Opportunity Zones – A Primer

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Outline

I. Introduction

II. Overview/Legislative History

III. Benefits of the Opportunity Zones Incentive

IV. How Do Investors Access Opportunity Zones?

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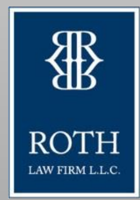

Richard Roth, LL.M.
Background

Richard is a Board Certified Tax Specialist and the founder and managing member of Roth Law Firm, LLC. He began his career as a Certified Public Accountant in Charleston, South Carolina. After three years of practicing public accounting, he returned to his hometown of New Orleans to attend Tulane University Law School and start his law practice. Before opening Roth Law Firm, Richard was a partner with Hickey & Riess in New Orleans.

Education:

- Georgetown University Law Center, Washington, DC, LL.M. in Taxation, 2009
- Tulane University Law School, New Orleans, Louisiana, J.D., 2008
- Clemson University, B.S. in Accounting, 2002

Roth Law Firm, L.L.C.

Roth Law Firm, LLC is a boutique tax law firm located in the Garden District of New Orleans that was founded in 2012. Our primary areas of focus include tax credit transactions, estate planning, successions, trusts, and general business tax planning.

Our firm has represented developers, lenders, and investors in transactions procuring more than $350 million in tax credits and representing close to $1.5 billion in economic development.

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Overview- Opportunity Zones

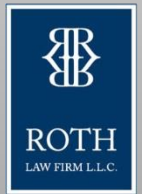
- Added to the tax code by the Tax Cuts and Jobs Act of 2017
- Intended to enhance long-term private sector investments in distressed, low-income communities
- Investors reinvest capital gains into Opportunity Zones
- First new national community investment program in over 15 years
- No cap or competitive application process
- No employment requirement (allowing real estate industry to participate)
- Simple self-certification process

Designated Opportunity Zones

Opportunity Zones

Low-Income Communities

Source: Novogradac & Co.



Opportunity Zones in Louisiana

Source: Louisiana Economic Development

Opportunity Zones in New Orleans

Source: Louisiana Economic Development

Incentives

1. Gain Deferral

2. Partial Forgiveness

3. Forgiveness of Future Gains

Gain Deferral

The period of capital gain tax deferral ends upon the earlier of December 31, 2026, or _____.

The amount of gain included in income as of December 31, 2016 is

- the lesser of (1) the deferred gain or (2) the FMV of the investment, over
- the taxpayer's basis in the investment.

Partial Forgiveness and Forgiveness of Additional Gains

Sale

Investment

Basis in QOF is $0

Held for 5 years

-Basis in QOF increased by 10% of the deferred gain
-Up to 90% taxed

Held for 7 years

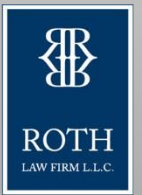
-Basis in QOF increased by 5% of the deferred gain
-Up to 85% taxed

Held for 10 years

Basis is equal to Fair Market Value

Forgiveness of gains on appreciation of investment

2019 2020 2021 2022 2023 2024 2025 2026 2027 2028 2029



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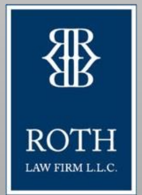
Eligible Gains

- Short and long term capital gains
- Unrecaptured Section 1250 gains
- Deemed gains under 1256 contracts, but only net gains for a year
- Gains from offsetting-position transactions (e.g. straddles) do not qualify
- Gains re-invested within 180-day period from a disposition of a QOF interest



Eligible Taxpayer

- Individuals
- Partnerships
- C corporations
- S corporations
- RICs
- REITs
- Trusts and Estates

Timing of Investment

- Invest in the QOF within 180 days of the event that triggers the gain
  - In the case of a partnership, the 180-day period begins on the end of the taxable year
- In an indirect structure, QOZ business has 31 months to hold cash as "working capital" if meets certain requirements (discussed later)
- Form 8949 for gain deferral election

Qualified Opportunity Fund

- Corporation or partnership for federal income tax purposes
- Must hold 90% of its assets in "QOZ Property" (discussed later)
  - Test date each six months of taxable year
  - Value is the same as reported on the QOF's financial statement, or, if no financial statement, cost basis of asset
  - If a QOF does not meet the 90% asset test, subject to monthly penalty
- Annual self-certification by filing a Form 8996

Qualified Opportunity Zone Property

Qualified Opportunity Zone Property

Qualified Opportunity Zones Partnership Interest (Qualified Opportunity Zone Business)

Qualified Opportunity Zone Stock (Qualified Opportunity Zone Business)

Qualified Opportunity Zone Business Property

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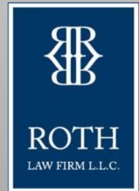
Qualified Opportunity Zone Property- Stock

- Acquired by the QOF after 2017, at its original issue from the corporation solely in exchange for cash
- At the time the stock was issued to the QOF, the corporation was a "Qualified Opportunity Zone Business"

Qualified Opportunity Zone Property- Partnership

- Acquired by the QOF after 2017, solely in exchange for cash
- At the time the interest was acquired by the QOF, the corporation was a "Qualified Opportunity Zone Business"



Qualified Opportunity Zone Property- Business Property

- Tangible property used in a trade or business that is either (i) first used by or (ii) "substantially improved" by the QOF
  - Property shall be treated as "substantially improved" if during any 30-month period after the date of the acquisition of the property, additions to basis of the property in the hands of the QOF exceed the adjusted basis of the property at beginning of the 30-month period
  - Any properly capitalized cost qualifies
  - It seems the 30-month period measuring substantial improvement may be chosen by the QOF
  - If a QOF purchases a building located on land wholly within a QOZ, substantial improvement on the property is measured by the QOF's additions to the adjusted basis of the building (excluding the land)
- Acquired after 2017 by an unrelated party from the QOF

Direct vs. Indirect Investment Structure

Opp. Zone Investors

General Partner

QOF

Indirect Structure

Project Owner

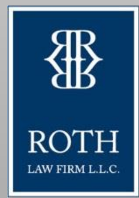
Project (Tangible Property, Real and Personal)

Direct vs. Indirect Investment Structure

Direct Structure

Qualified Opportunity Zone Business ("QOZB")

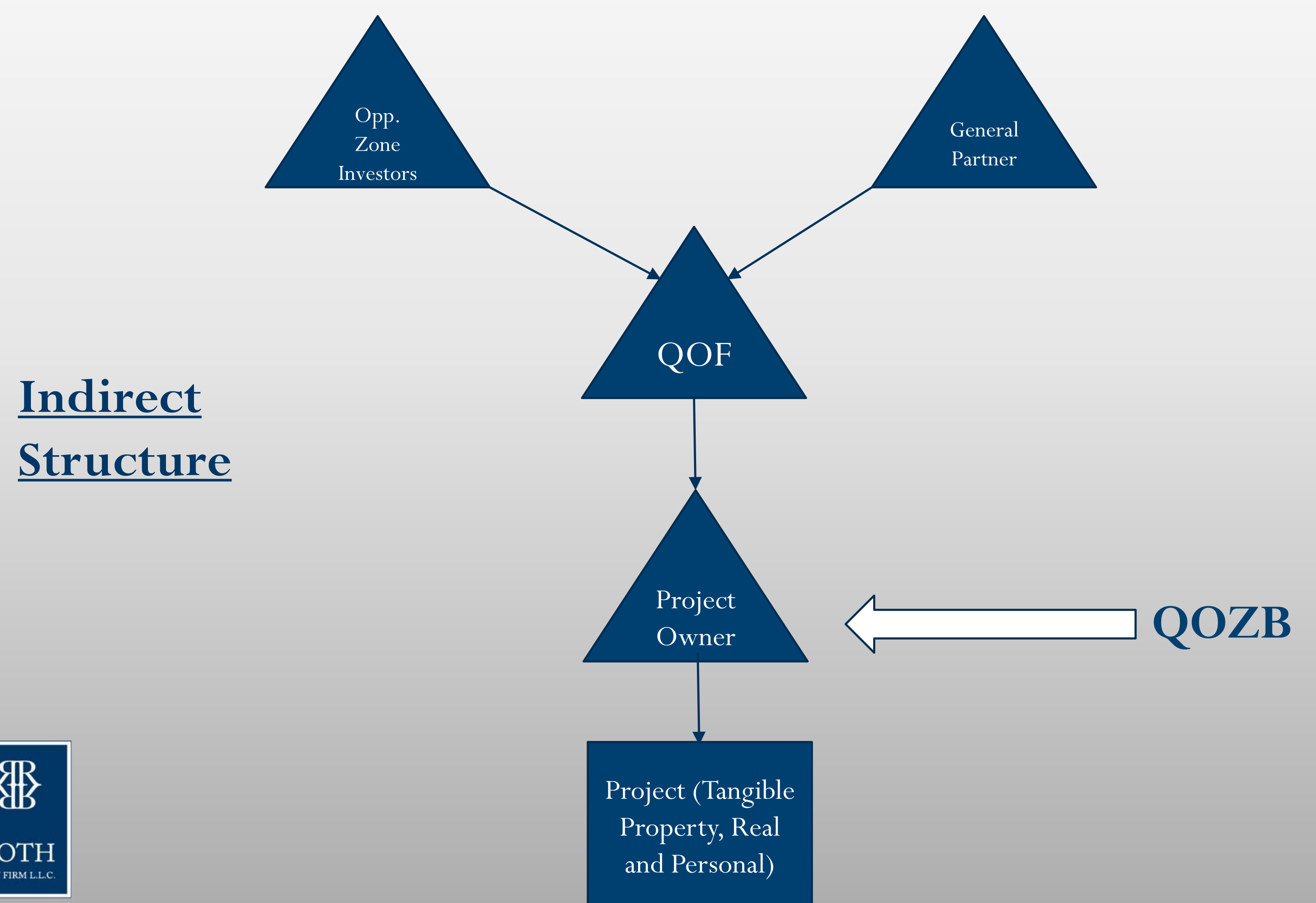
1. Substantially all (70%) of the tangible property owned or leased by the business if QOZB property
2. A substantial portion of the business's intangible property is used in the active conduct of the trade or business in the opportunity zone
3. At least 50% of the business's total gross income is from the active conduct of the trade or business in the opportunity zone
4. Less than 5% of the aggregated, unadjusted bases of the business's property is attributed to nonqualified financial property (e.g. debt, stock, p-ship interests), with the exception for reasonable amounts of working capital
5. Not a "Sin Business" (golf course, massage parlor, hot tub facility, gambling)



Safe Harbor- Working Capital

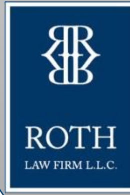
- In general, cash (that would otherwise not be invested by the QOF within the QOF's applicable 6-month period for purposes of the 90% Asset Test) can be invested as working capital in a QOZ Business
- Requirements:
  - have a written plan (and retain such plan in its records) that identifies the financial property (i.e., cash) as property held for the acquisition, construction, or substantial improvement of tangible property in an opportunity zone;
  - have a written schedule, such as a Gantt Chart, consistent with the ordinary business operations of the business showing that the property will be used within 31 months; and
  - the business must substantially comply with the schedule.

