The Cannon Estate Planning Teleconference Series

Participant Guide

CFI
1961

Gift and Estate Tax Black Holes

Cannon Financial Institute, Inc.

Presents

The 2023 Estate Planning Teleconference Series

Tuesday, September 19, 2023

By:

Charles A. Redd

CHARLES A. REDD, PARTNER
STINSON LLP
7700 FORSYTH BOULEVARD
SUITE 1100
ST. LOUIS, MISSOURI 63105-1821
(314) 259-4534 - TELEPHONE
(314) 259-3952 - FACSIMILE
charles.redd@stinson.com

www.stinson.com

The seminar materials and the seminar presentation are intended to stimulate thought and discussion, and to provide those attending the seminar with useful ideas and guidance in the areas of estate planning and administration. The materials and the comments made by the presenter during the seminar or otherwise do not constitute and should not be treated as legal advice regarding the use of any particular estate planning or other technique, device or suggestion or any of the tax or other consequences associated with them. Although we have made every effort to ensure the accuracy of these materials and the seminar presentation, neither STINSON LLP nor the lawyer, Charles A. Redd, assumes any responsibility for any individual's reliance on the written or oral information presented in association with the seminar. Each seminar attendee should verify independently all statements made in the materials and in association with the seminar before applying them to a particular fact pattern and should determine independently the tax and other consequences of using any particular device, technique or suggestion before recommending the same to a client or implementing the same on a client's or his or her own behalf.

CHARLES A. REDD

Charles A. Redd is a partner in the St. Louis, Missouri, office of the law firm of STINSON LLP. Mr. Redd concentrates his practice in estate planning, estate and trust administration and estate and trust-related litigation. Prior to joining Stinson, Mr. Redd was a partner in and Vice Chairman of the Trusts & Estates Practice Group at the law firm of SNR Denton US LLP (now Dentons US LLP). Mr. Redd was also previously a partner in the law firm of Armstrong, Teasdale, Schlafly & Davis (now Armstrong Teasdale LLP) and was Chairman of that firm's Trusts & Estates Department. He was previously employed as a Trust Administrator by First Wisconsin Trust Company (now U.S. Bank, N.A.), Milwaukee, Wisconsin, and as an Assistant Counsel by Centerre Trust Company of St. Louis (now Bank of America Private Bank).

Mr. Redd has extensive experience and expertise in: (a) the drafting of wills, trust instruments, durable powers of attorney, marital agreements and other estate planning documents; (b) pre- and post-death tax planning for individuals, trusts and estates; (c) preparation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (d) representation and filing of estate tax returns, gift tax returns and fiduciary income tax returns; (e) representation of individual and corporate fiduciaries and (f) litigation in the Probate Division and other equity divisions of the Circuit Court. Mr. Redd has worked on estates and estate planning projects, some involving assets valued at over a billion dollars, and has successfully handled numerous estate tax, gift tax and generation-skipping transfer tax matters, will and trust construction cases, will contests, contests of trust agreements, alleged breach of fiduciary duty cases and other types of cases involving estates and trusts.

Mr. Redd is a member of the State Bar of Wisconsin, The Missouri Bar, the Illinois State Bar Association, The Bar Association of Metropolitan St. Louis and the Estate Planning Council of St. Louis.

Mr. Redd was Chairman of the Missouri Bar's Health Care Durable Power of Attorney Subcommittee, and he played a significant role in the drafting and enactment of the Missouri Durable Power of Attorney for Health Care Act. In 1991, Mr. Redd received The Missouri Bar President's Award. Mr. Redd was the principal draftsman of the Missouri Family Trust Company Act.

Mr. Redd is an elected member of The American Law Institute and a Fellow of The American College of Trust and Estate Counsel (Past Missouri State Chair; Past Regent; Estate and Gift Tax Committee; and Fiduciary Litigation Committee). He was an adjunct professor of law (Estate Planning) at Northwestern University School of Law for fifteen years. He serves as a member of the Advisory Committee for the Heckerling Institute on Estate Planning and is Co-Chair of the Editorial Advisory Board of, and writes a regular column in, TRUSTS & ESTATES magazine. In 2018, he was inducted into the Estate Planning Hall of Fame® by the National Association of Estate Planners and Councils and, in 2023, was named Distinguished Estate Planner of the Year by the Estate Planning Council of St. Louis. Mr. Redd is listed in The Best Lawyers in America and is "Band 1" ranked by Chambers and Partners in their High Net Worth guide. He frequently writes and lectures nationally on topics in the trusts and estates field.

* * * * * * * * *

Turney P. Berry

Turney P. Berry concentrates his practice in the areas of estate planning, fiduciary matters, and charitable planning. Mr. Berry is the leader of Wyatt, Tarrant & Combs' Trusts, Estates & Personal Planning Service Team and a past member of the firm's Executive Committee.

Mr. Berry is active in the American College of Trust and Estate Counsel (ACTEC), and has served as President of the ACTEC Foundation, Regent of the College, State Chair for Kentucky, Chair of the Estate & Gift Committee, and Chair of the Charitable and Tax Exempt Committee. Currently he serves as Chair of the State Laws Committee, and a member of the Long Range Planning Committee.

As a Uniform Law Commissioner, Mr. Berry currently serves as Chair of the Study Committee on Transfers to Minors Act, Vice-Chair of the Drafting Committee on Conflicts of Laws in Trusts and Estates, Member of the Electronic Estate Planning Documents Committee, Member of the Joint Editorial Board for Uniform Trust and Estate Acts, and Member of the Drafting Committee on Uniform Determination of Death Act. He has served as chair of the Uniform Fiduciary Income and Principal Act (UFIPA), chair of the Uniform Power of Appointment Act, Vice Chair of the Drafting Committee on Electronic Wills Act, Co-Chair of the Drafting Committee on Uniform Cohabitants' Economic Remedies Act, and as a member of the drafting committees for the Directed Trust Act, the Revised Fiduciary Access to Digital Assets Act, the Trust Decanting Act, the Insurable Interests in Trusts Act, the Premarital and Marital Agreements Act, the Transfer on Death Deeds Act, the Revised Disposition of Community Property Rights at Death Act, and the Uniform Probate Code Artificial Reproductive Technology provisions, and an adjunct member of the Fundraising Through Public Appeals Act.

