of the balance of the estate tax for five years and then pay the balance in ten equal annual installments under Section 6166 because the hotel stock accounted for more than 35 percent of Anna Smith’s adjusted gross estate and was illiquid. The ten annual installment payments would begin on June 2, 1997 and end on June 2, 2006.

Although the assessed estate taxes remained unpaid, the successor trustees distributed the hotel stock from the trust to the four children on December 31, 1992. The distribution was motivated by restrictions under Nevada law on casino ownership by a trust. The trustees also distributed life insurance proceeds. Cognizant of the outstanding federal estate tax liability, the successor trustees and the trust beneficiaries executed a distribution agreement under which the beneficiaries agreed to bear the responsibility for paying additional federal or state estate taxes, interest, or penalties.

The hotel filed for Chapter 11 bankruptcy in January 2002. Beginning with the annual installment due on June 2, 2002, the estate ceased making the installment payments of deferred federal estate tax. The Service declared the installment agreement to be in default as of December 18, 2003. In June 2005, the IRS learned of the existence of the distribution agreement in which the beneficiaries agreed to pay the estate taxes. In 2011, the government filed a complaint against the four children seeking recovery of the $1,569,851 in federal estate tax. The government alleged that all four of decedent’s children were liable for the unpaid estate taxes to the extent that they received property included in the gross estate under Section 6324(a)(2). The district court determined that this claim could only be asserted as to life insurance proceeds received by the children as part of the distribution from the estate because the children conceded liability for the on those proceeds.

The government filed an amended complaint in August 2012. In the amended complaint, the government sought to enforce rights as a third party beneficiary of the distribution agreement. The district court ruled in favor of the four children concluding that it was untimely under Utah law and rejecting the government’s argument that the timeliness of the claim was governed by federal law. The district court also awarded attorney’s fees to the children on the grounds that the government’s position on the third party beneficiary claim was not substantially justified.

In the circuit court, the children conceded the government was a third party beneficiary in the distribution agreement but argued the claim was untimely because it was not filed within the six year Utah statute of limitations applicable to contract claims. The circuit court reversed. Instead, the circuit court found that the ten year federal statute of limitations set forth in Section 6502(a) applied based on United States v. Summerlin, 310 U.S. 414 (1940). In that case, the Supreme Court held that “the United States is not bound by state statutes of limitations…in enforcing its rights.” The court also ruled with respect to the district court’s conclusion the government’s claim with respect to insurance proceeds was timely filed. It found that the ten-year federal limitations period was suspended pursuant to Section 6503(d) because the estate made a Section 6166 deferral election. This suspension also applied to transferee liability.

The Tenth Circuit also reversed the district court’s award of fees and costs to the children because it ruled in favor of the government on its claim that the four children were liable for the full amount of the unpaid estate taxes since the government was a third party beneficiary to the distribution agreement.

**Billy F. Hawk, Jr., GST Non-Exempt Marital Trust v. Commissioner, \_\_\_ F. 3d \_\_\_ (6th Cir. 2019)**

**Sixth Circuit affirms Tax Court decision holding estate and decedent’s wife liable as transferees for a bowling alley’s unpaid income taxes resulting from sale of business after decedent’s death**

Under Section 6901, the government may pursue a delinquent taxpayer’s transferees in federal court. The government then assumes the position of a private creditor and state law determines whether the transferees must pay the debts of the taxpayer. This somewhat whimsical opinion upholds the Tax Court’s determination that the transferees owed a delinquent taxpayer’s taxes pursuant to Section 6901.

After the death of Billy Hawk in 2000, his wife, Nancy Sue, decided to sell the family bowing business, Holiday Bowl. With the help of lawyers and accountants, she made a deal with MidCoast, a company that claimed an interest in acquiring companies with corporate tax liabilities that it would set off against its net operating losses. Holiday Bowl first sold its assets, the bowling alleys, to Bowl New England, receiving $4.2 million in cash and generating approximately $1 million in federal taxes. After that, Nancy Sue and Billy Hawk’s estate sold Holiday Bowl to MidCoast for about $3.4 Million, in essence exchanging one pile of cash for another less the tax debt that MidCoast agreed to pay.

After the sale, MidCoast transferred Holiday Bowl to Sequoia Capital in exchange for a cancelation of a loan of Sequoia and about $325,000 in cash. According to MidCoast, Holiday Bowl would then enter the debt collection business, rapidly generating new losses that would offset Holiday Bowl’s existing taxes. Neither MidCoast nor anyone else ever paid Holiday Bowl’s outstanding taxes and the one-time bowling company was dissolved in 2006.

The Internal Revenue Service investigated MidCoast, uncovering the Holiday Bowl sale and about sixty some more transactions. In addition, a grand jury indicted several individuals associated with each of MidCoast, Sequoia, and a law firm that had done work for them. One defendant pleaded guilty. Others fled the country. At this time, the government launched a civil collection proceeding against the Hawks under Section 6901 in pursuit of the Holiday Bowl’s unpaid taxes. The Tax Court concluded that Sequoia’s loan to MidCoast was a sham and that Holiday Bowl had simply distributed cash to the Hawks, who were then liable to government as Holiday Bowl’s fraudulent transferees and permitted the government to recover the unpaid taxes from the Hawks under Tennessee law.

The Sixth Circuit upheld the Tax Court’s decision. The Sixth Circuit noted that Tennessee has adopted the Uniformed Fraudulent Transfer Act, which provided remedies to creditors when insolvent debtors fraudulently transfer assets to third parties. Although Nancy Sue and the Estate placed emphasis on the due diligence and lack of knowledge of the illegality, that defense did not shield them from the sham nature of the transaction and absolve them of transferee liability under Section 6901. This is because Tennessee courts looked at the economic realities of the transaction regardless of whether the parties knew about the fraud in determining if the transaction was fraudulent. Consequently, Nancy Sue and the estate were liable.

**United States v. Widtfeldt, \_\_\_\_\_ F. Supp. 3d. \_\_\_\_\_ (D. Neb. 2019)**

**District court grants government’s motion for summary judgment finding taxpayer liable for payment of gift and estate taxes**

James Widtfeldt’s mother gave Widtfeldt two parcels of real property, River Place, and O’Neill Rental Houses, in 2004. The value of the gifted properties was $1,041,987. The mother died in 2006. As a result of his mother’s death, Widtfeldt received or became titleholder to the property included in the estate. That property included two pieces of real property referred to as Fink Place and Rock Falls Place, with date-of-death values of $896,180 and $912,128 respectively.

The IRS in the audit of the estate determined the estate owed both gift and estate taxes. Neither the mother nor the estate filed a gift tax return for the lifetime gifts. The estate failed to file an estate tax return with respect to the mother’s death. The IRS determined that the estate owed $305,141 in gift tax, $68,659 in late filing penalties, and $76,285 in late payment penalties under Section 6651(a) and (b). The IRS found that the estate owed $170,954 in estate tax and $34,191.for an accuracy penalty under Section 6662(a).

Widtfeldt, as the executor of his mother’s estate, challenged the deficiencies in the Tax Court. The District noted that Widtfeldt filed several frivolous pleadings and raised numerous nonsensical arguments and failed to heed the advice of the Tax Court to make a relevant argument. The Tax Court granted the IRS’s Motion to Dismiss for Failure to Properly Prosecute in 2011 and,upheld the Service’s Notice of Deficiencies. The Eighth Circuit affirmed the decision of the Tax Court. Widtfeldt v. Commissioner, 449 F. App’x 561 (8th Cir. 2012) (unpublished per curiam).

Based on the Tax Court’s decision, the IRS assessed the estate for the deficiencies in 2012. Widtfeldt, as executor, did not pay the assessed liabilities. The IRS attached a lien to the estate’s property on March 19, 2013. As of 2019, the estate owed $813,699.28 in gift tax and $394,493.28 in estate tax.

In this case, the government sought a money judgment against Widtfeldt, holding him personally liable for the unpaid gift and estate taxes, and enforcement of that judgment against real property owned by Widtfeldt.

The court noted that when estate tax is not paid, a lien attaches to the gross estate under Section 6342(a)(1) and the recipient of the property becomes “personally liable for such unpaid tax” up to the value of the property at the time of the decedent’s death. A similar lien attaches to a gift if gift tax is not paid under Section 6324(b). Widtfeldt resisted paying the taxes owed, insisting, without support, that he completely purchased his mother’s property in 1994. The district court saw this as a rehashing of the decision of the Tax Court that the estate owed estate and gift taxes. The government contended, and the court agreed, that the prior decision precluded Widtfeldt from litigating the decision of the Tax Court. As a result, Widtfeldt, as the recipient of the estate’s property and the gifted property, was personally liable for the unpaid estate and gift taxes under Section 6324(a) and (b). The court then granted the request of the government and ordered the sale of River Place and Rock Falls Place to satisfy the gift tax and estate tax liabilities.

