Federal Transfer Tax Update

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Introduction

- Focus will be on Significant Gift, Estate, and GST Tax Developments in 2022
- Overview
  - No proposed legislation (no surprise)
  - Interesting Cases (settled and decided)
  - IRS Guidance, including three sets of proposed regulations

Sorensen v. Comm'r

- Brothers who founded Firehouse subs made *Wandry* style gift in 2014 and sold additional stock in 2015
- Taxpayers settled on audit, but the pre-trial memos provide important insight into IRS arguments on:
  - Mechanical and policy issues with formula clauses
  - Valuation issues (including tax-affecting)
  - Penalties
- T.C. Docket 24797-18, 24798-18, 20284-19, and 20285-18

Sorensen v. Comm'r

- <u>The Transfers</u>
  - 12/31/14: Taxpayers gave non-voting shares of Firehouse to trusts
    - Structured as a "Wandry" style transaction
    - Reported on 2014 gift tax returns as a gift of that number of shares having a fair market value of $5 million
  - 3/31/15: Taxpayers sold non-voting shares of Firehouse to the same trusts
    - Not a formulaic transfer
    - Taxpayers used same 12/31/14 appraisal
    - Not reported on gift tax returns

Sorensen v. Comm'r

- IRS Arguments:
  - 2014 gifts were *not* formulaic (gift was of a fixed number of shares; not a fixed $5 million gift)
    - Alternatively, *Wandry* was wrongly decided
  - A portion of the 2015 transfer was a gift because Taxpayers' appraisal was too low (surprise, surprise)
  - Penalties apply

Sorensen v. Comm'r

- Stipulations of Settled Issues filed 7/8/22:
  - Taxpayers conceded that the 2014 gifts were not governed by formulaic *Wandry* clause
  - Taxpayers conceded that the 2015 gifts were part gift/part sale

	12/31/2014 Transfer	3/31/2015 Transfer
No. Shares Transferred	9,385	5,365
Taxpayers' Valuation	$532.79/share $5,000,000* total	$532.79/share $2,858,418 total; no gift
IRS Valuation	$2,076.86/share $14,491,331 increase	$2,228.62/share $9,098,128 increase
Addt'l Gift Tax/ Penalty per IRS Values	$5,664,538 Addt'l Gift Tax $2,265,815 Penalty (40%)	$3,605,054 Gift Tax $1,442,022 Penalty (40%)
Settled Values	$1,640/share $10,391,400 increase	$1,722/share $6,380,112 increase
Addt'l Gift Tax/ Penalty per Settlement	$4,024,565 No Penalty	$2,516,045 $251,605 Penalty (10%)

Sorensen v. Comm'r

- Putting the Settlement in Context
  - As a result of the 2014/2015 Transfers & Settlement:
    - Each trust received stock valued at $24.6 million
    - Each Petitioner paid $6.5 million gift tax ($4 million relating to 2014 gifts), plus $2.5 million in penalties
  - 2015 – 2020: each trust received $18 million in distributions ($11.4 attributable to 2014 gifts)
  - 11/15/21: Firehouse sold for $1 billion cash - each trust received $153.3 million cash
  - 7/8/22: Taxpayers conceded *Wandry* issue. If, instead, Taxpayers won on *Wandry* and settled at stipulated values:
    - Trusts would have owed more than $66 mill. to Taxpayers because some of the shares treated as transferred to trusts would have been owned by Taxpayers
      - From sale of company, trusts would have owed approx. $66 million to Taxpayers
      - Trusts would have owed some portion of $11.4 million in distributions to Taxpayers
    - The sale of the company and distributions had to be a factor in Taxpayers' decision to settle on valuation issues

Sorensen v. Comm'r

- Although Taxpayers conceded *Wandry*, the Pre-Trial Memos highlight important planning considerations for *Wandry* transactions:
  - The donee of the gift should sign the transfer document to evidence agreement that the transfer is a formulaic transfer (not a transfer of a fixed no. of shares)
  - The donee should agree that any preliminary determination of the number of shares transferred does not entitle the donee to that number of shares
  - The donee should agree to adjustment/true-up mechanisms to be used if the preliminary determination of shares transferred is incorrect based on values as finally determined
  - The donee should agree that any dividends or tax reporting made based on any preliminary determination does not entitle the donee to the number of shares preliminarily determined
  - The donor and the donee should agree to use their best efforts to have tax returns, stock ledgers, etc., reflect that the number of shares held by donee is subject to the transfer document
  - Avoid references on the gift tax return to any preliminary determination of the number of shares transferred
  - Scrupulously adhere to the terms of the formulaic transfer

