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THE TOP TEN ESTATE PLANNING AND ESTATE TAX DEVELOPMENTS OF 2021

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Ronald D. Aucutt, Lakewood Ranch, Florida
Senior Fiduciary Counsel, Bessemer Trust
aucutt@bessemer.com

Page Numbers

Page numbers in square brackets refer to the page numbers where the discussion of this topic, if any, begins in the accompanying papers. Page numbers with "E" are in "Estate Planning Recent Developments," and page numbers with "W" are in "Washington Update: Pending and Potential Administrative and Legislative Changes." Both papers are also available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

PART ONE

WHAT TO EXPECT FROM THE IRS AND THE COURTS

Number Ten

The Good (maybe) – Moderate, Not Aggressive, Use of Hindsight in Valuation: *Estate of Michael J. Jackson v. Commissioner*, T.C. Memo. 2021-48 (May 3, 2021) [p. E142]

How Michael Jackson Made the Top Ten

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

The Dramatic Numbers

	Image, Likeness	NHT II*	NHT III**
Return	$2,105	0	$2,207,351
IRS Notice of Def.	$434,264,000	$469,005,086	$60,685,944
Estate at Trial	$3,078,000	0	$2,267,316
IRS at Trial	$161,307,045	$206,295,934	$114,263,615
Tax Court***	$4,153,912	0	$107,313,561
Change	197,235%		4,762%

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

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

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

What Happened?

"What Jackson had created during his lifetime was now fixed and it was to the considerable benefit of the estate that he was no longer able to get in the way of the rational profit maximizers who were now in control. And nearly everyone involved in these early days after Jackson's death turned out to be accomplished in the business side of the entertainment business. As crass as it might have seemed to Jackson's more sentimental fans, the business began almost immediately."

– Tax Court Judge Holmes

Takeaways

- Not expecting the worst when the IRS considers post-death developments in valuation. (In 2011, Sony/ATV paid **$750 million** for NHT II's interest.)
- Recognizing both the challenges and opportunities with image and likeness, and planning for it.
- Handling a high-profile case.
- Choosing appraisers with care.
- Beware of appraisals that are too pessimistic (or too optimistic).
- Mix of caution and affirmation regarding tax-affecting.
- Time it takes to resolve issues: He died in 2009.

Number Nine

The Bad (maybe) – John Doe Summons: *Taylor Lohmeyer v. United States*, 957 F.3d 505 (5th Cir. 2020), *en banc reh'g den.*, 126 AFTR 2d 2020-7208, *cert. den.* Oct. 4, 2021 [p. E133]

Background

- A client paid almost $4 million in tax, interest, and penalties regarding assignment of income to foreign accounts that the law firm had helped him structure.
- The IRS issued a “John Doe summons” to the law firm “seeking documents for … U.S. taxpayers, ‘who, at any time [over 23 years] used the services of [the Firm] ... to acquire, establish, maintain, operate, or control (1) any foreign financial account or other asset; (2) any foreign corporation, company, trust, foundation or other legal entity; or (3) any foreign or domestic financial account or other asset in the name of such foreign entity.’”
- The firm invoked attorney-client privilege.

District Court (W.D. Texas), Enforcing

- "Ultimately, because **blanket assertions of privilege are disfavored** … the Firm does not carry its burden. … Upon this Court ordering enforcement of the summons, if Taylor Lohmeyer wishes to assert any claims of privilege as to any responsive documents, it may then do so, provided that any such claim of privilege is supported by a privilege log which details the foundation for each claim on a document-by-document basis."

Fifth Circuit, Affirming

- The summons would not reach "motive, or other confidential communications of [legal] advice…. Consequently, the Firm's clients' identities are not 'connected inextricably with a privileged communication', and therefore, the 'narrow exception' to the general rule that client identities are not protected by the attorney-client privilege is inapplicable."
- The full court voted **9-8** to deny *en banc* rehearing.