**Hoff Stauffer v. IRS, \_\_\_\_\_ F.3d. \_\_\_\_\_ (1st Cir. 2019)**

**First Circuit affirms district court’s dismissal of son’s untimely suit on behalf of father’s estate for tax refund**

This case concerned the rules governing the timeliness of a claim for a refund of overpaid federal taxes and the renunciation of a durable power of attorney under Pennsylvania law. Hoff Stauffer sued the Internal Revenue Service on behalf of his father’s estate, alleging that the IRS improperly denied his April 2013 claim for his father’s 2006 tax refund as untimely. The estate argued that the applicable statute of limitations for the filing of a tax refund claim was tolled due to the father’s financial disability under Section 6511(h)(1). The district court dismissed the estate’s complaint, holding that the limitations period was not tolled because Hoff held a durable power of attorney authorizing him to act on his father’s behalf in financial matters. The First Circuit affirmed the decision of the district court.

Hoff and his father executed a written durable power of attorney in October 2005. The durable power of attorney was executed because the father was both elderly and mentally ill. The durable power of attorney granted Hoff broad powers, including the power to represent the father before the IRS with respect to new claims or proceedings having to do with tax liabilities.

After the power of attorney came into effect, Hoff discovered that the father had lost track of millions of dollars in assets in the form of uncashed checks, matured bonds and stocks. Hoff began recovering those assets. Despite Hoff’s financial management efforts, the father-son relationship began to deteriorate in March 2006. One reason for the tension was Hoff’s insistence that the father stop permitting his girlfriend to overspend his money.

Hoff claimed to have told his father at a meeting on March 15, 2006 that he would no longer exercise any rights granted under the durable power of attorney. The father drafted three notices revoking a durable power of attorney; however, the father never sent those notices and Hoff never received them. The father and son stopped talking and communicating. Hoff did tell his sister, the father’s accountant, and the father’s attorneys that he was no longer acting as his father’s agent under the durable power of attorney.

Four years later, the father and son reconciled. The father passed away in October 2012, and Hoff was named the personal representative of the estate. As representative of the estate, Hoff filed his father’s tax returns for tax years 2006 through 2012 in late April 2013. The 2006 return reported a tax overpayment of $137,403 of which the estate claimed a refund $96,364, and requested that $40,000 of the remaining $40,039 be applied to the father’s 2007 tax liability. The IRS denied the claim for the 2006 tax refund as untimely under Section 6511(h). The district court dismissed the estate’s complaint. The district court found that:

1. The father had the capacity to exercise the durable power of attorney.

2. Hoff was, as of 2005, authorized to act under the durable power of attorney in financial matters.

3. Hoff could not renounce the durable power of attorney.

4. The father did not effectively revoke the durable power of attorney.

The court noted that while the applicable limitations period will be tolled or suspended under Section 6511(h) (1) if a taxpayer is financially disabled, there is an exception to that exception which provides that an individual shall not be treated as financially disabled during any period that any person is authorized to act on behalf of such financially disabled individual in financial matters. The court found that the evidence showed that Hoff was authorized to act on behalf of his father under the power of attorney. Consequently, the exception did not apply. During his deposition, Hoff testified that he was not going to do anything with the durable power of attorney now, referencing a point in time after the March 15 meeting. To the court, this suggested that Hoff believed his rights went uninterrupted after the March 15meeting. In a letter that was sent to the father’s psychologist, Hoff also represented that he held the durable power of attorney until his father’s death in 2012. Moreover, the father never revoked the power of attorney.

As a result, the decision of the district court was upheld.

**Sveen v. Melin \_\_\_\_\_ U.S. \_\_\_\_\_ (2018)**

**Supreme Court holds that retroactive application of Minnesota statute providing that the dissolution or annulment of a marriage revokes any revocable beneficiary designation made by an individual to the individual’s former spouse does not violate the Contracts Clause of the Constitution**

In 2002, Minnesota enacted Minn. Stat. § 524-2-804, subd. 1, that provided that the “dissolution or annulment of a marriage revokes any revocable . . . beneficiary designation . . . made by an individual to the individual’s former spouse.” Under this statute, if one spouse has made the other the beneficiary of a life insurance policy or similar asset, their divorce automatically revokes that designation so that the insurance proceeds will instead go to the contingent beneficiary or the policyholder’s estate upon his or her death. The law did this on the theory that the policyholder would want that result. However, if the policyholder did not want this result the policyholder could rename the ex-spouse as beneficiary.

Mark Sveen and Kaye Melin were married in 1997. In 1998, Sveen purchased a life insurance policy naming Melin as the primary beneficiary and designating his two children from a prior marriage, Ashley and Antone Sveen, as contingent beneficiaries. Sveen and Melin divorced in 2007, but the divorce decree made no mention of the insurance policy and Sveen took no action to revise his beneficiary designations. Sveen passed away in 2011. Melin and the Sveen children made competing claims to the insurance proceeds.

The Sveens argued that under Minnesota’s revocation and divorce law, their father’s divorce cancelled Melin’s beneficiary designations, leaving them as the rightful beneficiaries. Melin claimed that because the law did not exist when the policy was purchased and she was named as the primary beneficiary, the application of the later-enacted law to the insurance policy violated the Contracts Clause of the Constitution. The District Court ordered the payment of the insurance money to the Sveens, while the Eighth Circuit Reversed, holding that the retroactive application of Minnesota’s law violated the Contracts Clause.

The Supreme Court in an 8 to 1 decision with Justice Gorsuch dissenting, held that the retroactive application of the Minnesota statute did not violate the Contracts Clause. It noted that the Contracts Clause restricts the power of states to disrupt contractual arrangements but it does not prohibit all laws affecting preexisting contracts. There is a two-step test for determining when such a law crosses the Constitutional line. The test first asks whether the state law has “operated as a substantial impairment of a contractual relationship.” In answering the first question, the court considers the following:

1. The extent to which the law undermines the contractual bargain;

2. The extent to which the law interferes with a party’s reasonable expectations; and

3. The extent to which the law prevents the party from safeguarding or reinstating his or her rights.

If those factors show a substantial impairment, the inquiry then turns to the second test of whether the state law is drawn in an “appropriate” and “reasonable” way to “advance a significant and legitimate public purpose.”

The court only looked at the first test. In its opinion, the three aspects of Minnesota’s law, taken together, showed that the law did not substantially impair pre-existing contractual arrangements. First, the law is designed to reflect the policyholder’s intent. Thus, it supports, rather than impairs, the contractual scheme. The law applied a prevalent legislative presumption that a divorcee would not want his or her former partner to benefit from his or her life insurance policy and other will substitutes. As a result, the law honors and does not undermine the intent of the only contracting party to care about who the beneficiaries are.

Second, the law is unlikely to disturb any policyholder’s expectations at the time of contracting because an insured cannot reasonably rely on a beneficiary designation staying in place after a divorce. The court noted that divorce courts have wide discretion to divide property upon the dissolution of a marriage, including the revocation of spousal beneficiary designations and life insurance policies or mandating that such designations remain in place. A life insurance purchaser cannot know what will happen to that policy in the event of a divorce and, as a result, the purchaser’s reliance interest is “next to nil.” That fact cuts against providing protection under the Contracts Clause.

Finally, the law supplied a mere default rule, which the policyholder could undo at any moment. If the law’s presumption about the desire of insured after divorcing is wrong, the insured could change it by sending a change of beneficiary form to the insurer. The court noted that it had long held that laws imposing such minimal paperwork burdens do not violate the Contracts Clause. Filing a change of beneficiary form is easy. And if an insured wanted his or her ex-spouse to stay as the beneficiary but did not send in the form, the result is only that the insurance is redirected to the contingent beneficiaries, not that the insured’s contractual rights are extinguished.

**United States v. Jan M. Mengedoht, \_\_\_\_\_\_, F. Supp. 3d \_\_\_\_\_\_ (Dist. Neb. 2019)**

**Court allows foreclosure for unpaid estate taxes**

This case was heard on a Motion for Summary Judgment brought by the government and was a civil action to reduce tax assessments to judgment and to enforce a federal tax lien.

The government sued Jan M. Mengedoht in his individual capacity and in his official capacities as executor of the Carl M. Mengedoht Estate and as trustee of the HCJ Holdings Trust and the Washington County Treasurer in order to enforce IRS tax liens against the estate. The Washington County Treasurer and Jan Mengedoht, individually, and as trustee of the trust, were sued only so that they could protect any interest that they might claim in the property.