Sorensen v. Comm'r

- Even if a Taxpayer who engages in a *Wandry* transaction does everything right, it would not be surprising if the IRS continues to argue that a *Wandry* style clause is a condition subsequent that violates public policy
  - Here, the IRS argued that, like *Procter* and *TOT Property,* the type of clause used in *Wandry* should be void as against public policy because it retroactively voids the part of the transfer that would be subject to gift tax and, as such, presents a "catch-22 situation" that leads to "trifling with the judicial process"
- Regardless of whether the IRS wins those arguments, audits can be stressful, time-consuming, and costly
- In its pretrial memo, the IRS made clear distinctions between a *Wandry* style formula clause and clauses where a taxpayer makes a gift of a set number of shares to multiple donees
- Important to discuss risks of *Wandry* with clients and evaluate whether other formulaic transfers may be preferred in light of a particular client's circumstances
  - *Petter/Christiansen* style clause - allocates the transferred interest between donees based on values as finally determined for federal gift tax purposes
  - *McCord/Hendrix* style clause - allocates the transferred interest between the donees based on the fair market value as agreed to by the donees
- Use of *King* style clause also would eliminate many of the arguments made by the IRS in *Sorensen*
  - *King* is for sales, but could be used to sell to a trust to which gifts had been made previously

Sorensen v. Comm'r

- Valuation issues:
  - No updated appraisal for 2015 sale
  - Tax Affecting was a key difference
    - The IRS cited several cases that rejected tax-affecting, but did not cite the more recent *Estate of Jones v. Commissioner*, which accepted a tax-affecting analysis under the facts of that case
  - Other valuation differences
    - Discount Rates – DHG's report used a discount rate of 26%; IRS appraiser used 13.14%
    - Selected Comparable Companies
    - Exclusion of EBIT Multiple – DHG's report did not consider EBIT multiples, while IRS appraiser did
    - Adjustment Factor – DHG's report used a size adjustment factor of 60% to lower its market approach value, while IRS appraiser did not use a size adjustment factor

Sorensen v. Comm'r

- Penalties
  - The IRS issued notices of deficiency asserting a 40% penalty for both 2014 and 2015
  - For the 2014 gifts, the IRS argued that each Taxpayer knew
    - he had transferred 9,385 shares of non-voting stock in 2014 (not shares worth $5 million); and
    - the shares were worth substantially more than $5 million because of Firehouse's prior five years of distributions, revenue and operating growth, and store expansion
  - For the 2015 gifts, the IRS argued that Taxpayers
    - did not exercise reasonable diligence to determine the fair market value of the transferred shares
    - failed to properly account for the transfer on their 2015 gift tax returns

Sorensen v. Comm'r

- Penalties (cont'd)
  - Three-prong test from *Neonatology Assoc.*: (1) the adviser was a professional with expertise to justify reliance; (2) the taxpayer provided accurate and necessary information to the adviser; and (3) the taxpayer actually relied on the adviser's judgment in good faith
  - For the 2014 gifts, Taxpayers argued that they lacked any reason to question the advice of their professionals on whom they relied
  - For the 2015 gifts, Taxpayers argued that it was reasonable to rely on the 2014 appraisal, and they did not report the 2015 transfers on their 2015 gift tax returns because they reasonably believed that they had received full and adequate consideration for the transfers
  - Settlement: no penalty on disclosed 2014 transfers; 10% penalty on undisclosed 2015 transfers

Estate of DeMuth v. Comm'r, T.C. Memo 2022-72

- Headlines
  - Court analyzed whether value of checks written by decedent that were paid after date of death should be excluded from estate for estate tax purposes
  - Court held that the value of four checks should be excluded from estate
    - The value of one check was properly excludible under the legal analysis
    - The value of three checks were excluded only because the IRS erroneously conceded in its Simultaneous Opening Brief that the checks were excluded, perhaps based on a misunderstanding of the relevant terms of art
    - Court held the IRS to its concession because the Taxpayer had relied on the concession when drafting its Simultaneous Answering Brief

Estate of DeMuth v. Comm'r

- Legal Analysis as to whether the value of checks paid after date of death should be excluded from the decedent's estate for estate tax purposes:
  - Value of check is includible if it still "belongs" to the decedent at date of death
  - Check does not "belong" to decedent if "decedent executed a completed gift of the check during their lifetime"
  - Gift is completed if the donor has so "parted with dominion and control as to leave him no power to change its disposition"
  - Whether a donor has the power to change the disposition is dependent on state law. Here, PA law governs. Mere delivery is not enough. "Drawee" or "Payor" bank must have accepted, certified, or made final payment of the check.
- Regardless, the value of three checks that were not "accepted, certified, or paid" were excluded from decedent's estate because the IRS conceded that they were excluded and the Taxpayer had relied on the IRS concession