Judge Elrod and 5 Others, Dissenting

- "The IRS has traditionally served such summonses on financial institutions and commercial couriers. **Not lawyers.** There is good reason to be wary of investigations that exert pressure on lawyers. The relationship between a customer and a financial institution or commercial courier plays little, if any, role in **our system's ability to administer justice** – but the same cannot be said of the lawyer-client relationship. When the IRS pursues John Doe summonses against law firms, **serious tensions with the attorney-client privilege** arise."

Judge Elrod, Concluding

- The firm “will have the opportunity to produce a privilege log, asserting privilege on particular responsive documents. … [T]he district court may choose then to conduct an in camera review of those documents. I am confident that any such review will be guided by the following [quoting the panel]: **‘[i]f the disclosure of the client’s identity will also reveal the confidential purpose for which he consulted an attorney, we protect both the confidential communication and the client’s identity as privileged.’**”

ACTC Amicus Brief – What Next?

"[T]he panel's decision could facilitate the issuance of John Doe summons to a law firm seeking documents identifying … any individuals who engaged the firm for legal advice regarding structuring **a family limited partnership or annuity trust**. Departing from longstanding and established precedent in this and other circuits, the panel's decision subjects the John Doe summons power to abuse by allowing the IRS to make broad requests to law firms to circumvent the privilege."

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

Takeaways

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

Number Eight

The Ugly – Estate Tax Closing Letters for a Sixty-Seven Dollar User Fee: Reg. §300.13 [p. E57 & W22]

Estate Tax Closing Letters

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

PART TWO

THE NEED FOR CARE IN THE PLANNING WE DO

Number Seven

Splitting from Control of Donor Advised Fund: *Fairbairn v. Fidelity Investments Charitable Gift Fund* and *Pinkert v. Schwab Charitable Fund* (N.D. Cal., Feb. 26, 2021, and June 17, 2021) [p. E140]

Issues

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

Holdings

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

Takeaways

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

- Scary: These donors tried to exert control.

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

Number Six

Intergenerational Split-Dollar Life Insurance: *Estate of Morrissette v. Commissioner*, 146 T.C. 171 (2016), T.C. Memo. 2021-60 (May 13, 2021) [p. E146]

Background

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

Tax Court Cases

- *Estate of Morrissette* (T.C. 2016): Arrangements met "economic benefit" standards of 2003 regulations.
- *Estate of Cahill* (T.C. Memo. 2018): Refused to rule that sections 2036, 2038, and 2703 did not apply, and *Cahill* was settled on terms favorable to IRS.
- *Estate of Morrissette* (T.C. Memo. May 13, 2021):
  - Sections 2036, 2038, and 2703 do not apply.
  - Reimbursement rights to be valued using the IRS expert's lower discount rates (6.4 & 8.85% rather than 15 & 18%) and **a maturity date of December 31, 2013** (about 3 years after filing of the 706).
  - Upheld 40% gross valuation misstatement penalty.

Takeaways

- The importance of “good facts,” especially an operating business.
- The “smell test” for a rather small value for a very large right of reimbursement.
- Hazard of revocation rights in an intergenerational split-dollar arrangement.
- Bottom line: The technique works, but maybe not as well, and maybe not all the time.

Number Five

Splitting Charitable Bequests: *Estate of Warne v. Commissioner*, T.C. Memo. 2021-17 (Feb. 18, 2021) [p. E134]

Summary

- Ms. Warne died in 2014 owning, through a trust, from 72.5% to 100% interests in 5 LLCs holding California real estate.
- The 100%-owned LLC was left **75%** to a family charitable foundation and **25%** to a church.
- The court allowed discounts for lack of control and lack of marketability for the majority LLC interests that were somewhat favorable to the estate.
- But the court applied **additional discounts** to the 25% and 75% interests **in calculating the charitable deductions**, which then totaled less than the value included in the gross estate.

Takeaways

- “But it’s all going to charity!” is an intuitive and understandable reaction.
- But there is well-established support for this result. *E.g., Ahmanson* (9th Circuit, where the Warnes live).
- The same issue could arise with the marital deduction or with a combination of charitable and marital deductions. *E.g.*, “reverse *Chenoweth*” in TAM 9050004.
- Consider a single bequest, for example to a DAF or foundation, which might give 25% to the church?