Mr. Berry is a Fellow of the American College of Tax Counsel, a member of the American Law Institute, a member of The International Academy of Estate and Trust Law, a member of the Advisory Council of the Heckerling Institute on Estate Planning, a Member of the Advisory Board of Trusts and Estates Monthly, and a member of the Bloomberg BNA Tax Advisory Board (Estates, Gifts, and Trusts). He serves as Adjunct Professor at the University of Miami Estate Planning LLM Program (teaching Business Succession Planning), and has served as Adjunct Professor at Vanderbilt University, the University of Missouri, and the University of Louisville, and regularly speaks at the nation's leading estate planning conferences. Since 1996, Mr. Berry has served as Co-Chair of the Midwest/Midsouth Estate Planning Institute at the University of Kentucky (the longest continuously run CLE event in Kentucky).

Mr. Berry has been certified as an Accredited Estate Planner® (AEP®) by the National Association of Estate Planners & Councils and is a member of its Estate Planning Hall of Fame [Kentucky does not recognize legal specialties]. He is listed in Woodward/White's The Best Lawyers in America® and in the Kentucky Super Lawyer Magazine in the area of Trusts and Estates.

A native of Tennessee, Mr. Berry received his B.A. and B.L.S. in 1983 from the University of Memphis and his J.D. in 1986 from Vanderbilt University.

TABLE OF CONTENTS

Page

Gift and Estate Tax Black Holes

By: Charles A. Redd
STINSON LLP
St. Louis, Missouri

I. INTRODUCTION

Planning to avoid, or at least minimize, gift and estate taxes can be daunting. That statement has never been more true than it is in 2023. The Internal Revenue Service ("IRS") often challenges tax benefits claimed by taxpayers implementing new or revised estate planning techniques and strategies and sometimes even formulates new theories by which to undermine or eliminate more traditional tax planning approaches.

II. EMERGING VALUATION AND OTHER PROBLEMS WITH GRATS

A. Chief Counsel Advice 201939002 -- Valuation of Publicly-Traded Stock Transferred to GRAT

CCA 201939002[1] addresses how properly to value for gift tax purposes publicly-traded stock transferred to a grantor retained annuity trust ("GRAT"). This would seem to be a rather straight-forward exercise, following the formula set out in Treas. Reg. Section 25.2512-2(b)(1),[2] but the IRS didn't see it that way.

1. *Facts*

The donor (D) was a co-founder and board chairman of a corporation (A) whose stock was publicly-traded. D conveyed shares of the stock to a GRAT.[3] Thereafter, A announced it was merging with another corporation (B). The value of A's stock increased substantially after the merger was announced. CCA 201939002 states as a fact that, on the date the GRAT was funded, a hypothetical willing buyer of the stock would've reasonably foreseen the merger and anticipated the stock would trade at a premium.

2. *Analysis*

The sole issue addressed in CCA 201939002 was the fair market value of the stock for gift tax purposes as of the date D transferred it to the GRAT. The Office of Chief Counsel ("OCC") acknowledged that Treas. Reg. Section 25.2512-2(b)(1) provides "…if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market or otherwise, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or bond." That principle, standing alone, would seem dispositive. The OCC, however, then invoked Treas. Reg. Section 25.2512-2(e), which states that, "[i]n cases in which it is

[1] Chief Counsel Advice 201939002 (September 27, 2019).
[2] The general rule of Treas. Reg. Section 25.2512-2(b)(1) is that the fair market value of stock traded on a stock exchange is the mean between the highest and the lowest quoted selling prices on the date of the gift.
[3] The terms of the GRAT weren't disclosed.

established that the value per bond or share of any security determined on the basis of the selling or bid and asked prices as provided under § 25.2512-2(b) does not represent the fair market value thereof, then some reasonable modification of the value determined on that basis or other relevant facts and elements of value shall be considered in determining fair market value." The OCC also took note of the "hypothetical willing buyer-willing seller" principle of valuation and cited and quoted from Treas. Reg. Section 25.2512-1, which, along with Rev. Rul. 59-60,[4] established that principle.[5]

CCA 201939002 concludes the fair market value of the stock as of the date of GRAT funding couldn't be determined without taking A's "pending merger" with B into account. The OCC reached this conclusion for two reasons. First, said the OCC, the hypothetical willing buyer and willing seller, as of the date the GRAT received the stock, would be reasonably informed during the course of merger negotiations and would have knowledge of relevant facts – including the pending merger. Second, according to the OCC, the merger was "practically certain to go through."

Neither of these justifications for CCA 201939002's conclusion withstands scrutiny.[6] The OCC applied the "hypothetical willing buyer-willing seller" principle without considering the probability that the "seller," D, would've been prohibited by securities law[7] from disclosing the merger discussions with the "buyer," the GRAT Trustee. The result of that prohibition would've been that the "buyer" couldn't have had any knowledge of the possible merger and so couldn't have considered it in formulating (theoretically) a purchase offer. Thus, applying the "hypothetical willing buyer-willing seller" principle to the facts of CCA 201939002, while apparently assuming the hypothetical willing seller could and would proceed illegally, was inherently unfair and inappropriate. Moreover, the OCC cites no facts supporting its assertion that, on the date the GRAT was funded, it was "practically certain to go through." Until a definitive agreement was in place, innumerable events could've occurred and/or circumstances developed that would've cratered the merger.

B. Chief Counsel Advice 202152018 -- Large Undervaluation of Stock Transferred to GRAT Leads to Disqualification Under IRC Section 2702

1. *Facts*

In CCA 202152018,[8] the donor (D) was the founder of a very successful closely-held company (X). On "Date 1," D received offers from five corporations to buy his X stock. Three days later, on "Date 2," D established a two-year GRAT and conveyed X stock into the GRAT. The governing instrument provided that the annual annuity payments would be a fixed

---

[4] Rev. Rul. 59-60, 1959-1 C.B. 237.

[5] Treas. Reg. Section 25.2512-1 states that "the value of [gifted] property [at the date of the gift] is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts."

[6] Chief Counsel Advice 201939002 was, in fact, a docketed Tax Court case. *Daniel R. Baty v. Comm'r*, Docket No. 12216-21. A stipulated decision was entered on June 17, 2022.