Direct vs. Indirect Investment Structure



Direct vs. Indirect Investment Structure

Requirement	Direct Investment	Indirect Investment
% of QOF's assets that must be invested in QOZBP	90%	70%
% of QOF's assets that must be invested in stock or p-ship interests	N/A	90%
% of QOF's assets that may be held in cash or other liquid investments	10%	35%
% of QOF's assets that may be held in intangible property	10% (together with cash)	30% and must be used in trade or business
% of QOF's assets that must be invested in tangible property	90%	70%
% of gross income that must be derived from Opportunity Zone	No requirement	50%
Working Capital Safe Harbor?	No	Yes
Sin Business?	Allowed	Prohibited
Restrictions on Financial Property	No	Less than 5% of aggregate unadjusted bases of the property is attributed to non-qualified financial prop



Direct vs. Indirect Investment Structure

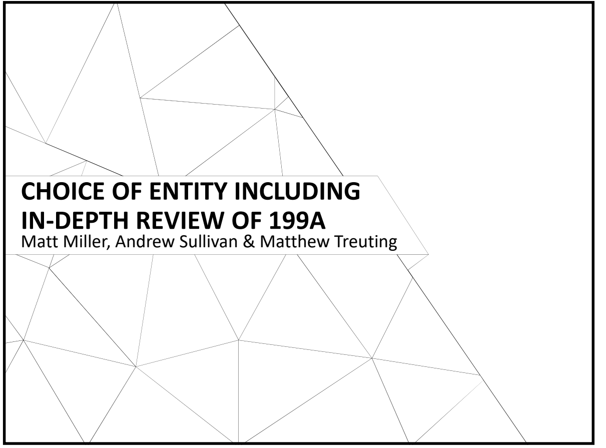
Direct Investment	Indirect Investment
Less than 10%, but more than 5% of the QOF's property is "nonqualified financial property"	Everything else
Sin business	

Combining OZ With Other Incentives

- NMTC
- HTC
- ITC

Unanswered Questions

- Treatment of Raw Land or Land With Demolished Buildings
- Are distributions in excess of basis treated as capital gain? What is the tax treatment of a cash out refinance?
- Can an investor exit other than through a sale of the QOF?
- How can a QOZB be structured to allow for employee ownership?
- How are interim gains of a QOF treated?



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SECTION 199A 20% DEDUCTION FOR QUALIFIED BUSINESS INCOME

- Tax Cuts and Jobs Act ("TCJA") adds new Section 199A, "Deduction for Qualified Business Income for Pass-Thru Entities"
- Intended to reduce tax rate on qualified business income ("QBI") to rate closer to corporate tax rate (i.e., 21%)
- Name is misleading (also available to sole proprietors)
- Only applicable to U.S. income

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PRE-TCJA MAXIMUM FEDERAL INCOME TAX RATES DISTRIBUTION OF ALL AFTER-TAX EARNINGS

C Corporation

Maximum Corporate Rate	35.00
Shareholder Qualified Dividend (20% x 65%)	13.00
Shareholder Medicare Surtax (3.8% x 65%)	2.47
Total	50.47%

Pass-Through Entity

Maximum Individual Rate	39.60
Medicare Surtax	3.80
Total	43.40%

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CHANGES UNDER TCJA

- Taxation of C Corporations
  - Flat rate of 21%
  - Top marginal rate on distributions of 39.8% (21% + (79%*23.8%)=39.8%)
  - No sunset
- Taxation of Pass-Through Entities
  - 20% QBI deduction
  - Top marginal rate of 29.6% (37% top rate – (37% * 20% deduction=29.6%); plus 3.8% net investment income tax=33.4%, if applicable
  - Sunset provisions apply

UNDER TCJA MAXIMUM FEDERAL INCOME TAX RATES DISTRIBUTION OF ALL AFTER-TAX EARNINGS NO SECTION 199A DEDUCTION

C Corporation

Maximum Corporate Rate	21.00
Shareholder Qualified Dividend (20% x 79%)	15.80
Shareholder Medicare Surtax (3.8% x 79%)	3.00
Total	39.80%[1]

Pass-Through Entity

Maximum Individual Rate	37.00
Medicare Surtax	3.80
Total	40.80%[2]

1. A reduction of 10.67% from Pre-TCJA maximum rate.
2. A reduction of 2.60% from Pre-TCJA maximum rate.

UNDER TCJA MAXIMUM FEDERAL INCOME TAX RATES DISTRIBUTION OF ALL AFTER-TAX EARNINGS SECTION 199A DEDUCTION[1]

C Corporation

Maximum Corporate Rate	21.00
Shareholder Qualified Dividend (20% x 79%)	15.80
Shareholder Medicare Surtax (3.8% x 79%)	3.00
Total	39.80%[2]

Pass-Through Entity

Maximum Individual Rate [37% - (20% x 37%)]	29.60
Medicare Surtax	3.80
Total	33.40%[3]

1. No W-2 wage/basis limitation applicable.
2. A reduction of 10.67% from Pre-TCJA maximum rate.
3. A reduction of 7.40% from Pre-TCJA maximum rate.

SECTION 199A MATRIX

Specified service income and W-2 wage/basis limitations:

Threshold[1] and Phase-In Amounts	Trade or business is not specified service	Trade or business is a specified service
Taxable income <u>less than or equal to</u> $157,500 (single), $315,000 (joint)	W-2 wage/basis limitations do not apply	W-2 wage/basis limitations do not apply; specified service income is eligible
Taxable income <u>greater than</u> $157,500 (single), $315,000 (joint) but <u>less than</u> $207,500 (single), $415,000 (joint)	W-2 wage/basis limitations are phased in over $50,000/$100,000 range	"Applicable percentage" of specified service income is eligible; AND W-2 wage/basis limitations are phased in over the $50,000/$100,000 range
Taxable income <u>greater than</u> $207,500 (single), $415,000 (joint)	W-2 wage/basis limitations apply in full	Specified service income not eligible
[1] These threshold amounts apply to calendar 2018 and will be subject to COLA in subsequent years.		

SECTION 199A COMPUTATION: TAXABLE INCOME <u>DOES NOT EXCEED THRESHOLD</u> ($157,000 SINGLE; $315,000 JOINT)

Section 199A deduction is <u>lesser</u> of:

(a) 20% of total QBI amounts for all trades/businesses (including "specified services")[1], <u>plus</u> 20% of combined qualified REIT dividends and publicity traded partnership (PTP) income;

OR

(b) 20% of taxable income excluding net capital gain.

____

[1] QBI from specified services qualifies for deduction with no W-2 wage/basis limitations. If total combined QBI is a negative number, then QBI amount is zero (0), with negative amount carried over to next year as negative QBI amount from a separate trade/business to be netted.

[2] If combined REIT and PTP income is a negative number, then zero (0) is used and the negative amount carries over to be netted against REIT and PTP income in the following year.

SECTION 199A COMPUTATION: TAXABLE INCOME <u>WITHIN PHASE-IN RANGE</u> (SINGLE, GREATER THAN $157,000, BUT LESS THAN $207,000; JOINT, GREATER THAN $315,000, BUT LESS THAN $415,000)

Section 199A deduction is <u>lesser</u> of :

(a) QBI Component[1], <u>plus</u>

20% of combined qualified REIT dividends and publicity traded partnership (PTP) income[2];

OR

(b) 20% of taxable income excluding net capital gain.

____

[1]If a trade/business is a "specified service," then only the "applicable percentage "of its QBI and W-2 wage/basis amounts are taken into account. The applicable percentage is 100% reduced by the percentage equal to a fraction, the numerator of which is the excess over the threshold, and the denominator is $50,000 (single) or $100,000 (joint), whichever is applicable.

If the W-2 wage/basis amount is <u>less</u> than 20% of QBI, the QBI Component is the amount equal to 20% of QBI, reduced by the "reduction amount." The reduction amount is the excess of 20% of QBI over the W-2 wage/basis amount multiplied by the "applicable fraction."

No reduction occurs if the W-2 wage/basis amount is greater than 20% of QBI.

The same proportionate netting of negative and positive QBI and carryover applies.

[2]The same netting and carryover of REIT and PTB income applies.

SECTION 199A COMPUTATION: TAXABLE INCOME EXCEEDS AGGREGATE THRESHOLD AND PHASE-IN AMOUNTS ($207,500 SINGLE; $415,000 JOINT)

Section 199A deduction is lesser of:

(a) The QBI Component[1], plus

20% of combined qualified REIT dividends and publicity traded partnership (PTP) income[2];

OR

(b) 20% of taxable income excluding net capital gain.

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[1] No QBI or W-2 wage/basis limitations attributable to a "specified services" are taken into account. The QBI Component is the sum of QBI amounts for each non-specified trade/business, and for each is the lesser of:

(a) 20% of QBI; or

(b) The greater of:

(i) 50% of W-2 wages; or

(ii) 25% of W-2 wages plus 2.5% of unadjusted basis of qualified property.

If at least one business has negative QBI, each business with a positive QBI must net a pro rata portion of its positive QBI. The W-2 wage/basis amounts from trade/businesses generating negative QBI are not taken into account and do not carry over to subsequent years. If overall QBI from all trades/businesses is negative, then the QBI Component is zero (0), and the negative amount is treated as a negative QBI from a separate trade/business in the next year.

[2] If combined REIT and PTP income is a negative number, then zero (0) is used and the negative amount carries over to be netted against REIT and PTP income in the following year.

W-2 WAGES

- W-2 wages must be calculated for each trade or business, similar to former IRC § 199 for certain domestic production activities
- Management Company Exception: wages paid by third party payors can be included so long as there is no double counting
- Wages are pro-rated where businesses are acquired or disposed of during year based on time period of employment
- If employee is used in multiple businesses, wages are allocated among those businesses

UBIA OF QUALIFIED PROPERTY

- "Qualified Property" – depreciable tangible property used or available for use in trade or business for production of QBI whose depreciable period has not ended before close of year
- Depreciable period begins when placed in service and ends on later of 10 years or last day of property's recovery period
- Period is not affected by depreciation or cost recovery, including bonus first year depreciation or special expensing deduction under IRC §179
- Partnership special basis adjustments under IRC §§ 734(b) or 743(b)
- Rules for qualified property received in tax-free transaction (e.g., contribution to partnership, like-kind exchange, involuntary conversion)

QBI DEFINITION

- QBI Defined
  - Includes: net amount of income, gain, deduction and loss for each trade or business, including IRC §751 income
  - Excludes:
    - REIT dividends and publicity trade partnership (PTP) income
    - Income from trade or business as employee and reasonable compensation paid to taxpayer from QBI
    - Capital gains, dividends and interest income (unless interest income is derived from accounts or notes receivable for goods or services sold). Section 1231 gains and losses that are capital are excluded but those that are ordinary are included.
    - Guaranteed payments to partner under IRC §707(c) or payments to partner under IRC §707(a) Previously suspended losses; Net operating loss carryovers
  - What about depreciation recapture? Section 1250 Gains?