Estate of DeMuth v. Comm'r

- Lessons learned
  - Verbiage matters! It's important to get the technical details right. Here, both the IRS and the Taxpayer seemingly misconstrued the term 'drawee bank' to mean 'depositary bank,'" to the detriment of the IRS
  - Make gifts with cashier's checks or by wire transfer, esp. in situations like this where it is known that the donor's health was failing
    - The result here should not be surprising. The DeMuth's court analysis was similar to the analysis in DiSanto v. Comm'r, T.C. Memo 1999-421. There, checks had been paid on date of death, but decedent had actually died prior to banks opening (and therefore could not stop pmt.), but court still held that gifts were not complete.
    - Interestingly, the Taxpayers in DiSanto also argued for the extension of the relation-back doctrine used in Bacchus v. United States (relating to annual exclusion gifts) to estate situations, but the Court declined to do so

IRS Guidance

- Rev. Proc. 2022-38 (exemption amounts)
  - The silver lining of inflation
- Priority Guidance Plan for 2022-2023 (released 11/4/22)
  - Three new sets of substantive regulations
  - Bonus: rev. proc. relating to portability elections, and the re-appearance of a project regarding basis and grantor trusts
- CCA 202233014
  - No Marital *or* Charitable Deduction for portion of sprinkling CRUT even though Spouse and Charity were the only Beneficiaries

2023 Exemption Amounts

- Rev. Proc. 2022-38
- Gift tax annual exclusion: $17,000
  - Increase from 2022 amount of $16,000
  - From 2018 through 2021, amount was $15,000
- Basic Exclusion Amount: $12,920,000 per person
  - Increase of $860,000 from 2022!
  - For a married couple, the amount is close to $26 mill.!

Treasury Priority Guidance Plan

- Plan for 7/1/22- 6/30/23 released 11/4/22
  - Plan projects represent priorities for allocation of Treasury Dept. and Service resources for 12-month period
  - Plan projects will not necessarily be completed within the Plan year
- 205 projects on the plan
  - 11 projects under "GIFTS AND ESTATES AND TRUSTS"
  - No real developments in 2022 on seven of the projects (prop regs for four of them were issued previously)
  - For the remaining four projects, we have three sets of new regs published in 2022 and one new rev. proc.

Treasury Priority Guidance Plan

- Four projects on which proposed regs were published prior to 2022 (nothing new in 2022 on these projects)
  - Final regs under §§1014(f) and 6035 re: basis consistency. *Prop. Regs publ'd 2016*
  - Regs under §2032(a) re: imposition of restrictions on estate assets during alt. val. period. *Prop. regs publ'd 2011*
  - Final regs under §2642(g) re: granting of extension of time to allocate GST exemption. *Prop. regs publ'd 2008*
  - Final regs under §2801 re: tax imposed on U.S. citizens & residents who receive gifts from certain expats. *Prop. regs publ'd 2015*

Treasury Priority Guidance Plan

- No developments in 2022 on three other projects (except that one of them re-appeared on the list after an absence)
  - Guidance re: §1014 basis adjustment at the death of the owner of a §671 grantor trust when trust assets are not included in the owner's estate for estate tax purposes
    - Added back to Plan after absence in 2021-2022 Plan
  - Regs under §20.2056A-2 for QDOT elections on estate tax returns, updating obsolete references
  - Regs under §2632 re: allocation of GST exemption, the definition of a GST trust under §2632(c), and ordering rules when GST exemption is allocated in excess of the transferor's remaining exemption

Treasury Priority Guidance Plan

- Four projects that had developments in 2022
  - Prop. Regulations under §2010 regarding "Boomerang Clawback" issued 4/27/22
  - Prop. Regulations under §2053 issued 6/28/22
  - Prop. Regulations under §7520 regarding the use of actuarial tables issued 5/5/22
  - Rev. Proc. 2022-32 provides guidance on portability regulatory elections

Prop. Regs under §2010

- The history behind the proposed regs:
  - 2017 TCJA increased BEA from $5 mill* to $10 mill* for *gifts made, or decedents dying, on or before 12/31/25*
  - ***Clawback***? If, for ex., a client made a gift of $12 mill. in 2022, then died in 2026, would estate tax be owed because BEA at death would be less than amount of gift?
  - ***Anti-Clawback*** final regulations pub'd 11/26/19, enacted taxpayer favorable "<u>Special Rule</u>"
  - "***Proposed Exceptions***" to the Anti-Clawback Special Rule set forth in prop. regs. publ'd 4/26/22

