FEDERAL ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAX
RECENT DEVELOPMENTS*

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*The outline highlights select developments from October 2017 through mid-December 2018 focusing on key points relevant to the code section under which it appears. The outline reflects the views of the author and not those of the University of Montana.
I. FEDERAL ESTATE TAX

A. Key Inflation Adjusted Amounts

Treasury issued estate, gift and generation-skipping transfer tax inflation adjusted amounts for 2019 in Revenue Procedure 2018-57, I.R.B. 2018-49 (Nov. 16, 2018). The inflation adjusted amounts set forth in the revenue procedure are as follows:

1. Basic Exclusion Amount and GST Exemption

The formerly named Tax Cuts and Jobs Act, P.L. 115-97, doubled the basic exclusion amount and GST exemption from an indexed $5 million to an indexed $10 million amount effective for tax years 2018 through 2025. I.R.C. § 2010(c)(3)(C); I.R.C. § 2505(a). The basic exclusion amount for federal estate and gift tax during 2019 increases to $11,400,000 from its former 2018 amount of $11,180,000. The generation-skipping transfer tax exemption is the same amount. Treasury issued proposed regulations ruling out the possibility of a “clawback” of basic exclusion amount in the event the basic exclusion amount in fact halves in 2026, and those proposed regulations are discussed below.

2. Gift Tax Annual Exclusion

The federal gift tax annual exclusion amount of $10,000 adjusts for inflation for years following 1998. I.R.C. § 2503(b). The per-person per-year exclusion from gift tax for 2019 remains $15,000. For non-U.S. citizen spouses the annual gift tax exclusion amount for 2019 increases to $155,000 from the former 2018 amount of $152,000.

3. Special Use Valuation Limitation

The special use valuation election is limited to $750,000 as that amount is adjusted for inflation after 1998. I.R.C. § 2032A(a)(3). The special use valuation limitation increases to $1,160,000 for 2019, up from the 2018 amount of $1,140,000.

4. Section 6166 2-Percent Amount

If an I.R.C. Section 6166 election is made to defer tax, a certain portion of the estate tax to be paid will bear interest at the rate of 2 percent. The 2 percent portion is determined based on a formula specified per I.R.C. 6601(j), specifically, an amount equal to the tentative tax on the sum of $1 million (as that amount is adjusted for inflation) and the applicable exclusion amount, less the applicable credit amount. The $1 million amount increases in 2019 to $1,550,000, up from the 2018 amount of $1,520,000. Accordingly, in 2019, the 2 percent portion would be calculated as follows: The tentative tax on the sum of
$1,550,000 and $11,400,000 is $5,125,800. That amount less the applicable credit amount for 2019 of $4,505,800 is $620,000. Thus, the 2 percent portion as calculated for 2019 is $620,000.

B. Section 2010: Unified Credit


**Treasury Issues Anti-Clawback Proposed Regulations.** Treasury issued proposed regulations preventing clawback of transfer tax in the event the basic exclusion amount halves in 2026. *See* News Release, IR-2018-229, November 20, 2018 (“Today the IRS announced that individuals taking advantage of the increased gift and estate tax exclusion amounts in effect from 2018 to 2025 will not be adversely impacted after 2025 when the exclusion amount is scheduled to drop to pre-2018 levels.”). The proposed regulations provide there will be no loss of the increased basic exclusion amount for taxpayers who make taxable gifts exceeding the basic exclusion amount available in the year of death. As drafted, however, the proposed regulations require a taxpayer to make gifts in excess of the $5 million basic exclusion amount as that amount is adjusted for inflation in order to obtain any benefit from the temporary increase in basic exclusion amount when applied to lifetime transfers. Taxpayers unwilling to make aggregate gifts in excess of the $5 million basic exclusion amount, as that amount is adjusted for inflation, will not obtain any transfer tax benefit from the temporary increase in place from 2018 through 2025 unless the taxpayer’s death occurs within that time frame. In choosing to issue regulations that deem the first $5 million of the basic exclusion amount as used first, rather than the temporary increase of $5 million first, Treasury benefits only the very most wealthy Americans willing to make transfers during the period of increased basic exclusion amount, and correspondingly provides no benefit from the temporarily increased amount for those taxpayers with assets insufficient to comfortably make gifts in excess of the anticipated basic exclusion amount as of 2026 unless, of course, death occurs prior to 2026.

**Proposed Regulation, In General.** The proposed regulations achieve this result by adjusting the applicable credit amount to reflect the greater of the aggregate credit amounts attributable to the basic exclusion amount (BEA) applied in making lifetime transfers and the applicable credit amount allowable at donor’s death. Specifically, the proposed regulations provide a special rule in the event the basic exclusion amount used to shelter gifts made by taxpayer differs from the basic
exclusion amount applicable at donor’s death. The special rule added as Prop. Treas.Reg. § 20.2010-1(c)(1) provides:

“If the total of the amounts allowable as a credit in computing the gift tax payable on the decedent’s post-1976 gifts, within the meaning of section 2001(b)(2) [referencing computation based on the tax rate applicable at date of death], to the extent such credits are based solely on the basic exclusion amount as defined and adjusted in section 2010(c)(3) [meaning the inflation adjusted basic exclusion amount], exceeds the credit allowable within the meaning of section 2010(a) [referencing the applicable credit amount] in computing the estate tax, again only to the extent such credit is based solely on such basic exclusion amount, in each case by applying the tax rates in effect at the decedent’s death, then the portion of the credit allowable in computing the estate tax on the decedent’s taxable estate that is attributable to the basic exclusion amount is the sum of the amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on the decedent’s post-1976 gifts.

The special rule will be effective as of the date Treasury publishes final regulations. Prop. Treas. Reg. § 20.2010-1(f)(2).

The proposed regulations use a singular simplified example unrelated to actual credit amounts provided by statute to explain the calculation of the proposed regulation. The example essentially provides:

A, a person who has never married, makes cumulative taxable gifts of $9 million. The full amount of the $9 million in taxable gifts was “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, at a time when the basic exclusion amount is $5 million…. Because the total of the amounts allowable as a credit in computing the gift tax payable on A’s [] 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 decedent’s date of death … 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 [] gifts made by A.

*Impact of Inflation Adjustments.* The references in the example to a $10 million allowable basic exclusion amount at the time of the gifts and a $5 million basic
exclusion amount after 2026 do not track the proposed regulation itself referencing the “basic exclusion amount as defined and adjusted in section 2010(c)(3)…” (Emphasis added.) The plain wording of the special rule demonstrates a clear intent to account for inflation adjustments. The proposed treasury regulation § 20.2010-1(e)(3) further defines “basic exclusion amount” with reference to inflation adjustments, taking into account the switch to the chained CPI. The special rule, thus, accounts for inflation adjustments to the BEA despite the example’s use of unadjusted amounts.

**Potential Impact of Ported DSUEA.** More troubling is that the lack of any reference in the proposed regulations acknowledging the possibility the donor’s applicable exclusion amount (AEA) may include a ported deceased spousal unused exclusion amount (DSUEA) leaves a void of knowledge as to how the special rule deals, if at all, with a ported DSUEA. The preamble to the proposed regulations in contrast clearly acknowledges: “For the sake of simplicity, the following discussion assumes that, as may be the more usual case, the [applicable exclusion amount or] AEA includes no DSUE or restored exclusion amount and thus refers only to the BEA.” To clarify the scope of the special rule, the final regulations should include a similar statement if in fact the formula of the special rule does not take into account any ported DSUEA. Courts typically look only to the plane language of the statute and for this reason it is important to include the same statement in the regulations. Alternatively, final regulations would benefit from an example demonstrating interaction with a ported DSUEA especially in light of the reference in the proposed regulations to the applicable credit amount in I.R.C. Section 2010(a), which is defined in terms of the estate tax on the sum of the BEA and any ported DSUEA.

The proposed regulations could benefit from further clarifying language with respect to whether its reference to the I.R.C. § 2010(a) applicable credit amount takes into account a ported DSUEA or not. If Treasury intended to weigh aggregate credit derived from the use of the increased BEA allocated to shelter gifts against that derived from the basic exclusion amount allowable as of decedent’s death, why did it not simply parallel the reference to I.R.C. § 2010(c)(3) as applicable at death? Why did it reference the applicable credit amount that is determined based on the sum of the BEA and the ported DSUEA? Is it suggesting the comparison should be to the applicable credit amount based on the AEA? On the one hand, the proposed regulation’s reference to I.R.C. § 2010(a) is immediately followed by a limiting reference – “again only to the extent such credit is based solely on such basic exclusion amount,” which would indicate the applicable credit amount at death for purposes of the formula is
limited to the tax on the BEA portion of the AEA. On the other hand, “such credit” by definition is never based solely on the BEA if a ported DSUEA is available, in that case it is comprised of the combined BEA and DSUEA. Despite this somewhat confusing reference to I.R.C. § 2010(a), the best interpretation of the formula as written is that it applies only to determine the value of the BEA that, when added to any ported DSUEA, yields the AEA on which the applicable credit is to be calculated. The formula carves out the “portion of the applicable credit allowable in computing the estate tax … attributable to the basic exclusion amount.” The final regulations could clarify the formula with an accompanying example addressing the interaction of the ported DSUEA and the temporary increase in BEA.