[7] Specifically, 17 C.F.R. §230.144 (commonly known as Rule 144).

[8] Chief Counsel Advice 202152018 (December 30, 2021).

percentage of the GRAT's initial fair market value and in all respects "appeared to satisfy the requirements for a qualified interest under § 2702 and the corresponding regulations." For gift tax purposes, D valued the stock transferred to the GRAT based on an appraisal: (a) dated as of seven months before it was transferred to the GRAT; and (b) that had been prepared for Internal Revenue Code ("IRC") Section 409A purposes. On "Date 3," about three months after Date 1, D received revised, higher offers from four of the five corporations. On "Date 4," an unspecified amount of time after Date 3, D gifted X stock to a separate charitable remainder trust. About three months after Date 3, and several weeks after D's transfer to the charitable remainder trust, D accepted one of the revised offers to purchase the X stock. The initial cash tender offer was at a price nearly three times higher than the X stock value as determined in the IRC Section 409A appraisal. For income tax purposes, D valued the stock that had been transferred to the charitable remainder trust at the initial cash tender offer price. Roughly six months after termination of the GRAT, the successful bidder to buy the X stock purchased the remaining shares at a price almost quadruple the value of X stock as determined in the IRC Section 409A appraisal.

2. *Issues and Analysis*

Two issues were identified and addressed in CCA 202152018. First, in a gift tax valuation analysis involving the CCA's facts, should it be assumed that the hypothetical willing buyer and willing seller of company stock would consider X's pending merger? Second, on creation and funding of the GRAT, did D retain a "qualified annuity interest" under IRC Section 2702?

In light of CCA 201939002, the OCC's discussion and resolution of the first issue is unsurprising. In fact, the portion of CCA 202152018 addressing the first issue is lifted almost verbatim from CCA 201939002. Suffice it to say CCA 202152018 concludes the pending merger must be considered.

The OCC's handling of (even taking up) the second issue is what has caused CCA 202152018 to reverberate ominously in the estate planning world. The CCA states that, by paying an annuity whose amount was "intentionally" based on the IRC Section 409A appraisal, the GRAT Trustee triggered an "operational failure" and that this failure resulted from "deliberately using an undervalued appraisal…to artificially depress the required annual annuity."[9] This "operational failure" led the OCC to conclude that D hadn't retained a qualified annuity interest under IRC Section 2702.[10] To support its conclusion, the OCC cited and discussed *Atkinson*,[11] in which the Eleventh Circuit ruled that a charitable remainder annuity trust failed to qualify as such for tax purposes because, although the governing instrument wasn't technically defective, the required annuity payments in fact weren't made.

---

[9] The CCA also refers to the IRC Section 409 appraisal as "outdated" and misleading."

[10] Of course, if D's retained interest in the GRAT wasn't a qualified interest, the value of D's retained interest was zero. IRC Section 2702(a)(2)(A). Thus, all the X stock D transferred to the GRAT constituted a taxable gift, and the whole point of using the GRAT strategy was eviscerated.

[11] *Atkinson v. Comm'r*, 115 T.C. 26, 32 (2000), *aff'd* 309 F.3d 1290 (11th Cir. 2002).

The OCC obviously found the facts of CCA 202152018 upsetting, and it's not hard to understand why. It seems as if D may have been playing the gift tax audit lottery. If D's gift tax return hadn't been selected for examination, D would've created a successful GRAT and received annuity payments very likely far lower in amount than would've been the case had a properly dated appraisal obtained for gift tax purposes been used. Conversely, D could've expected that, if D's gift tax return were examined and the value of the X stock were increased, the amount of each of the required annuity payments would increase but no additional gift tax would result. Put another way, heads I win; tails you lose!

That said, the GRAT instrument presumably contained the provision mandated by Treas. Reg. Section 25.2702-3(b)(2) regarding incorrect valuations of trust property.[12] If such is the case, it would seem D adopted the resolution of the CCA 202152018 valuation issue precisely as mandated by the Service's own regulations and ought to be able to rely on those regulations.

Cautious estate planners should redouble their efforts to ensure GRATs they design don't fall within the scope of CCA 202152018. Certainly, any appraisal used to support the value of property contributed to a GRAT should be dated as of the date the property was contributed to the GRAT or as close to that date as possible and should be prepared for gift tax purposes. In addition, planners should consider funding GRATs using documentation containing a defined value clause such as that which received judicial approval in *Wandry*.[13]

III. STEP TRANSACTION AND VALUATION NIGHTMARES

A. *Smaldino v. Commissioner* -- Purported Gifts to Spouse Held to Have Been Gifts to Trust

1. *Facts*

In *Smaldino*,[14] Louis Smaldino owned an $80 million portfolio of rental real estate. He was married and had six children (and 10 grandchildren) from a prior marriage. He wished to pass a large portion of his real estate rental business to his children separate from any wealth he would give to his wife to promote her financial security.

[12] Treas. Reg. Section 25.2702-3(b)(2) states: If the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iii) of this chapter (relating to adjustments for any incorrect determination of the fair market value of the property in the trust). Treas. Reg. Section 1.664-2(a)(1)(iii) states: The stated dollar amount may be expressed as a fraction or a percentage of the initial net fair market value of the property irrevocably passing in trust as finally determined for Federal tax purposes. If the stated dollar amount is so expressed and such market value is incorrectly determined by the fiduciary, the requirement of this subparagraph will be satisfied if the governing instrument provides that in such event the trust shall pay to the recipient (in the case of an undervaluation) or be repaid by the recipient (in the case of an overvaluation) an amount equal to the difference between the amount which the trust should have paid the recipient if the correct value were used and the amount which the trust actually paid the recipient.

[13] *Wandry v. Comm'r*, T.C. Memo. 2012-88.

[14] *Smaldino v. Comm'r*, T.C. Memo. 2021-127 (November 10, 2021).

