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A Turbulent Time of Twists and Turns

Two controversial sets of proposed regs and a startling election victory may impact tax policy and laws

The year 2016 was remarkable and exciting for estate-planning professionals. Among many noteworthy developments, the Internal Revenue Service promulgated two important and controversial compilations of proposed regulations (proposed regs), two significant Tax Court cases were resolved in favor of taxpayers and the election on Nov. 8 produced a startling victory for Donald J. Trump and the Republicans that will certainly have substantial impact on the nation's tax policy and tax laws.

Basis Consistency

On March 4, 2016, the IRS published temporary and proposed regs[1] providing guidance regarding the basis consistency and information reporting rules of Internal Revenue Code Sections 1014(f) and 6035.[2] These regulations implement the statutory mandates that: (1) the basis of certain property acquired from a decedent shall not exceed the value of such property as finally determined for federal estate tax purposes; and (2) the executor of any estate required to file a federal estate tax return (Form 706) because of IRC Section 6018(a) must provide, both to the Treasury Secretary and to each recipient of property included in the gross estate, a statement identifying the estate tax value of such property and certain other information.

Certain aspects of these proposed regs have caused concern among estate planners. A few examples follow. First, if the executor files a Form 706 but doesn't report the value of certain after-discovered property or omitted property before the period of limitation on assessment expires, the basis of such property is zero.[3] Similarly, if the executor didn't file a Form 706, the basis of all property subject to IRC Section 1014(f) would be zero until the value of such property is finally determined for federal estate tax purposes.[4] Second, to address the numerous occasions in which the executor hasn't made distribution decisions by the time the executor must provide the statement required by IRC Section 6035, the executor is required to provide to each estate beneficiary a statement referencing all property that could under any circumstances be used to satisfy such beneficiary's interest in the estate.[5] Third, regarding property that was reported or required to be reported on a statement furnished to a recipient, in most cases in which the recipient transfers the property to a "related transferee,"[6] the recipient is required to provide a supplemental statement to the IRS and to the transferee.[7]

In mid-November, a Treasury Department official indicated the Department is striving to finalize these regulations on or before Jan. 31, 2017. If this goal is achieved, the regulations will apply retroactively to July 31, 2015, the date of enactment of the underlying legislation.[8]

The Obama Administration seeks expansion of the scope of IRC Sections 1014(f) and 6035 to apply to donees of gifts required to be reported on a gift tax return and recipients of certain property received from a decedent qualifying for the estate tax marital deduction.[9]

Grantor Trust Installment Sales

In *Estate of Woelbing*,[10] Donald Woelbing, in 2006, sold stock he valued at $59 million to an irrevocable grantor trust in exchange for a note bearing interest at the applicable federal rate. The sale agreement contained a defined value clause, under which the number of shares, but not the aggregate value, of the stock transferred would change on a revaluation of

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the stock for gift tax purposes, thereby avoiding gift tax upon revaluation.

Donald died in 2009. The IRS examined the estate tax return and issued a notice of deficiency claiming $63.8 million owed in gift tax, interest and penalties and $88.4 million owed in estate tax, interest and penalties. The IRS asserted that: (1) the stock sale should be treated as a taxable gift under IRC Section 2702; (2) the value of the stock when sold was actually $116.8 million; (3) the stock sale should be treated as a transfer with a retained interest under IRC Sections 2036 and 2038; and (4) the note wasn't bona fide. The notice didn't address the defined value clause.

The executor countered with a Tax Court petition asserting that: (1) the stock sale was a bona fide sale for full and adequate consideration; (2) the principal amount of the note had a fair market value equal to the value of the stock transferred; and (3) the trust had sufficient property (including life insurance policies with substantial cash surrender value (CSV)), in excess of 10 percent of the face value of the note, to support making note payments.

The case settled, resulting in a stipulated decision entered by the Tax Court in which the estate was determined not to owe any of the claimed deficiencies.

Generational Split Dollar

In *Estate of Morrissette*,[11] Clara Morrissette had established a revocable trust in 1994 and three dynasty trusts, one for each of Clara's sons and their respective families, in 2006. The dynasty trusts purchased universal life insurance policies on the lives of the sons. Clara's revocable trust entered into split-dollar arrangements[12] with each dynasty trust. Under the arrangements, Clara's revocable trust contributed a combined $29.9 million to the dynasty trusts, which, in turn used the funds to make lump-sum single premium payments on the policies. The arrangements further provided that, on the death of a respective insured, Clara's revocable trust was to receive a portion of the death benefit equal to the greater of the CSV and the aggregate premium payments. If the arrangement was terminated during a son's life, Clara's revocable trust would receive the greater of the CSV and the aggregate premiums paid. In addition, the split-dollar contracts contained the following recital:

> WHEREAS, the parties intend that this Agreement be taxed under the economic benefit regime of the Split-Dollar Final Regulations, and that the only economic benefit provided to the [dynasty] Trust[s] under this arrangement is current life insurance protection.

From 2006 to 2009, Clara filed gift tax returns reporting gifts to the dynasty trusts using the economic benefit regime set forth in Treasury Regulations Section 1.61-22. The amount reported each year was the cost of the life insurance protection reduced by the amount of premiums paid.