Given the special rule does not discuss how it impacts use of a ported DSUEA, the question remains: Must a donor make gifts in excess of both the BEA calculated on a $5 million base amount and any ported DSUEA in order to take advantage of the increased temporary basic exclusion amount when making gifts? Or, will the donor only need to make gifts in excess of the BEA calculated based on a $5 million base amount in order to benefit from the temporary BEA increase? Considering that the portability regulations provide an ordering rule deeming any gifts made by a surviving spouse use the ported DSUEA first, and the BEA second (see, Treas. Reg. § 25.2505-2(b)), it would make sense for the final anti-clawback regulations to clarify that a taxpayer must make gifts in excess of both the BEA calculated on a $5 million base amount and any ported DSUEA in order to reap a benefit from the temporarily increased BEA.

**Potential Impact of Restored Exclusion Amount.** Likewise, the final regulations would benefit from a clarifying example when the donor is entitled to a “restored” basic exclusion amount. The example is confusing at best as it posits a taxpayer that has never been married, but later references a restored exclusion amount that could only occur if the taxpayer had been married, citing IRS Notice 2017-15. A plain reading of the special rule would indicate, to the extent the donor is entitled to a restored basic exclusion amount, the restored basic exclusion amount should be used in determining basic exclusion amount under the formula. Assuming this is a correct interpretation, the final regulations should so indicate.

**Planning in Light of the Scheduled Decrease in BEA.** Planning implications of the proposed regulations suggest:

- Clients whose estates potentially may owe federal estate tax come 2026, but who are unwilling to make sufficiently large gifts to benefit from the temporarily increased basic exclusion amount, should primarily consider
gifting strategies using annual exclusion gifts or sales that freeze estate tax values. These strategies do not depend on the sheltering ability of the applicable exclusion amount. For those clients, current gifts using the applicable exclusion amount will produce no added benefit as a result of the temporary increase in BEA, and may have the downside of causing assets to miss out on the benefit of a stepped-up income tax basis.

- Clients with sufficient assets to comfortably make a gift in excess of one-half the current basic exclusion amount during the years 2018 through 2025 should make the gift prior to 2026, and should consider making the gift as soon as possible in order to maximize the freeze benefits from any lifetime transfer. Any current gift should be followed with additional gifts to pick up annual increases in basic exclusion amount. This assumes, however, no ported DSUEA, and also assumes the wealth transfer tax benefits of such a transfer outweigh any potential income tax benefits of a stepped-up basis.

**Conclusion.** The preamble to the proposed regulations confirms the temporary increase in BEA will not impact the estate and gift tax calculation. Thus, the decision to make large gifts now to take advantage of the temporary increase in BEA largely depends on the client’s willingness to make a large enough gift. The analysis of Treasury as set forth in the preamble determines the temporary increase will have no bearing on transfer taxes owed if the BEA increases at death (as opposed to decreasing at death); nor if it decreases over the course of making gifts. With the promulgation of the special rule, neither will a decrease in BEA as of date of death impact estate tax owed. Notably in confirming the impact of the temporary increase in BEA, the preamble to the proposed regulations outlines a helpful step by step guide for the calculation of gift tax and of estate tax in the event decedent makes adjusted taxable gifts. The final regulations would benefit by the same clarity specified in the preamble and further benefit by additional examples discussing the impact of a ported DSUEA and a restored exclusion amount.

2. **Joint Committee of Taxation General Explanation of 2017 Legislation (December 2017), also known as, the Blue Book, page 89, Explanation of the Temporary Increase in Basic Exclusion Amount.**

*The Joint Committee on Taxation Confirms Proposed Regulations and Provides Further Explanation of GST Tax Exemption Allocation.* The Joint Committee of Taxation explains the impact of the temporarily increased basic exclusion amount.
The explanation confirms Treasury’s interpretation of Congress’ direction to apply anti-clawback rules. It states:

“The provision doubles the estate and gift tax exemption for estates of decedents dying and gifts made after December 31, 2017, and before January 1, 2026. This is accomplished by increasing the basic exclusion amount provided in section 2010(c)(3) of the Code from $5 million to $10 million. The $10 million amount is indexed for inflation occurring after 2011. For 2018, the basic exclusion amount is $11,180,000 for determining the amount of the unified credit against estate tax. [Footnote omitted.] Because the generation-skipping transfer tax exemption under section 2631(c) is set by cross-reference to the basic exclusion amount in effect for estate tax purposes, this increase to the basic exclusion amount also increases the amount of generation-skipping transfer tax exemption available to be allocated from January 1, 2018, through December 31, 2025. [Footnote 372 omitted, and quoted separately below] As a conforming amendment to section 2001(g) (regarding computation of estate tax), the provision provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of the section with respect to differences between the basic exclusion amount in effect at the time of the decedent’s death and at the time of any gifts made by the decedent. It is intended that such regulations will address in particular the computation of the estate tax where (1) a decedent dies in a year in which the basic exclusion amount is lower than the basic exclusion amount that was in effect when the decedent made taxable gifts during his or her life, and (2) such taxable gifts exceeded the basic exclusion amount in effect at the time of the decedent’s death. Because the increase in the basic exclusion amount does not apply for estates of decedents dying after December 31, 2025, it is expected that this guidance will prevent the estate tax computation under section 2001(g) from recapturing, or “clawing back,” all or a portion of the benefit of the increased basic exclusion amount used to offset gift tax for certain decedents who make taxable gifts between January 1, 2018, and December 31, 2025, and die after December 31, 2025.

The Blue Book in footnote 372 clarifies the ability of taxpayers to allocate increased GST exemption to GST trusts previously created by transferor that are not fully exempt. The footnote provides the following clarifying example:
“For example, assume that on March 15, 2016, T gave property with a value of $6,000,000 to a trust for the benefit of T’s descendants (Trust A) and T’s entire then-remaining generation skipping transfer tax exemption of $5,400,000 was allocated to trust A on a timely filed 2016 gift tax return. As of the date of the 2016 gift, Trust A has an inclusion ratio of 0.100 [1 ¥ ($5,400,000/$6,000,000)]. On July 1, 2018, when the property in Trust A has a fair market value of $7,000,000, T files a gift tax return and allocates $700,000 of generation-skipping transfer tax exemption to Trust A, reducing Trust A’s inclusion ratio from 0.100 to zero [1 ¥ ((($700,000 + (90% x $7,000,000)) / $7,000,000))], effective on July 1, 2018. Absent additional contributions to Trust A, the generation-skipping transfer tax on taxable distributions from, or a taxable termination with respect to, Trust A on or after July 1, 2018, is determined using an inclusion ratio of zero.”

This footnote clarifies the ability to make an allocation of increased exemption to a prior transfer made at a time when the GST exemption was not sufficient to fully protect the transfer from GST taxation.

3. **Private Letter Ruling 201827003 (July 6, 2018)**

*Extension Issued to Make Portability Election.* In 2017, Treasury approved a simplified procedure for obtaining an extension to file a late portability election. Revenue Procedure 2017-34, 2017-34 I.R.B. 1282, however, allows the simplified procedure only if the estate makes the election within the date two years after the date of decedent’s death. In that event the estate may file the return and simply indicate it is made pursuant to the revenue procedure. The simplified procedure only applies if the estate would not need to file but for the need to make the portability election. Revenue Procedure 2017-34 indicates the Service will continue to address private letter ruling requests for an extension in other cases.

In Private Letter Ruling 201827003 the Service grants an extension to make the portability election under the 9100 regulations. In addressing whether the extension should be issued, the Service indicated:

A request for relief under § 301.9100-3 will be granted when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government. Section 301.9100-3(b)(1)(iii) provides that 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.

As in prior rulings, the Service does not provide an indication the taxpayer must actively seek advice to meet the reasonable diligence requirement. Prior rulings suggested the following statement needed to be made to obtain the ruling: (1) a statement that the need to file was discovered after the due date for filing the estate tax return on which the election was required to be made, and (2) a statement that the aggregate of the value of decedent’s gross estate and lifetime gifts does not exceed the basic exclusion amount.