SECTION 199A: EXAMPLE

- Teresa is single and is a 30% owner of an LLC, which is classified as a partnership for tax purposes. In 2018, LLC has a single trade or business and reported QBI of $3,000,000. LLC paid total W-2 wages of $1,000,000, and its total UBIA of qualified property is $100,000. Teresa is allocated 30% of all items of the partnership. For the 2018 tax year, Teresa reports $900,000 of QBI from LLC. After allowable deductions unrelated to LLC, Teresa's taxable income is $880,000.
- Because Teresa's taxable income is above the threshold amount, the QBI component of Teresa's Sec. 199A deduction will be limited to the lesser of (1) 20% of Teresa's share of LLC's QBI, or (2) the greater of the W-2 wage or UBIA of qualified property limitations.
  - 20% of Teresa's share of QBI of $900,000 = $180,000
  - W-2 wage limitation = 50% of Teresa's share of LLC's wages ($300,000) or $150,000
  - UBIA of qualified property limitation = $75,750, sum of (1) 25% of Teresa's share of LLC's wages ($300,000) or $75,000 and (2) 2.5% of Teresa's share of UBIA of qualified property ($30,000) or $750
  - Greater of limitation amounts ($150,000 and $75,750) is $150,000
  - Thus, QBI component of Teresa's Sec. 199A deduction is thus limited to $150,000, i.e., lesser of (1) 20% of QBI ($180,000) and (2) greater of limitations amounts ($150,000)
  - Teresa's Code Sec. 199A deduction = lesser of (1) 20% of QBI from business as limited ($150,000) or (2) 20% of her taxable income ($880,000 x 20% = $176,000); thus, Teresa's Sec. 199A deduction for 2018 is $150,000

NETTING

- Taxpayers must apply wage and property limitations to each profitable business separately, <u>but</u> loss businesses must have such losses netted against profitable businesses before applying wage and property limitations to the profitable businesses
- Wages and property allocable to loss entities are <u>not</u> included when calculating these limits for the profitable businesses

RENTALS AS A TRADE OR BUSINESS

- Trade or Business – regular, continuous, and substantial
- Safe harbor under which a "rental real estate enterprise" will be treated as a trade or business for purposes of Section 199A
  - Requirements
    - Separate books and records maintained
    - Performance of rental services: at least 250 hours of services
    - Contemporaneous records of rental services
  - Taxpayers either must treat each property held for production of rents as a separate enterprise or must treat all similar properties held for production of rents as a single enterprise
  - Commercial and residential real estate cannot be combined in same enterprise

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RENTALS AS A TRADE OR BUSINESS (CONT.)

- Exclusions from safe harbor
  - Real estate used by taxpayer as residence for any part of year under Section 280A
  - Real estate rented or leased under triple net lease
- Failure to meet safe harbor: may still be treated as a trade or business
- Rental or licensing of tangible or intangible property may be treated as trade or business if rented/licensed to a commonly controlled trade or business
  - Applies even where the rental is on a triple net lease basis
  - Does not apply to rental/license to a C corporation

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AGGREGATION RULES

- Often, a single trade or business cannot be conducted through more than one entity
- However, taxpayers are permitted, but not required, to aggregate separate trades or businesses if following requirements are satisfied:
  - Each trade or business so aggregated must itself be a "trade or business."
  - Same persons, with attribution, must, directly or indirectly, own 50% or more of each trade or business for a majority of the year and all businesses must use the same tax year
  - None of the businesses can be a "specified service."
  - At least two of the following three factors apply to the integrated trade or business:
    - Businesses provide the same product or service or are customarily provided together
    - Businesses share facilities or centralized business elements
    - Businesses are operated in coordination with or in reliance upon each other (e.g., supply chain interdependencies)

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SPECIFIED SERVICES

- A specified service trade or business ("SSTB") is any trade or business involving the performance of services in the following fields:
  - Health
  - Law
  - Accounting
  - Actuarial Services
  - Performing Arts
  - Consulting
  - Athletics
  - Financial Services
  - Brokerage Services
  - Principal asset is the reputation or skill of one or more of its owners or employees
  - Investing or investment management, trading or dealing in securities, partnership interests or commodities

  Does NOT include engineering and architecture.

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SPECIFIED SERVICES (CONT.)

- Status of being SSTB: determined at entity level
- De minimis rule provides exception to SSTB status for mixed trades or businesses:
  - With gross receipts of $25 Million or less and less than 10% of gross receipts are attributable to prohibited services
  - With gross receipts in excess of $25 Million, if less than 5% of gross receipts are attributable to prohibited services
- Anti "cracking" and "packing" rules apply to prevent artificial separations and/or combinations of trades or businesses to avoid SSTB status
- Businesses Incidental to SSTB
  - if non-SSTB and SSTB activities are in separate trades or business, fact that businesses are commonly controlled and share expenses will not cause non-SSTB business to be treated as part of SSTB business

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SPECIFIED SERVICES: CONSULTING

- Advice and counsel
- Includes lobbyists
- This remains a broad yet vague category, as the regulations focus on those who assist clients in achieving goals and solving problems

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SPECIFIED SERVICES: FINANCIAL SERVICES

- Financial Advisors, Investment Bankers, Investment Managers, Asset Managers, Wealth Managers, M&A Advisors, and Retirement Advisors
- Excludes Bankers and Real Estate Managers
- This category, much like the consulting category, focuses on those who provide advice and counsel to help their clients achieve specific goals

SPECIFIED SERVICES: BROKERAGE SERVICES

- Narrowly defined
- Limited to persons arranging transactions between a buyer and a seller with respect to securities for a commission or fee
- Good news for real estate and insurance agents and brokers as it was widely expected that both of these could be included as SSTBs

SPECIFIED SERVICES: CATCH-ALL (PRINCIPAL ASSET IS REPUTATION OR SKILL)

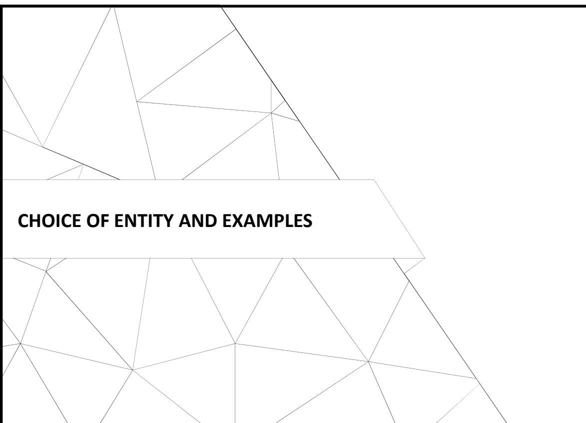
- Trade or business where person receives compensation or fees for:
  - Endorsements
  - Licensing of individual’s name, likeness, signature, etc.
  - Appearances at events or on radio, TV, or other media format
- Focus is on income derived from person’s reputation

ANTI-CRACKING AND PACKING

- Aimed to prevent strategies developed to strip out income of an SSTB and into an eligible business (e.g., removing qualified business from SSTB and having it charge a fee to the SSTB)
- 50% Test – Final Regulations provide if a trade or business provides property or services to a 50% or more commonly owned SSTB, that portion of the trade or business providing property or services will be treated as a separate SSTB
- **Example**: A and B own law firm AB. A and B purchase a building in AB LLC, and rent 50% of the building to the law firm and 50% to unrelated third party tenants. The building is the only asset the LLC owns. Even though the rental of real property is generally not treated as an SSTB, because the same owners own 50% or more of both the LLC and the law firm, the rental income related to the lease of the building to the law firm is treated as being earned in an SSTB, and is not eligible for the 20% deduction. The remaining 50% of the rental activity will not be treated as an SSTB.

SECTION 199A: ESTATES AND TRUSTS

- Estates and non-grantor trusts and their beneficiaries share QBI and the W-2 wage and basis limitations based on the proportion of the estate or trust's distributable net income (DNI) that is retained or distributed.
  - In determining whether the trust's taxable income exceeds the income threshold amounts, the taxable income after taking into consideration the distribution deduction is used. (Proposed regulations stated before)
- Grantor trusts, including electing qualified subchapter S trusts (QSSTs), are ignored. QBI and W-2 wage and basis limitations directly apply to the grantor or QSST income beneficiary, as the case may be.
- ESBTs are entitled to the Section 199A deduction. Multiple non-grantor trusts to depress the individual taxable income threshold are aggregated and treated as a single trust if the trusts:
  1. Have the same grantor or grantors;
  2. Substantially the same primary beneficiaries; and
  3. A "principal" purpose for establishing multiple trusts is to obtain the Section 199A deduction.



199A AND COMPENSATION TO OWNERS

S Corp		Partnership	
NI before wages	1,000,000	NI before wages	1,000,000
Wages to others	400,000	Wages to others	400,000
Owner Wages	250,000	Owner Wages	0
QBI	350,000	QBI	600,000
199A Deduction	70,000	199A Deduction	120,000

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199A AND COMPENSATION TO OWNERS

S Corp		Partnership	
NI before wages	1,000,000	NI before wages	1,000,000
Wages to others	0	Wages to others	0
Owner Wages	250,000	Owner Wages	0
QBI	750,000	QBI	1,000,000
199A Deduction	125,000	199A Deduction	0

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EXISTING VENTURES – CONVERSION TO C CORPORATION?

- Tax rate differential is not the only consideration.
  - The double tax on liquidation after the repeal of the General Utilities doctrine.
  - Waste of suspended losses due to partnership income tax basis, at-risk and/or passive activity loss limitations.
  - Inability to specially allocate tax items under IRC §704(b).
  - Recognized gain where liabilities exceed basis under IRC §§351 and 357.
  - Limitations on cash method of accounting.
  - Loss of outside basis for a partner's share of partnership liabilities.
  - Revocation of S election prohibits re-election for 5 years unless IRS consents.
  - Section 754 election/bonus depreciation.