The components of Louis' estate plan included:

1. The Smaldino Family Trust, a revocable trust created in 2013 of which Louis was the settlor and Trustee;

2. The Smaldino 2012 Dynasty Trust, an irrevocable trust established on December 21, 2012, of which Louis was the settlor, Louis' son, Allen, was the Trustee and Louis' children and grandchildren were the beneficiaries; and

3. Smaldino Investments, LLC, created in 2003 but inactive until 2012, whose equity interests were structured as 1% Class A Voting member units and 99% Class B Non-Voting member units. Initially, the Smaldino Family Trust was the sole member, and Louis was the manager. The operating agreement did not include a member's spouse as a permitted transferee.

After a health scare, Louis decided he wanted to transfer a portion of his real estate investments to his children and grandchildren and other, non-real estate assets to his wife, Agustina. Agustina agreed with this plan. Accordingly, in December of 2012, Louis transferred ten California properties into Smaldino Investments, LLC. "Effective: April 14, 2013," Louis assigned a "sufficient number" of Class B membership units of Smaldino Investments, LLC to his wife so that the fair market value of such units as determined for federal gift tax purposes would equal $5.249 million (Agustina's then remaining federal gift tax exemption). "Effective: April 15, 2013," Agustina assigned an identically described interest in Smaldino Investments, LLC to Allen, as Trustee of the Smaldino 2012 Dynasty Trust. "Effective: April 15, 2013," Louis assigned to Allen, as Trustee of the Smaldino 2012 Dynasty Trust, a "sufficient number" of Class B membership units of Smaldino Investments, LLC so that the fair market value of such units as determined for federal gift tax purposes would equal $1.032 million.

The documents by which the above-referenced three transfers were implemented did not indicate the date on which they were signed. Neither the LLC's operating agreement nor any federal income tax return filed for the LLC ever indicated that Agustina was ever a member of the LLC.

To quote the Tax Court, "[w]hen the dust settled," the following assignments had ostensibly occurred:

1. A 41% interest in Smaldino Investments, LLC from the Smaldino Family Trust to Agustina;

2. A 41% interest in Smaldino Investments, LLC from Agustina to the Smaldino 2012 Dynasty Trust; and

3. An 8% interest in Smaldino Investments, LLC from the Smaldino Family Trust to the Smaldino 2012 Dynasty Trust.

Louis reported on his 2013 gift tax return the $1.032 million assignment from the Smaldino Family Trust to the Smaldino 2012 Dynasty Trust. He didn't elect to split the gift.[15] He didn't report any gift to Agustina. Agustina reported on her 2013 gift tax return her $5.249 million assignment to the Smaldino 2012 Dynasty Trust. She didn't elect to split the gift.

The IRS issued a notice of deficiency to Louis and determined that Louis had a $1.154 million gift tax deficiency. It alleged, among other things, that the gift Louis purportedly made to Agustina was, for gift tax purposes, in fact, a gift to the Smaldino 2012 Dynasty Trust – thus, regardless of whether reported on Louis' 2013 gift tax return, not qualifying for the gift tax marital deduction.[16]

2. *Tax Court's Opinion*

The Tax Court found that Louis effectively gifted a 49% interest in Smaldino Investments, LLC to the Smaldino 2012 Dynasty Trust and didn't gift any interest in Smaldino Investments, LLC to his wife.

First, the Tax Court highlighted that the LLC's operating agreement did not recognize a member's spouse as a permitted transferee, and so Agustina was precluded (in the absence of board approval, which was never sought or obtained) from receiving the interest in Smaldino Investments, LLC that Louis claimed to have transferred to her. Second, the Tax Court observed that Exhibit A of the operating agreement wasn't amended to reflect that Agustina was ever the holder of any membership interest, but, notably, it was amended to show the Smaldino 2012 Dynasty Trust's status as holding a 49% membership interest. Third, the Tax Court found it "more likely than not" that the assignment documents were signed no earlier than August 22, 2013, and so, as a practical matter, Agustina never had any ability to exercise ownership rights. Fourth, the Tax Court noted that the LLC's 2013 tax return didn't reference Agustina as an LLC member at any time during that year. Fifth, the Tax Court emphasized that, particularly in connection with transactions between family members, heightened scrutiny is warranted, and so the substance of an intra-family transfer, rather than deference to paperwork, should govern its tax consequences.

In sum, the Tax Court held that the preponderance of the evidence supported: (a) the conclusion that the gifts from Louis to his wife and from his wife to the Smaldino 2012 Dynasty Trust were effectuated pursuant to a prearranged plan; and (b) re-characterizing Louis' alleged transfer of membership interests in Smaldino Investments, LLC to his wife as, in reality, a gift by him to the Smaldino 2012 Dynasty Trust. Indeed, quite damaging to Louis' position in Tax Court was Agustina's sworn testimony that, before Louis gave her any LLC membership interests, she had already made "a commitment, promise" to transfer such interests to the Smaldino 2012 Dynasty Trust and that she could not have changed her mind "because I believe in fairness."

[15] *See* IRC Section 2513.
[16] *See* IRC Section 2523.

3. *How Case Might Have Gone Differently*

Though no fact in this case was independently dispositive, making one or more of the following changes in the facts may have rendered a different result:

- Increase the amount of time between Louis' gift to Agustina and Agustina's gift to the Smaldino 2012 Dynasty Trust;
- Engineer Louis' gift and Agustina's gifts so they are not of the exact same assets and/or not in the exact same amount.
- Ensure Louis' transfer to his wife was authorized – either by amending the operating agreement expressly to include a member's spouse as a permitted transferee or by obtaining prior board approval;
- Carefully memorialize the transfers of the LLC's membership interests within the LLC's organizational documents; and
- Ensure the LLC's tax returns reflect the existence of all members for relevant the periods of membership, however short.

B. *Nelson v. Commissioner* -- Defined Value Provision Disaster

1. *Facts*

Nelson[17] involved transfers of limited partner interests in Longspar Partners, Ltd. to a trust. One transfer was a gift; the other was an installment sale. A "Memorandum of Gift and Assignment of Limited Partner Interest" ("Memorandum of Gift") stated that Mary Nelson, the donor, was making a gift of a limited partner interest having a fair market value of $2,096,000.00 as of December 31, 2008, as determined by a qualified appraiser within 90 days of the effective date of the gift. Similarly, a "Memorandum of Sale and Assignment of Limited Partner Interest" ("Memorandum of Sale") provided that Mary, the seller, was selling a limited partner interest having a fair market value of $20,000,000.00 as of January 2, 2009, as determined by a qualified appraiser within 180 days of the effective date of the sale.