C. Section 2031: Inclusion in Gross Estate

_Estate of Streightoff v. Commissioner, T.C. Memo. 2018-178 (Oct. 24, 2018)_

_Court Values Interest Transferred as a Limited Partnership Interest, Not an Assignee Interest._ The tax court’s opinion in _Estate of Streightoff v. Commissioner_ follows on the heels of _Estate of Powell v. Commissioner_, 148 T.C. No. 18 (May 18, 2017), and its opinion in _Estate of Cahill v Commissioner_, discussed below. The court in _Streightoff_, like the court in the earlier opinions in _Powell_ and _Cahill_, focuses its analysis on the terms of the partnership agreement and draws its holding in large part based on those terms. In _Powell_, the court focused on language of the partnership agreement allowing the decedent, through decedent’s revocable trust, to act jointly with another to terminate the partnership, and based on that language applied I.R.C. Section 2036(a)(2) to include the underlying partnership assets in decedent’s gross estate. Likewise in _Estate of Cahill_, the court looked to the terms of a split dollar life insurance arrangement to determine that decedent likewise retained a jointly held power to terminate the arrangement pursuant to I.R.C. Section 2036. Again in _Streightoff_, the tax court looks to the terms of the agreement and transfer documents to determine the limited partnership interests held in decedent’s revocable trust should be valued as limited partnership interests and not as assignee interests. _Streightoff_ may in fact be most significant for what it does not say – the Service respected the partnership and included value of the partnership interests in the gross estate, rather than the value of the underlying assets in the gross estate as was done in _Powell_ when decedent held a power to terminate. In _Streightoff_, the Tax Court framed the issue in terms of the type of interest and the value of the interest transferred to decedent’s revocable trust.
Decedent’s daughter, as decedent’s attorney-in-fact created the family limited partnership (FLP) on October 1, 2008 with the purpose to increase wealth, provide for family management and preserve family assets. The FLP was funded primarily with marketable securities and other liquid assets. During his life, decedent transferred limited partnership interests to his children and former daughter-in-law, and reported these gifts on a filed gift tax return. The partnership agreement allows limited partners owning at least 75% of the limited partnership interests to remove the general partner and thereby terminate the partnership. Decedent’s revocable trust owned more than 88% of the limited partnership interests as of decedent’s death. The partnership agreement also provided that a partner could not transfer more than an assignee interest unless the general partner admitted the assignee as a substitute limited partner. Decedent signed an “Assignment of Interest” binding himself to the terms of the partnership agreement. The court found the transfer to be a “permitted transfer” under the terms of the partnership agreement.

The estate, based on an appraisal, valued the decedent’s partnership interest held through the revocable trust as an assignee interest claiming discounts for minority interest and lack of marketability. The Service asserted the interests should be valued as partnership interests, not assignee interests.

After rejecting the estate’s procedural arguments, the court focused on the characterization of the interest and its value. The court begins by asserting that substance, and not form, would control characterization of the partnership interest. In finding the transfer was of a limited partnership interest, the court focused on the language of the transfer agreement noting: “It … stated that decedent transferred with the interest ‘all and singular the rights and appurtenances thereto in anywise belonging’. Although the transfer was labeled an ‘[a]ssignment’, the agreement states that the revocable trust is entitled to all rights associated with the ownership of decedent’s 88.99% limited partnership interest, not those of an assignee. All ‘rights and appurtenances’ belonging to decedent’s interest include the right to vote as a limited partner and exercise certain powers as provided in the partnership agreement.” Based on this analysis of the transfer agreement the tax court concluded: “The agreement satisfied all the conditions for the transfer of decedent’s limited partnership interest and the admission of the revocable trust as a substituted limited partner.” The court, relying on its decision in Kerr v. Commissioner, 113 T.C. 449 (1999), aff’d, 292 F.3d 490 (5th Cir. 2002), highlighted the lack of any substantial difference to the decedent’s rights before and after the transfer by imputing the rights held by
decedent’s daughter as a limited partner in her own right to her as trustee of her revocable trust. (This reasoning is reminiscent of the courts analysis in *Powell* imputing the rights of the general partner to the decedent because decedent’s attorney-in-fact was also the general partner of the FLP.) The court also relied on the fact decedent held the power to revoke the trust and regain control of the transferred limited partnership interests. All this led the court to characterize the transfer as one of limited partnership interests.

The court valued the interest based on attributes of a limited partnership interest. Because decedent was deemed to hold a greater than 88% limited partnership interest, the court rejected any minority or lack of control discount. The court did allow a discount for lack of marketability, however, of 27.5 percent.

D. **Section 2032: Alternate Valuation**

*Private Letter Ruling 201815001 (April 13, 2018)*

*Service Grants Extension to Make Alternate Valuation Election.* Pursuant to Treasury Regulations Sections 301.9100-1 and -3, the Service grants an extension to make an alternate valuation election in Priv. Ltr. Rul. 201815001. The CPA filing the estate tax return did not advise the executor to make the alternate valuation election. An extension is granted because taxpayer reasonably relied on a qualified tax professional when initially failing to elect. *See also* Priv. Ltr. Rul. 201825013, 201820010.

E. **Section 2032A: Special Use Valuation**


   *Treasury Issues Interest Rate for Computing Special Use Value.* Revenue Ruling 2018-22 publishes average annual effective interest rates to be used in computing special use value for 2018. Examples as to use of these rates are included in Rev. Rul. 81-170, 1981-1 C.B. 454.

2. **Private Letter Ruling 201814004 (April 6, 2018)**

   *Service Grants Extension to Elect Special Use Valuation.* The Service granted estate an extension to elect special use valuation where CPA filing estate tax return failed to make the election. The extension was granted pursuant to the 9100 regulations, Treas. Reg. § 301.9100-3.
F. **Section 2036: Transfers With Retained Life Estate**

1. **Badgley v. United States, 2018-1 U.S.T.C. ¶60, 705 (N.D. Cal. 2018)**
The federal district court in *Badgley v. United States* upheld the validity of Treasury Regulation 20.2036-1(c)(2) and included the property held in a grantor retained annuity trust in decedent’s gross estate. Decedent had transferred a one-half interest in a multi-unit apartment complex to a trust retaining an annuity interest for 15 years or her earlier death. Decedent’s daughters were to receive the remainder interest. The income produced proved sufficient to more than cover the annuity payments. The daughters argued that I.R.C. Section 2036(a)(1) does not cover annuity interests, and further argued that Treasury Regulation 20.2036-1(c)(2) was overly broad in including property of the GRAT. The government argued an annuity equates to possession or enjoyment and cited three early United States Supreme Court cases indicating substance should control inclusion and not form. The court acknowledged that the statute does not specifically reference an annuity interest, but held: “Based on the Supreme Court’s pragmatic approach to section 2036’s operative language, Patricia’s right to a fixed-annuity payment from the GRAT brought her transferred property within the meaning of that section.” Applying the *Chevron* two-part test, the court upheld the treasury regulation noting that Treasury in promulgating the regulation also relied on the early Supreme Court cases. The fact the regulation includes only that property necessary to support the annuity payment persuaded the court to uphold the regulation.

2. **Estate of Cahill v. Commissioner, T.C. Memo. 2018-84**
The Tax Court in *Estate of Cahill v. Commissioner*, T.C. Memo. 2018-84 includes the cash surrender value subject to an intergenerational split dollar agreement in the decedent’s gross estate pursuant to I.R.C. Section 2036(a)(2) and 2038. It also applies I.R.C. Section 2703 to ignore any restrictions in the agreement that have a depressing effect on value includible in the gross estate. The Tax Court in Cahill takes the opportunity to reinforce the tax court’s 2017 holding in *Estate of Powell*, 148 T.C. No. 18 (2017), and goes one step further in applying I.R.C. Section 2703 to the split dollar arrangement.

**Facts of Cahill.** Decedent’s son, Patrick Cahill, entered into split dollar agreements on behalf of his father, Richard Cahill, at a time when Richard was 90 years old and lacked capacity to manage his own affairs. Slip Op. at 3. Richard died December 12, 2011. *Id.* Patrick served as Richard’s attorney-in-fact and as trustee of Richard’s “Survivor” trust. The parties stipulate that Richard’s gross estate includes the assets of the Survivor Trust. *Id.* In 2010, as attorney-in-fact
Patrick created the irrevocable “Morris Brown Trust,” termed the MB Trust, naming his cousin and business partner William as trustee, and himself and his descendants as beneficiaries. The MB Trust owns three whole life insurance policies, two on the life of Patrick’s spouse with a policy amount of $39.8 million, and one on Patrick’s life with a policy amount of $40 million, with each policy guaranteeing a 3-percent return. Id. at 4. Each policy is the subject of a split dollar agreement with the Survivor Trust agreeing to pay the premium as an advance to the MB Trust. Id. The Survivor Trust obtained a five year loan at 1.5 percent interest, guaranteed by Richard and Patrick, for the purpose of making the premium payment. The split dollar agreements further provided: “Survivor Trust will receive a portion of the death benefit equal to the greatest of: any remaining balance on the loan as relates to the relevant policy, the total premiums paid by Survivor Trust with respect to that policy, or the cash surrender value of the policy immediately before the insured's death.” Slip. Op. at 5-6. The MB Trust receives the excess. Id. Under the agreements “MB Trust is not permitted to sell, assign, transfer, borrow against, surrender, or cancel the related policy without the consent of Survivor Trust.” Slip. Op. at 6.