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EXISTING VENTURES – CONVERSION TO C CORPORATION? (CONTINUED)

- If control of Congress and the White House changes and C corporation rate advantages are scaled-back, a return to pass-through status will have issues to consider:
  - If an S election:
    - Requirement of one class of stock.
    - The 5 year waiting period to re-elect S status.
    - Tax on built-in gains will apply for 5 years since there will be a C corporation history.
    - LIFO inventory recapture.
    - Distributions allocable to C corporation earnings and profits will be dividends.
- If conversion is to an entity taxed as a partnership:
  - A constructive liquidation with a sale of all assets at fair market value results in gain to the corporation, followed by a shareholder level gain on the constructive disposition of stock.

31

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Professionalism - Different Perspectives from Tax Attorneys on Opposing Sides

Annual Mardi Gras LSBA Tax Section Meeting

February 22, 2019

Matthew Mantle,
Partner,
Jones Walker

Antonio C. Ferachi,
Director of Litigation, Louisiana
Department of Revenue

1

The legal profession is a learned calling. As such, lawyers should act with honesty and integrity and be mindful of our responsibility to the judicial system, the public, our colleagues, and the rule of law. We as lawyers, should always aspire to the highest ideals of our profession.

- Preamble to the Code of Professionalism

2

2

I. Louisiana's code of professionalism

3

Louisiana's Amended code of professionalism : What's new?

- The new changes that have been made include: a new preamble, inclusive thinking, cooperation, public image of the legal profession, improvement of the system of justice, social media concerns, Pro Bono and Public Service, mentorship, and continuing skill development and adaptation.
- All new language is underlined and any revised or updated pledges are in *italics*

4

4

Louisiana's code of professionalism : Preamble to the Code of Professionalism

- The legal profession is a learned calling. As such, lawyers should act with honesty and integrity and be mindful of our responsibility to the judicial system, the public, our colleagues, and the rule of law. We as lawyers, should always aspire to the highest ideals of our profession.

5

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Louisiana's code of professionalism

- My word is my bond.
- Ex: Opposing counsel asks for a continuance and/or an extension of time regarding a matter. You must honor your commitment.

6

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Louisiana's code of professionalism

- I will conduct myself with honesty, dignity, civility, courtesy, and fairness and will not engage in any demeaning or derogatory actions or commentary toward others.
- Ex: Attended a recent CLE given by a judge and he referenced a recent example where an attorney in one of the briefs submitted to the court call opposing counsel "one of the most unethical attorneys in the profession." Before the case came for oral argument, the case was settled, but the judge said he planned to ask the attorney about it at oral argument and contemplated sanctions against the attorney.

7

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Louisiana's code of professionalism

- *I will not knowingly make statements of fact or the law that are untrue or misleading and I will clearly identify for other counsel changes I have made in documents submitted to me.*
- Ex: settlement agreements and other documents working on with opposing counsel need to have a redline version attached. Attorneys send docs with changes and nothing to denote the changes.
- Ex: Opposing counsel representing facts not accurate at oral argument.

8

8

Louisiana's code of professionalism

- *I will be punctual in my communication with clients, other counsel and the court. I will honor scheduled appearances and will cooperate with other counsel in all respects.*
- Ex: I try to keep a 24 hour rule to respond to any of these groups. Not perfect, but close.

9

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Louisiana's code of professionalism

- I will allow counsel fair opportunity to respond and will grant reasonable request for extensions of time.
- Ex: Generally, everyone gets first extension granted and others should be allowed for good cause. More exchange of info serves both sides in narrowing issues and getting matters to resolution.

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Louisiana's code of professionalism

- I will not abuse or misuse the law, its procedures or the participants in the judicial process.
- Ex: Discovery- How much is too much and how much is enough to do due diligence? Fine line.

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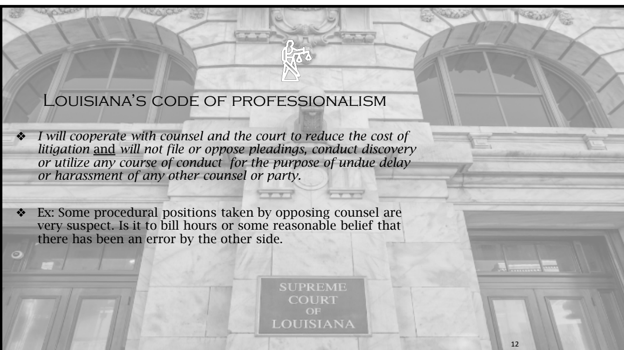

Louisiana's code of professionalism

- *I will cooperate with counsel and the court to reduce the cost of litigation* and *will not file or oppose pleadings, conduct discovery or utilize any course of conduct for the purpose of undue delay or harassment of any other counsel or party.*
- Ex: Some procedural positions taken by opposing counsel are very suspect. Is it to bill hours or some reasonable belief that there has been an error by the other side.

12

12

Louisiana's code of professionalism

- *I will not engage in personal attacks on other counsel or the court* or *use the threat of sanctions as a legal tactic.*
- Ex: have seen oppsoing counsel threaten sanctions against a new attorney to gain a strategic position. Such behavior is unacceptable.

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Louisiana's code of professionalism

- I will work to protect and improve the image of the legal profession in the eyes of the public.
- Ex: I think we all owe a duty to conduct ourselves in the most professional manner. We should ensure our comments about the court or attorney on the other side is respectful to not degrade the confidence of others in the court and practices of law.

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Louisiana's code of professionalism

- I will endeavor to improve our system of justice.
- Ex: Volunteer with programs and committees with your local state bar association. Give back.

15

15

Louisiana's code of professionalism

- I will use technology, including social media, responsibly. My words and actions, no matter how conveyed, should reflect the professionalism expected of me as a lawyer.

- Ex: The Arizona Supreme Court Judicial Advisory Committee states that Judges and Judcicial employees must exercise great caution when using social media in order to ensure that they maintain an appearance of impartiality on those websites. Examples include that judges and judicial employees should avoid being friends with those who appear frequently before their court, and not "like" any potential candidiate or candidtate for a public office.

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Louisiana's code of professionalism

- I will use technology, including social media, responsibly. My words and actions, no matter how conveyed, should reflect the professionalism expected of me as a lawyer.

- Ex: The California State Bar Standing Committee on Professional Responsibility and Conduct states an attorney's blog constitutes a communication under the Rules of Professional Conduct when:
  - expresses the attorney's availability either directly or implicitly for professional employment;
  - is integrated into an attorney's or law firm's website (to the extent the website is considered a communication); and
  - is on a stand-alone site discussing legal topics and expresses the attorney's availability for employment.

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Louisiana's code of professionalism

- I will use technology, including social media, responsibly. My words and actions, no matter how conveyed, should reflect the professionalism expected of me as a lawyer.

- Ex: The California State Bar Standing Committee on Professional Responsibility and Conduct states an attorney's blog post is not considered communication when the blog:
  - discusses legal topics but is on a stand-alone website and does not express the attorney's availability for employment; and
  - Does not discuss legal topics and is on a stand-alone site but cannot contain extensive identifying information about the attorney or else that portion of the blog will be considered a communication

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Louisiana's code of professionalism

- I will use technology, including social media, responsibly. My words and actions, no matter how conveyed, should reflect the professionalism expected of me as a lawyer.
- Ex: The Massachussetts Judicial Branch states that judges can have Twitter accounts identifying them as a judge in Massachusetts, but should exercise extreme caution so that no reasonable viewer of the judge's tweets, retweets, likes, or who the judge follows on Twitter can believe that the judge is biased in favor of certain views and the judge's impartiality toward any proceeding before their court is protected.

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Louisiana's code of professionalism

- I will seek opportunities to be of service to the bench and bar and assist those who cannot afford legal help.
- Ex: Pro bono work and ask a lawyer programs.

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Louisiana's code of professionalism

- I will be supportive of new members in the profession.
- Ex: New members mentorship program created by LSBA.

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Louisiana's code of professionalism

- I will stay informed about changes in the law, communications, and technology which affect the practice of law.
- Ex: CLE

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II. Professionalism in the courts

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PROFESSIONALISM IN THE COURTS

- General Administrative Rules, Supreme Court of Louisiana Section 11. The Code of Professionalism in the Courts Current with Amendments through October 26, 1999

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PROFESSIONALISM IN THE COURTS

- Preamble: The following standards are designed to encourage us, the judges and lawyers, to meet our obligations to each other, to litigants and to the system of justice, and thereby achieve twin goals professionalism and civility, both of which are hallmarks of a learned profession dedicated to public service

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PROFESSIONALISM IN THE COURTS

- These standards shall not be used as a basis for litigation or sanctions or penalties. Nothing in these standards alters or detracts from existing disciplinary codes or alters the existing standards of conduct against which judicial or lawyer negligence may be determined.

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II. Lawyer's Duties to the courts

27

LAWYER'S DUTIES TO THE COURTS

- We will speak and write civilly and respectfully in all communications with the court.
- We will be punctual and prepared for all court appearances so that all hearings, conferences, and trials may commence on time; if delayed, we will notify the court and counsel, if possible

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LAWYER'S DUTIES TO THE COURTS

- We will be considerate of time constraints and pressures on the court and court staff inherent in their efforts to administer justice.
- We will not knowingly misrepresent, mischaracterize, misquote, or miscite facts or authorities in any oral or written communication to the court

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LAWYER'S DUTIES TO THE COURTS

- We will not engage in any conduct that brings disorder or disruption to the courtroom. We will advise our clients and witnesses appearing in court of the proper conduct expected and required there and, to the best of our ability, prevent our clients and witnesses from creating order and disruption.

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LAWYER'S DUTIES TO THE COURTS

- We will not engage in ex parte communication on any pending action.
- We will attempt to verify the availability of necessary participants and witnesses before dates for hearings or trials are set, or if that is not feasible, immediately after such date has been set, so we can promptly notify the court of any likely problems.

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LAWYER'S DUTIES TO THE COURTS

- We will act and speak civilly to court marshals, clerks, court reporters, secretaries, and law clerks, with an awareness that they too, are an integral part of the judicial system.

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What We Don't Talk About When We Talk About Estate Planning

Summary: The recent changes in tax laws have provided a nearly a decade of estate planning opportunities for many of our clients. Seismic demographic shifts in the population, rapidly evolving family and social norms, and even the recent tax laws have presented significant challenges to the estate planning community and our clients. Whether our clients are broke or billionaires, estate taxes are rarely the biggest threat to an estate plan. This program will focus on several case studies, with issues ranging from premarital agreements to broken estate plans to addiction and mental health issues, looking to estate planning and modern trust law for ways to respond to our client's toughest problems.