Carl Mengedoht died on May 29, 1998. The estate failed to file a federal estate tax return with the IRS. On April 18, 2011 the government assessed federal estate tax, penalties, and interest against the estate. The amount due with interest and statutory additions through October 1, 2018 was over $2,700,000. The major asset of the estate, constituting more than 90 percent of the value of the estate, was real estate in Washington County, Nebraska was held in the trust. The court held that under the terms of the trust, Carl Mengedoht held the power to alter, amend, revoke or terminate the trust at the time of his death and consequently the property was part of the estate for estate tax purposes under Sections 2036 and 2037.

Neither the estate nor the trust properly appeared or answered in the suit and the court entered default judgment against them on December 12, 2017.

The remaining issue in the case was whether Jan Mengedoht had a personal interest in the real estate that was subject to the federal tax lien that attached to the real property. The court found that Jan Mengedoht had not rebutted the presumption of correctness given the assessments by the IRS. Default judgment had been entered against the trust and the estate and those entities could claim that they had an interest that would have priority to the tax liens. The government and Washington County had agreed that any real property taxes that were owed to Washington County were entitled to priority over the federal tax liens. The court found that the government’s lien should be enforced in accordance with Section 7403 and the property sold. After the satisfaction of the federal tax lien, any residual proceeds would be paid to the trust. The court noted that Jan Mengedoht was deposed in the case and, when asked if he had a personal interest in the property, he refused to answer, stating “I don’t want to waive my natural right to not be compelled to be a witness against myself.” He refused to answer other questions on numerous subjects.

**Estate of Skeba v. United States, \_\_\_\_\_ F. Supp. 3d. \_\_\_\_\_ (D. N.J. 2019)**

**District court finds IRS’s imposition of penalty for late filing of estate tax return arbitrary and capricious**

This case was before the district court on cross-motions for summary judgment. The primary issue was the challenge of the estate of Agnes Skeba to the imposition of $450,959 in penalties assessed by the Internal Revenue Service for the alleged late filing of the federal estate tax return.

The decedent died on June 10, 2013 and the initial date for her estate to file the federal estate tax return was March 10, 2014, nine months after the date of death. On March 6, 2014, the counsel for the estate filed Form 4768 (Application for Extension of Time to File a Return and/or pay U.S. Estate Taxes) and included a partial payment of the estate tax of $725,000 with a cover letter explaining the reasons for the application to extend the time for filing the estate tax return and paying the estate tax. The counsel’s letter to the IRS stated that the estate was paying all of its liquid assets to New Jersey, Pennsylvania and the federal government through the payment of state and federal estate taxes. The estate also was seeking to secure a mortgage on commercial property to provide the remainder of the estate tax owed to the federal government, but this would require additional time. The counsel indicated that the estate had liquid assets of $1.475 million and the estimated value of the total estate was $14.7 million. The estate paid $575,000 to New Jersey for estate taxes, $250,000 to Pennsylvania for inheritance taxes, and the balance of $725,000 as partial payment of the expected federal estate taxes. The counsel’s letter also noted that there had been delays in securing the necessary valuations and appraisals due to contested estate litigation that was pending in New Jersey. Approximately $10.2 million of the estate’s assets consisted of farm land and fanning machinery.

Subsequently, on March 18, 2014 (eight days after the original due date for payment of the federal estate tax), the estate paid $2,745,000 to the IRS. Consequently, by March 18, 2014, $3,470,000 in federal estate taxes were paid to the IRS.

On June 25, 2014, one IRS agent approved the application to extend the time to file the estate tax return to September 10, 2014. On July 8, 2014, a second agent approved the extension of time to pay the estate tax to September 10, 2014. Neither letter from the IRS acknowledged the payment of the estimated estate taxes. Both IRS letters advise that any further extension must be applied for prior to the last day of the previous extension.

The estate did not file its federal estate tax return until June 30, 2015. The filed estate tax return reported net estate tax of $2,528,838. Subtracting the estate tax owed from the prior estimated payment of $3,470,000 left an overpayment of $941,162.

On August 3, 2015, the IRS responded to the return. It showed an overpayment on account (before adjustment) of $941,162. It then assessed a penalty of $450,959.50 due to the estate’s failure to timely file the estate tax return. The failure to pay penalty was 25 percent of the unpaid amount of $1,803,838. The IRS calculated the amount due on March 10, 2014, as $2,528,838 less the $750,000 paid or $1,803,838.

On August 17, 2015, the counsel for the estate requested an abatement of the entire penalty. The counsel referenced to discussions with various IRS representatives in which the counsel was informed that so long as payment was previously made in full, the filing of the return beyond the extension deadline was permissible and would not subject the estate to any penalty. In addition, the letter mentioned that the litigation in which the estate had been involved had been delayed because of health concerns with respect to the executor as well as the diagnosis of cancer for the estate’s litigation attorney and the need to change its litigation counsel. On November 5, 2015, the IRS responded to counsel’s letter briefly stating that the letter did not “establish reasonable cause or show due diligence.”

In response to the IRS’s letter, the personal accountant of the executor filed an appeal. The accountant’s letter reiterated the same points as then counsel’s August letter. It also stated that the accountant’s belief that the IRS’s lacked knowledge of the extension in place at the time the penalty was assessed and lacked any record of the additional payment of $2,745,000. The accountant noted not only the payment of the entire estate tax owed by the due date to pay, but also the overpayment. The accountant finally noted that Section 6651(6) bars a penalty for late filing when estimated taxes are paid. The IRS never replied to the accountant’s letter.

Upon the receipt of the IRS’s August 3 letter, the counsel called the contract person on the letter and was advised that there was an error and that the assessment was incorrect. In the summary judgment proceedings, evidence was also presented that the IRS had advised that “if you’re paid in, you’re fine.” The IRS during discovery tried to argue that the estate took a lackadaisical approach in filing the return.

After discussing when disputes might be resolved by summary judgment, the court addressed the primary issue of the estate’s liability for the penalty. The court first noted that under Gould v. Gould, 245 U.S. 151 (1917), tax statutes are to be narrowly construed when they are interpreted. In the event of ambiguity, the court’s interpretation should be “construed most strongly against the government, and in favor of the citizen.” However, in United States v. Boyle, 469 U.S. 241 (1985), the law in estate tax matters is that the estate bears the burden to prove that it has exercised ordinary business care and prudence in the event it filed a late return. Simple reliance on an attorney or accountant does not meet the reasonable care exception.

The court then described how Section 6651(a)(1) addresses the assessment of penalties of the late filing of a return and Section 6651(a)(2) addresses the assessment of the penalty for failure to timely file the tax. The estate argued that the two sections should be read together. If the two statutes are read in tandem, the late filing penalty is calculated by applying the penalty percentage to the net amount due as of the “date prescribed for payment.” Consequently, since the estate tax was overpaid on March 18, 2014, and the extension ran until September 10, 2014, no amount was due on the September deadline and no penalty could be imposed. Secondly, the plaintiff argued that the failure was due to reasonable cause and not willful neglect.

Stating that the requirements of Section 6651 must be construed with Section 6151, the government argued that the tax must be assessed as of the time and place fixed for filing the return (determine without regard any extension of time for filing the return). The government contended that only $750,000 was paid on or before the original due date of March 10, 2014, and $2,528,838 was due on that date. This left $1,803,838 due as of the original due date.

The court disagreed with the IRS. It found that both Sections 6651(a)(1) and (a)(2) designated the specific day on which penalties will be assessed for both the late filing and the payment of estate taxes. As a result, they override a more generic statute like Section 6651.

The court also found that the estate had reasonable cause for timely filing the return and was not willfully neglectful. It noted that counsel for the estate submitted his letter explaining the rationale for not filing and without a hearing or communication with the counsel to investigate the facts, the IRS’s reply was “that pending litigation is not a reasonable cause.” The court then noted that the judge presiding over the litigation question was a “terrific” judge and there was little reason to believe that the judge let the case sit on the docket without cause. It also noted that the firm to which the attorney handling the estate litigation who was diagnosed with cancer belonged was a prestigious and professional firm and that the IRS’s that would not delay matters. Finally, it noted that “New Jersey is not Iowa” and appraisals of farmland in New Jersey require extensive knowledge of zoning considerations. The IRS should have conducted an evidentiary hearing or undertaken some investigation before deciding that there was not reasonable cause for the delay in filing. As a result, the “curt one-line denial of the IRS was arbitrary and capricious” and the court granted the estate’s motion for summary judgment.