Postscript [p. E156]

- In *Buck v. United States*, 128 AFTR 2d 2021-6041 (D. Conn. Sept. 24, 2021), a donor's **simultaneous gifts** of **48%** interests in tracts of timberland to each of his two sons (while retaining a 4 percent interest for himself) were valued with a **55% discount**.
  - Because the court found the gift tax to be different from the estate tax, after scrupulous analysis.
  - Rev. Rul. 93-12, 1993-1 C.B. 202, says the same thing, but the court did not cite it.

Number Four

Splitting Intrafamily Gifts: *Smaldino v. Commissioner*, T.C. Memo. 2021-127 (Nov. 10, 2021) [p. E159]

What Might Appear To Have Happened

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

What Really Happened

- On **about April 14 or 15**, Donor **hired an appraiser** to determine the value of a **49%** interest in the LLC.
- The appraiser's report dated **August 22** determined the value of a 49% interest to be **$6,281,000**.
- Then by formula* Donor assigned to his wife nonvoting units **with a value of $5,249,118.42** ($881.58 less than the exclusion amount), not dated but "Effective April 14, 2013."
- She made the same formula* assignment to the Dynasty Trust, not dated but "Effective April 15, 2013."

* The Formula

A “sufficient number” of nonvoting units in the LLC “so that the fair market value of such nonvoting units as determined **for federal gift tax purposes** shall be Five Million Two Hundred Forty Nine Thousand One Hundred Eighteen and 42/100ths Dollars ($5,249,118.42)”

What Really Happened (Continued)

- And he made a similar formula assignment to the Dynasty Trust of nonvoting units **with a value of $1,031,881.58**, not dated but "Effective April 15, 2013."
- **And $5,249,118.42 plus $1,031,881.58 happens to be $6,281,000!**
- Which is how Judge Thornton figured out those assignments could not have been signed in April.
- No operating agreement amendment or income tax return of the LLC ever showed her as a member.

What Really Really Happened

- Judge Thornton: “On the basis of all the evidence in the record, we conclude that petitioner **never effectively transferred** any membership interest in the LLC to Mrs. Smaldino and consequently that the Dynasty Trust received **its entire 49%** of the class B membership interests **as a gift from petitioner**.”
- There were also valuation issues, issues about amendments of the operating agreement to replace Donor’s management fees with guaranteed payments and then switch back, and a first-ever substantive discussion of section 2701.

The Clincher

- “Mrs. Smaldino testified that before the purported transfer in question she had already made ‘a commitment, promise’ to her husband and family that she would transfer the LLC units to the Dynasty Trust. When asked on direct examination whether she could have changed her mind if she had wanted to, she responded: ‘No, because I believe in fairness.’”
  - Regardless of the timing of the transfers.
- So the IRS and the Tax Court clearly got it right.
- But doesn’t this kind of thing happen all the time between spouses?

PART THREE

BROADER ISSUES OF POLICY

Number Three

Playing with the Unified Credit/Basic Exclusion Amount: Build Back Better Act (H.R. 5376, Sept. 15, 2021); Priority Guidance Plan, Gifts, Estates & Trusts, Item 3 (Sept. 9, 2021) [p. E67 & W34]

“Sunset”

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

Anti-Anti-Clawback Regs.

- Anti-clawback regulations implementing section 2001(g)(2) (in anticipation of sunset) proposed in November 2018 and finalized in November 2019.
- Preventing clawback after 2026 sunset for gifts made before then.
- Preserving portability elections.

- Warning of future **"anti-abuse" additions to the regulations regarding inclusion under section 2036, etc.**

From the Preamble to the Final Regs.

"A commenter [NYSBA Tax Section] recommended consideration of an anti-abuse provision to prevent the application of the special [anti-clawback] rule to transfers … that are **not true inter vivos transfers**, but rather are **treated as testamentary transfers** for transfer tax purposes. Examples include transfers subject to a retained life estate or other retained powers or interests, and certain transfers within the purview of chapter 14 of subtitle B of the Code. … An anti-abuse provision could except from the application of the special rule **transfers where value is included in the donor's gross estate** at death."