Clara died in 2009, and the split-dollar arrangement receivables were valued for inclusion in Clara's gross estate at $7.479 million. The IRS issued a deficiency notice pertaining to Clara's 2006 gift tax return and took the position that Clara should have reported the full $29.9 million as a taxable gift.

The Tax Court, in a summary judgment proceeding initiated by the executor, had to determine whether the dynasty trusts, on receipt of the $29 million, possessed an economic benefit above and beyond life insurance protection. If not, then Clara's revocable trust would be the deemed owner of the policies, the economic benefit regime would apply and the value of the economic benefit provided to the non-owners (the dynasty trusts) would be limited to the cost of current life insurance protection, plus the amount of cash value to which the non-owners had current access, plus any additional economic benefits.[13]

Whether the dynasty trusts had any such additional economic benefits turned on whether they had current access to the policies' cash value. A non-owner has current access to the cash value if: (1) the non-owner has a current or future right to all or a portion of the cash value; and (2) that right currently is directly or indirectly accessible by the non-owner, inaccessible to the owner or inaccessible to the owner's creditors.[14]

The Tax Court held that the dynasty trusts didn't have current access to the cash value because the split-dollar arrangement was a valid and enforceable contract between Clara's revocable trust and the dynasty trusts under which Clara's revocable trust was entitled in all events to recover the greater of the CSV and the aggregate premium payments. Thus, the manner in which Clara's 2006 gift tax return reported the amount of the taxable gift associated with the $29.9 million contribution to the dynasty trusts was validated.[15] The value of the split-dollar arrangement receivables in Clara's gross estate wasn't determined.

Valuation of Family-Controlled Entities

On Aug. 4, 2016, the IRS published proposed regs[16] under IRC Section 2704. The proposed regs are, in part, revisions of the original set of regulations under IRC Section 2704 that were finalized on Jan. 28, 1992 and are, in part, new regulations. In the preamble to the proposed regs, the IRS explained that changes in state laws and other developments since the issuance of the current regulations under Section 2704 have rendered the current regulations "substantially ineffective."

Section 2704(a) provides that, if there's a lapse of any voting or liquidation right in a corporation or partnership, and the corporation or partnership is family-controlled immediately before and after the lapse, then such lapse shall be treated as a gift, in the event of a lifetime lapse, or as a transfer includible in a decedent's gross estate, in the event that the lapse occurs at death.[17] The amount of the transfer is the excess of the value of the transferred interest before the lapse over the value of the interest after the lapse.

Section 2704(b) provides that, if: (1) there's a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family; (2) the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity; and (3) after the transfer, either (i) an "applicable restriction" lapses, in whole or in part, or (ii) the transferor or any member of the transferor's family, either alone or collectively, has the right to remove, in whole or in part, an applicable restriction, then the applicable restriction is to be disregarded in determining the value of the transferred interest.

Generally, an "applicable restriction" is any restriction that: (1) effectively limits the ability of the corporation or partnership to liquidate; (2) is more restrictive than the limitations that would generally apply under state law in the absence of the restrictions in the governing instrument; and (3) either the restriction by its terms will lapse at any time after the transfer, or the transferor (or the transferor's estate) and any members of the transferor's family can remove the restriction immediately after the transfer.[18]

The proposed regs have three fundamental components. First, they introduce the entirely new concept of "disregarded restrictions." Disregarded restrictions, as the term suggests, are ignored in valuing the transfer of any family-controlled business equity. A "disregarded restriction" is a restriction (imposed under an entity's governing documents or state law) on an owner's right to liquidate or redeem the owner's interest in an entity that: (1) limits the ability of the interest holder to compel liquidation or redemption of the interest; (2) limits the liquidation or redemption proceeds to an amount that's less than a minimum value; (3) defers or permits deferral of the payment of the liquidation or redemption proceeds for more than six months; or (4) permits the payment of any portion of the liquidation or redemption proceeds in any manner other than in cash or other property.

Second, they revise, for purposes of determining whether an applicable restriction or a disregarded restriction exists, the meaning of the phrase "imposed or required to be imposed by any Federal or state law."[19] A restriction is considered required to be imposed by federal or state law under Section 2704(b)(3)(B) if the restriction can't be removed or overridden and is mandated by the federal or state law, is required to be included in the governing documents or otherwise is made mandatory.

Third, they expand the circumstances in which the lapse of a liquidation right results in a transfer to include (unless the lapse occurs more than three years before the death of the holder of such right) the relinquishment of such a right, even if the right itself hasn't been restricted or eliminated.

Reaction to these proposed regs has been extraordinary and overwhelming. Written comments to the IRS were due by Nov. 2, and rumor has it that the IRS received over 28,800 comments. A huge majority of those comments that have been made public were strongly negative. The IRS conducted a hearing on these proposed regs on Dec. 1. Among the concerns expressed at the hearing were that the proposed regs are confusing, ambiguous, overreaching and reflect disregard for economic realities and family dynamics. Although the Treasury Department denies it was intended, many estate-planning experts have opined, both in written comments and at the hearing, that certain language used in the proposed regs leads inexorably to the conclusion that a put right is deemed to exist with respect to any equity in a family-controlled enterprise. Some commentators, including this writer, believe at least the portion of these proposed regs creating "disregarded restrictions" goes beyond legitimate IRS regulatory authority.

