

McGUIREWOODS

The Top Ten Estate Planning and Estate Tax Developments of 2016

By Ronald D. Aucutt

Prepared for a Webinar of the

National Association of Estate Planners & Councils

December 14, 2016

NUMBER TEN

Developments in Split-Dollar Life Insurance

Estate of Morrissette v. Commissioner, 146 T.C. No. 11 (April 13, 2016)

- In 2006, when Mrs. Morrissette was 93, her revocable trust paid about \$30 million of premiums to buy life insurance on her sons' lives under a split-dollar arrangement.
- The insurance proceeds were payable to dynasty trusts, after payment to the revocable trust of the greater of the premiums advanced or the cash surrender value of the policies.

Estate of Morrissette v. Commissioner, continued

- Mrs. Morrissette's gift tax returns for 2006 through 2009 reported gifts to the dynasty trusts of the cost of the current life insurance protection less premiums paid by the trusts.
- Upon Mrs. Morrissette's death in 2006, her executors valued the reimbursements to her revocable trust (deferred to her sons' deaths) at about \$7.5 million.
 - This gift tax and estate tax treatment was consistent with the “**economic benefit**” regime of Reg. §1.61-22(c)(1)(ii), as the split-dollar arrangements had recited.

Estate of Morrisette v. Commissioner, continued

- The IRS argued, if effect, that the value of the receivable in Mrs. Morrisette's gross estate should be determined with reference to the **"loan" regime** of Reg. §1.7872-15, which presumably would produce a much higher value included in the gross estate because interest would accrue on the \$30 million payment.
- In partial summary judgment, the Tax Court (Judge Goeke) agreed with the executors that **the economic benefit regime applied**, because the dynasty trusts received no economic benefit beyond the current life insurance protection.

Morrisette Epilogue

- The value of Mrs. Morrisette's revocable trust's right to repayment still needs to be addressed by the Tax Court or by settlement.
 - That outcome may determine the true significance of the *Morrisette* holding and the true value of this intergenerational split-dollar technique.
- *Morrisette* was followed with little additional analysis in *Estate of Levine v. Commissioner*, Tax Court Docket No. 9345-15 (order issued July 13, 2016).
- *Morrisette* is appealable to the Fourth Circuit.
- *Levine* is appealable to the Eighth Circuit.

NUMBER NINE

Unannounced Apparent IRS Policy Changes

Changes in IRS Policy or Practice That Have Been Learned Informally or Anecdotally

- Refusal to issue a waiver of the federal estate tax lien before the estate tax is paid in full or it is determined that there is no tax due.
 - This reportedly took effect June 1, 2016.
 - Arguably it is what section 6325 has always required.
- Refusal to issue letter rulings regarding the GST tax implications of the modification of a GST-exempt trust.
 - This reportedly is driven by the need to conserve resources.
 - The announced no-rule policy is limited to “a factual scenario that is similar to a factual scenario set forth in one or more of the examples contained in §26.2601-1(b)(4)(i)(E).”

Rev. Proc. 2016-3, 2016-1 I.R.B. 126, sec. 3.01(101).
 - Watch for Rev. Proc. 2017-3.

NUMBER EIGHT

QTIP Elections on Portability-Only Returns

Rev. Proc. 2001-38, 2001-24 I.R.B. 1335

- The IRS “will disregard [a QTIP] election and treat it as null and void” if “the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes.”
- Rev. Proc. 2001-38 was a relief measure. The transitional sentence between the summary of the background law and the explanation of the problem was: “The Internal Revenue Service has received requests for relief in situations where an estate made an unnecessary QTIP election.”
- With portability made permanent in the American Taxpayer Relief Act of 2012, Rev. Proc. 2001-38 caused concern that QTIP elections on an estate tax return filed only to elect portability (not needed for estate tax purposes) would be treated as “null and void.”