**Berkenfeld v. Lenet, \_\_\_\_\_\_\_ F.Supp.3d \_\_\_\_\_\_\_\_ (D.Md. 2018)**

**Broker not liable for annuity beneficiaries taking lump sum distributions**

This case was before the court on a motion for summary judgment by the defendants Claire Blumberg passed away in February 2014 at which time she owned annuities issued by Lincoln Financial and Commonwealth/Scudder. When Blumberg died, her daughters and grandson were the beneficiaries of the annuities and each elected a lump sum distribution from the annuities. Each also elected not to have federal income tax withheld from their lump sum distributions. If the daughters and grandson had elected different distribution options, they could have avoided in excess of $200,000 in overall income tax liabilities. They alleged that they elected lump sum distributions because Lenet, an advisor at Morgan Stanley, advised them that the lump sum distribution was the only distribution option. The daughters and grandson sued Morgan Stanley and Lenet in Maryland state court for negligence and breach of fiduciary duty. The defendants remanded the case to federal court. The federal court ruled in favor of the financial advisor and Lenet.

According to the court, no contract or agreement existed between the parties obligating Lenet or Morgan Stanley to give tax advice or an opinion concerning plaintiffs’ available distribution options. The plaintiffs also stated that Lenet advised them to seek independent tax advice concerning their distribution options. The plaintiffs did not seek advice despite having financial advisors and tax experts at their disposal.

Each plaintiff also signed a statement in electing a lump sum disbursement for each annuity which expressly notified them of all available distributions option. Plaintiffs additionally elected not to have federal income tax withheld from their lump sum distributions despite having been warned in writing, “if you opt out of our tax withholding, you are still liable for applicable taxes on your distribution….you may want to discuss your withholding election with a qualified tax advisor.”

The court found that the requirements for summary judgment were met. The party seeking summary judgment must bear the initial burden of demonstrating the absence of a genuine dispute of material fact. In reviewing a motion for summary judgment, the court must take all facts and inferences in the light most favorable to the non-moving party.

The court first examined the claims of negligence against Lenet and Morgan Stanley to see whether the defendant owed a duty to the plaintiffs, whether the defendant breached that duty, whether a causal relationship existed between the breach and the harm plaintiffs suffered, and the amount of damages.

The court stated that Lenet owed a duty of care to the plaintiffs. In addition, sufficient evidence existed to establish Lenet’s breach because plaintiffs testified that Lenet erroneously advised that the lump sum distributions were the only disbursement option. Also, Lenet’s advice did not conform to the standard of care that was owed to the plaintiffs. It was clear that professional standards of care required Lenet to research plaintiffs’ disbursement options and advise them accordingly. As a result, Lenet’s erroneous advice was negligent.

The evidence, construed most favorably to plaintiffs, also established causation. Plaintiffs showed that, but for Lenet’s advice, they would not have chosen the lump sum distribution option. It was also foreseeable that plaintiffs would rely on the advice of a trusted financial advisor, the result of which was greater tax liability than that associated with the other distribution options. In addition, plaintiffs established a *prima facie* case of negligence against Lenet directly and vicariously as to Morgan Stanley. However, summary judgment was nonetheless warranted because plaintiffs was contributorily negligent.

As the court put it, this case is one in which no room for a difference of opinion exists as to the contributory negligence of the plaintiffs. Two plaintiffs had years of prior experience with annuities similar to the Lincoln and Commonwealth Scudder annuities. It was also undisputed that plaintiffs failed to exercise ordinary care to make prudent investment choices after Blumberg passed away. Despite Lenet expressly telling plaintiffs to obtain independent tax advice before electing a lump sum distribution, plaintiffs never did so even those they had professional advisors. Finally, the election form which plaintiffs used to select a lump sum distribution clearly identified all other distribution alternatives and required that plaintiffs select one. The Lincoln forms also stated, “Instructions, important information, please read carefully and completely”. Defendant’s motion for summary judgment was also granted on the breach of fiduciary duty count. While a breach of fiduciary duty may support a negligence or breach of contract claim it is not a stand-alone cause of action under Maryland law.

**United States v. Paulson, 204 F. Supp. 3d 1102 (S.D. Cal. 2018)**

**Court denies defendant’s motion to stay proceedings pending decision of state court**

Allen Paulson established a living trust in 1986. In 1988, Allen Paulson entered into an ante-nuptial agreement with Madeleine Pickens. The ante-nuptial agreement defined their respective separate property and established certain gifts for Madeleine in the event of Allen’s death. Allen subsequently amended and restated the living trust several times in early 2000 prior to his death on July 19, 2000.

The living trust gave Madeleine the power to elect between receiving property under the anti-nuptial agreement or under the living trust but not both. The living trust also created a marital trust for Madeleine’s benefit. Under the terms of the living trust, the marital trust was to receive a residence and all personal property located at the residence in Rancho Santa Fe, California. The living trust also gave Madeleine the right to receive a second residence located in Del Mar, California as well as the tangible property in that residence. The marital trust also was to receive 25 percent of the residue of the living trust. The living trust named Madeleine, Michael Paulson (Allen’s son), and Edward White as the co-trustees of the marital trust.

At the time of Allen’s death, all of Allen’s assets were held in the living trust except his shares in the Gold River Hotel and Casino Corporation. The living trust assets included approximately $24,764,500 in real estate; $113,761,706 in stocks and bonds; $23,664,644 in cash and receivables, and $31,243,494 in miscellaneous assets. Accordingly, the estate assets totaled approximately $193,434,344. Michael Paulson, served as the executor of Allen’s estate. Michael Paulson also became the co-trustee of the living trust, with Edward White until White’s resignation on October 8, 2001. Thereafter, Nicholas V. Diaco acted as co-trustee of the living trust with Michael Paulson.

In April 2001, the estate requested an extension of time to file the Form 706 until October 19, 2001 and an extension of time to pay taxes until October 19, 2002. Both requests for extension were granted. On October 23, 2001, the IRS received the estate’s Form 706 which was signed by Michael Paulson as co-executor of the estate. In completing the tax return, the estate elected to use the alternate evaluation date of January 19, 2001. The estate reported a total gross estate of $187,726,626, a net taxable estate of $9,234,172 and an estate tax liability of $4,459,051. On November 22, 2001, the IRS assessed the reported tax of $4,459,051. The estate elected to pay part of its taxes and defer the other portion under Section 6166. Accordingly, the estate paid $706,296 as the amount not qualified for deferral, leaving a deferral balance of $3,752,755 to be paid under the Section 6166 installment election. While the estate’s tax return was under review, personal disputes arose between Michael, Madeleine, and other beneficiaries. In 2003, the parties reached a settlement which was approved by the California Probate Court. Under the 2003 settlement, Madeleine forewent property under both the ante-nuptial agreement and the living trust, instead choosing to receive direct distributions from the living trust. Madeleine received the Rancho Santa Fe residence, the Del Mar residence, and the stock in the Del Mar Country Club. These distributions were made directly to Madeleine as trustee of her separate property trust. During 2004, Michael, as trustee of the living trust, distributed $5,921,888 of trust assets to various individuals.

On January 16, 2005, the IRS issued a notice of deficiency to Michael as executor of the estate which proposed a $37,801,245 deficiency in estate tax. This was argued before the tax court and the tax court determined that the estate had $6,669,477 in additional estate tax which the estate elected to pay under Section 6166. During 2006, Michael distributed an additional $1,250,000 from the living trust. In March 2009, the probate court removed Michael Paulson as trustee for misconduct. At that point, two other children of Allen, Vikki Paulson and James Paulson were appointed as co-trustees. They reported that the living trust had assets worth $13,738,727. On May 7, 2010, in response to one or more missed installment payments, the IRS issued the estate a notice of final termination, stating that the extension of time for payment under Section 6166 no longer applied. On June 10, 2010, the probate court removed James Paulson as a co-trustee for breach of court orders. Accordingly, Vikki remained as the sole trustee of the living trust.

On August 5, 2010, the estate filed a petition in the tax court challenging the proposed termination of the Section 6166 installment payment election. On February 28, 2011, Crystal Christensen was appointed as co-trustee of the living trust. At this time, the living trust assets were worth approximately $8,802,034. In May 2011, the tax court entered a stipulated decision sustaining the IRS’s decision to terminate the installment payment election. Between June 28, 2011 and July 7, 2011, the IRS reported notices of federal tax liens against the estate in the property records of San Diego and Los Angeles counties. On August 16, 2012, Vikki Paulson and Crystal Christensen, as successor trustees to the living trust, filed a petition for review of the estate’s collection due process rights with the tax court. This was dismissed by the tax court on April 18, 2013 for lack of jurisdiction because Michael Paulson, who was the court-appointed executor at the time the petition was filed, did not sign the petition.