The appraisals required by the Memorandum of Gift and the Memorandum of Sale were prepared, but that task was not concluded within the time specified by the Memorandum of Gift and the Memorandum of Sale. The appraiser determined the fair market value of a 1% interest in Longspar to be $341,000.00. The lawyer, using that figure, converted the dollar values set out in the Memorandum of Gift and the Memorandum of Sale to percentages of limited partner interests—6.14% for the gift and 58.65% for the sale. Those percentages were reflected within

[17] *Nelson v. Comm'r*, No. 20-61068 (5th Cir. November 3, 2021), *aff'g* T.C. Memo. 2020-81 (June 10, 2020).

Longspar's records, Longspar's amended partnership agreement and Mary and James Nelson's 2008 and 2009 gift tax returns.[18]

The IRS selected the gift tax returns for examination. The IRS asserted that Mary had gifted limited partner interests representing 6.14% of the value of Longspar and that such interests were worth more than $2,096,000.00 on the effective date. The IRS likewise claimed that Mary had sold limited partner interests representing 58.65% of the value of Longspar and that such interests were worth more than $20,000,000.00. Mary and James countered that, pursuant to the Memorandum of Gift, Mary had gifted limited partner interests with a fair market value on the effective date of $2,096,000.00 and no more, and, pursuant to the Memorandum of Sale, Mary had sold limited partner interests with a fair market value on the effective date of $20,000,000.00 and no more.

2. *Analysis*

In sustaining the IRS' position, the Tax Court noted that the operative language of the Memorandum of Gift and the Memorandum of Sale "hang[s] on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes." The court cited and favorably discussed cases in which the efficacy of language defining fair market value as that "finally determined for federal [estate][gift] tax purposes" was upheld.[19] The court stated it wouldn't disregard the "by a qualified appraiser within [a fixed period]" language of the Memorandum of Gift and the Memorandum of Sale and replace it with "for federal estate and gift tax purposes."

In affirming the decision of the Tax Court, the U.S. Court of Appeals for the Fifth Circuit didn't add substance to the Tax Court's analysis. The Court of Appeals observed that the operative language referenced in the preceding paragraph effectively redefined "fair market value" to mean that value as determined by a qualified appraiser, and so, once the appraiser had determined the fair market value of a 1% limited partner interest in Longspar, all that was left to do was to convert the dollar value arrived at by the appraiser to percentages. The Fifth Circuit stated: "[t]hose percentages were locked, and remained so even after the valuation changed" and concluded:

> The transfer documents clearly and unambiguously state that Mary [] was gifting and selling the percentage of limited partner interests that an appraiser determined to have a fair market value equal to a stated dollar amount. The transfer agreements must be interpreted as written. The Nelsons therefore transferred what the plain language of their transfer instruments stated—$2,096,000 and $20,000,000 of limited partner interests in Longspar as determined by a qualified appraiser to be 6.14% and 58.65% of such interests.

---

[18] James was Mary's husband. Mary and James elected to split gifts under IRC Section 2513.
[19] *Estate of Christiansen v. Comm'r*, 130 T.C. 1 (2008), *aff'd* 586 F.3d 1061 (8th Cir. 2009); *Estate of Petter v. Comm'r*, T.C. Memo. 2009-280, *aff'd* 653 F.3d 1012 (9th Cir. 2011).

The Court of Appeals was impressed by the IRS' analogy to selling cows:

> As the government well-analogized, if a farmer agrees to sell the number of cows worth $1,000 as determined by an appraiser, and the appraiser determines that five cows equals that stated value, then the sale is for five cows. If a later appraisal determined that each cow was worth more, and that two extra cows had been included in the sale, nothing in the agreement would allow the farmer to take the cows back. The parties would be held to what they agreed—a transfer of the number of cows determined by the appraiser to equal $1,000. So too here. No language in the transfer agreements allows the Nelsons to reopen their previously closed transaction and reallocate the limited partner interests based on a change in valuation.

It seems clear that the taxpayers' position crashed and burned because the defined value provisions embedded in the Memorandum of Gift and the Memorandum of Sale were seriously flawed. Those who design and use defined value clauses should closely follow the models provided in the several cases in which the taxpayers have been victorious.[20]

IV. Gift Tax Consequences of Trust Modifications, Premature Terminations and Decanting

A. Modification or Termination

When trust beneficiaries come together to modify a trust for the purpose of making changes that are purely administrative, clarifying or corrective, gift tax consequences generally shouldn't result. On the other hand, a trust modification by beneficiaries[21] that alters or shifts beneficial interests, or that sets up the possibility that beneficial interests will be altered or shifted, or a premature termination of a trust by its beneficiaries, may constitute a current gift or a gift in the future.[22]

1. *Overarching Principle*

Lest there be any doubt that a trust modification that alters or shifts beneficial interests may give rise to a taxable gift, Treas. Reg. Section 26.2601-1(b)(4)(i)(E), *Example 7*, should nullify that doubt. In the example, A, B, and C are to receive equal shares of the income of a trust during their lives. At the death of the first of them to die, one-third of the trust property is to be distributed to his or her descendants. At the death of the second of them to die, one-half of the trust property is to be distributed to his or her descendants. At the death of the last of them to die, all remaining trust property is to be distributed to his or her descendants. The Trustee, with the consent of B and C, petitioned the appropriate local court, and the court approved a

[20] *Id*. *See*, *also*, *Hendrix v. Comm'r*, T.C. Memo. 2011-133; *Wandry v. Comm'r*, T.C. Memo. 2012-88.

[21] The fact that court action may be required to effectuate a modification (or termination) driven by the beneficiaries does not obviate the possibility that tax consequences will ensue. *See*, *e.g.*, PLR 201932001.

[22] Engineering the premature termination of a QTIP trust is particularly hazardous. See Chief Counsel Advice 202118008 (May 6, 2021).

modification of the trust that increased A's share of trust income. The IRS concluded that, although the modification would not subject the trust to the provisions of Chapter 13 of the IRC, it would be a transfer by B and C to A for federal gift tax purposes.