Annual Mardi Gras LSBA Tax Section Meeting

February 22, 2019
New Orleans, Louisiana

Materials Prepared and Presented by:

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Annual Mardi Gras LSBA Tax Section Meeting
February 22, 2019
New Orleans, Louisiana

What We Don't Talk About
When We Talk About Estate Planning

William I. Sanderson
McGuireWoods LLP[1]

THE FUTURE OF ESTATE PLANNING

Summary of Provisions of the 2017 Tax Act Impacting Estate, Gift, and Generation-Skipping Transfer Taxes

On December 22, 2017, President Donald J. Trump signed into law the tax reform bill, "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018" (H.R. 1). The text of the Act extends nearly 500 pages and has an important, if short-term, impact on estate, gift, and generation-skipping transfer taxes.

Doubling of the Estate and Gift Tax Basic Exclusion Amount and GST Tax Exemption Amount. The Act temporarily doubles the basic exclusion amount for purposes of the estate and gift taxes and the exemption amount for purposes of the generation-skipping transfer ("GST") tax (the "GST exemption"). Under current law, the basic exclusion amount was scheduled to increase to $5.6 million on January 1, 2018. For decedents dying and gifts made after December 31, 2017 and before January 1, 2026 (the "Covered Years"), the basic exclusion amount now equals $10 million, adjusted for inflation annually for each taxable year after 2011. Because the GST exemption amount equals the basic exclusion amount, a corresponding increase in the GST exemption amount will also apply to generation-skipping transfers made during the Covered Years. On January 1, 2019, the basic exclusion amount and GST exemption amount increased to $11.4 million per individual (or $22.8 million for married couples). See Revenue Procedure 2018-57 (November 15, 2018). As noted below, regulations have been issued to ensure that any exemption used prior to the sunsetting of the increased exemption is not clawed back if a donor who has used all of his or her exemption during life prior to the sunsetting dies after the sunsetting of the increased exemption.

[1] Portions of this outline are based on materials prepared by the Tax and Employee Benefits Department of McGuireWoods LLP.

Basic Exclusion Amount and GST Exemption Amount as Adjusted for Inflation			
2017 Amounts for Individuals		**2019 Amounts for Individuals**	
Gift & Estate Tax Basic Exclusion Amount	$5.49M	Gift & Estate Tax Basic Exclusion Amount	$11.4M*
GST Exemption Amount	$5.49M	GST Exemption Amount	$11.4M*
* Revenue Procedure 2018-57			

The temporary increase in the basic exclusion amount expires on December 31, 2025. Congress has authorized the Treasury Department to issue guidance addressing the treatment of gifts made during the Covered Years by individuals dying after 2025.

Treasury Department issues proposed anti-clawback regulations. Proposed Regulations (REG-106706-18) were released on November 20, 2018, and published in the Federal Register on November 23, 2018 (83 Fed. Treas. Reg. 59343), to prevent the "clawback" of the benefits of the doubled federal gift tax exemption during 2018 through 2025 if the "sunset" of those benefits occurs in 2026 as currently scheduled and the donor dies in 2026 or later. Although neither the statute nor the proposed regulations use the word "clawback," the regulations would carry out the mandate of the 2017 Tax Act in new Section 2001(g)(2), which provides that Treasury "shall prescribe such regulations as may be necessary or appropriate to carry out this Section with respect to any difference between (A) the basic exclusion amount under Section 2010(c)(3) applicable at the time of the decedent's death, and (B) the basic exclusion amount under such Section applicable with respect to any gifts made by the decedent."

The proposed regulations would add a new paragraph (c) to Treas. Reg. § 20.2010-1 (with the current paragraphs (c) through (e) redesignated as (d) through (f)), providing that if the total of the unified credits attributable to the basic exclusion amount that are taken into account in computing the gift tax payable on any post-1976 gift is greater than the unified credit attributable to the basic exclusion amount that is allowable in computing the estate tax on the donor's estate, then the amount of the credit attributable to the basic exclusion amount that is allowable in computing that estate tax is not determined under Section 2010(c) but is deemed to be that greater total of gift tax unified credits attributable to the basic exclusion amount.

Example. Proposed Treas. Reg. § 20.2010-1(c)(2) provides the following Example:

"Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were 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 and the basic exclusion amount on A's date of death is $5 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 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 the decedent's date of death, under paragraph (c)(1) of this Section, 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 the post-1976 gifts made by A."

Viewed another way, if what would otherwise be the basic exclusion amount for estate tax purposes is less than the total of the basic exclusion amount applied to post-1976 taxable gifts, it is increased for estate tax purposes under this new regulation to equal that total. And if, in the example, the gift had been $12 million instead of $9 million, then the entire assumed $10 million basic exclusion amount would be used with still some gift tax payable (the donor having never married), and the estate tax credit would be computed as if the basic exclusion amount were $10 million.

Under Proposed Treas. Reg. § 20.2010-1(f)(2), the anti-clawback rule would take effect when it is adopted as a final regulation.

Contemporaneously with the release of the proposed regulations, the IRS issued a news release with the reassuring headline of "Treasury, IRS: Making large gifts now won't harm estates after 2025." The press release includes an even simpler explanation that "the proposed regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the BEA [basic exclusion amount] applicable to gifts made during life or the BEA applicable on the date of death."

In their practical effect, the proposed regulations do what the statute asks – nothing more, nothing less. The statute compares a transfer at death after 2025 (subparagraph (A)) with a transfer by gift before 2026 (subparagraph (B)). And this is what the proposed regulation would address. For example, the proposed regulation would not address the similar scenario of gifts both before 2026 and after 2025. If large amounts of the increased credit attributable to the new doubled basic exclusion amount are used to shelter gifts from gift tax before 2026 (like the $9 million gift in the Example), then after 2025 the donor might have to wait for decades for the indexed $5 amount to catch up so there can be more credit available for gift tax purposes.

Likewise, the text of the regulation and the Example (and the description above in this Alert) are painstakingly limited in all cases to the amount of the credit that is attributable to the basic exclusion amount – that is, the amount (indexed since 2012) defined in Section 2010(c)(3). Regarding portability, for example, that approach makes it clear that the deceased spousal unused exclusion amount (DSUE amount) defined in Section 2010(c)(4) is not affected by this special rule and is still added under Section 2010(c)(2)(B), in effect thereby generating an additional credit of its own in cases in which the anti-clawback rule applies. But it still may be that the words "lesser of" in Section 2010(c)(4) will limit the DSUE amount available to the estate of a person who dies after 2025 (assuming no change in the law) to the sunsetted basic exclusion amount of $5,000,000 indexed for inflation in effect at the time of the death of the surviving spouse referred to in Section 2010(c)(4)(A), despite the assertion in Treas. Reg. § 20.2010-2(c)(1) that "the DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts – (i) The basic exclusion amount in effect in the year of the death of the decedent" (presumably the predeceased decedent), and despite the statement in the preamble to the June 2012 temporary regulations that "[t]he temporary regulations in Treas. Reg. § 20.2010-2T(c)(1)(i) confirm that the term 'basic exclusion amount' referred to in Section 2010(c)(4)(A) means the basic exclusion amount in effect in the year of the death of the decedent whose DSUE amount is being computed." That limitation gives

effect to the general notion held by congressional drafters that portability should, in effect, be allowed to no more than double what would otherwise be the survivor's exemption.

But if the proposed regulations follow the statute very closely as to their practical effect, it is harder to say that they follow the context of the statute as to their approach and form. Before the proposed regulations were released, there was speculation that the regulations under Section 2001(g)(2) would mirror Section 2001(g)(1) with which their statutory authority is linked and provide, in effect, that in calculating the estate tax the basic exclusion amount in effect at the time of death will be used to calculate the hypothetical "total gift tax paid or payable" on pre-2026 adjusted taxable gifts that is deducted under Section 2001(b)(2) on line 7 of Part 2 of the estate tax return. And by increasing the amount on line 7, which is subtracted in line 8, the estate tax would be appropriately reduced to offset the clawback effect.

But the proposed regulations take a different approach. The preamble implies that other approaches were considered, but concludes that "in the view of the Treasury Department and the IRS, the most administrable solution would be to adjust the amount of the credit in Step 4 of the estate tax determination required to be applied against the net tentative estate tax." In the context of the new regulation, "Step 4" in the preamble apparently most closely corresponds to line 9a of Part 2 of the estate tax return ("basic exclusion amount"); Step 2 corresponds to line 7.

By increasing the amount on line 9a, rather than the amount on line 7, the proposed regulations would achieve the same result, of course, because both line 7 and lines 9a through 9e produce subtractions in the estate tax calculation. But line 7 already requires three pages of instructions, including a 24-line worksheet, to complete, and an incremental increase of complexity in what already has a reputation for being a tangled morass might be easier to process than adding a new challenge to line 9, which now requires less than one-third of a page of instructions. But, needless to say, IRS personnel see more returns than we do, they see the mistakes, and they hear the complaints. Presumably – hopefully – they contributed to forming the assessment that the line 9 approach is "the most administrable solution."

That approach should work fine if the law is not changed and sunset occurs January 1, 2026. But, although the example in Proposed Treas. Reg. § 20.2010-1(c)(2) mentions that the donor "dies after 2025," the substantive rule in Proposed Treas. Reg. § 20.2010-1(c) applies by its terms whenever "changes in the basic exclusion amount … occur between the date of a donor's gift and the date of the donor's death." It is not limited to 2026 or to any other particular time period. The 2010 statutory rule in Section 2001(g)(1) and the 2017 statutory rule in Section 2001(g)(2) are not limited to any time period either. Therefore, if Congress makes other changes in the law, particularly increases in rates or decreases in exemptions, and doesn't focus on the potential clawback issue in the context of those changes, the generic anti-clawback regime of Section 2001(g)(1) and (2) and these regulations could produce a jigsaw puzzle of adjustments going different directions that may strain the notion of administrability cited in the preamble.

The Example in Proposed Treas. Reg. § 20.2010-1(c)(2) is generally helpful, mainly because it is simpler and more readable than the rule in Proposed Treas. Reg. § 20.2010-1(c)(1) itself. But,

perhaps to help achieve that simplification, the drafters of the example used unindexed basic exclusion amounts of $10 million before 2026 and $5 million after 2025, thereby rendering it an example that could never occur under current law, and possibly causing concern that the proposed anti-clawback rule would apply only to the unindexed basic exclusion amount. Because the inflation adjustment is an integral part of the definition of "basic exclusion amount" in Section 2010(c)(3), there should be no question that it is the indexed amount that is contemplated and addressed by the regulation, despite the potential implication of the example.

In any event, the final regulations could benefit from more examples than just one, showing how the outcome would adapt to changes in the assumptions, including examples with indexed numbers, examples with numbers below $5 million (indexed) and above $10 million (indexed), examples with portability elections, and examples with allocations of GST exemption.