In exchange for $10 million in premium payments, Richard retained termination rights. Richard, in conjunction with MB Trust, could terminate the split dollar agreements and either (1) MB Trust then could retain the policy and pay Richard the greater of premium payments or cash surrender value of the policy; or, (2) MB Trust could decline to retain the policy and pay over the policy to the bank in satisfaction of the five year loan. Slip. Op. at 7-8. Because it would not make economic sense for MB Trust to allow exercise of the termination rights, the estate took the position the termination rights had no value. The estate also took the position that Richard’s right to the death benefits was worth little because the insureds were expected to outlive Richard. Slip. Op. at 8-9.

On Richard’s death the combined cash surrender value of the policies totaled $9,611,624. Id. The estate tax return for Richard’s estate reported the total value as $183,700, and Richard had previously reported a gift under the economic benefit regime of $7,578. Id. at 5-6.

*I.R.C. Sections 2036(a)(2) and 2038 Inclusion.* With reference to *Estate of Powell*, the Cahill court determines I.R.C. Sections 2036(a)(2) and 2038(a)(1) apply to include in decedent’s gross estate his interest in the cash surrender value of the insurance policies under the split dollar arrangements. The court rejects the estate’s assertion that, because the irrevocable MB trust could prevent termination of the split dollar arrangement, the decedent had not retained any rights to the
cash surrender value of the policy. In response, the court cites the ability of
decedent, through the revocable trust, to terminate the split dollar arrangement in
conjunction with the irrevocable trustee, asserting “the words ‘in conjunction with
any person’ in section 2036(a)(2), and ‘in conjunction with any other person’ in
section 2038(a)(1)” must be given meaning. Slip Op. at 15. Analyzing the facts it
concludes: “the rights to terminate and recover at least the cash surrender value
were clearly rights, held in conjunction with another person (MB Trust), both to
designate the persons who would possess or enjoy the transferred property under
section 2036(a)(2) and to alter, amend, revoke, or terminate the transfer under
section 2038(a)(1).” Id. It did not matter that the decedent could not unilaterally
force termination.

In applying the bona fide sale for adequate and full consideration exception, the
court addresses both prongs – whether the transaction was bona fide, and whether
there was adequate and full consideration received by Richard. In determining
whether the transaction was bona fide, the court asks: “Whether a transfer was a
bona fide sale is a question of business purpose; i.e., did decedent have a
legitimate and significant nontax reason, established by the record, for
transferring the $10 million?” Slip Op. at 17. Unresolved facts preclude the court
from determining the bona fide nature of the transaction. The manner in which
the court states the question may indicate a shift in focus from whether a non-tax
motive supported the transfer to whether the transaction makes economic sense
from the perspective of the transferor. As to the second prong of the exception,
the court determines the transaction lacked adequate and full consideration. The
court applies the following test: “Whether a transfer was for adequate and full
consideration is a question of value; i.e., did what decedent transferred roughly
equal the value of what he received in return?” Id. at 18. Focusing on the estate’s
application of a 98 percent discount, and noting that the basis for the discount
applied from the inception of the transaction, the court determines there was a
failure to meet the adequate and full consideration prong of the exception. On
this basis the court denies the estate’s request for summary judgement that I.R.C.
Section 2036(a)(2) and 2038(a)(1) do not apply.

I.R.C. Section 2703 Disregarded Restrictions. The court holds I.R.C. Section
2703 applies to the split dollar arrangement. Important to note, the Cahill court
begins its I.R.C. Section 2703 analysis with the view that “the relevant property
interests for purposes of section 2703(a) are the rights held under the split-dollar
agreements, and [] the estate has not disputed that decedent did, in fact, own the
termination rights and decedent's death benefit rights.” Cahill at 20-21. The court
holds the split dollar arrangement subject to the requirements of I.R.C. Section 2703:

On the basis of the undisputed facts, we conclude that under section 2703(a)(1) the split-dollar agreements, and specifically the provisions that prevent decedent from immediately withdrawing his investment, are agreements to acquire or use property at a price less than fair market value.

***

Next, it is clear that under section 2703(a)(2) the split-dollar agreements, and specifically MB Trust's ability to prevent termination, also significantly restrict decedent's right to use the termination rights.

Slip Op. at 23-24. With regard to application of I.R.C. Section 2703(a)(1) the court notes the MB Trust provided no consideration for its rights under the agreement. And, as to I.R.C. Section 2703(a)(2), the court assumes, absent the agreement, decedent would have the right to terminate the agreements and withdraw from the investment. Might this imply that if both parties provided consideration I.R.C. Section 2703 would not apply? Of note, the court distinguishes the split dollar arrangement from the formation of a partnership validly recognized under state law and from a promissory note on the basis that parties bargain and consideration passes both ways under the note. *Id.* at 24.

Of great concern, the court brushes aside policy implications of a literal reading of its holding: “if section 2703(a) applies in this case, it would also apply to all sorts of other options, agreements, rights, and restrictions. For example, the estate argues that ‘almost every two-party agreement has a restriction that one party cannot just unilaterally terminate the agreement.’” *Id.* at 27. The court impliedly acknowledges this broader reading by replying Congress provided an exception under I.R.C. Section 2703(b), specifically subsection (b)(3), which compares the terms of the agreement to “similar arrangements entered into by persons in an arms' length transaction.” *Id.* As with its Section 2036 analysis, the court applies I.R.C. Section 2703 and requires taxpayer to prove the exception applies. If this in fact is the court’s intended meaning, I.R.C. Section 2703 can apply broadly to all sorts of transfers among family members.

**Economic Benefit Regime Applies.** Citing *Estate of Morrissette v. Commissioner*, 146 T.C. 171, 178-179 (2016), the Cahill court determines the economic benefit regime, and not the loan regime, applies. Under the economic benefit regime, decedent would be deemed the owner of the policy and this becomes important in
the court’s response that estate and gift tax consequences are in tandem. The court arrives at a similar conclusion to *Morissette*. It reasons:

Generally, the regulations treat the person named as the legal owner in the insurance contract as the contract’s owner. Sec. 1.61-22(c)(1), Income Tax Regs. A nonowner is any person other than the owner who has any direct or indirect interest in the contract. Id. subpara. (2). Under this general rule, MB Trust would be considered the owner of the policies, and the loan regime would apply. Id. para. (b)(3)(i). As an exception, however, section 1.61-22(c)(1)(ii), Income Tax Regs., provides a special ownership rule: if the only economic benefit provided to the donee (MB Trust, in this case) under the split-dollar life insurance arrangement is current life insurance protection, then the donor (decedent, in this case) will be deemed the owner of the life insurance contract, irrespective of formal policy ownership, and the economic benefit regime will apply. Id. paras. (b)(3)(ii)(B), (c)(1)(ii)(A)(2). In general, the economic benefit regime treats the cost of current life insurance protection as a transfer each year from the donor/owner to the donee/nonowner. Id. para. (d)(1) and (2).

*Estate of Cahill,* slip op. at 13-14. This holding is not surprising in light of *Morissette* and results in only the cost of current insurance being treated as a gift transfer.

G. **Section 2055: Estate Tax Charitable Deduction**

**Private Letter Ruling 201845014 (November 9, 2018)**

*Service Grants Favorable Ruling for CRUT With Discretionary Distributions of Unitrust Amount Among Multiple Beneficiaries.* In Private Letter Ruling 201845014, grantor creates two CRUTs, one with grantor receiving a percentage of the unitrust amount and an independent trustee being able to distribute the remaining unitrust amount among grantor and other charitable beneficiaries. Grantor retained the ability to designate the class of charitable beneficiaries eligible to receive a distribution of the unitrust amount. Grantor’s spouse had the right to replace the independent trustee. The second of the two CRUTs also provided a survivor’s interest to grantor’s spouse. Based on these facts the Service provided a favorable ruling that the CRUTs qualified as CRUTs, and the distributions of unitrust amount to charities are eligible for the charitable deduction at the time made, and as to the survivor’s interest in the second CRUT, that CRUT would qualify for both the marital and charitable deductions as of grantor’s death.
H. Section 2056: Estate Tax Marital Deduction

1. Estate of Turner v. Commissioner, 151 T.C. No. 10 (Nov. 20, 2018)

Right of Reimbursement Prevents Reduction in Marital Deduction Despite Immediate Payment of Taxes from Marital Share. The estate of Clyde Turner has generated three tax court opinions. The first opinion held Section 2036 included in the gross estate limited partnership interests transferred by Mr. Turner prior to his death, Estate of Turner I, T.C. Memo. 2011-209. The second opinion, held inclusion of the partnership interests pursuant to I.R.C. Section 2036 did not qualify for the marital deduction because the interests did not pass from decedent to the surviving spouse, Estate of Turner II, 138 T.C. 306 (2012). As a result, the inclusion of limited partnership interests in the gross estate for which no marital deduction was allowed caused the estate to owe estate tax.