[Compare tables on p. W32 and p. W35.]

Number Two [could be promoted]

Bold Proposals to Coordinate Transfer Taxes and Income Taxes: Deemed Realization [p. E5 & W7] and Grantor Trust [p. E29 & W15] Proposals

HR 5376: Grantor Trusts & Transfer Tax

OMITTED FROM HOUSE-PASSED VERSION

- New chapter 16, **section 2901**, would align transfer tax treatment with grantor trust treatment:
  - Value is included in grantor's gross estate.
  - Distributions are taxable gifts.
  - Termination of grantor trust status is a taxable gift.
- Only if the **grantor** is the **deemed owner**.
- Usefulness of grantor trusts would almost entirely disappear.
- A grantor trust could not be used as the donee to simplify income tax treatment during a gift tax audit.

Grantor Trusts & Income Tax

OMITTED FROM HOUSE-PASSED VERSION

- Unless a trust is fully revocable, new **section 1062** would **ignore grantor trust status** in determining whether a transfer is **a taxable sale**.
  - Nullifying Rev. Rul. 85-13.
  - Would apply to a §678 deemed-owned trust too.
- Section 267 would be amended to disallow losses.
- Examples:
  - Sale by a grantor to a grantor trust.
  - Sale by a beneficiary to a BDIT.
  - Exercise of a swap power.
  - Distribution in-kind to grantor of a GRAT.

Effective Date of New §§2901 and 1062

- Trusts **created** – or **portion** of trust attributable to "a **contribution**" – **on or after date of enactment**.
- Committee report: "The portion of the provision relating to sales and exchanges between a deemed owner and a grantor trust is intended to be effective for **sales** and other **dispositions** after the date of enactment" [*i.e.*, regardless when created or funded].
  - Footnote 935: "A **technical correction** may be necessary to reflect this intent."
- Includes distribution in-kind to grantor of **2020** GRAT.
- Estimated 10-year revenue effect: **+$8 billion**.