There had also been speculation that the regulations might address the option of making, for example, a $5 million gift during the 2018-2025 period (assuming no previous taxable gifts) and treating that gift as using only the temporary "bonus" exclusion resulting from the 2017 Tax Act, which is sometimes described as using the exclusion "off the top," still leaving the exclusion of $5 million (indexed) to generate a credit to be used against the estate tax after 2025. But that type of relief would go beyond the objective of preserving the benefits of a 2018-2025 use of the increase in the basic exclusion amount and would, in effect, extend the availability of those benefits beyond 2025. Although the preamble to the proposed regulations does not refer directly to that issue, it appears that it would require a different regulatory analysis to achieve that result.

The Notice of Proposed Rulemaking asked for comments from the public by February 21, 2019, and announces a public hearing to be held, if requested, on March 13, 2019.

Planning for Clients after the Tax Act

Although the increase in the basic exclusion amount and GST exemption amount will not expire until the end of 2025, individuals with significant wealth should consider making use of the increased amounts in 2018. The increased amounts provide the opportunity to leverage gifts for future generations. Estate-planning techniques that benefit most from the increases include:

- Making gifts to existing or new irrevocable trusts, including generation-skipping trusts where appropriate,
- Leveraging gifts to support the funding of life insurance or existing sales to trusts, and
- Pairing gifts with philanthropy.

The exemption will continue to be indexed for inflation, but will be indexed using the "Chained Consumer Price Index." The Chained CPI is short hand for "Chained Consumer Price Index for All Urban Consumers" and increases more slowly than the "Consumer Price Index for All Urban Consumers" or "CPI-U." Basically, the Chained CPI takes account of substitutions consumers would make in response to rising prices of certain items. For example, if the cost of a certain form of transportation went up, individuals might switch to another kind of transportation. This "substitution" is factored into the Chained CPI. Thus, inflation adjustments of the exemptions from estate, gift, and GST taxes should be smaller in the future than they would have been under prior law.

While the doubling of the basic exclusion amount to $10 million (now $11.18 million, indexed for inflation) will allow most individuals to escape federal estate taxes, estate planning will still be necessary to permit an individual to pass assets to his or her beneficiaries in the form that he or she would like. This could include outright gifts or gifts in trust. One has only to look at the contest over the estate of Prince, who died in 2016 with no will, to see the value of estate planning. Prince's heirs came out of the woodwork to fight over his estate.

The Internal Revenue Service provides the following information on the number of estate tax returns filed in 2016, the latest year for which information is available.

Of all 12,411 estate tax returns filed in 2016, 8,270 (2/3 of all returns filed) reported a gross estate LESS THAN $10 million. 4,142 returns were filed with a gross estate MORE THAN $10 million. Under the 2017 Tax Act, only about 1 out of every 3 returns filed last year would be required to file in coming years. 12% of all returns were for estates over $20 million. The table looks like this:

All Returns Reporting < $10 million	8,270
% of All Returns Filed	67%
All Returns Reporting Gross Estate > $10 million	4,142
% of All Returns Filed	33%
All Returns Reporting Gross Estate > $20 million	1,507
% of All Returns Filed	12%

One relevant consideration regarding returns reporting assets of $20 million or more is whether the return is subject to tax. If one assumes that a married couple could take advantage of the basic exclusion amount up to $22.8 million, one might assume that some significant percentage of the taxable returns filed in 2016 reporting gross estates more than $20 million dollars reflects the number of taxpayers, going forward, that will PAY estate tax annually. This does not account for a married couple that makes significant lifetime gifts and it does not account for the number of taxpayers that use the charitable deduction, or for another reason, do not end up paying tax at the death of the survivor. But the number of returns that reported paying tax in 2016 with a gross estate of more than $20 million is 911, or 7% of all returns filed.

The estate plans of all clients should be reviewed to determine the possible impact of the changes in the estate, gift, and generation-skipping taxes on them.

Planning for Our Legal Practice after the Tax Act

The IRS tracks attorneys' fees as a deductible expense in a separate column. The total attorneys' fees claimed on all returns filed in 2016 with gross estates LESS THAN $10 million was approximately $213 million dollars ($25 million for estates less than $5 million; $188 million for estates between $5 to $10 million). No doubt some percentage of attorneys' fees will still be required for administration, but this could be a significant impact on the estate tax return preparation industry.

Planning for Individuals Not Subject to Estate Tax and for Whom Planning is Unnecessary to Avoid Estate Tax

An estate plan is a plan for transporting one's wealth. Like any transportation plan, it designates a destination—the persons who will receive the property. It also can provide instructions on how the property may be used. In transportation, minimizing breakage is a goal. Likewise, in an estate plan, minimizing loss of property, to taxes or to waste, is an important goal in establishing a plan to pass property as the client wishes.

In order to accomplish these goals, an individual will need to formulate his or her specific objectives and desires about the disposition of his or her property, the use of trusts, and the appointment of fiduciaries. The estate planning professional must assist the individual in this process by explaining the available alternatives, and the impact of tax planning and creditor protection considerations.

Wills, revocable trusts, powers of attorney, and medical directives will still be needed for individuals not subject to estate tax.

PLANNING FOR FAMILY MEMBERS THAT CANNOT HELP THEMSELVES

Parsons v. Parsons, 2014 Va. App. LEXIS 402 (Dec. 9, 2014). Mingling of Inheritance Converted Assets into Marital Property.

Husband and wife were successful real estate investors who owned twenty-three properties at the time of their divorce. Husband had inherited several of these properties from his mother. The inherited properties were transferred from his mother's estate to Husband and Wife as tenants by the entirety. The properties were then transferred by Husband and Wife to a trust through which they managed their investment properties.

Husband and Wife leveraged the inherited properties, along with the other properties in the trust, to obtain financing for additional properties.

During the divorce proceedings, Husband argued that he intended to maintain the inherited properties as his separate property. He claimed to have asked for the transfer of the inherited properties to himself and his wife as tenants by the entirety to protect the inherited properties from judgment creditors of the husband.

An attorney who provided assistance to the husband later testified (1) that the husband did have judgment creditors from a prior business when he inherited the properties from his mother and (2) that the conveyance to husband and wife as tenants by the entirety was to protect the properties from these prior creditors. The attorney also testified that the properties were subsequently transferred to the trust for estate planning purposes.

The wife had testified that the husband had considered the inherited properties to be gifts to both of them. The wife had complete and unlimited access to the rental income produced by the inherited properties. The husband had commingled the rental income with income from other marital properties.

The trial court classified the inherited properties as marital property because the court found that the husband intended to give his wife an interest in them when he directed his mother's executor to convey the properties to the husband and wife as tenants by the entirety. The court concluded that the husband made no distinction between the properties he inherited from his mother and other marital properties acquired during the marriage. The husband appealed.

The Court of Appeals affirmed the circuit court's classification of the inherited properties as marital property. The court concluded that the conveyance of the properties to husband and wife as tenants by the entirety (at the request of the husband), together with the wife's testimony about her husband's intent and the wife's access to the rental income generated by the inherited properties, was sufficient to establish the husband's donative intent. As a result, the inherited properties were converted into marital property.

Georgia House Bill 441 (2018). Georgia Governor vetoes domestic asset protection trust legislation

In late March 2018, the Georgia House of Representatives (by a vote of 103-56) and the Georgia Senate (by a vote of 43-6) passed HB 441, which would have made Georgia the 18th state to permit self-settled domestic asset protection trusts or DAPTs. Currently, 17 states — Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming — have enacted DAPT-enabling legislation. Georgia, however, did not join their ranks, because on May 8, Gov. Nathan Deal vetoed HB 441.

Under current Georgia law, spendthrift provisions in a trust that shield the trust's assets from certain creditors are enforceable if the trust is settled by someone other than the trust's beneficiaries. HB 441 would have gone further, as the other DAPT states have done, by providing creditor protections to an irrevocable trust even if the settlor is also a beneficiary of the trust.

Deal indicated in his veto statement that he was open to further negotiations on this issue. However, the version of the bill Georgia's governor rejected already contained remarkably large gaps in the creditor protection that HB 441 supposedly would have provided. Tort, child support, and spousal claims, for instance, were completely exempted. Secured creditors also enjoyed an exemption for assets specifically pledged by a debtor. That left credit card and medical claims as perhaps the only types of debt that HB 441 would have allowed a settlor to avoid.

It is also worth noting that, with this veto, Deal has strengthened Georgia's standing as one of the most creditor-friendly states in the country. Further, in 2015, Georgia enacted the Uniform Voidable Transfer Act (UVTA). Under the UVTA, creditors may avoid certain transfers made by an insolvent debtor by using the less-onerous preponderance-of-the-evidence standard, as opposed to the clear-and-convincing standard used in many jurisdictions. The UVTA also makes it more difficult for debtors, and the trusts they settle, to start the statute-of-limitations clock for allegedly voidable transfers.

Deal's veto of HB 441 appears to continue Georgia's generally creditor friendly legal tradition.

<u>Toni 1 Trust v. Wacker</u>, 2018 WL 1125033 (Alaska, Mar. 2, 2018). Alaska Supreme Court determines that Alaska state courts do not have exclusive jurisdiction over fraudulent transfer actions under AS 34.40.110(k)

Donald Tangwall sued William and Barbara Wacker in Montana state court in 2007. The Wackers counterclaimed against Tangwall, his wife, Barbara Tangwall, his mother-in-law, Margaret "Toni" Bertran, and several trusts and businesses owned or run by the Tangwall family. As a result, several default judgments were entered against Donald Tangwall and his family.

In 2010, before the issuance of the last of the default judgments, Toni Bertran and Barbara Tangwall transferred parcels of real property to an Alaskan trust called the "Toni 1 Trust" which was an Alaska self-settled domestic asset protection trust." The Wackers filed a fraudulent transfer action under Montana law in Montanan state court alleging that the transfers were fraudulent and default judgments were entered against Barbara Tangwall, the Toni 1 Trust, and Toni Bertran.

After the issuance of the fraudulent transfer judgments by the Montana court, the Wackers purchased Barbara Tangwall's one half interest in one of the parcels at a sheriff's sale in partial satisfaction of their judgment against Donald Tangwall and the family. Before the Wackers could purchase the remaining half interest, Toni Bertran filed for Chapter 7 bankruptcy in Alaska. As a result, her interest in the property in the Toni 1 Trust was subject to the jurisdiction of the federal bankruptcy court.

In December 2012, Donald Tangwall, as trustee of the Toni 1 Trust, filed a complaint in the bankruptcy court alleging that the service on the trust in the Montana fraudulent transfer action was defective, which rendered the judgment against the trust void. However, rather than litigate the issue of service in Montana, the bankruptcy trustee brought a fraudulent transfer claim against Tangwall under the federal bankruptcy fraudulent transfer statute. The bankruptcy court entered a default judgment against Tangwall, which judgment was sustained upon appeal.