Because the remaining assets of the estate passed to the surviving spouse and the personal representative had to use those assets to pay estate tax attributable to the limited partnership interests, the Service asserted a decrease in the allowable marital deduction which in turn would trigger an increase in estate tax owed. The estate claimed there should be no decrease in the marital deduction (i) because the estate held a right of recovery pursuant to I.R.C. Section 2207B and (ii) because the marital deduction should be increased to the extent of post-death income reported on the estate’s income tax return, but not included in the gross estate. In Estate of Turner III, the Tax Court held the marital deduction should not be reduced by estate tax paid from assets passing to the surviving spouse, and held that post-death income not included in the gross estate is not eligible for the marital deduction.

As to the first issue: whether the marital deduction is reduced by federal and state estate tax owed on the property included in the gross estate pursuant to I.R.C. Section 2036 but paid from the marital shares, the court held for the estate. The court began its analysis by determining appropriate allocation of tax liabilities. It cited the United States Supreme Court opinion in Riggs v Del Drago, 317 U.S. 95 (1942), for the proposition that absent a contrary direction by decedent, state law applies to determine allocation of tax liabilities. In Estate of Turner, Georgia law applied and allocated taxes to be paid from the residue. The testamentary documents transferred the residue of Mr. Turner’s estate to the credit shelter trust, which was never funded due to inclusion of the limited partnership interests in decedent’s gross estate. The court found the testamentary documents clearly demonstrated decedent’s intent that property passing for the benefit of the surviving spouse qualify for the marital deduction. The court determines that the
right of recovery provided pursuant to I.R.C. Section 2207B as against property included in the gross estate per I.R.C. Section 2036 controls because neither decedent’s will nor Georgia law provided otherwise. Given the specifically stated intent in the will that the property qualifying for the marital deduction not be reduced by estate tax liabilities, the court further found decedent would want the executor to take all steps necessary to exercise the I.R.C. Section 2207B right of recovery against the holders of the limited partnership interests. It noted: “Because the value of the section 2036 assets is already included in the calculation of the gross estate, any recovery under section 2207B should not increase the gross estate but will enable the executor to distribute to the surviving spouse the net value of the estate, undiminished by the tax liabilities attributable to the section 2036 inclusion.” The Tax Court specifically notes that in Turner III the executor was required to pay the estate tax due, and not the spouse. On that basis, the Tax Court distinguishes Treas. Reg. § 20.2056(b)-4(c)(2) and the courts holding in Estate of Wycoff v. Commissioner, 506 F.2d 1144 (10th Cir. 1974), aff’g 59 T.C. 617 (1973), where the testamentary documents permitted payment of liabilities from the marital share if the executor found it prudent to do so. The court held that because Mr. Turner’s spouse was not required to pay estate tax attributable to estate tax owed on the limited partnership interests, the Tax Court declined to apply the rule of the treasury regulation to the facts of Turner III. On recovery of the tax, the marital share ultimately will not bear the tax burden.

As to the second issue – whether post-death income reported on the estate’s income tax return and distributed to the surviving spouse, but not included in decedent’s gross estate, should be included to increase the marital share -- the court held it did not increase the marital deduction. The estate argued the marital deduction should be increased based on the Hubert regulations that indicate post-death income increases the marital share for purposes of determining whether payment of management expenses from the marital share reduces the marital deduction. The court summarily dispenses with this issue noting the Hubert regulations, Treas. Reg. § 20.2056(b)-4(d), inapplicable to a determination of this issue, and that no marital deduction is allowable pursuant to I.R.C. § 2056 unless the property subject to the deduction was included in decedent’s gross estate. Post-death income did not meet this latter requirement.

2. Private Letter Ruling 201832003 (August 10, 2018)

Extension to Make QTIP Election Granted. In Private Letter Ruling 201832003 the Service granted an extension of time to make a QTIP election where the trust needed to be severed to provide for an IRA trust and a non-IRA trust. See also Priv. Ltr. Rul. 201850008 (also allowing allocation of GST exemption).
3. **Private Letter Ruling 201834001 (August 24, 2018)**

*Service Grants Favorable Ruling for Non-Pro Rata Division of QTIP Trust Followed by Surviving Spouse’s Renunciation.* In Private Letter Ruling 201834001, following a non-pro rata division of a QTIP trust, the surviving spouse renounces her interest in one of the divided QTIP trusts, with the remainder in that trust passing to a charitable trust. The spouse will be deemed to have made a gift of the charitable interest in the one trust. The renunciation over the one trust will not impact the tax consequences of the second divided QTIP trust.

**I. Section 2056A: Qualified Domestic Trust**

*Private Letter Ruling 201830001 (April 17, 2018)*

*Extension Granted to Elect Marital Deduction.* In Private Letter Ruling 201830001, the Service granted an extension to elect to take a marital deduction for after discovered property not reported on the initial return as passing to the QDOT.

**II. FEDERAL GIFT TAXATION**

A. **Section 2511: Transfers In General**

*Private Letter Ruling 201825003 (March 9, 2018)*

*Contingency Based on Favorable Ruling Protects from Completed Gift.* In Private Letter Ruling 201825003, taxpayer asked for a ruling indicating a transfer of artwork with a retained life estate is an incomplete gift. The ruling concluded otherwise except for the fact that the transfer was made contingent on obtaining a favorable ruling. The gift was subject to contingencies, but none were within the control of the donor, thus, making the gift complete but for the requirement of a favorable ruling. The contingency of a favorable ruling prevented the gift from in fact being complete.

B. **Section 2513: Split Gift Treatment**

*Private Letter Ruling 201811002 (November 27, 2017)*

In Private Letter Ruling 201811002, the Service determined the gift tax statute of limitations had run on a gift that was adequately disclosed and reported on a timely filed gift tax return. The Service acknowledged the gift was finally determined as reported on the gift tax return because the Service did not contest the gift and the statute of limitations had run, citing I.R.C. Section 2504. The Service so ruled despite the fact that the value of the gift reported was contrary to the I.R.C. Section 2513 gift splitting rules which deem a gift to be made one-half
by each spouse when the election to split gifts is made. The donor made an
election to split gifts, but reported the value of the donor’s gift as three-fourths of
the property transferred and spouse reported the gift as one-fourth of the property
transferred, rather than as made one-half by each. For purposes of determining
value of the gift, the Service ruled the I.R.C. Section 2504 rules trump the I.R.C.
Section 2513 rules. The taxpayer later discovered that no allocation of
generation-skipping transfer tax exemption had been made, and attempted to
make a late election allocating GST exemption equal to three-fourths the value of
the trust. The spouse did not correspondingly file to make a late allocation of
GST exemption. For purposes of allocating GST exemption, the ruling
determined that, upon making the split gift election, each spouse was the deemed
transferor of one-half the property transferred to the trust for generation-skipping
transfer tax purposes effectively making it impossible for taxpayer to allocate
GST exemption in proportion to the full value of the reported gift.

C. Section 2514: General Powers of Appointment

1. Private Letter Ruling 201817002 (April 27, 2018)
   Appointment as Trustee Does not Cause Beneficiary to Hold a GPOA. The
taxpayer proposes to appoint a beneficiary as co-trustee of a GST exempt trust in
Private Letter Ruling 201817002. The concern is whether appointment of a trust
beneficiary as one of three required co-trustees will cause the beneficiary to
thereafter hold a general power of appointment. The trust provides a distribution
standard to beneficiaries subject to an ascertainable standard, specifically,
allowing trustee discretion to make distributions as trustee: “may deem necessary
for the reasonable support, care, education, and maintenance of Child.” The trust
continues with similar distribution standard for Child’s descendants on death of
the child. The analysis notes that ascertainable powers are not general powers of
appointment. It further notes that state law construes discretionary powers held
by a beneficiary as trustee to be limited to an ascertainable standard. In
addressing the concern that pursuant to Treasury Regulation § 25.2514-3(c)(4)
resignation or removal of a trustee who holds a general power of appointment
causes a lapse of the power to occur, the analysis cites Revenue Procedure 94-44,
1994-2 C.B. 684. Revenue Procedure 94-44 addressed Florida’s adoption of a
savings clause applying an ascertainable standard to all trusts irrevocable as of a
certain date and ruled: “Pursuant to the revenue procedure, the Service will not
treat the statute as causing the lapse of a general power of appointment for
purposes of sections 2041 and 2514, where the scope of a fiduciary power held by
a beneficiary was restricted as a result of the statute.” In line with the revenue
ruling the private letter ruling holds that appointment of beneficiary as trustee will
not cause a lapse of a power with respect to another beneficiary who becomes trustee. The private letter ruling also holds that the trust will continue to be an exempt trust citing Treasury Regulation § 26.2601-1(b)(4)(i)(E), Example 10 noting administrative changes that do not otherwise shift beneficial interests do not impact the exempt status of the trust.