Value of Interests in Entities

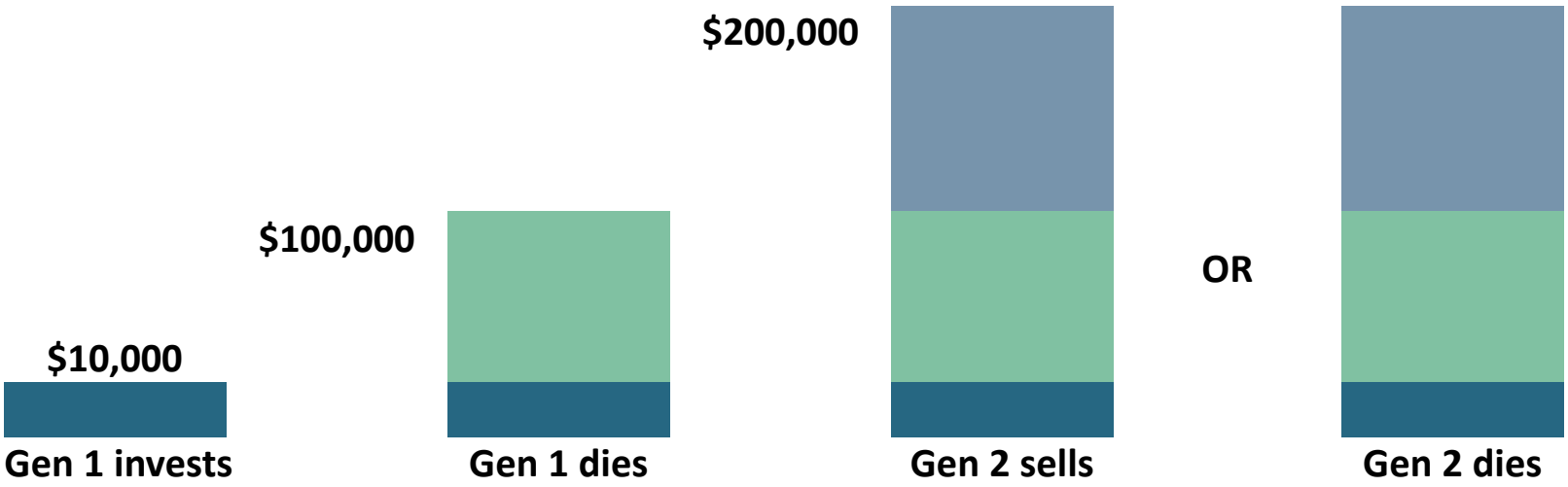
OMITTED FROM HOUSE-PASSED VERSION

- **Look-through** values for **nonbusiness** assets.
  - As if those assets had been transferred directly.
  - "(and no valuation discount shall be allowed…)"
  - Interest itself valued without regard to such assets.
  - No "non-tax reason" exception.
- Applies to gifts and deaths **after date of enactment**.
- Does not apply if interest is actively traded.
- Estimated 10-year revenue effect: +$20 billion.

Greenbook (May 28): Realization

- Effective **January 1, 2022** (no "fresh start" basis).
- Gain = fair market value minus basis:
  - "Valued using … gift or estate tax … methodologies."
  - But a "partial interest would be its proportional share of the fair market value **of the entire property**."
- Losses at death offset gains + $3,000 ordinary income.
- Reported "on the Federal gift or estate tax return or on a separate capital gains return."
- Income tax **deductible for estate tax purposes**.
- Rate = **39.6%** for AGI over $1 million.
- Thus, rate on appreciation = .396+.4(1-.396) = **63.76%**.

Illustration



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

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Exclusions

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

Special Rules for Trusts and Entities

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

Targeted Relief Provisions

- “Payment of tax on the appreciation of certain family-owned and -operated **businesses** would not be due until the interest in the business is sold or the business ceases to be family-owned and operated.”
- A “**15-year** fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets ... and … businesses for which the deferral election is made.”
- The IRS would be authorized to require reasonable **security** “at any time … from any person, and in any form, deemed acceptable by the IRS.”

Administrative Provisions

- Deduction for the full cost of related **appraisals**.
- Imposition of **liens**.
- Waiver of penalties for underpayment of estimated tax attributable to deemed realization at death.
- Right of recovery of the tax on unrealized gains.
- Rules to determine who selects the return to be filed.
- **Broad regulatory authority**, including
  - reporting on the decedent's final 1040, and
  - **"rules and safe harbors for determining the basis of assets in cases where complete records are unavailable."**

Revenue Estimate

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

Previous Congressional Rumblings

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

“Bold” Proposals?

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

Possible Outcome? (Like 2017?)

’Twas the night before Christmas
When what came through the House
Still had each of us stirring,
Not leavin’ our mouse!

…..

So we heard them exclaim,
In a voice like St. Nick’s,
“Happy Tax Cuts to all,
Until Twenty Twenty-Six!”

Number One

Continued Polarization, Health, Justice, and Other Society Challenges

Forces of the Day

- Political and rhetorical polarization.
  - One reason we have no legislation yet.
- COVID-19
  - Was thought to be pulling us together, making us more others-focused.
  - Now fatigue, impatience, and the tension between interdependence and autonomy drive us apart.
  - But some have actually gotten used to being home and don’t want to commute as much any more.
- Sharper awareness of racial and other social justice issues.

Continued Professional Challenges

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

RECAP

1. Polarization, Health, Justice, and Other Challenges
2. Coordinating Transfer Taxes and Income Taxes
3. Unified Credit/Basic Exclusion Amount
4. Splitting Intrafamily Gifts: *Smaldino*
5. Splitting Charitable Bequests: *Estate of Warne*
6. Split-Dollar Life Insurance: *Estate of Morrissette*
7. Control of a Donor Advised Fund: *Fairbairn, Pinkert*
8. Estate Tax Closing Letters for $67 User Fee
9. John Doe Summons: *Taylor Lohmeyer Law Firm*
10. Hindsight in Valuation: *Estate of Michael Jackson*


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