** Indexed for inflation*

Prop. Regs under §2010

- Why did Treasury think we need Proposed Exceptions?
- Huge increase to the BEA + Anti-Clawback Special Rule = Use it or Lose it!
- But – what if a client has more than $5 mill.*, but not really enough to give away $10 mill.* and isn't married or doesn't want to create a SLAT for other valid reasons?
- There are some types of planning that allow a client to "use up" BEA with a taxable gift, but still retain some or all of the economics of that gift during lifetime
- Proposed Exceptions are designed to eliminate this "have your cake and eat it too" planning

** Indexed for inflation*

Prop. Regs under §2010

- Proposed Exceptions to the Anti-Clawback Special Rule:
  - Transfers includible in the gross estate pursuant to section 2035, 2036, 2037, 2038, or 2042, regardless of whether all or any part of the transfer was deductible pursuant to section 2522 or 2523
  - Transfers made by enforceable promise to the extent they remain unsatisfied as of the date of death
  - Transfers described in § 25.2701-5(a)(4) or § 25.2702-6(a)(1)
  - Transfers that would have been described in the three bullet-points above but for the transfer, relinquishment, or elimination of an interest, power, or property, effectuated within 18 months of the date of the decedent's death by the decedent alone, by the decedent in conjunction with any other person, or by any other person

Prop. Regs under §2010

- Exceptions to the Proposed Exceptions to the Anti-Clawback Special Rule:
  - Transfers includible in the gross estate in which the value of the taxable portion of the transfer, determined as of the date of the transfer, was 5 percent or less of the total value of the transfer
  - Transfers, relinquishments, or eliminations described above that are effectuated by the termination of the durational period described in the original instrument of transfer by either the mere passage of time or the death of any person

Prop. Regs under §2053

- Under §2053, certain claims and expenses can be deducted from the value of the gross estate for estate tax purposes
- Proposed regs would do the following:
  - for certain expenses paid more than three years after death, limit the amount of the deduction to the present value of the expense
  - provide guidance on the deductibility of interest on tax and penalties
  - provide guidance on the deductibility of interest on certain estate loans
  - amend/clarify req's for substantiating the value of certain deductible claims
  - provide guidance on the deductibility of amounts paid under a decedent's personal guarantee
- Prop. regs provide that they would apply to the estates of decedents dying on or after the date of publication of the final rule in the Federal Register

Prop. Regs under §2053

- Guidance on use of **present-value principles** in determining the amount of a deductible claim or expense
- Present-value rules would not apply to:
  - expenses within three years of date of death (the "grace period")
  - unpaid principal of mortgages and other indebtedness deductible under § 20.2053-7
- Otherwise, present-value rules apply to expenses/claims that will be paid after grace period
  - the discount rate to be used is the appropriate mid-term or long-term applicable federal rate in effect at decedent's date of death
  - a supporting statement showing the calculation of present value must be filed with the Form 706

Prop. Regs under §2053

- **<u>Deductibility of Interest on Tax & Penalties</u>**
  - interest payable on unpaid estate tax deferred under section 6166 is not deductible
    - Rationale: this interest is subject to a more favorable interest rate under section 6601(j)
  - non-section 6166 interest on unpaid estate tax deferred under section 6161 or section 6163 is deductible because the interest expense is actually and necessarily incurred in the administration of the estate
    - Rationale: the extension was based on a demonstrated need to defer payment; thus, the interest expense was actually/necessarily incurred
  - non-section 6166 interest is ***not*** deductible to the extent it is attributable to an executor's negligence, disregard of applicable rules or regulations (including careless, reckless, or intentional disregard of rules or regulations) as defined in § 1.6662-3(b)(2), or fraud with intent to evade tax

Prop. Regs under §2053

- **Deductibility of Interest on Certain (i.e., *Graegin*) Loans**
  - *Graegin* loan
    - If estate does not have funds to pay estate tax, estate can borrow
    - If loan has a fixed interest rate and prohibits prepayment, then amount of interest to be paid is ascertainable, overcoming one hurdle to deduction of interest expense
    - Interest expense also must be ***necessarily*** incurred under Reg. §20.2053-3(a)
  - Prop Reg. §20.2053-3(d)(2) would require that "both the loan . . . and the loan terms must be actually and necessarily incurred . . . and must be essential to the proper settlement of the decedent's estate
    - prop reg goes on to provide a non-exclusive list of 11 "factors that collectively may support a finding that the interest expense also satisfies the additional requirements . . ."