2. **Private Letter Ruling 201843005 (October 26, 2018)**
   *Reformation of Trust Does not Cause Beneficiaries to Hold GPOA.* In Private Letter Ruling 201843005, all agreed attorney made a mistake in drafting an irrevocable trust. Trustor’s intent was to exclude trust property from children’s gross estate for purposes of wealth transfer taxation. The trust as drafted failed to limit withdrawal powers to the annual exclusion amount and lapses to a five and five power. The Service ruled reformation of trust to include these provision would not cause inclusion in the children’s gross estate, and would not cause the children to be deemed to hold a general power of appointment. The ruling also allowed an extension of time to allocate GST exemption as of the time of the original transfers to the trusts. See also Priv. Ltr. Ruls. 201843006, 201843007, 201843008, 201845029, 201837005, 201837006, 201837007, 201837008, 201837009.

3. **Private Letter Ruling 201803003 (January 19, 2018)**
   *Release of Power of Appointment Not a Gift.* In Private Letter Ruling 201803003, the Service addresses a pre-1942 power of appointment. It rules that complete release by child of her power of appointment results in great-grandchildren continuing to hold a pre-1942 power of appointment and that the subsequent release of the power by great-grandchildren will likewise not result in a gift or inclusion in the gross estate. Disclaimer by a great-grandchild will not result in a gift, but on receipt by great-grandchildren when modified trust terms indicate that property will pass outright or be paid to the great-grandchild’s estate if the great-grandchild dies prior to attaining 21, the property in trust will be includible in that beneficiary’s estate.

   a) **Trust Ruled a Non-Grantor Trust, Transfers as Incomplete Gifts and Joint Powers Are Not General Powers of Appointment.**
   In a series of private letter rulings, the Service rules the trust is a non-grantor trust, transfers to the trust by grantor are incomplete gifts, exercise of powers by a distribution committee will not be treated as gifts by the members of the committee, and none of the Distribution committee members hold general powers of appointment. The rulings indicate the
grantor will be deemed to make a gift at such time that there is a distribution from the trust to a permissible beneficiary other than grantor. The facts typically indicate creation of an irrevocable trust for benefit of grantor and “permissible” beneficiaries, with a corporate trustee. The trustee makes distributions at the direction of a Distribution Committee to the “permissible” beneficiaries. The Distribution Committee acts by majority vote with consent of the Grantor, or may act by unanimous vote on its own. Grantor holds a nonfiduciary power to direct distribution to permissible beneficiaries other than grantor for a beneficiary’s maintenance, education, support or health. Distributions need not be equal. The distribution committee must at all times consist of at least two members, with successors in the order named, and the committee terminates on grantor’s death. At death, the grantor may direct distribution to persons other than grantor’s estate or the creditors of the estate. This is termed a limited power of appointment, but in fact under the Code, powers retained by the grantor are not subject to taxation under IRC Section 2041 causing the terminology of the trust to be confusing. See Priv. Ltr. Ruls. 201832009; 201832008, 201832007, 201832006, 201832005; 201836006, 201838006, 201838002, 201838003, 201838004, 201838005, 201838006, 201838007, 201848002, 201848009.

b) **Ruling Acknowledges that Community Property Transferred to Trust May Receive a Stepped-Up Basis at Death.**

Private Letter Ruling 201850006 makes an additional ruling not addressed in the immediately preceding rulings. It addresses consequences on transfer of community property to a trust subject to exercise of jointly held powers by a distribution committee so that the transfer is protected from being treated as a completed gift and the trust is protected from being treated as a grantor trust. The ruling determines the property held in trust will receive a stepped up basis on the death of the first spouse to die. Private Letter Ruling 201850006 (July 31, 2018). See also Priv. Ltr. Ruls. 201850001, 201850002, 201850003, 201850004, 201850005,

D. **Section 2518: Disclaimers**

1. **Private Letter Ruling 201831003 (August 3, 2018)**

*Renunciation of Pre-1977 Trust Interest Completed Within Reasonable Time.* In Private Letter Ruling 201831003 taxpayer will renounce an interest in a trust created prior to 1977. The Service applies Treasury Regulation Section 25.2511-
1(c)(2), which provides a complete and unqualified refusal to accept property from a pre-1977 trust as allowed under state law “within a reasonable time after learning of the existence of the transfer” does not result in a taxable gift if the disclaimant has not accepted any benefits. The ruling states: “the disclaimer will not be subject to the gift tax if it is made within a reasonable time after the disclaimant obtains knowledge of the transfer creating the interest. The question of what constitutes a reasonable time is dependent on federal, rather than state, criteria and is generally dependent on the facts and circumstances presented. We note that a disclaimer made within nine months of the disclaimant learning of the existence of the transfer creating the interest would generally satisfy the reasonable time requirement of the regulations, in the absence of facts to the contrary.” The ruling, however, goes on to say: “We express or imply no opinion as to when Taxpayer first obtained the requisite knowledge of the transfer creating the interest.”

2. **Private Letter Ruling 201845002 (November 9, 2018)**

**Disclaimer Within 9 Months of Attaining Age 18 Qualifies.** In Private Letter Ruling 201845002 the taxpayer proposes to disclaim a contingent interests in an irrevocable trust within 9 month of attaining the age of majority. The Service rules the disclaimant will not be deemed to have made a gift.

### III. GENERATION SKIPPING TRANSFER TAX

#### A. Section 2601: Modification of Grandfathered Trusts

Treasury regulations allow certain modifications to or trustee actions impacting a GST exempt trust without a loss of exempt status if the modification or trustee action does not shift a beneficial interest in the trust to a beneficiary occupying a lower generation than the person holding the beneficial interest prior to the modification.

1. **Modification of Trust to Provide for Special Needs**

   In **Private Letter Ruling 201814005** trustee asks court to modify the trust terms to eliminate withdrawal powers allowing beneficiary to withdraw a portion of the trust at 25 and the rest at age 30. Modification instead allows trustee to make discretionary distributions for benefit of one child granting the child a testamentary general power of appointment instead. Modification also allows trust to create a special needs trust for another child. The Service rules in taxpayer’s favor finding the trust retains its exempt statute and applies the regulations applicable to grandfathered trusts, specifically citing Treas. Reg. § 26.2601-1(b)(4)(i)(D) and 26.2601-1(b)(4)(i)(E) example 7. The ruling also finds no gift and no income tax consequences of the modification.
2. **Release or Lapse of Pre-1942 General Power of Appointment**

*Release or Lapse of a Pre-1942 Power of Appointment Does not Trigger a Gift or Impact the Exempt Status.*  
In *Private Letter Ruling 201803003* the Service ruled that the release or lapse of a pre-1942 power will not be treated as an addition to a grandfathered GST trust. It stated:

“In this case, Trust provides Daughter with a general power of appointment. This power was created before October 22, 1942. After Daughter dies, the grandchildren will succeed to her power of appointment. To the extent that any grandchild disclaims his or her interest in the pre-1942 power of appointment or dies during the 21-year period following Daughter's death, some great-grandchildren (or more remote beneficiaries) will also succeed to her power of appointment. As in the case of § 20.2041-1(e), Example 3, the power of appointment held by the great-grandchildren (and more remote beneficiaries) is considered a power created before October 22, 1942, even though it is only a contingent interest until Daughter's death. The release or lapse of such a power is not treated as an exercise of the power and will not result in an inclusion into the powerholder's estate for purposes of chapter 11 or a gift by the powerholder for purposes of chapter 12. Further, because the release or lapse is not treated as a taxable transfer under chapters 11 and 12, the release or lapse will not be treated as an addition to trust for GST purposes. Therefore, based on the facts submitted and the representations made, we conclude that the complete release or lapse of such a power of appointment will not subject any portion of Trust to federal estate, gift, or GST tax.”

In addition modification pursuant to a settlement agreement does not cause the trust to lose its exempt status.