Tangwall then sought relief in Alaska state court in which he argued that AS 34.40.110 granted Alaska courts exclusive jurisdiction over any fraudulent transfer actions against the trust. On this basis, Tangwall sought a declaratory judgment stating that all judgments against the trust from other jurisdictions were void and that no future actions could be maintained against the trust because the statute of limitations had run.

The Alaska Superior Court dismissed this complaint and Tangwall appealed. The Alaska Supreme Court found that AS 34.40.110(k) could not limit the scope of the jurisdiction of other states. Citing Tennessee Coal, Iron and Railroad Company v. George, 233 U.S. 354 (1914), the Court held that states are not constitutionally compelled to acquiesce to sister states' attempts to circumscribe their jurisdictions over actions. It stated that Tennessee Coal held that the Full Faith and Credit Clause of the United States Constitution does not compel states to follow another state's statutes claiming exclusive jurisdiction over suits based on a cause of action "even though the other state created the right of action." The Court did acknowledge that the Alaska legislature attempted to grant Alaska courts exclusive jurisdiction over claims against an Alaska self-settled domestic asset protection trust. It also acknowledged that several other states had similar statutes and that similar statutes do restrict their jurisdiction. However, the court found that under Tennessee Co, the assertion of exclusive jurisdiction did not render a fraudulent transfer judgment against an Alaskan trust from a Montana court void for lack of subject matter jurisdiction.

In addition, the court found that it could not grant Tangwall relief under federal judgment. It noted that Tennessee Coal only addressed the state's ability to restrict the jurisdiction of sister states. However, Marshall v. Marshall, 547 U.S. 293 (2006), concluded that state efforts to limit federal jurisdiction were invalid even though the state created the right of action that gave rise to the suit. It noted that AK 34.40-110(k) purported to grant Alaska courts exclusive jurisdiction over all fraudulent transfer claims against Alaska self-settled domestic asset protection trusts. Because 28 U.S.C. § 1334(a) gives federal courts' jurisdiction over some of these claims, the Alaska law conflicted with federal law to the extent that it was impossible to comply simultaneously with both. Consequently, under the Supremacy Clause of the Constitution, state courts are precluded from limiting federal jurisdiction. Therefore, relief could not be granted to Tangwall from the federal judgment.

<u>In re Olson</u>, ___ F. Supp. 3d ___ (C.D. Cal. 2018). U.S. District Court declines to approve settlement of bankruptcy trustee with respect to offshore trust

In 2010, Jana W. Olson was sued in California Superior Court by Passport Management LLC. Within a month of the service of the lawsuit, Olson transferred her beneficial interest in a self-settled Cook Islands offshore asset protection trust from herself to her two minor children for no consideration. This transfer had the appearance of a fraudulent transfer. Subsequently, Olson filed a petition for bankruptcy. Passport Management LLC became the primary creditor of the bankruptcy estate.

At some point, Olson agreed to repatriate the money in the self-settled Cook Islands trust and a stipulated order was entered by the bankruptcy court directing Olson to do so. The bankruptcy court's order specifically required repatriation but did not decide if the money was the property of the bankruptcy estate.

Olson then, according to the district court, proceeded to disobey the bankruptcy court's order by sabotaging the repatriation effort with a letter designed to convince the Cook Islands trustee that her request to repatriate the money was made under duress. As a result, apparently, the Cook Islands trustee refused to repatriate the money. The bankruptcy court then jailed Olson for more than a year for civil contempt. Eventually, the bankruptcy trustee decided that jail was not going to convince Olson to repatriate the funds in the trust from the Cook Islands. The bankruptcy trustee then negotiated an agreement with Olson and Olson's father and Olson's brother, as trustee of a new California trust with the two minor children as beneficiaries, under which the money would be returned to California with approximately 80 percent going to the bankruptcy estate and 20 percent to the California trust.

After the repatriation of the funds to California, the bankruptcy trustee moved for approval of the compromise agreement before the bankruptcy court. Passport Management opposed the motion claiming that there was no authority to disburse property of the bankruptcy estate in contravention of the priority rules and that, in any event, there was no reason to allow Olson effectively to be rewarded for her contempt. Passport Management LLC also argued that other pressure could have been brought to bear before a compromise was struck that allowed Olson or her family to retain part of the funds.

The bankruptcy trustee argued that the agreement was the only way to get property back into the reach of the United States court and that 80 percent was better than getting nothing at all. The trustee also believed that the fraudulent transfer claim could have been easily won, but that subsequent collection would have been virtually impossible because of the difficulty of seeking collection in the Cook Islands. As a result, the bankruptcy court granted the motion to approve the compromise, but declined to determine whether the trust funds held in the Cook Islands were always the property of the bankruptcy estate.

The district court rejected the compromise. First, the court said that without a judgment avoiding the transfers, the Cook Islands funds were not a part of the bankruptcy estate at the time of the petition. The transfers would have to be formally avoided through a fraudulent transfer claim to make the funds part of the bankruptcy estate. In addition, the bankruptcy court had no equitable duty to approve the compromise after Olson and her family arranged for the repatriation money in

reliance on the settlement. This effectively minimized the independent role of the bankruptcy court in the process. The court also agreed with Passport Management that a benefit to Olson's minor children was an indirect benefit to Olson herself as the money set aside in trust was money that Olson did not have to pay for her children's welfare. The court then rejected the argument of the bankruptcy trustee that the minor children might be individually liable for their mother's debt as beneficiaries of the trust. The court noted that the normal rule is that beneficiaries are not liable for the wrongful acts of the trust. As a result, the district court rejected the settlement agreement.

Benefits of Placing Property in Trust

Individuals often believe that they need nothing more than a simple will if their estates are below the applicable exclusion amount and they do not anticipate that federal estate tax will be due at either their death or the death of their spouse. A will that leaves all the assets to the spouse and, upon the spouse's death, divides the assets equally among the children is considered sufficient to protect the family adequately. A closer look points out the risks inherent in such a plan.

If an individual leaves even modest amounts of money to a spouse who has never had any experience with financial management and investment decisions, he or she may be placing an unfair burden upon the spouse. This type of burden translates into anxiety instead of security.

- The surviving spouse may remarry, and all or a portion of the assets originally intended to go to children may end up in the hands of the new spouse, or children of the second marriage.

- Even if the surviving spouse does not remarry, he or she may be put in the position of saying "no" to a child who wishes to use the inherited wealth for a risky new business venture or some speculative investment. Depending upon the relative strengths of the child and surviving spouse, imprudent decisions may be made which could rapidly dissipate the property left for the family.

- A surviving spouse who has been insulated from financial matters may, upon receiving an inheritance, may fall prey to unscrupulous people who do not act in the spouse's best interests. Alternatively, the surviving spouse could become overwhelmed by the immediate feeling of wealth and independence and live in a manner that could quickly exhaust the remaining estate.

By using trusts to transfer property, either during life or at death, the donor is able to maintain an element of control over the property. The donor can designate under what circumstances and for what purposes a beneficiary will receive that property or its income. Trusts also permit the donor to determine who will manage the property as trustee. Other advantages of trusts include the following:

- Retention of property in trust preserves the benefits of the investment and management skills of the trustee.

- A trust can protect assets from the claims of third-party creditors of the beneficiary, such as the plaintiff in a lawsuit or a spouse in a failed marriage. Generally, a

creditor or litigant cannot gain access to assets set aside in a properly drafted trust by someone other than the beneficiary. The same is generally true with respect to a divorcing spouse, although state law varies on the degree to which courts can consider the existence of trust assets in determining the division of assets upon divorce.

- Children who have not fully matured may rapidly dissipate an outright inheritance, whereas a trust can provide for incremental distribution of inheritances.

- Large outright distributions may spoil children and destroy their incentive to provide for self-support.

On the other hand, an overly restrictive trust may prevent an entrepreneurial child from reaching the property and exploiting a business opportunity. A well-drafted trust can be flexible enough to allow a capable beneficiary to take advantage of such opportunities.

Placing property in trust may grandfather trust assets from future estate tax changes such as a return to the pre-2018 rules in 2026 as provided in the Act.

Advising on Creditor Protection

Outright Gifts of Property. Outright gifts are a simple way for a client to protect his or her assets from the claims of future creditors. Assets that the client gives away are no longer subject to seizure by the client's creditors. However, if the client is insolvent, or would become insolvent by making the gift, there may be consequences under the Fraudulent Conveyance statutes.

- Trusts. Trusts may be the most important regularly used and accepted asset protection tool available. For transfer of property by gift, a trust can be used to alleviate the client's concerns about the beneficiary's imprudent use of the property.

- Co-Ownership. Different forms of co-ownership, such as tenancy by the entirety, joint tenancy with right of survivorship, and tenancy in common, may provide some protection against creditors.

- Trusts for Disabled Beneficiaries. The most likely potential creditor of a disabled beneficiary is the federal, state, or local agency that provides public assistance to that beneficiary. Over the past 10 to 15 years, public agencies have become more aggressive in seeking reimbursement for the cost of caring for disabled persons. Many states have passed laws that permit agencies to seek reimbursement and that define the assets which are available to the government agency. These statutes must be considered carefully when drafting a trust that is designed to provide supplemental benefits to a disabled person in order to improve the quality of the person's life without having the entire trust subject to confiscation by a government agency.

- State case law is not consistent in defining the standard of distribution that will cause trust assets to be chargeable for a disabled beneficiary's care. In many states, a trust that allows the trustee to make distributions for the "support and maintenance" of a beneficiary will be

treated as an asset of the beneficiary for the purpose of determining eligibility for public aid. However, in other cases, a state has been unable to obtain reimbursement for public aid where the trust instrument allowed the trustee to use principal for the beneficiary's support and maintenance (especially in cases in which the trust instrument evidenced the testator's intent that trust assets merely supplement support from other sources). Many state legislatures are now attempting to provide statutory guidelines for when trust assets will be considered available to the beneficiary for the purpose of qualifying the beneficiary for public assistance or allowing the state to seek reimbursement from trust assets.

- Exempt Assets. Separate and apart from the protection of a tenancy by the entirety arrangement, most states have a homestead exemption that allows an individual to always retain a certain amount of equity in their residence. In many states, the exemption is limited; for example, in Illinois, it is $7,500. Florida and Texas, however, have homestead exemptions that allow residents to retain all the equity in their home and adjacent land, subject to certain size (but not value) limitations.
    - Florida allows a homestead exemption for properties of up to 160 acres outside a municipality, and up to one-half acre inside a municipality.
    - Texas has a rural homestead exemption for up to 200 acres for a family, 100 acres for a single person; and an urban homestead exemption for up to one acre.