Rev. Proc. 2016-49, 2016-42 I.R.B. (Sept. 27, 2016)

- Took the same approach as Rev. Proc. 2001-38, but made it inapplicable to QTIP elections on estate tax returns filed only to elect portability.
 - So greater care is required on a non-taxable estate tax return?
- Ways to claim relief from an inadvertent QTIP election:
 - The surviving spouse's estate tax return. No change.
 - Not a ruling request. Deleted by Rev. Proc. 2016-49.
 - A supplemental estate tax return for the estate of the predeceased spouse. Added by Rev. Proc. 2016-49.
 - A gift tax return for the surviving spouse. Also added.

NUMBER SEVEN

Business (Purpose) as Usual with FLPs

Decided Tax Court Cases

- *Estate of Purdue*, T.C. Memo. 2015-249 (Dec. 28, 2015)
 - To hold and manage marketable securities and a commercial building was held to be a “legitimate nontax motive” for transfers to a family-owned LLC, so the value of the LLC assets was not included in the transferor’s gross estate.
- *Estate of Holliday*, T.C. Memo. 2016-51 (March 17, 2016)
 - The creation of a limited partnership to hold marketable securities 25 months before the decedent died was held not to be a bona fide sale, and the decedent was held to have retained an interest under section 2036(a) because the partnership appeared to be operated essentially to meet the decedent’s needs.
- *Estate of Beyer*, T.C. Memo. 2016-183 (Sept. 29, 2016)
 - Gift tax (plus penalties) and estate tax upheld regarding transfers to a family limited partnership.

NUMBER SIX

Uncertainty About Defined Value Clauses

Estate of Donald Woelbing v. Commissioner and Estate of Marion Woelbing v. Commissioner

- *Woelbing*: Sale to a grantor trust.
 - Issues were—
 - gift tax valuation,
 - promissory notes valued at zero under section 2702,
 - sold assets subject to estate tax under sections 2036 and 2038,
 - effect of guarantees,
 - estate tax value, and
 - effect of a defined value formula.
 - Settlement (stipulated decisions March 25 & 28, 2016):
 - No additional gift tax for either Mr. or Mrs. Woelbing.
 - No additional estate tax for Mr. Woelbing's estate.
 - But additional estate tax for Mrs. Woelbing's estate.
- Another pair of “defined value” cases: *Karen S. True v. Commissioner & H.A. True III v. Commissioner*, Tax Court Docket Nos. 21896-16 & 21897-16 (petitions filed Oct. 11, 2016).

- Treasury-IRS Priority Guidance Plan (Aug. 15, 2016):
 - Item #9: “Guidance on the gift tax effect of defined value formula clauses under §§2512 and 2511.”
- Previous cases: *Procter* (1944), *Knight* (2000), *McCord* (2003, 2006), *Christiansen* (2008, 2009), *Petter* (2009, 2011), *Hendrix* (2011), *Wandry* (2012).
 - The Ninth Circuit (2011), affirming *Petter*, said:

“[W]e expressly invite[] the Treasury Department to “amend its regulations” if troubled by the consequences of our resolution of th[is] case.” *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704, 713 (2011) (quoting *United Dominion Indus., Inc. v. United States*, 532 U.S. 822, 838 (2001)).

NUMBER FIVE

Proposed Regulations on Consistency of Basis

Proposed Regulations Published March 2, 2016

- Form 8971 is due 30 days after the estate tax return is filed.
 - How can an executor know who gets what by then?
- Successive transferors must furnish and file Schedule A on the occasion of gifts and other carryover basis transactions, apparently in perpetuity.
- After-discovered property might get a zero basis.
- But cash, modest tangible personal property, and property that is sold need not be reported.

- A public hearing was held on June 27.

- **Regulations should be finalized by January 31, 2017.**
 - Within 18 months of enactment of the statute, to permit them to be retroactive, under section 7805(b)(2).

NUMBER FOUR

Proposed Regulations Under Section 2704 (August 2, 2016)

Disregarded Restrictions Under Section 2704(b)

(4) Other restrictions. The Secretary may by regulations provide that **other restrictions** shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family **if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee.**

- **Likely target?** The ephemeral restriction that supports a discount until the estate tax statute of limitations has run, but then can be removed with no harm to the underlying assets or to the family owners.