3. **Decanting to a New Trust.**

*Decanting Does Not Impact Exempt Status.*  
In *Private Letter Ruling 201820007* the trustee proposes to decant an exempt trust to a new trust with similar terms to the original trust except the beneficiary may exercise the limited power of appointment in such manner as to create a further trust for the permissible appointees. The trust for the permissible appointees grants the permissible appointees a testamentary general power of appointment. The ruling applies the regulations addressing exempt status of a grandfathered trust, and notes: “No guidance has been issued concerning the modification of a trust that may affect the status of a trust that is exempt from GST tax because sufficient GST
exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, modification that would not affect the GST status of a grandfathered trust will similarly not affect the exempt status of such a trust.” The ruling analyzes the issue pursuant to Treasury Regulation § 26.2601-1(b)(4)(i)(D). It concludes that because the trust for the permissible beneficiary grants the beneficiary a testamentary general power of appointment, the decanting does not result in a shift in beneficial interest to a lower generation beneficiary. See also Priv. Ltr. Rul. 201845006.

4. **Declaratory Judgment Construing Trust**

*Declaratory Judgment Does Not Impact Exempt Status.* In **Private Letter Ruling 201814001** the Service ruled that a declaratory judgment clarifying ambiguity as to whether the reference to issue included adopted issue in line with the rulings of the state’s highest court did not cause the trust to lose its grandfathered exempt status or for a gift to be made or income tax triggered as a result. In rendering the ruling the Service relied on Treas. Reg. § 26.2601-1(b)(4)(i)(C) and Treas. Reg. § 26.2601-1(b)(4)(i)(E) example 3. See also Priv. Ltr. Rul. 201814002.

5. **Division into Separate Trusts.**

*Pro-rata Division of Trusts Does Not Change Exempt Status.* In **Private Letter Ruling 201818005** the pro-rata division of trusts into separate trusts does not impact the GST exempt status of the trusts. See also Priv. Ltr. Rul. 201817012, 201817013, 201817014, 201817016, 201833015.

B. **Section 2632: Special Rules for Allocation of GST Exemption**

1. **Extension to Elect Out of Automatic Allocation Rules**

*Service Allows Extension to Elect Out of Automatic Allocation Rules.* The Code sets forth a series of automatic allocation rules for applying the GST exemption amount. If a taxpayer wishes to elect out of the automatic allocation, the taxpayer may do so on a timely filed gift tax return for the calendar year in which the election would become effective, see IRC § 2632(c)(5). The Service grants an extension in the following Private Letter Rulings: 201826001; 201826006; 201839003.

2. **Extension to Sever Trust to Allow Automatic Allocation Rules to Apply.**

*Service Grants Extension to Sever Trust.* **Private Letter Ruling 201825023** requests an extension of time to sever a residuary trust into an exempt and non-exempt share, and requests a ruling that upon the severance the automatic allocation rules will apply to allocate unused GST exemption to the GST Exempt...
trust. The ruling grants an extension to sever trusts and directs reporting on a supplemental 706. It further rules the automatic allocation rules would apply to allocate to the newly severed GST exempt trust.

3. Allocation of GST Exemption Void

Service Voids Mistaken Allocation of GST Exemption. In Private Letter Ruling 201836004 (September 7, 2018), taxpayer asks Service to void allocation of GST exemption mistakenly made to trusts which had no GST tax potential. The Service provides a favorable ruling voiding the misallocation of GST exemption. See also Priv. Ltr. Rul. 201836007.

C. Section 2642: Generation Skipping Inclusion Ratio

Extension to Allocate Exemption

Rulings Allow Extension to Allocate GST Tax Exemption. It is advantageous to request an extension to allocate a transferor's GST exemption because the allocation can then be made based on the value of the property at the time of transfer, rather than at time of a "late" allocation of the exemption. Taxpayers may request the ruling pursuant to Notice 2001-50, and the relief will be granted upon a showing that the taxpayer acted reasonably and in good faith, and that the extension will not prejudice the interests of the government. The taxpayer acts reasonably and in good faith if she reasonably relies on the advice of a qualified tax professional. The extension may be sought both for elections under I.R.C. Sections 2632(b)(3) or (b)(5), and 2642(b)(1) or (2). The following is a list of rulings that allow the taxpayer an extension to allocate generation-skipping transfer tax exemption: Priv. Ltr. Ruls. 201803001; 201806006; 201817005; 201839001; 201847003, 201849007,

D. Section 2652: Reverse QTIP Election

Extensions Allowing Reverse QTIP Elections

Rulings Allow Extension to Make a Reverse QTIP Election. The following is a list of rulings in which the Service grants an extension to make a reverse QTIP election, and in some instances, to sever a trust and allocate the other spouse’s GST exemption to one trust: Priv. Ltr. Ruls. 201820015; 201840001, 201850010, 201845007.
IV. SPECIAL VALUATION RULES

Section 2702: Special Valuation Rules in Case of Transfers of Interests in Trusts

Private Letter Ruling 201808001 (February 23, 2018)
Service Rules Transfer of Interest in Jointly Purchased Property Grandfathered.
In Private Letter Ruling 201808001, the Service ruled that a pre-October 9, 1990 joint purchase where two of the original purchasers thereafter make a gift of a “geographically defined portion” of their interests in the jointly purchased property will make a gift valued of their respective interests based on the I.R.C. Section 7520 for the month in which the transfer occurred. The ruling also confirms that on making the gift, the transferred interests in the property will not thereafter be subject to gross estate inclusion.

V. ODDS AND ENDS

Section 1014: Basis on Death

Hurford Investments No. 2, Ltd. v. Commissioner, Docket No. 23017-11 (April 17, 2017)
An interesting side note following the court’s issuance of Estate of Powell, Estate of Cahill and Estate of Streightoff, is the question of what basis the partnership assets take if the partnership is disregarded in favor of including assets in the decedent’s gross estate pursuant to I.R.C. Section 2036. The Tax Court in a 2017 order issued by Judge Holmes in Hurford Investments No. 2, Ltd. v. Commissioner, Docket No. 23017-11 (April 17, 2017) at 12, https://www.ustaxcourt.gov/UstcDockInq/DocumentViewer.aspx?IndexID=7090 068 (accessed Aug. 2, 2018), provided a clear answer to this question. (Judge Holmes also issued the initial decision in Estate of Hurford v. Commissioner, T.C. Memo. 2008-278, in which the court disregarded the family limited partnership.) The following analysis is taken in substantial part from Elaine Gagliardi on The Family Limited Partnership in 2018: Powell, Cahill, and Income Tax Basis at Death, 2018 Lexis Federal Tax Journal Quarterly, December 2018 (LexisNexis 2018), and reprinted with the permission of LexisNexis.

In Hurford Investments, the Tax Court addressed the I.R.C. Section 1014 basis of phantom stock earlier included in decedent’s gross estate when the court disregarded the family limited partnership which owned the phantom stock. The order states:

But HI-2 has a final tax-minimizing argument. It says it's entitled to a step up in basis to $59,639,588, which was the phantom stock's value at the time of Thelma's death. This might seem an argument too far. The Code section that creates the step up in basis generally limits that benefit to property acquired “from a decedent.” I.R.C. §1014(a). Thelma was not yet
a “decedent” at the time she contributed the phantom stock to HI-2. Yet section 1014(b)(9) tells us to consider property “to have been acquired from or to have passed from the decedent … if by reason thereof the property is required to be included in determining the value of the decedent's gross estate.” That's what happened here — in the estate-tax case we included the value of the phantom stock in Thelma's gross estate. See Estate of Hurford, 96 T.C.M. (CCH) at 442; see also Conn. Nat'l Bank v. United States, 937 F.2d 90, 92 (2d Cir. 1991); Schrader v. Commissioner, 420 F.2d 443, 445 (6th Cir. 1970) (retention of life estate drew value of property into estate but gives stepped up basis); H.R. Rept. No. 94-1380, at 36 (1976), 1936-3 C.B. (Vol. 3) 770 (“For the purposes of determining what property is given a stepped-up basis, the test is generally whether the property was included in the gross estate of the decedent”).


**Basis of Partnership Assets Included in the Gross Estate.** Going forward, date of death income tax basis will depend on whether the tax court chooses to apply Judge Halpern’s analysis or Judge Lauber’s analysis in *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017), with regard to the extent underlying partnership assets are included in the gross estate. Judge Lauber in *Estate of Powell* would ignore the family limited partnership as illusory for purposes of I.R.C. Section 2036, and include full value of the assets. If Judge Lauber’s analysis becomes the prevailing analysis, *Hurford Investments* will control basis of partnership assets for income tax purposes in cases such as *Estate of Hurford* and *Estate of Powell*. Judge Halpern in *Estate of Powell*, asserted that I.R.C. Section 2043 should control the extent to which partnership assets are in fact included in the gross estate under I.R.C. Section 2036. If Judge Halpern’s opinion is deemed to be correct by future courts, only a portion of the underlying family limited partnership assets will be included under I.R.C. Section 2036 and as a consequence only a portion of the assets will obtain a Section 1014 basis at date of death. This leaves the remaining portion of the basis of the limited partnership assets to remain the same as in the hands of the partnership prior to decedent’s death. Judge Halpern wrote the plurality opinion in *Estate of Powell*, but his analysis as to I.R.C. Section 2043 did not obtain a majority of judges in agreement. In fact, as to the issue of application of I.R.C. Section 2043 it may be
that a majority of judges do not agree with Judge Halpern’s opinion, but we will not know for certain because two judges chose not to join in either opinion and concurred in result only.