From approximately 2007 through 2013, several disputes arose between Michael, Vikki, Crystal Christensen, James, and other interested parties which were eventually settled on June 3, 2013. As a result of the 2013 settlement, Michael obtained the living trust’s ownership interest in Supersonic Aerospace International LLC, the Gold River Hotel and Casino Corporation, and the Gold River Operation Corporation. As of July 10, 2015, the estate had an unpaid estate tax liability of $10,261,217. On September 16, 2015, the IRS filed a complaint seeking judgment against the estate for unpaid estate taxes and against, the defendants in either their representative or individual capacities or both for unpaid estate taxes.

As of September 16, 2015, there were several complaints against the trustees or executors for unpaid taxes and cross-claims between them. There were also several motions for summary judgment that were pending on the eve of decision in this matter.

Vikki and Crystal requested that the court stay the various motions for summary judgment while the California Probate Court heard their petition which was filed on February 13, 2018. The court noted that in determining when a stay is appropriate, it must weigh competing interest and maintain an even balance. In determining whether to grant the stay, courts considered three factors:

1. the possible damage which may result in granting the stay;

2. the hardship or inequity which a party may suffer in being required to go forward; and

3. the orderly course of justice measured in terms of the simplifying or complicating of issues, proof, and questions of law which could be expected result from a stay.

The court in looking at the request determined that the defendants would not suffer undue hardship if the action was not stayed. It then noted, that the government would be prejudiced if a stay were granted. It noted the defendants made this request nearly three years after the government first filed this action and provided no indication of when the probate court would resolve the issues. In addition, the probate petition would not simplify the issues before the court. Instead, because this case invoked the federal question, as well as issues that the federal court had been dealing with since 2015, staying the case would be “unconstructive”. As a result, all three factors weighed against the defendants’ motion to stay and the motion was denied.

**Comptroller of the Treasury v. Taylor, 189 A.3d 799 (Md. Ct. Spec. App. July 25, 2018), reversed by Maryland Court of Appeals, 21-C-15-055059 (July 29, 2019); In re Estate of Seiden, NYLJ 10/12/18 p. 23, col. 5 (N.Y. County Surr. Ct.) (addressed by New York State Legislature in April 2019 Executive Budget)**

**Maryland and New York Courts and New York State legislature address impact of federal QTIP elections on calculation of state death taxes**

The facts in these cases were simple; however, the consequences could have been complex if the Maryland Court of Appeals (the highest court in Maryland) had not reversed the decision of the Maryland Court of Special in Taylor in 2019 and the New York legislature had enacted legislation in 2019 to counter the decision in Seiden. In 1981, when Congress added Section 2056(b)(7) to the Code to permit what have become known as QTIP trusts, it seemed like such a perfect idea. Even though the trust for the surviving spouse (or donee spouse under Section 2523(f)) did not need any of the traditional features that by their terms would include the value of the trust assets in the surviving spouse’s gross estate – such as a general power of appointment in the case of Sections 2056(b)(5) and 2523(e) or payment to the estate in the case of Treas. Reg. §20.2056(c)-2(b)(1)(iii) – that inclusion in the surviving spouse’s gross estate was assured by the contemporaneous enactment of Section 2044, providing for inclusion whenever a marital deduction was allowed under Section 2056(b)(7) or 2523(f), backstopped by Section 2519 in the case of the surviving spouse’s actions during life. Thus was maintained the fundamental character of the marital deduction as a deferral only – the asset escapes tax at the first death but is taxed at the second death. Even if the surviving spouse who is a U.S. citizen moves out of the country, Section 2001(a) continues to apply, and if such a surviving spouse with sufficient income or assets also renounces that U.S. citizenship, Sections 877 and 2107 ensure continued taxation for 10 years. Meanwhile, the 1981 objective of making the marital deduction unlimited without having to give the surviving spouse control over the disposition of the remainder is fulfilled in the QTIP trust.

Since 2001 and the three-year phase-out of the credit for state death taxes, and especially with state legislatures setting their estate tax exemptions lower than the federal basic exclusion amount, some states that still have an estate tax have provided for a state-only QTIP election, available when the estate is under the federal exclusion amount but not under the state exemption, or applicable to the extent the state exemption is less than the federal exclusion amount. But symmetry is lost to the fact that a state is powerless when the surviving spouse moves out of the state. “Worldwide,” or nationwide taxation is not allowed, and, under Section 1 of the Fourteenth Amendment to the U.S. Constitution, a citizen of a state loses that citizenship merely by moving to another state. That dissymmetry is the backdrop for these cases identified as the sixth top development of 2018.

In Taylor, the predeceased spouse died domiciled in Michigan and created a trust. Both federal and Michigan QTIP elections were made. The surviving spouse moved to Maryland and died domiciled in Maryland.

The Maryland Tax Court held in 2015 that the QTIP property should be included the estate of the surviving spouse. The circuit court then held in 2016 that the federal QTIP election simply enabled the trust assets to be taxable as part of the federal estate. The QTIP election did not convert the trust assets into the personal property of the surviving spouse which could be subjected to Maryland estate tax.

The Maryland Court of Special Appeals in 2018 affirmed the circuit court and held that Maryland cannot tax the QTIP trust because no Maryland QTIP election had been made. The court cited Code of Maryland-Tax-General § 7-309(b)(6)(i) (emphasis added):

“For purposes of calculating Maryland estate tax, a decedent shall be deemed to have had a qualifying income interest for life under §2044(a) of the Internal Revenue Code with regard to any property for which a marital deduction qualified terminable interest property election was made for the decedent’s predeceased spouse *on a timely filed Maryland estate tax return*.”

The Maryland Court of Appeals reversed the Maryland Court of Special Appeals in 2019. It held that the state did not seek to tax the property of the first spouse to die or the transfer of the first spouse’s property but to tax the deemed transfer of the QTIP property upon the surviving spouse’s death as a Maryland resident. The Court of Appeals found § 7-309(b)(6) to be irrelevant since it read that section as only apply to augmenting the Maryland estate with additional property. The QTIP property was included in the surviving spouse’s estate under federal law and there was no additional property to augment the Maryland estate. It concluded that the plain language and the legislative history of the pertinent provisions of the Maryland Code reveal that the value of the surviving spouse’s estate was the same for federal and Maryland estate tax purposes. Interpr3eting the statutes otherwise could result in a loophole (as noted in the concurring opinion) where Maryland “would tax only the QTIP trusts that were elected in Maryland estate tax returns, and not QTIP trusts that created in other States, where the beneficiary of the trust resided in Maryland at the time of death.”

In Seiden, the predeceased spouse died domiciled in New York in 2010, when there was no federal estate tax. But New York still had its estate tax, and a New York-only QTIP election was made. The surviving spouse did not move out of the state and died domiciled in New York.

The New York court held that New York cannot tax the QTIP trust because New York totally piggybacks on the federal gross estate, and there was no QTIP trust for federal estate tax purposes. Like the Maryland court in Taylor, the New York court relied on the New York statute, New York Tax Law §954(a), which provides that the New York gross estate of a deceased resident “means his or her federal gross estate.” Because there was no federal QTIP election, the value of the trust assets was not included in the federal gross estate and hence were not included in the New York gross estate either.

The New York result in Seiden was not limited to surviving spouses of predeceased spouses who died in 2010. For example, if the first spouse died domiciled in New York in 2014 with a gross estate of $10 million, the federal exclusion would have been $5.34 million, and the New York exemption would have been $1 million. A reduce-to-zero marital bequest to a QTIP trust related solely to the federal estate tax would have been $4.66 million, leaving a tentative New York taxable estate of $3.66 million. New York tax could have been avoided with a New York-only QTIP election for a trust funded with $3.66 million. Upon the surviving spouse’s death, in 2018 for example (assuming no changes in values), the federal gross estate would include the $4.66 million federal-QTIP trust, but not the $3.66 million New York-only-QTIP trust. A very odd result from the term “New York-only.”

The New York State Legislature enacted corrective action to address Seiden in the Executive Budget that Governor Cuomo signed into law on April 12, 2019. The legislation increases the New York taxable estate of a surviving spouse by the value of the property in the marital trust created at the first spouse’s death for which a QTIP election was made for New York estate tax purposes even if a federal QTIP election was not made for the marital trust. This provision is effective for estates of decedents dying on or after April 1, 2019.

**Letter Ruling 201923002 (Issued March 4, 2019; Released June 7, 2019)**

**Decedent’s IRA is not an inherited IRA and taxpayer can roll over distribution from IRA into one or more IRAs established in her own name**

Decedent owned an individual retirement account (IRA), the beneficiary of which was Taxpayer’s Trust. Taxpayer, the spouse of the decedent, was the sole trustee and beneficiary of Taxpayer’s Trust and Taxpayer had the right to withdraw the net income and principal of the trust. Taxpayer had the right to modify, amend, or revoke Taxpayer’s Trust at any time and Taxpayer had the sole authority and discretion to distribute the IRA proceeds to herself at any time. Taxpayer intended to roll over the amounts paid to her from Decedent’s IRA to an IRA in her own name.