New “Disregarded Restrictions” Under Proposed Reg. §25.2704-3

- Specified restrictions (called “disregarded restrictions”) are disregarded in valuing an interest for gift or estate tax purposes when that interest is transferred to a family member. Proposed Reg. §25.2704-3.
- A “disregarded restriction” is a “**provision**” (of the governing document or applicable law) that **limits** the ability of the holder of the interest to **compel** liquidation or redemption **of that interest** on no more than **six months’ notice for cash or property** equal at least to “**minimum value.**”
 - Not for a promissory note, except in the case of certain “market interest rate” notes issued by entities engaged in an active trade or business. Proposed Reg. §25.2704-3(b)(1)(iv).
- “Minimum value” is the interest’s pro rata share of the net fair market value of the assets of the entity.

Threshold element is still that family members can remove the restriction. Prop. Reg. §25.2704-3(b)(1).

- An interest held by a nonfamily member that might give that nonfamily member the power to prevent the removal of a restriction is disregarded unless that interest –
 - represents at least 10% of the entity and at least 20% of the entity when aggregated with other nonfamily members,
 - has been held by that nonfamily member for at least 3 years, and can be redeemed by the nonfamily holder on no more than six months' notice. Prop, Reg. §25.2704-3(b)(4)(i) & -3(b)(6).
- **Likely target?** A nominal interest held by a “captive” charity, which has neither the ability to bail out nor any incentive to rock the boat. See *Kerr v. Commissioner*, 113 T.C. 449, 473 (1999), *aff'd*, 292 F.3d 490 (5th Cir. 2002).

Effect of Disregarding a Restriction

- “Minimum value” is merely a part of the test to identify a “disregarded restriction.”
 - “Minimum value” is not the minimum value for transfer tax purposes!
 - The proposed regulations would not require the holder of any interest in any entity to **have** the right to redeem for “minimum value.”
 - Nor would the proposed regulations require the interest to be valued **as if** the holder **had** such a right [“deemed put”].
- “If a restriction is disregarded under this section, the fair market value of the transferred interest is determined **under generally applicable valuation principles** as if the disregarded restriction does not exist in the governing documents, local law, or otherwise.” Prop. Reg. §25.2704-3(f).

Factors That an Appraiser Cannot Disregard

- Factors that will still support discounts, if relevant, include
 - the risk that the holder of the interest may be unable to negotiate a favorable buyout,
 - the risk a hypothetical willing buyer would incur in dealing with an unrelated family, and
 - the lack of ability to control or influence the operations or investments of the entity as a going concern.
- And in the case of a family-owned operating business,
 - the business plan, business environment, competition, illiquidity and the need for capital, unpredictability, or other obstacles to the business's redemption of the interest,
 - the fact that partial liquidation (redemption) makes a business not just smaller, but weaker and less competitive, and
 - the fact that the managers or majority owners of the business therefore may not consider a partial liquidation to be in the best interests of the business or the other owners.

Other Issues

- **Exception for “any restriction imposed or required to be imposed, by any Federal or State law”:** Limited to really mandatory, unavoidable restrictions.

Proposed Reg. §25.2704-2(b)(4)(ii) & -3(b)(5)(iii).

- **Covered entities:** Any “entity”?

Proposed Reg. §25.2701-2(b)(5)(i) & (iv) & Reg. §301.7701-2(a).

- **Marital deduction:** The rules apply “for purposes of determining both the amount includible in the gross estate and the amount allowable as a marital deduction.”

Proposed Reg. §25.2704-3(g), *Example 3*.

Lapses of Voting or Liquidation Rights Under Section 2704(a)

- **Section 2704(a)(1):** “A lapse of any voting or liquidation right in a corporation or partnership ... shall be treated as a transfer.”
 - **Reg. §25.2704-1(c)(1) (1992):** “A transfer of an interest that results in the lapse of a liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated.”
 - **As proposed to be amended:** A transfer of a voting or liquidation right in a family-owned entity **within three years** before the transferor’s death “is treated as a lapse occurring on the transferor’s date of death, includible in the gross estate pursuant to section 2704(a).”