**Basis of Limited Partnership Interests.** What Hurford Investments does not answer, is what basis limited partnership interests will take to the extent the decedent continues to hold family limited partnership interests as of decedent’s death. Again the answer to the question of date of death income tax basis for family limited partnership interests held by decedent at date of death depends on whether Judge Lauber’s opinion or Judge Halpern’s opinion ultimately prevails as the tax court’s analysis.

If Judge Halpern’s opinion controls it is clear the family limited partnership interests held by decedent as of date of death will be included in decedent’s gross estate pursuant to I.R.C. Section 2033 and for that reason will obtain a Section 1014 date of death basis. If Judge Lauber’s opinion controls, the partnership is deemed illusory for estate tax purposes, yet the partnership interests for income tax purposes are respected as owned by the partners. To determine date of death basis of the partnership interests in this instance, it becomes necessary to look to a former revenue ruling and general counsel memorandum to determine basis. The fact the partnership is ignored for estate tax purposes does not mean it is ignored for income tax purposes. The characterization of partnership interests as having “no distinct value” for estate tax purposes per Judge Lauber’s analysis does not reflect the reality that the partnership is recognized as a tax reporting entity for income tax purposes and that state law recognizes the partnership, and transfer of partnership interests, for property law purposes.

The limited partnership interests ignored for estate tax inclusion purposes, nevertheless, prove to be interests acquired from the decedent for state law purposes. If owned by decedent at death, the partnership interests arguably would be included within “[p]roperty acquired by bequest, devise, or inheritance, or by the decedent’s estate from the decedent.” I.R.C. § 1014(b)(1). If the partnership interests were owned by a revocable trust, they arguably would be included as “[p]roperty transferred by the decedent during … lifetime in trust…with the right reserved to the decedent … to revoke the trust…” I.R.C. § 1014(b)(2). Neither sub-section referenced specifically requires that property be included in the decedent’s gross estate in order to obtain a date of death fair market value basis. In fact the Service took this position in Revenue Ruling 84-139, 1984-2 C.B. 168, and Gen. Counsel Mem. 39320, 1985 GCM LEXIS 3 with reference to foreign property not included in the gross estate. In both pronouncements the Service ruled the plain language of Section 1014(b)(1) does not require inclusion in decedent’s gross estate for its terms to apply. Specifically, the Service stated: “In reaching this conclusion, we have considered the possibility of interpreting section 1014 to say that only property includable in the decedent’s gross estate can qualify for a basis step-up. However, both the language of section 1014 and its legislative history negate such an interpretation.” Gen. Counsel Mem. 39320.
If a court were to apply the plain wording of Section 1014, the limited partnership interests in the hands of the executor or beneficiary of decedent’s estate would take a date of death fair market value basis regardless of whether includible in the decedent’s gross estate. Assuming Section 1014 applies to determine basis of limited partnership interests, fair market value would likely take into account lack of marketability and minority interest discounts attributable to those interests.

Only if decedent held the limited partnership interests at death would Section 1014 provide a fair market value date of death basis for the partnership interests. If decedent had gifted limited partnership interests after formation, the beneficiaries in receipt would hold the partnership interests with a Section 1015 transferred basis. The basis of the partnership interests transferred prior to death to beneficiaries would not change on decedent’s death.

_A Simplified Example Explaining the Impact of the Two Opinions in Estate of Powell._ The respective impact of Judge Halpern’s and Judge Lauber’s opinions in _Estate of Powell_, can be demonstrated by a simple example:

For illustration purposes, assume decedent forms a limited partnership with one share of stock valued at $100, and assume limited partnership interests received in return take a fair market value of $75 after application of a 25% discount. Assume further that decedent’s basis in the share of stock at the time of its contribution to the partnership is $40. Further assume (as was the case in _Estate of Powell_) decedent owns the limited partnership interests at death and did not make any transfers of interests prior to death.

Under either Judge Halpern’s analysis or Judge Lauber’s analysis, the gross estate includes $100 of total value. The following diagrams depict the differing opinions regarding gross estate inclusion:
Judge Halpern’s opinion breaks new and unexpected ground by applying Section 2043(a) to determine the appropriate amount included in the gross estate under Section 2036. Judge Halpern turns to I.R.C. Section 2043 because he is concerned that not doing so could require a double inclusion of value in the gross estate that should not in fact occur. Application of Section 2043(a) includes in the gross estate “only the excess of fair market value at the time of death of the property otherwise to be included [in this case under Section 2036] on account of such transaction” less “the value of consideration received therefor by the decedent.” I.R.C. § 2043(a). The Code section applies if the transfer “is made...for a consideration in money or money’s worth, but is not a bona fide sale for an adequate and full consideration in money or money’s worth.” Id. In Estate of Powell, Judge Halpern explains: “In the present cases [referring to Estate of Powell], because of the limitation provided by section 2043(a), section 2036(a)(2), if applicable, would include in the value of decedent's gross estate only the excess of the fair market value at the time of her death of the cash and securities transferred to NHP over the value of the 99% limited partner interest in NHP issued in exchange for those assets.” In other words, the gross estate per Section 2036(a)(2) includes only the discount allowable based on date of death value, referred to by the court as “the doughnut hole,” with the partnership interests referred to as the “doughnut” includible under Section 2033 or if
transferred during life accounted for at death as an adjusted taxable gift. *Id.* at 408-409. Accordingly, Judge Halpern determines the purpose underlying Section 2043(a) is to limit “the reach of the inclusionary rules to transactions that deplete a decedent’s estate” is fulfilled. His opinion notes: “To the extent that the value of assets transferred to a family limited partnership does not exceed the value of the partnership interest received in return, the exchange does not deplete the transferor's estate or allow for the avoidance of transfer taxes.”

Thus, per the example, as illustrated in the diagram, Judge Halpern’s opinion would include the date of death value of the family limited partnership interests in the gross estate per I.R.C. Section 2033, which in the example is $75. His opinion would also include in the gross estate the date of death value of the portion of the underlying partnership assets estate equal to the discount applied to the partnership interest.(the doughnut hole), which in the example is $25.

**Gross Estate Inclusion Per Judge Lauber’s Analysis**

![Diagram](image)

Judge Lauber’s concurring opinion rejects Judge Halpern’s concern that a double inclusion of value in the gross estate could result. Judge Lauber explains that in fact current law does not result in the double inclusion issue claimed by the Tax Court’s opinion. The concurring opinion reasons: “The partnership was an empty box into which the $10 million was notionally placed. Once that $10 million is included in [decedent’s] gross estate under section 2036(a)(2), it seems
perfectly reasonable to regard the partnership interest as having no distinct value because it was an alter ego for the $10 million of cash and securities.”  Id. at 423. The court notes: “This is the approach that we have previously taken to this problem.” Thus, per the example, the gross estate includes 100 percent of the partnership assets according to Judge Lauber or, in this example $100, and the partnership interests are completely ignored for purposes of determining the gross estate.

Switching to a determination of income tax basis, the simplified example would result in the following income tax basis as depicted in the following diagrams of the application of Judge Lauber’s and Judge Halpern’s respective opinions. The example for this purpose assumes the partnership assets on formation and immediately before death had an income tax basis of $40.

Applying the analysis of Judge Lauber, the partnership assets would take a Section 1014 basis of $100, the value included in the gross estate pursuant to Section 2036, and, as a result, the basis per Section 1014(b)(9) and Hurford Investments. For income tax purposes, the partnership interests would take a fair market value date of death basis of $75, which reflects a 25% discount and assumes no appreciation from time of receipt to date of death per Section 1014(b)(1) and Rev. Rul. 84-139. In this instance, if there is a choice, a Section 754 election should not be made.
Per Judge Halpern’s opinion, the partnership interests take a date of death basis per Section 1014(b)(1) of $75. The inside basis includes (i) the value of 25 percent of the asset included in decedent’s gross estate or $25 per Section 1014(b)(9) and **Hurford Investments**, and (ii) the basis of the remaining 75 percent portion of the asset not included in the decedent’s gross estate reflecting a proportionate basis of $30 (75% of the original $40 basis). This analysis yields an inside basis for 100 percent of the asset of $55. In this instance, the estate would prefer a Section 754 election.