The Internal Revenue Service ruled that:

1. Decedent’s IRA would not be treated as an inherited IRA.
2. Taxpayer was eligible to roll over distributions from Decedent’s IRA to her own IRA or IRA’s.
3. Taxpayer would not be required to include any portion of the proceeds rolled over to her IRA or IRA’s in her gross income in the year of the rollover.

Taxpayer was entitled to the proceeds of Decedent’s IRA as the sole beneficiary of Taxpayer’s Trust during Taxpayer’s life. Consequently, Taxpayer was effectively the individual for whose benefit the retirement account was maintained for purposes of determining that the IRA was not an inherited IRA. Under Treas. Reg. § 1.408-8 Q&A-5, a surviving spouse may elect to the teat the spouse’s entire interest as a beneficiary in the individual’s IRA as the spouse’s own. If Taxpayer received a distribution of the proceeds of Decedent’s IRA, Taxpayer could roll over the distribution into one or more IRA’s established and maintained in her name.

**Letter Ruling 201927009 (Issued April 8, 2019; Released July 5, 2019)**

**Transfer of funds via a trustee to trustee transfer from decedent’s IRA to inherited IRA did not result in taxable distributions or rollovers**

Decedent died after the required beginning date. Decedent’s spouse predeceased him and decedent was survived by two children. Pursuant to decedent’s will, the estate was payable to Trust. Under the Trust, the assets were to be distributed in accordance with the terms of the family trust. Upon the death of Decedent, the family trust assets were divided in equal shares for decedent’s two children that were to be distributed outright to the two children.

Decedent was the owner of an individual retirement account (IRA). Decedent named his estate as the beneficiary of IRA. The estate wanted to divide the IRA by means of a trustee to trustee transfer into two separate inherited IRAs for the benefit of Child 1 and Child 2 respectively.

The Internal Revenue Service ruled that the estate could transfer via a trustee to trustee transfer, amounts from the decedent’s IRA to one inherited IRA in the name of Child 1 and to another inherited IRA in the name of Child 2 in order to separate the interests of Child 1 and Child 2 in decedent’s IRA. These transfers would not result in taxable distributions or rollovers.

The IRAs created by means of the trustee to trustee transfers would be inherited IRAs as defined in Section 408(d)(3)(C).

**Letter Ruling 201839005 (Issued June 25, 2018; Released September 28, 2018)**

**Taxpayer allowed to rollover deceased husband’s state maintained retirement plan into IRA**

Decedent died in 2017 and was survived by his wife and his children. The decedent was employed by a state and was a participant in a qualified plan maintained by the state. Under the terms of the plan, upon a participant’s death, the plan proceeds were payable to the participant’s designated beneficiary. However, if a participant lacked a valid designated beneficiary in effect at the time of death, the participant’s benefit was payable to the participant’s estate. In this letter ruling, the decedent did not have a designated beneficiary in effect at the time of death and the entire plan benefit was payable to the decedent’s estate.

Because the decedent died intestate, his estate would have been payable to his wife and the children under state law. However, the children validly disclaimed their interest in the decedent’s estate. As the result, the wife was the sole beneficiary of the estate. The wife, as the surviving spouse of the decedent and sole beneficiary of the estate, desired to cause the plan to pay the decedent’s benefit to the estate and within 60 days after the date of distribution from the plan to roll the entire distribution from the plan into a IRA set up and maintained in the name of the wife. The wife sought a ruling that the proposed rollover of the plan benefit into an IRA would have no adverse income tax consequences and the amount distributed would be excluded from the wife’s income.

The Service ruled that the taxpayer could rollover the plan benefit into an IRA provided that the rollover was completed within 60 days and to the extent that the amount distributed from the plan was timely rolled over to that IRA it would be excluded from income under Section 402(c)(1). Section 402(c)(1) provides generally that if any portion of an eligible rollover distribution from a qualified trust is transferred into an eligible retirement plan, the portion of the distribution so transferred shall not be includable in gross income. An IRA is an eligible retirement plan for purposes of the rollover.