2. *Modification or Termination as Exercise of General Power of Appointment*

Modification or termination of a trust by beneficiaries in a way that changes or sets up changes to their beneficial interests may be viewed as their exercising a power of appointment. Whether such exercise by a given beneficiary amounts to a taxable transfer by him or her would seem to hang on whether the power is a general power of appointment as defined in IRC Section 2514(c). The general rule of IRC Section 2514(c) is that a power is a general power of appointment if it is exercisable in favor of the powerholder, his or her estate or the creditors of either.[23] A power exercisable by a trust beneficiary to modify or terminate a trust in favor of him or herself is a power within the parameters of the general rule. There are significant exceptions to the general rule, however, rendering a power not a general power of appointment in the following circumstances:

- Where the power is limited to an ascertainable standard relating to the powerholder's health, education, maintenance or support;[24]

- Where the power is exercisable only in conjunction with the creator of the power;[25] or

- Where the power is exercisable only in conjunction with a person having a substantial interest in the property subject to the power, which is adverse to exercise in favor of the powerholder.[26]

B. Decanting

Similar to trust modification by beneficiaries, when a Trustee decants to make innocuous, non-dispositive changes to a trust instrument, no one should be treated as having made a gift. A decanting transaction that alters or shifts beneficial interests, however, whether immediately or in the future, clearly has gift tax implications.[27] Determining when a gift occurs, if at all, and ascertaining the gift's value, could be very challenging.

---

[23] Treas. Reg. Section 25.2514-1(c).
[24] IRC Section 2514(c)(1).
[25] IRC Section 2514(c)(3)(A); Treas. Reg. Section 25.2514-3(b)(1).
[26] IRC Section 2514(c)(3)(B); Treas. Reg. Section 25.2514-3(b)(2).
[27] Obviously, the Internal Revenue Service has concerns about the possible gift (and other) tax consequences of a decanting that results in a change in a trust's beneficial interests. *See* Notice 2011-101, 2011-52 I.R.B. 932 (December 27, 2011).

1. *By Interested Trustee*

If the Trustee is also a beneficiary (an "interested Trustee"), then, to the extent the interested Trustee decants in a manner that eliminates or reduces the value of his or her beneficial interest, the interested Trustee could be transferring something of value. Treasury Regulations implicitly recognize this possibility:

> If a trustee has a beneficial interest in trust property, a transfer of the property by the trustee isn't a taxable transfer ***if*** it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument.[28] (Emphasis added.)

2. *By Independent Trustee*

A non-beneficiary Trustee (an "independent Trustee") who implements a decanting that impacts, or in the future may impact, beneficial interests isn't transferring anything of value in which he has "ownership" or a beneficial interest. Such a Trustee can't make a gift of something that isn't his or hers.[29] If, however, a beneficiary whose beneficial interest is diminished or eliminated by the decanting could've sued the Trustee and successfully caused the decanting to be reversed, but instead allows it to stand unchallenged, that beneficiary (an "acquiescing beneficiary") may have made a gift when expiration of the applicable statute of limitations forecloses suing the Trustee.[30]

Whether a gift may occur in such an instance depends on how likely it is that the acquiescing beneficiary could have succeeded in causing the decanting to be reversed.[31] Gift tax consequences should potentially arise only if the acquiescing beneficiary had more than the mere ability to object but in fact had a reasonable chance of ***successfully*** objecting to the decanting.[32]

As a strategic matter, obtaining a court order, or entering into a court-approved nonjudicial settlement agreement, binding on all interested parties, authorizing or approving, ***in advance***, a decanting transaction might be considered. Rev. Rul. 73-142[33] may be considered solid precedent for the proposition that such a judicially-sanctioned decanting transaction should be recognized for tax purposes as entirely legitimate and not giving rise to a cause of action by the acquiescing beneficiary.

---

[28] Treas. Reg. Section 25.2511-1(g)(2). *See*, *also*, IRC Section 2514(c)(1).

[29] Treas. Reg. Section 25.2511-1(g)(1).

[30] *See* Rev. Rul. 81-264, 1981-2 C.B. 185 (concluding that an individual who permits the statute of limitations to expire on the recovery of a loan to a family member has made a gift if the debtor had some financial resources available to repay the loan).

[31] *See* RESTATEMENT (THIRD) OF TRUSTS (2003) § 50, indicating that an impending transaction by a Trustee may be subject to "judicial control" only if necessary to "prevent misinterpretation or abuse of discretion by the trustee."

[32] Also relevant to whether or the extent to which a gift may result in this context are the expected costs of suing the Trustee.

[33] Rev. Rul. 73-142, 1973-1 C.B. 205.

V. Mismatch Between Gross Estate Inclusion and Marital or Charitable Deduction Amounts -- *Estate of Warne v. Commissioner*

A. Facts

In *Estate of Warne*,[34] Miriam Warne owned, in what was obviously a revocable trust but was called a "Family Trust," controlling, majority interests in five limited liability companies. Miriam owned 100% of the equity of Royal Gardens LLC, one of the five LLCs. The LLCs owned fee interests and leased fee interests in real estate. On December 27, 2012, Miriam gave fractional interests in three of the LLCs to her two sons and three granddaughters. She did not file a federal gift tax return for 2012. She died on February 20, 2014. The Family Trust's governing instrument directed that 75% of the equity in Royal Gardens be distributed to the Warne Family Charitable Foundation and 25% to St. John's Lutheran Church.

Miriam's estate filed a 2012 federal gift tax return reporting the 2012 gifts. The estate timely (on extension) filed a federal estate tax return claiming: (a) valuation discounts for lack of control and lack of marketability with respect to the estate's equity interests in all of the LLCs except Royal Gardens; (b) a value of $25,600,000 for Royal Gardens; and (c) charitable deductions of $19,200,000 for the disposition to the foundation and $6,400,000 for the disposition to the church. In its examination of the gift tax return, the IRS increased the value of all the gifts and imposed a failure to file penalty under IRC Section 6651(a)(1). Regarding the estate tax return, the IRS asserted increased values of all the LLC interests reported as estate assets because, said the IRS, the estate had undervalued the LLCs' underlying real estate interests and had overstated the amounts of claimed valuation discounts. The IRS also decreased the aggregate estate tax charitable deduction from $25,600,000 to $21,405,796.