Prop. Regs under §2053

- **<u>Deductibility of Interest on Certain (i.e., *Graegin*) Loans</u>**
  - Some of the non-exclusive factors are particularly problematic for certain *Graegin* loans. For example, ninth and tenth factors:
    - The lender is not a beneficiary of a substantial portion of the value of the estate, and is not an entity over which such a beneficiary has control or the right to compel or direct the making of the loan
    - The lender/lenders are not beneficiaries whose individual share of liability under the loan is substantially similar to their share of the estate
  - These particular factors can be overcome with a loan from a third party bank, but a loan from a related entity may make more sense from a business perspective

Prop. Regs under §2053

- **Deductibility of Interest on Certain (i.e., *Graegin*) Loans**
  - Preamble of prop regs: "if illiquidity has been created intentionally (whether in the estate planning, or by the estate with knowledge or reason to know of the estate tax liability) . . ., the underlying loan . . . most likely will not be found to be actually and necessarily incurred"
    - Illiquidity can be a side effect of estate planning that is undertaken for other, non-tax reasons
    - ACTEC comments propose balanced approach based on whether estate is able to demonstrate significant non-tax purpose for transactions that occurred within three years of death, along with carve-out for loans to estate from ILIT
  - Full list of non-exclusive factors, and further discussion, can be found in Appendix C of paper (ACTEC 2053 Comments)

Prop. Regs under §2053

- **<u>Substantiation of Certain Amounts Deductible</u>**
  - Current regs require qualified appraisal for substantiation of claims deductible under §20.2053-4(b) or (c) (claims and counterclaims in a related matter or unpaid claims totaling not more than $500,000)
  - Prop regs replace "qualified appraisal" with a written appraisal document that is *signed under penalties of perjury* by an unrelated person who is qualified by knowledge and experience to appraise the claim being valued
  - ACTEC 2053 Comments note that:
    - Term "appraisal" implies that it must be prepared by an appraiser
    - Unlikely that unrelated party has firsthand knowledge of underlying facts, making "penalties of perjury" requirement inappropriate
  - Contrast Treas. Reg. § 20.2031-6(a), (b) and (c), which requires statement accompanying appraisal that is signed by *executor* (not appraiser) under penalties of perjury

Prop. Regs under §2053

- **Deductibility of Amounts Paid under Decedent's Personal Guarantee**
  - Prop regs provide guidance on whether a guarantor agreement is contracted for adequate and full consideration (as req'd under 2053)
  - ACTEC 2053 Comments note that:
    - Courts have long held that the consideration need not be paid to the decedent
    - Rather, courts have held that the guarantor's obligation is contracted for adequate and full consideration if there is a loan made to a third party on account of binding guaranty
    - The guarantor's right to subrogation constitutes adequate and full consideration if the guarantor had a *bona fide* expectation of repayment
  - ACTEC 2053 Comments recommend that prop regs be clarified to be consistent with long-standing case law

Prop. Regs under §7520

- Prop regs are largely computational in nature; nothing too controversial, except the effective date transitional rule
- Effective Date Transitional Rule: 1/1/21 to date final regulations are effective, taxpayers can choose between old tables and new tables
  - Arguably, 1/1/21 should be changed to 5/1/19
- Further guidance needed on some rounding issues and election under effective date transitional rule
- New tables reflect dramatic increase in life expectancies
  - Old tables better for CRTs and gift of remainder interest in residence to charity
  - New tables better for CLTs

Rev. Proc. 2022-32

- Provides a simplified method to extend time to make a portability election within ***five*** years of date of death
- Supersedes Rev. Proc. 2017-34: generally gave *two* years
- Requirements:
  - decedent (a) was survived by a spouse, (b) died after 12/31/10, and (c) was a citizen or resident of the U.S.
  - Executor not otherwise required to file Form 706
  - Executor did not file Form 706 within time required
  - The Form 706 is filed on or before fifth anniversary, prepared in accordance with § 20.2010-2(a)(7) and has portability statement at the top
- If more than five years have passed since the decedent's date of death, executor can still request extension by letter ruling under § 301.9100-3

CCA 202233014

- Decedent dies, leaving a portion of his estate to a CRUT. CRUT terms:
  - annual unitrust payments of 5% to widow for life
  - trustee must distribute 25% of unitrust to widow
  - trustee may distribute 75% of unitrust to either charity or widow, at trustee's complete discretion
  - Upon widow's death, remainder of CRUT passes to charity
- Only beneficiaries are widow and charity, but no marital ***or*** charitable deduction for 75% portion
  - Charity's interest not in the form of a fixed unitrust amount
  - Not possible to ascertain how much of 75% would pass to widow
- Change from prior rulings specifically referenced in footnote, but without any reason for explanation of change

Questions?

Thank you!