**2020 State Death Tax Chart (as of January 1, 2020)**

| **State**  **Type of Tax** | **Current Law** | **2020 State Death Tax Threshold** |
| --- | --- | --- |
| Alabama  None | Tax is tied to federal state death tax credit.  AL ST § 40-15-2. |  |
| Alaska  None | Tax is tied to federal state death tax credit.  AK ST § 43.31.011. |  |
| Arizona  None | Tax was tied to federal state death tax credit.  AZ ST §§ 42-4051; 42-4001(2), (12).  On May 8, 2006, Governor Napolitano signed SB 1170 which permanently repealed Arizona’s state estate tax. |  |
| Arkansas  None | Tax is tied to federal state death tax credit.  AR ST § 26-59-103; 26-59-106; 26-59-109, as amended March, 2003. |  |
| California  None | Tax is tied to federal state death tax credit. CA REV & TAX §§ 13302; 13411. |  |
| Colorado  None | Tax is tied to federal state death tax credit. CO ST §§ 39-23.5-103; 39-23.5-102. |  |
| Connecticut  Separate Estate Tax | On October 31, 2017, the Connecticut Governor signed the 2018-2019 budget which increased the exemption for the Connecticut state estate and gift tax to $2,600,000 in 2018, to $3,600,000 in 2019, and to the federal estate and gift tax exemption in 2020.  On May 31, 2018, Connecticut changed its estate tax law to extend the phase-in of the exemption to 2023 to reflect the increase in the federal exemption to $10 million indexed for inflation in the 2017 Tax Act. The exemption will be phased in as follows:  2019: $3.6 million  2020: $5.1 million  2021: $7.1 million  2022: $9.1 million:  2023: federal exemption for deaths on or after January 1, 2023.  Beginning in 2019, the cap on the Connecticut state estate and gift tax is reduced from $20 million to $15 million (which represents the tax due on a Connecticut estate of approximately $129 million). | $5,100,000 |
| Delaware  None | On July 2, 2017, the Governor signed HB 16 which sunsets the Delaware Estate Tax on December 31, 2017. |  |
| District of Columbia  Pick-up Only | No separate QTIP election.  DC Bill B22-0685 was introduced in the DC City Council on February 8, 2018. This proposal cut the DC threshold to $5.6 million adjusted for inflation retroactive to January 1, 2018. This change was enacted by the DC City Council on September 5, 2018 as part of the Budget Support Act. | $5,681,760 (2019) |
| Florida  None | Tax is tied to federal state death tax credit.  FL ST § 198.02; FL CONST. Art. VII, Sec. 5 |  |
| Georgia  None | Effective July 1, 2014, the Georgia estate tax was repealed. See § 48-12-1. |  |
| Hawaii  Modified Pick-up Tax | On May 2, 2012, the Hawaii legislature passed HB 2328 which conforms the Hawaii estate tax exemption to the federal estate tax exemption for decedents dying after January 25, 2012.  On June 7, 2018, the governor signed SB 2821, which amended HI ST § 236E-6 to reduce the Hawaiian exemption, effective January 1, 2018, to $5,000,000 indexed for inflation.  The Hawaii Department of Taxation released Announcement 2018-13 on September 4, 2018 in which it announced that the exemption will remain at the amount available to decedents dying during 2017.  In response to calls from practitioners, the Hawaii Department of Taxation indicated that was not going to adjust the exemption for inflation in 2019.  Effective January 1, 2020, Hawaii increased the rate of its state estate tax on estates valued at over $10,000,000 to 20 percent. See Act No. 3 (April 4, 2019). | $5,490,000 |
| Idaho  None | Tax is tied to federal state death tax credit.  ID ST §§ 14-403; 14-402; 63-3004 (as amended Mar. 2002). |  |
| Illinois  Modified Pick-up Only | On January 13, 2011, Governor Quinn signed Public Act 096-1496 which increased Illinois’ individual and corporate income tax rates. Included in the Act was the reinstatement of Illinois’ estate tax as of January 1, 2011 with a $2 million exemption.  Senate Bill 397 passed both the Illinois House and Senate as part of the tax package for Sears and CME on December 13, 2011. It increased the exemption to $3.5 million for 2012 and $4 million for 2013 and beyond. Governor Quinn signed the legislation on December 16, 2011.    Illinois permits a separate state QTIP election, effective September 8, 2009. 35 ILCS 405/2(b-1). | $4,000,000 |
| Indiana  None | Pick-up tax is tied to federal state death tax credit.  IN ST §§ 6-4.1-11-2; 6-4.1-1-4.  On May 11, 2013, Governor Pence signed HB 1001 which repealed Indiana’s inheritance tax retroactively to January 1, 2013. This replaced Indiana’s prior law enacted in 2012 which phased out Indiana’s inheritance tax over nine years beginning in 2013 and ending on December 31, 2021 and increased the inheritance tax exemption amounts retroactive to January 1, 2012 | . |
| Iowa  Inheritance Tax | Pick-up tax is tied to federal state death tax credit. IA ST § 451.2; 451.13.  Effective July 1, 2010, Iowa specifically reenacted its pick-up estate tax for decedents dying after December 31, 2010. Iowa Senate File 2380, reenacting IA ST § 451.2.  Iowa has a separate inheritance tax on transfers to others than lineal ascendants and descendants. |  |
| Kansas  None | For decedents dying on or after January 1, 2007 and through December 31, 2009, Kansas had enacted a separate stand-alone estate tax. KS ST § 79-15, 203 |  |
| Kentucky  Inheritance Tax | Pick-up tax is tied to federal state death tax credit. KY ST § 140.130.  Kentucky has not decoupled but has a separate inheritance tax and recognizes by administrative pronouncement a separate state QTIP election. |  |
| Louisiana  None | Pick-up tax is tied to federal state death tax credit. LA R.S. §§ 47:2431; 47:2432; 47:2434. |  |
| Maine  Pick-up Only | For decedents dying after December 31, 2002, pick-up tax was frozen at pre-EGTRRA federal state death tax credit, and imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law) (L.D. 1319; March 27, 2003).  On June 20, 2011, Maine's governor signed Public Law Chapter 380 into law, which increased the Maine estate tax exemption to $2 million in 2013 and beyond. The rates were also changed, effective January 1, 2013, to 0% for Maine estates up to $2 million, 8% for Maine estates between $2 million and $5 million, 10 % between $ 5 million and $8 million and 12% for the excess over $8 million.  On June 30, 2015, the Maine legislature overrode the Governor’s veto of LD 1019, the budget bill for fiscal years 2016 and 2017. As part of the law, the Maine Exemption was tagged to the federal exemption for decedents dying on or after January 1, 2016.  The tax rates are:  8% on the first $3 million above the Maine Exemption;  10% on the next $3 million above the Maine Exemption; and  !2% on all amounts above $6 million above the Maine Exemption.  The new legislation did not include portability as part of the Maine Estate Tax.  On September 12, 2018, LP1655 became law without the Governor’s signature. The new law amends M.R.S. Title 36, Section 4102 and Section 4119 to make the Maine exemption $5,600,000 adjusted for inflation for decedents dying on and after January 1, 2018.  For estates of decedents dying after December 31, 2002, Sec. 2058 deduction is ignored in computing Maine tax and a separate state QTIP election is permitted. M.R.S. Title 36, Sec. 4062.    Maine also subjects real or tangible property located in Maine that is transferred to a trust, limited liability company or other pass-through entity to tax in a non-resident’s estate. M.R.S. Title 36, Sec. 4064. | $5,800,000 |
| Maryland  Pick-up Tax  Inheritance Tax | On May 15, 2014, Governor O’Malley signed HB 739 which repealed and reenacted MD TAX GENERAL §§ 7-305, 7-309(a), and 7-309(b) to do the following:   1. Increased the threshold for the Maryland estate tax to $1.5 million in 2015, $2 million in 2016, $3 million in 2017, and $4 million in 2018. For 2019 and beyond, the Maryland threshold will equal the federal applicable exclusion amount. 2. Continued to limit the amount of the federal credit used to calculate the Maryland estate tax to 16% of the amount by which the decedent’s taxable estate exceeds the Maryland threshold unless the Section 2011 federal state death tax credit is then in effect. 3. Continued to ignore the federal deduction for state death taxes under Sec. 2058 in computing Maryland estate tax, thus eliminating a circular computation. 4. Permitted a state QTIP election.   On April 5, 2018, HB 0308 became law. The new law provides that for 2019 and thereafter, the Maryland threshold will be capped at the fixed amount of $5 million rather than being equal to the inflation-adjusted federal exemption as provided under prior law.  The new law also provides for the portability of the unused predeceased spouse’s Maryland exemption amount to the surviving spouse beginning in 2019. | $5,000,000 |
| Massachusetts  Pick-up Only | For decedents dying in 2002, pick-up tax is tied to federal state death tax credit. MA ST 65C §§ 2A.  For decedents dying on or after January 1, 2003, pick-up tax is frozen at federal state death tax credit in effect on December 31, 2000. MA ST 65C §§ 2A(a), as amended July 2002.  Tax imposed on estates exceeding applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount.  See, Taxpayer Advisory Bulletin (Dec. 2002), DOR Directive 03-02, Mass. Guide to Estate Taxes (2003) and TIR 02-18 published by Mass. Dept. of Rev.  Massachusetts Department of Revenue has issued directive, pursuant to which separate Massachusetts QTIP election can be made when applying state’s new estate tax based upon pre-EGTRRA federal state death tax credit. | $1,000,000 |
| Michigan  None | Tax is tied to federal state death tax credit.  MI ST §§ 205.232; 205.256 |  |
| Minnesota  Pick-up Only | Tax frozen at federal state death tax credit in effect on December 31, 2000, clarifying statute passed May 2002.  Tax imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 (including scheduled increases under pre-EGTRRA law), even if that amount is below EGTRRA applicable exclusion amount.  MN ST §§ 291.005; 291.03; instructions for MN Estate Tax Return; MN Revenue Notice 02-16.  Separate state QTIP election permitted.  On May 30, 2017, the governor signed the budget bill, H.F. No. 1 which increased the Minnesota estate tax exemption for 2017 from $1,800,000 to $2,100,000 retroactively, and increases the exemption to $2,400,000 in 2018, $2,700,000 in 2019, and $3,000,000 for 2020 and thereafter.  A provision enacted in 2013 to impose an estate tax on non-residents who own an interest in a pass-through entity which in turn owned real or personal property in Minnesota was amended in 2014 to exclude certain publicly traded entities. It still applies to entities taxed as partnerships or S Corporations that own closely held businesses, farms, and cabins. | $3,000,000 |
| Mississippi  None | Tax is tied to federal state death tax credit.  MS ST § 27-9-5. |  |
| Missouri  None | Tax is tied to federal state death tax credit.  MO ST §§ 145.011; 145.091. |  |
| Montana  None | Tax is tied to federal state death tax credit.  MT ST § 72-16-904; 72-16-905. |  |
| Nebraska  County Inheritance Tax | Nebraska through 2006 imposed a pick-up tax at the state level. Counties impose and collect a separate inheritance tax.  NEB REV ST § 77-2101.01(1). |  |