B. Analysis

A large majority of the Tax Court's opinion consists of a laborious summary of the reports compiled by the estate's and the IRS' respective valuation expert witnesses and the Tax Court's ultimate resolutions of value. The one interesting aspect of the Tax Court's opinion regarding valuation relates to discounts for lack of control with respect to the estate's controlling, majority interests in four LLCs.[35] The Tax Court pointedly observed that ordinarily a discount for lack of control with respect to an asset that embodies control would be a non-starter, but in this case the Tax Court accepted the principle that such a lack of control discount could apply – largely because the parties agreed the estate was entitled to such a discount, although they disagreed as to the amount of the discount. The estate's valuation experts argued for a 5% lack of control discount and in so doing placed considerable weight on the possibility that minority interest holders would strongly oppose dissolution and would litigate to stop it. The IRS' valuation expert characterized the risk of litigation as "merely a hypothetical possibility" and suggested a 2% lack of control discount would be appropriate. The Tax Court agreed with the IRS's expert that the risk of litigation initiated by the minority was pure speculation and not reasonably probable and so refused

[34] *Estate of Warne v. Comm'r*, T.C. Memo. 2021-17 (February 18, 2021).

[35] As the controlling, majority interest owner, the decedent had the unilateral power to dissolve the LLCs and to appoint and remove managers.

to consider such risk in its analysis. Nevertheless, the Tax Court found the remainder of the estate's experts' analysis superior to that of the IRS' expert and settled on a 4% discount for lack of control.

The Tax Court's handling of the charitable deduction issue is essentially a regurgitation of *Ahmanson*[36] – but with a twist. Relying on *Ahmanson*, the Tax Court applied the principle that, for gross estate inclusion purposes, the value of an asset passing in part to a charity is the asset's value as an undivided whole, but, for purposes of determining the amount of the charitable deduction, only the value of what the charity receives is deductible. *Ahmanson* is not entirely on point, however, because *Ahmanson* involved dividing an asset between the decedent's son and a charitable foundation. Here, Royal Gardens was divided between two charities, and so it passed 100% in charitable dispositions. The Tax Court nevertheless upheld the IRS' application of discounts to each charitable disposition because each charity individually received an interest with a diminished value as compared to its percentage interest in an undivided whole. The Tax Court adopted the parties' stipulations of discounts appropriate in the event the Tax Court determined discounts were proper: 27.385% for the church's interest in Royal Gardens and 4% for the foundation's interest.

The estate offered no substantive defense for the decedent's failure to file a 2012 gift tax return, so the failure to file penalty was sustained.

[36] *Ahmanson Foundation v. United States*, 674 F.2d 761, 81-2 U.S.T.C. ¶ 13,438 (9th Cir. 1981).

CANNON
FINANCIAL INSTITUTE

Certificate of Attendance

____

(Participant Name)

Has successfully completed the Cannon Financial Institute, Inc. course:

Gift and Estate Tax Black Holes

September 19, 2023

Laurie Sebestyen
Laurie Sebestyen
Professional Education Coordinator

- **Certified Public Accountant** — **1.5 credit hours**
  In accordance with the standards of the National Registry of CPE Sponsors, CPE credits have been granted based on a 50-minute hour.
  Instructional delivery method: Group-Internet-Based
  NASBA #103655; Field of Study-Tax
  Knowledge Level-Intermediate
- **Enrolled Agent (IRS)** — **1.0 credit hour**
  Cannon is designated as a qualified education sponsor by the IRS and can offer continuing education credit to Enrolled Agents. Cannon's agreement with the IRS Office of Professional Responsibility does not constitute an endorsement by the IRS as to the quality of the programs or their contribution to the professional competence of the enrolled individual.
  Course # VRUGV-T-00177-23-O
- **Certified Financial Planner (CFP™)** — **1.5 credit hours**
  Course #309445
- **Accredited Fiduciary Investment Manager (AFIM™)** — **1.5 credit hours**
- **Certified Wealth Strategists (CWS®)** — **2.0 credit hours**
- **Certified Investment Management Analyst (CIMA®)** — **1.5 credit hours**
  Course # 22CFI024
  If you hold the CIMA®, CIMC® or CPWA® certification, you may report this pre-accepted CE program online by logging into your account at https://investmentsandwealth.org/.

- **Certified Trust and Fiduciary Advisor (CTFA™)** — **2.0 credit hours**
- **Certified Retirement Plan Professional (CRPP™)** — **2.0 credit hours**
- **Certified Trust Operations Professional (CTOP™)** — **2.0 credit hours**
- **Certified Fiduciary and Investment Risk Specialist (CFIRS™)** — **2.0 credit hours**
- **Chartered Life Underwriter & Chartered Financial Consultant (**No Individual State Insurance Credit Available)** — **1.5 credit hours**
- **Fiduciary Investment Risk Management Association (FIRMA®)** — **2.0 credit hours**

Any questions regarding CE credit, please contact Laurie Sebestyen at (706) 389-7645.
Fax (706) 353-3994, Email lsebestyen@CannonFinancial.com
355 Oneta St. Building D 500, Athens, GA 30601

CANNON
FINANCIAL INSTITUTE

Certificate of Attendance

____
(Participant Name)

____
(Attorney Bar # or Social Security #)

Has successfully completed the Cannon Financial Institute, Inc. course:

Gift and Estate Tax Black Holes

September 19, 2023

CANNON FINANCIAL INSTITUTE, INC. CORPORATE SEAL GEORGIA

Laurie Sebestyen
Professional Education Coordinator

Continuing Legal Education Credits for this course are as follows:
The following states have been approved for 1.5 hours of General Credit: (Course number is indicated in parenthesis):Alabama, Arkansas (TWE91327), California, Delaware, Georgia, Idaho, Illinois, Iowa (385207), Kentucky (247366), Louisiana, Maine (67985), Minnesota (477988), Mississippi, Montana, Nebraska, Nevada, New Mexico, New York, North Carolina, North Dakota, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee (Distance Ed), Texas (174170392), Utah, Vermont, Virginia, Washington, Wisconsin, & Wyoming