Effective Dates

- The provisions of the proposed regulations applicable to voting and liquidation rights are proposed to apply to rights and restrictions created after October 8, 1990, but only to transfers occurring after the date the regulations are published as final regulations.
- The new rules for “Disregarding Certain Restrictions on Redemption or Liquidation” (Proposed Reg. §25.2704-3) will not take effect until 30 days after the date the regulations are published as final regulations.
 - See 5 U.S.C. §553(d) [the provision of the Administrative Procedure Act rule applicable to “substantive” regulations].

NUMBER THREE

Reaction to the Proposed Section 2704 Regulations

History of the Proposed Regulations

- Chapter 14, including section 2704, was enacted 11/5/90.
- Regulations proposed 4/9/91 and 9/11/91, were finalized 1/28/92.
- New project first appeared in the 2003-2004 Treasury-IRS Priority Guidance Plan.
- “Modify Rules on Valuation Discounts” in Budget proposals (“Greenbooks”) 5/11/09, 2/1/10, 2/14/11 & 2/13/12.
 - Then omitted from the 2013 Greenbook (4/10/13).

State of the Union Address (February 12, 2013)

“Now, the good news is we can make meaningful progress on this issue while driving strong economic growth. I urge this Congress to get together, pursue a bipartisan, market-based solution to climate change, like the one John McCain and Joe Lieberman worked on together a few years ago. **But if Congress won’t act soon to protect future generations, I will.**”

- The 2013 Greenbook (April 10, 2013) dropped the proposal to “Modify Rules on Valuation Discounts.”

Oops! What Were They Thinking?

- **“Disregarded restrictions”?** The Greenbooks had stated:
This proposal would create an additional category of restrictions (**“disregarded restrictions”**) that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor’s family. **Specifically, the transferred interest would be valued by substituting for the disregarded restrictions certain assumptions to be specified in regulations.**
- **“Minimum value”** that is not minimum transfer tax value?
- “If a restriction is disregarded under this section, the fair market value of the transferred interest is determined under generally applicable valuation principles as if the disregarded restriction does not exist in the governing documents, local law, **or otherwise.**” Proposed Reg. §25.2704-3(f).

Contemporaneous Political Statements (Aug. 2, 2016)

- “Today, the U.S. Department of the Treasury announced a new regulatory proposal to close a tax loophole that certain taxpayers have long used to understate the fair market value of their assets for estate and gift tax purposes.”

Mark Mazur, Assistant Secretary of the Treasury for Tax Policy
(<https://www.treasury.gov/connect/blog/Pages/Treasury-Issues-Proposed-Regulations-to-Close-Estate-and-Gift-Tax-Loophole.aspx>)

- “The Obama administration has made considerable progress over the past eight years to make our tax code fairer. This week, the Treasury Department is building on that progress through proposed new rules closing a loophole that allows some wealthy families to avoid paying their fair share in estate taxes.”

White House statement (<https://www.whitehouse.gov/blog/2016/08/03/closing-estate-tax-loophole-wealthiest-few-what-you-need-know>)

Political Backlash

- Bills were introduced in Congress to block the regulations.
 - H.R. 6042 (Rep. Sensenbrenner, Jr. (R-WI), Sept. 15, 2016).
 - “Protect Family Farms and Businesses Act,” H.R. 6100 (Rep. Warren Davidson (R-OH), Sept. 21, 2016) and S. 3436 (Sen Marco Rubio (R-FL) Sept. 28, 2016):

The proposed regulations under section 2704 of the Internal Revenue Code of 1986 relating to restrictions on liquidation of an interest with respect to estate, gift, and generation-skipping transfer taxes, published on August 4, 2016, in the Federal Register (81 Fed. Reg. 51413) shall have no force or effect. No Federal funds may be used to finalize, implement, administer, or enforce such proposed regulations or any substantially similar regulations.

- This leaves the future of the regulation project very much in doubt.