| Nevada  None | Tax is tied to federal state death tax credit.  NV ST Title 32 §§ 375A.025; 375A.100. |  |
| New Hampshire  None | Tax is tied to federal state death tax credit.  NH ST §§ 87:1; 87:7. |  |
| New Jersey  Inheritance Tax | On October 14, Governor Christie signed Assembly Bill A-12 which was the tax bill accompanying Assembly Bill A-10 which revised the funding for the state’s Transportation Fund. Under this law, the Pick-Up Tax had a $2 million exemption in 2017 and was eliminated as of January 1, 2018. The new law also eliminated the tax on New Jersey real and tangible property of a non-resident decedent.  The repeal of the pick-up tax did not apply to the separate New Jersey inheritance tax. | . |
| New Mexico  None | Tax is tied to federal state death tax credit.  NM ST §§ 7-7-2; 7-7-3. |  |
| New York  Pick-up Only | The Executive Budget of 2014-2015 which was signed by Governor Cuomo on March 31, 2014 made substantial changes to New York’s estate tax.  The New York estate tax exemption which was $1,000,000 through March 31, 2014 was increased as follows:  April 1, 2014 to March 31, 2015 -- $2,062,500  April 1, 2015 to March 31, 2016 -- $3,125,000  April 1, 2016 to March 31, 2017 -- $4,187,500  April 1, 2017 to December 31, 2018 -- $5,250,000  As of January 1, 2019, the New York estate tax exemption amount will be the same as the federal estate tax applicable exclusion amount **prior** to the 2017 Tax Act which is $5,000,000 adjusted for inflation.  The maximum rate of tax will continue to be 16%.  Taxable gifts within three years of death between April 1, 2014 and December 31, 2018 will be added back to a decedent’s estate for purposes of calculating the New York tax.  The New York estate tax is a cliff tax. If the value of the estate is more than 105% of the then current exemption, the exemption will not be available.  On April 1, 2015, as part of 2015-2016 Executive Budget, New York enacted changes to the New York Estate Tax. New York first clarified that the new rate schedule enacted in 2014 applies to all decedents dying after April 1, 2014. Previously, the rate schedule only applied through March 31, 2015. New York then modified the three year gift add-back provision to make it clear that the gift add-back does not apply to any individuals dying on or after January 1, 2019. Previously, the gift add-back provision did not apply to gifts made on or after January 1, 2019.  New York continues not to permit portability for New York estates and no separate state QTIP election is allowed when portability is elected on a federal return. | $5,850,000 |
| North Carolina  None | On July 23, 2013, the Governor signed HB 998 which repealed the North Carolina estate tax retroactively to January 1, 2013. |  |
| North Dakota  None | Tax is tied to federal state death tax credit.  ND ST § 57-37.1-04 |  |
| Ohio  None | Governor Taft signed the budget bill, 2005 HB 66, repealing the Ohio estate (sponge) tax prospectively and granting credit for it retroactively. This was effective June 30, 2005 and killed the sponge tax.  On June 30, 2011, Governor Kasich signed HB 153, the biannual budget bill, which contained a repeal of the Ohio state estate tax effective January 1, 2013. |  |
| Oklahoma  None | Tax is tied to federal state death tax credit.  OK ST Title 68 § 804  The separate estate tax was phased out as of January 1, 2010. |  |
| Oregon  Separate Estate Tax | On June 28, 2011, Oregon’s governor signed HB 2541 which replaced Oregon’s pick-up tax with a stand-alone estate tax effective January 1, 2012.  The new tax has a $1 million threshold with rates increasing from ten percent to sixteen percent between $1 million and $9.5 million.  Determination of the estate for Oregon estate tax purposes is based upon the federal taxable estate with adjustments. | $1,000,000 |
| Pennsylvania  Inheritance Tax | Tax is tied to the federal state death tax credit to the extent that the available federal state death tax credit exceeds the state inheritance tax.  PA ST T. 72 P.S. § 9117 amended December 23, 2003.  Pennsylvania had decoupled its pick-up tax in 2002, but has now recoupled retroactively. The recoupling does not affect the Pennsylvania inheritance tax which is independent of the federal state death tax credit.  Pennsylvania recognizes a state QTIP election. |  |
| Rhode Island  Pick-up Only | Tax frozen at federal state death tax credit in effect on January 1, 2001, with certain adjustments (see below). RI ST § 44-22-1.1.  Rhode Island recognized a separate state QTIP election in the State’s Tax Division Ruling Request No. 2003-03.  Rhode Island's Governor signed into law HB 5983 on June 30, 2009, effective for deaths occurring on or after January 1, 2010, an increase in the amount exempt from Rhode Island estate tax from $675,000, to $850,000, with annual adjustments beginning for deaths occurring on or after January 1, 2011 based on "the percentage of increase in the Consumer Price Index for all Urban Consumers (CPI-U). . . rounded up to the nearest five dollar ($5.00) increment." RI ST § 44-22-1.1.  On June 19, 2014, the Rhode Island Governor approved changes to the Rhode Island Estate Tax by increasing the exemption to $1,500,000 indexed for inflation in 2015 and eliminating the cliff tax. | $1,579,922 |
| South Carolina  None | Tax is tied to federal state death tax credit.  SC ST §§ 12-16-510; 12-16-20 and 12-6-40, amended in 2002. |  |
| South Dakota  None | Tax is tied to federal state death tax credit.  SD ST §§ 10-40A-3; 10-40A-1 (as amended Feb. 2002). |  |
| Tennessee  None | Pick-up tax is tied to federal state death tax credit.  TN ST §§ 67-8-202; 67-8-203.  Tennessee had a separate inheritance tax which was phased out as of January 1, 2016. |  |
| Texas  None | Tax was permanently repealed effective as of September 15, 2015 when Chapter 211 of the Texas Tax Code was repealed. Prior to September 15, 2015, the tax was tied to the federal state death tax credit. |  |
| Utah  None | Tax is tied to federal state death tax credit.  UT ST § 59-11-102; 59-11-103. |  |
| Vermont  Modified Pick-up | In 2010, Vermont increased the estate tax exemption threshold from $2,000,000 to $2,750,000 for decedents dying on or after January 1, 2011. As of January 1, 2012, the exclusion equaled the federal estate tax applicable exclusion amount, so long as the FET exclusion was not less than $2,000,000 and not more than $3,500,000. VT ST T. 32 § 7442a.  On June 18, 2019, Vermont enacted H. 541 which increased the Vermont estate tax exemption to $4,250,000 in 2020 and $5,000,000 in 2021 and thereafter.  No separate state QTIP election permitted.  Vermont does not permit portability of its estate tax exemption. | $4,250,000 |
| Virginia  None | Tax is tied to federal state death tax credit.  VA ST §§ 58.1-901; 58.1-902.  The Virginia tax was repealed effective July 1, 2007. Previously, the tax was frozen at federal state death tax credit in effect on January 1, 1978. Tax was imposed only on estates exceeding EGTRRA federal applicable exclusion amount. VA ST §§ 58.1-901; 58.1-902. |  |
| Washington  Separate Estate Tax | LEGISLATIVE FRAMEWORK. On February 3, 2005, the Washington State Supreme Court unanimously held that Washington’s state death tax was unconstitutional. The tax was tied to the current federal state death tax credit, thus reducing the tax for the years 2002 - 2004 and eliminating it for the years 2005 - 2010. Hemphill v. State Department of Revenue 2005 WL 240940 (Wash. 2005).  In response to Hemphill, the Washington State Senate on April 19 and the Washington House on April 22, 2005, by narrow majorities, passed a stand-alone state estate tax with rates ranging from 10% to 19%, a $1.5 million exemption in 2005 and $2 million thereafter, and a deduction for farms for which a Sec. 2032A election could have been taken (regardless of whether the election is made). The Governor signed the legislation.  WA ST §§ 83.100.040; 83.100.020.  Washington voters defeated a referendum to repeal the Washington estate tax in the November 2006 elections.  On June 14, 2013, Governor Inslee signed HB 2075 which closed an exemption for marital trusts retroactively immediately prior to when the Department of Revenue was about to start issuing refund checks, created a deduction for up to $2.5 million for certain family owned businesses and indexes the $2 million Washington state death tax threshold for inflation.  SEPARATE QTIP ELECTION. Washington permits a separate state QTIP election. WA ST §83.100.047.  NO INDEXING FOR INFLATION IN 2019. Washington State was supposed to index the exemption annually for inflation. However, this was not done for 2019.  On December 18, 2018, the Department of Revenue sent an email stating that pursuant to Revised Code of Washington (RCW) 83.100, the Department must adjust the Washington applicable estate tax exclusion amount annually using the Seattle-Tacoma-Bremerton metropolitan area October consumer price index (Seattle CPI).  As of January 1, 2018, the US Bureau of Labor and Statistics (USBLS) no longer calculates the consumer price index for the Seattle-Tacoma-Bremerton metropolitan area. Instead, the USBLS will calculate the Seattle-Tacoma-Bellevue Core Based Statistical Area for the Puget Sound region.  As a result of these changes, the definition of “consumer price index” in RCW 83.100.020(1)(b) does not match with the current CPI measure calculated by the USBLS.  The Department is using the last CPI figure for the Seattle CPI. This resulted in no increase in the applicable exclusion amount for 2019 and 2020. | $2,193,000 |
| West Virginia  None | Tax is tied to federal state death tax credit.  WV § 11-11-3. |  |
| Wisconsin  None | Tax is tied to federal state death tax credit. WI ST § 72.01(11m).  For deaths occurring after September 30, 2002, and before January 1, 2008, tax was frozen at federal state death tax credit in effect on December 31, 2000 and was imposed on estates exceeding federal applicable exclusion amount in effect on December 31, 2000 ($675,000), not including scheduled increases under pre-EGTRRA law, even though that amount is below the lowest EGTRRA applicable exclusion amount. Thereafter, tax imposed only on estates exceeding EGTRRA federal applicable exclusion amount.  WI ST §§ 72.01; 72.02, amended in 2001; WI Dept. of Revenue website.  On April 15, 2004, the Wisconsin governor signed 2003 Wis. Act 258, which provided that Wisconsin will not impose an estate tax with respect to the intangible personal property of a non-resident decedent that has a taxable situs in Wisconsin even if the non-resident’s state of domicile does not impose a death tax. Previously, Wisconsin would impose an estate tax with respect to the intangible personal property of a non-resident decedent that had a taxable situs in Wisconsin if the state of domicile of the non-resident had no state death tax. |  |
| Wyoming  None | Tax is tied to federal state death tax credit.  WY ST §§ 39-19-103; 39-19-104. |  |

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1. These materials were prepared by Charles D. Fox IV, Stephen W. Murphy, and other McGuireWoods lawyers, and the presenter thanks each of them for their invaluable contributions. [↑](#footnote-ref-1)