These states have been approved for the following General Credit: Colorado – 2 hours, Florida - 2 hours (2207409N), Missouri –1.8 hours (705752), Oklahoma – 2 hours, West Virginia – 1.8 hours

The following states either do not require/do not accept outside CLE Credit/or do not accept teleconference calls for CLE Credit: District of Columbia, Maryland, Massachusetts, Michigan & South Dakota
The following states have special circumstances:
Alaska-Attorneys can use this certificate to submit to Alaska State Bar for 1.5 credits
Arizona-On honor system 1.5 credits
Connecticut-Attorneys can use this certificate to submit to Connecticut MCLE 1.5 credits
Hawaii- Attorneys can use this certificate for Hawaii CLE for 1.5 General credits (Reciprocity Rule)
Indiana-Site Coordinators must apply for credit as the sponsor for participants to receive credit
New Hampshire- *NHMCLE does not approve or accredit CLE activities for the NH Minimum CLE requirement. NH attendees must self-determine whether a program is eligible for credit and self-report their attendance.*
New Jersey-Attorneys can use this certificate for New Jersey CLE for 1.5 General credits (Reciprocity Rule)
New York–Attorneys may use this certificate to report their attendance as it is accredited by Approved NY Jurisdictions: AL, AR, DE, GA, KY, LA, MS, NM, NC, ND, OK. Type of credit: Areas of Professional Practice 1.5 Credits
****As required by the following State Bars, Cannon will submit the mandatory attendance rosters for the attorneys seeking CLE credits **ONLY** in the following states: Alabama, Delaware, Georgia, Idaho, Illinois, Louisiana, Maine, Montana, Nebraska, Nevada, New Mexico, North Carolina, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Utah, Washington, and West Virginia. ****

Any questions regarding CE credit, please contact Laurie Sebestyen at (706) 353-3346.
Fax (706) 353-3994, Email lsebestyen@CannonFinancial.com
355 Oneta St. Bldg D 500, Athens, Georgia 30601

CERTIFICATE OF ATTENDANCE FOR CALIFORNIA MCLE

<u>To be Completed by the Provider</u>

Provider: Cannon Financial Institute (CA Provider #12179)

Subject Matter/Title: Gift and Estate Tax Black Holes

Date and Time of Activity: September 19, 2023, 1:00-2:30 PM ET, 12:00-1:30 PM CT, 11:00AM-12: 30 PM MT,

10:00AM- 11:30 AM PT

Location: Teleconference

Length of Presentation: 1.5 Hours

ELIGIBLE CALIFORNIA MCLE CREDIT:

TOTAL HOURS: 1.5

Legal Ethics:

Elimination of Bias in the Legal Profession:

Competence:

<u>To Be Completed by the Attorney after Participation in the Above-Name Activity</u>

By signing below, I certify that I participated in the activity described above and am entitled to claim the following California MCLE credit hours:

TOTAL HOURS: ______________________

(You may not claim credit for the following sub-fields unless the provider is granting credit in these areas as listed above.)

Legal Ethics: ______________________

Elimination of Bias in the Legal Profession: ______________________

Competence: ______________________

Attorney Signature:

REMINDERS: Keep this record of attendance for four years. In the event that you are audited by the State Bar, you may be required to submit this record of attendance. Send this to the State Bar only if you are audited. You must sign in on the Official Record of Attendance for California MCLE maintained by this provider in order for these hours to qualify for California MCLE credit.

CANNON

FINANCIAL INSTITUTE

Certificate of Attendance

____

(Participant Name)

____

(Colorado Attorney Registration #)

Has successfully completed the Cannon Financial Institute, Inc. course:

Gift and Estate Tax Black Holes

(823465)

September 19, 2023

CANNON FINANCIAL INSTITUTE, INC. CORPORATE SEAL GEORGIA

Laurie Sebestyen

Laurie Sebestyen
Professional Education Coordinator

<u>Continuing Legal Education Credits for this course are as follows:</u>

Colorado – 2.0 General Credits

****As required by the State of Colorado, attorneys must submit their own credits.

Any questions regarding CE credit, please contact Laurie Sebestyen at (706) 389-7645
Email lsebestyen@CannonFinancial.com
355 Oneta St. Building D 500, Athens, Georgia 30601

Virginia MCLE Board

Certification of Attendance (Form 2)

Certify your attendance online at www.vsb.org

MCLE requirement pursuant to Paragraph 17, Section IV, Part Six, Rules of Virginia Supreme Court and MCLE Board Regulations

MCLE Compliance Deadline - October 31. MCLE Reporting Deadline - December 15.

A $100 fee will be assessed for failure to comply with either deadline.

Member Name: ______________________ **VSB ID#:** ______________________

Address: ______________________ **Phone:** ______________________

____

______________________ **Email:** ______________________

City **State** **Zip**

Course ID: NKK0543

Sponsor: Cannon Financial Institute

Title: Gift and Estate Tax Black Holes

Credits: 1.5 **CLE** 0.0 **(Ethics)** 0.0 **Well-being**

Date Completed: ______________________ **Location:** ______________________

To be completed by sponsor for distance learning programs.

By my signature below I certify:

____ I attended a total of _____ (hrs/mins) of approved CLE of which (_____) (hrs/mins) were approved Ethics and _____ (hrs/mins) were approved Well-being.

____ Credit is awarded for actual time in attendance (0.5 hr. min) rounded to the nearest half hour. (1hr 15 min = 1.5hr)

____ The sessions I am claiming had written instructional materials to cover the subject.

____ I participated in this program in a setting physically suitable to the course.

____ I was given the opportunity to participate in discussions with other attendees and/or the presenter.

____ I understand I may not receive credit for any course/segment which is not materially different in substance than a course/segment for which credit has been previously given during the same completion period or the completion period immediately prior.

____ I understand that a materially false statement shall be subject to appropriate disciplinary action.

NOTE: A maximum of 8.0 hours from pre-recorded courses may be applied to your yearly MCLE requirement. Minimum of 4.0 hours from live interactive courses required.

______________________ ______________________

Date **Signature**

This form may be mailed to:
Virginia MCLE Board
Virginia State Bar
1111 East Main Street, Suite 700
Richmond, VA 23219-0026
(804) 775-0577 / MCLE@vsb.org

Course Type: Live

Delivery Method: Webcast