IRS Hearing (December 1, 2016): 36 Speakers and 4 IRS and Treasury Panelists

- Many small business owners, and lawyers, CPAs, and trade association representatives stressed:
 - the importance of family-owned businesses,
 - the importance and challenges of business succession,
 - that their businesses might not survive these regulations, and
 - that the proposed regulations far exceed the statutory authority.
- Many appraisers argued that the proposed regulations:
 - rewrite the rules and attempt to redefine fair market value,
 - require disclosure of restrictions that are disregarded, and
 - leave them with no comparables or relevant market data.
- The government panelists:
 - stated that they did not intend to eliminate minority discounts or to make the new three-year rule for lapses applicable to inter vivos transfers before the effective date of the regulations, and
 - seemed in good humor and willing to be responsive.

NUMBER TWO

The House Republicans' "Blueprint" (June 2016)

“A Better Way: Our Vision for a Confident America” House Republicans’ “Blueprint” (June 23, 2016)

“This Blueprint will achieve three important goals:

- It will fuel job creation and deliver opportunity for all Americans.
- It will simplify the broken tax code and make it fairer and less burdensome.
- It will transform the broken IRS into an agency focused on customer service.”



Proposed Individual Income Tax Brackets and Rates

Current Law	Blueprint
10%	0%/12%
15%	
25%	25% [the top small business rate]
28%	
33%	33%
35%	
39.6%	
<p>“[T]he new standard deduction is larger than the current-law standard deduction and personal exemptions combined. This, in effect, creates a larger 0 percent bracket. As a result, taxpayers who are currently in the 10 percent bracket always will pay lower taxes than under current law.”</p>	
<p>In addition, the individual AMT will be repealed.</p>	

“Blueprint,” continued

- “This Blueprint will **repeal the estate and generation-skipping transfer taxes**. This will eliminate the Death Tax, which can result in double, and potentially even triple, taxation on small businesses and family farms.”
 - [In contrast, the Trump Campaign website stated: “**The Trump Plan will repeal the death tax**, but capital gains held until death and valued over \$10 million will be subject to tax.”]
- “This Blueprint reflects the elimination of all itemized deductions except the **mortgage interest** deduction and the **charitable contribution** deduction.”
- “This Blueprint will continue **the current tax incentives** for [retirement] savings.”

Business Provisions

- Greater use of **expensing** the cost of capital investments.
 - “**Job creators** will be allowed to **deduct interest expense against any interest income**, but no current deduction will be allowed for net interest expense. Any net interest expense may be **carried forward indefinitely** and allowed as a deduction against net interest income in future years.”
- Limitation of net operating losses (NOLs) to **90%** of net taxable income determined without regard to the carryforward.
- Repeal of the corporate AMT.

NUMBER ONE

The 2016 Election Results: The Political Climate and Tax Reform Prospects for Repeal of the Estate Tax

Tax Reform: Touted Every Four Years, but Harder To Do Than It Sounds

- Fairness versus simplicity.
- Where to start.
 - Individuals versus businesses.
 - Corporations versus passthroughs.
 - Passthroughs include trusts.
 - Trusts involve individuals.
- And the challenges of “pay-fors” and sequestration in a challenging fiscal environment.
 - Unlike 2001, for example, the fiscal outlook is one of increasing national debt.
- Yet the pressure to pass significant tax reform before the August recess will be enormous.

The Political Climate Following the 2016 Election

- Republican control of Congress is barely changed.
- But 60 votes in the Senate (to call the question, through a cloture vote) will require Democratic support.
- Budget reconciliation will probably be used, but is limited.
- Republicans in the House still favor repeal of the estate tax, and their June 2016 “Blueprint” calls for it.
 - But the technical paths to permanent repeal are complicated, aggressive, and risky.
 - And repeal of the estate tax could leave the gift tax intact or could be accompanied by a new capital gains tax regime.
- **Conclusion: Repeal of the estate tax would require political capital that will probably be spent elsewhere.**

Questions or Comments?

Copyright 2016 by McGuireWoods LLP. All Rights Reserved.

**Ronald D. Aucutt
raucutt@mcguirewoods.com**

www.mcguirewoods.com

**See also “Estate Tax Changes Past, Present and Future”
(<http://www.mcguirewoods.com/estate-tax-changes>)**