Most of the proposed amendments to the existing regulations under Section 2704 apply to transactions

involving property subject to restrictions created after Oct. 8, 1990, occurring on or after the publication of final regulations. Prop. Treas. Regs. Section 25.2704-3, the new section on disregarded restrictions, applies to transfers of property subject to restrictions created after Oct. 8, 1990 occurring 30 or more days after the publication of final regulations.

Impact of Election Results

The United States is faced today with a surprising new political reality. On Nov. 8, the Republicans achieved a trifecta. Donald J. Trump will soon take the oath of office as our 45th President. Republicans control the U.S. Senate 52-48, and they control the House of Representatives 241-194. What this means in terms of impending evolution of tax law important to estate planning isn't entirely clear, but a couple of generalizations, which would have seemed close to absurd before Nov. 8, are now worthy of contemplation.

First, federal estate tax may be considered for repeal. Repeal of the "death tax," along with imposition of capital gains tax at death in certain cases, is an explicit part of the Trump Tax Plan. The Republican platform promotes federal estate tax repeal, along with repeal of the federal gift tax. Whether repeal of any federal transfer taxes can be accomplished with such a narrow Republican majority in the Senate will depend heavily on whether "permanent" repeal is sought, in which case 60 affirmative votes in the Senate may be needed, or whether repeal with a sunset provision, as occurred in connection with the 2001 tax legislation that resulted in a one-year federal estate tax repeal, is the approach that's pursued.

Second, it seems very probable that the proposed regs under Section 2704 are dead. It seems certain that these proposed regs, clearly antithetical to estate tax repeal, wouldn't move forward in a Trump administration. Indeed, President-elect Trump has pledged that, for each new regulation to be imposed under his administration, two existing regulations will be removed.[20] In the very unlikely event they were finalized before Jan. 20, the new President, as head of the Executive Branch (which, obviously, includes the Department of the Treasury), could thereafter cause them to be dismantled.

Endnotes

1. T.D. 9757.
2. Enacted as part of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, P.L. 114-41 (July 31, 2015).
3. Proposed Treasury Regulations Section 1.1014-10(c)(3)(i)(B).
4. Prop. Treas. Regs. Section 1.1014-10(c)(3)(ii).
5. Prop. Treas. Regs. Section 1.6035-1(c)(3).
6. Defined in Prop. Treas. Regs. Section 1.6035-1(f) as "any member of the transferor's family as defined in section 2704(c)(2), any controlled entity (a corporation or any other entity in which the transferor and members of the transferor's family (as defined in section 2704(c)(2)), whether directly or indirectly, have control within the meaning of section 2701(b)(2)(A) or (B)), and any trust of which the transferor is a deemed owner for income tax purposes."
7. Prop. Treas. Regs. Section 1.6035-1(f).
8. *See* Internal Revenue Code Section 7805(b).
9. General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals, Department of the Treasury (Feb. 9, 2016).
10. *Estate of Woelbing v. Commissioner*, Docket Nos. 30261-13 and 30260-13 (settled March 25, 2016).
11. *Estate of Morrissette v. Comm'r*, 146 T.C. No. 11 (April 13, 2016).
12. Under a split-dollar arrangement, a non-insured party pays the premiums on a life insurance contract and, in exchange, is entitled to recover all or a portion of the premiums, which contract right is secured by the life insurance proceeds. Treas. Regs. Section 1.61-22(b)(1).
13. *See* Treas. Regs. Section 1.61-22(d)(2).
14. Treas. Regs. Section 1.61-22(d)(4)(ii).
15. *See also Estate of Levine v. Comm'r*, T.C. No. 9345-15 (July 13, 2016), reaching the same conclusion in a case substantially identical to *Morrissette*.
16. REG-163113-02.
17. Treas. Regs. Section 25.2704-1(a)(1); *see, e.g., Estate of Rankin M. Smith, Sr. v. United States*, 109 A.F.T.R.2d 2012-987 (Ct. Fed. Cl. 2012).
18. Treas. Regs. Section 25.2704-2(b).
19. Prop. Treas. Regs. Sections 25.2704-2(b)(4)(ii) and 25.2704-3(b)(5)(iii).
20. *https://urldefense.proofpoint.com/v2/url?u=https-3A__www.youtube.com_watch-3Fv-3D7xX-5FKaStFT8&d=DgIGaQ&c=H98IxvesFHsI1ZPcztRg-4g&r=KWvfXvYeRVe9vy8kHFKUFgqACPHP8moG85quLY27dYs&m=qgDGB-mzW-W2sPIRE0t_fz2bf0ApreZ0CXBIivL_F0cg&s=x-v9LIo4TVWyI7oTbIXE-zLPYvhixGwqIwuHvjTi6aSc&e=*.