Life Insurance. Many states exempt life insurance and annuity contract proceeds or cash value or both from the reach of creditors. In some states, like Illinois, the exemption is available only if the insurance is payable to a member of the immediate family or other dependent. Variable life insurance policies and variable annuity contracts can have a significant investment element. In fact, they frequently are sold as an alternative investment vehicle, with the insured/annuitant being able to invest in a number of mutual funds inside the policy or contract. Thus, an individual can use an investment-oriented insurance policy as an alternative to transferring property in trust.

Retirement Plans. Both ERISA and the laws of many states protect qualified retirement plans from creditors. Individual retirement accounts are not subject to the ERISA protections, but are protected under the laws of some states, like Texas. One simple asset protection step for a person in a high-risk profession is to take maximum advantage of opportunities to contribute to qualified retirement plans.

Limited Partnerships

The family-owned partnership has become a popular vehicle for managing and controlling family assets. A typical family partnership is a limited partnership with one or more general partners and limited partners. The family partnership provides a number of benefits, both tax and non-tax, including investment efficiencies, valuation discounts, transfers of value without relinquishing control, and restrictions on further transfer of limited partnership interests.

With respect to asset protection planning, a limited partner's personal exposure for the debts of the partnership is generally limited to his investment in the partnership. This prevents a creditor of

the partnership from reaching the personal assets of a limited partner to satisfy debts owed by the partnership.

A limited partnership also can provide a modest level of creditor protection against creditors of a partner who are seeking assets to satisfy a debt or judgment. Almost every state has enacted a version of the Revised Uniform Limited Partnership Act ("RULPA"). RULPA helps protect a limited partnership interest from the claims of creditors of the partner by mandating an unattractive remedy for a creditor seeking that partner's interest.

Usually, the sole remedy provided to creditors with respect to a debtor's interest in a limited partnership is the charging order. Section 703 of RULPA provides that a court may charge the partnership interest of the partner with payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. Under Section 702 of RULPA, the assignee judgment creditor is only entitled to receive those distributions to which the debtor partner would have been entitled, unless there is a contrary provision in the partnership agreement. The effect of the charging order is that a partner's creditor will only receive those partnership distributions which, absent the charging order, would have been distributed to the debtor partner.

Limited Liability Companies

The limited liability company ("LLC") is a viable alternative to the use of a limited partnership. The LLC first became available in Wyoming in 1977 and is now available in almost every state. The LLC has the limited liability of a corporation, but preserves the flow-through treatment of taxable income (or loss) of a partnership. The LLC can provide an attractive alternative to the use of a general or limited partnership, especially where there is a desire to limit the personal liability of the family members in relation to the activities of the entity.

With respect to asset protection issues, many state LLC statutes contain charging order sections similar to that found in the RULPA. Also, LLC statutes generally contain the following types of provisions which provide protection quite similar to the protection afforded by a limited partnership:

- A member's interest in an LLC is personal property and is not an interest in specific assets of the LLC;
- An assignee will not become a member of the LLC without the unanimous consent of the other members; and
- An assignee who is not a member is only entitled to receive the share of profits and income to which the assignor is entitled and has no right to participate in the management of the LLC.

Domestic Asset Protection Trusts

Certain states permit the settlor of an irrevocable trust to obtain spendthrift protection from an irrevocable trust if certain require are met.

While Missouri was the first state to enact Domestic Asset Protection Trust legislation in 1986, few attorneys outside of Missouri paid attention to it or were even aware of it. However Domestic Protection Trusts gained public awareness when, in 1997, both Alaska and Delaware enacted legislation permitting Domestic Protection Trusts.

As of January 1, 2018, the following 18 states allow such self-settled asset protection trusts: Alaska, Colorado, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, **Virginia**, West Virginia, and Wyoming.

The requirements of such a trust vary by state, but basic requirements in each of these Domestic Asset Protection States are the following:

- There must be a resident trustee in the state.
- Some of the assets of the trust must be held in the state.
- Some of the administration of the trust must take place in the state.
- The transfer of assets to the domestic asset protection trust cannot be a transfer in fraud of creditors.
- The trust must be irrevocable.
- The settlor is a discretionary beneficiary of the income and principal of the trust.

Offshore Protection Trusts

Offshore Protection Trusts have become one of the most talked about estate planning techniques for many years. They are heavily promoted as effective barriers against claims of creditors because the laws of most offshore trust havens make it difficult for creditors to obtain jurisdiction over, or levy against, a trust, even if the settlor retains an interest in the trust property. Unlike most states of the United States, a number of foreign jurisdictions, usually former British colonies or current British dependencies permit a settlor to create a spendthrift trust for his or her own benefit. These barriers often insulate the property entirely from creditors, or produce early and inexpensive settlements.

Creditor Protection Benefits:

- An Offshore Protection Trust can create geographic, legal, procedural, and financial hurdles to reaching its assets.
- The mere fact that a trust is a foreign trust may deter creditors from pursuing the trust. This is particularly likely if the trust is funded with assets from the foreign jurisdiction. The cost of pursuing a claim against a foreign trust can be high, especially since foreign jurisdictions may prohibit contingent fee litigation or require significant deposits to commence a proceeding.

- Some jurisdictions, such as the Cook Islands, do not recognize foreign judgments. Thus, an action first brought in a United States court may have to be tried all over in a foreign jurisdiction.

- As mentioned, many foreign jurisdictions have favorable spendthrift trust provisions which protect the interests of a settlor-beneficiary. Such provisions are in contrast to dominant rule in the United States that one may not create a spendthrift trust for one's own benefit.

Individuals may still want to establish long-term trusts that could last several generations to protect assets from creditors, to provide centralized management of assets, and also to protect the assets in the trust from the imposition of a future estate, gift, or generation-skipping transfer tax.

The ability to established long-term irrevocable trusts for several generations has been greatly aided by the enactments of laws in many states that have either eliminated or greatly extended the common law rule against perpetuities. In fact, without a gift tax, unlimited amounts could be placed in such a trust.

The common law Rule Against Perpetuities (the "Rule") provides that no interest is valid unless it vests or fails within a life in being plus twenty-one years. Currently, twenty states effectively have abolished the Rule. Nine states have repealed the Rule outright. A tenth (Delaware) has repealed the Rule with respect to interests in personal property. An additional nine states and the District of Columbia have preserved the Rule, but have granted trust settlors the authority to opt out of it by including specified provisions in their trust instruments. In 2000 Florida extended the perpetuities period to 360 years, and in 2001 Washington extended it to 150 years. In 2003, Utah extended its perpetuities period to 1,000 years. Also, in 2003, Wyoming adopted an opt-out provision for personal property and extended the perpetuities period to 1,000 years. In 2005, Nevada extended the perpetuities period to 365 years. In 2006, Colorado extended the perpetuities period to 1,000 years. In 2007, Tennessee extended the perpetuities period to 360 years.

PLANNING FOR BENEFICIARIES THAT CANNOT HELP WHO THEY LOVE

Lee Graham Shopping Ctr., LLC v. Estate of Kirsch, 777 F.3d 678 (4th Cir. Va. 2015). Federal court could interpret terms of a partnership agreement and trust, which fell outside of the probate exception to diversity jurisdiction. Further, terms of a limited partnership agreement prohibited the transfer of an interest to a non-family member.

The Lee Graham Shopping Center Limited Partnership was a closely held business owned by two families. In 2011, Diana Kirsch attempted to assign her interest in the partnership to her revocable trust. Under the terms of the trust, upon Kirsch's death the interest was to pass to an irrevocable trust for the benefit of her long-time companion, Wayne Cullen. Kirsch died in 2012, and Kirsch's trust purported to pass the interest to Cullen's trust.

In 2013, the partnership filed suit in federal court, seeking a declaratory judgment that the partnership agreement did not permit the transfer to Cullen's trust. The partnership agreement provided that transfers were subject to a right of first refusal by the partnership. A partner could assign his or her interests without this restriction to a "spouse, parent, descendant, or spouse of a descendant, or to a trust of which any of said persons are beneficiaries."

The court concluded that the case did not fall within the "probate exception" that would preclude federal diversity jurisdiction to hear the case. The court then granted summary judgment for the partnership, ruling that the partnership agreement prohibited the transfer to Cullen's trust. Cullen appealed.

The "probate exception" to federal jurisdiction is limited to two categories of cases: cases that require a court to probate or annul a will or to administer a decedent's estate, and cases that require the court to dispose of property in the custody of a state probate court.

The probate exception did not apply and the federal court had jurisdiction to hear the case, because the case did not fit into the two categories of this exception. Instead, the court was being asked to interpret a partnership agreement and the terms of a trust.

Sveen v. Melin _____ U.S. _____, 138 S.Ct. 939 (2018). Supreme Court holds that retroactive application of Minnesota statute providing that the dissolution or annulment of a marriage revokes any revocable beneficiary designation made by an individual to the individual's former spouse does not violate the Contracts Clause of the Constitution

In 2002, Minnesota enacted Minn. Stat. § 524-2-804, subd. 1, that provided that the "dissolution or annulment of a marriage revokes any revocable . . . beneficiary designation . . . made by an individual to the individual's former spouse." Under this statute, if one spouse has made the other the beneficiary of a life insurance policy or similar asset, their divorce automatically revokes that designation so that the insurance proceeds will instead go to the contingent beneficiary or the policyholder's estate upon his or her death. The law did this on the theory that the policyholder would want that result. However, if the policyholder did not want this result the policyholder could rename the ex-spouse as beneficiary.

Mark Sveen and Kaye Melin were married in 1997. In 1998, Sveen purchased a life insurance policy naming Melin as the primary beneficiary and designating his two children from a prior marriage, Ashley and Antone Sveen, as contingent beneficiaries. Sveen and Melin divorced in 2007, but the divorce decree made no mention of the insurance policy and Sveen took no action to revise his beneficiary designations. Sveen passed away in 2011. Melin and the Sveen children made competing claims to the insurance proceeds.

The Sveens argued that under Minnesota's revocation and divorce law, their father's divorce cancelled Melin's beneficiary designations, leaving them as the rightful beneficiaries. Melin claimed that because the law did not exist when the policy was purchased and she was named as the primary beneficiary, the application of the later-enacted law to the insurance policy violated the Contracts Clause of the Constitution. The District Court ordered the payment of the insurance money to the Sveens, while the Eighth Circuit Reversed, holding that the retroactive application of Minnesota's law violated the Contracts Clause.

The Supreme Court in an 8 to 1 decision with Justice Gorsuch dissenting, held that the retroactive application of the Minnesota statute did not violate the Contracts Clause. It noted that the Contracts Clause restricts the power of states to disrupt contractual arrangements but it does not prohibit all laws affecting preexisting contracts. There is a two-step test for determining when such a law crosses the Constitutional line. The test first asks whether the state law has "operated as a substantial impairment of a contractual relationship." In answering the first question, the court considers the following:

1. The extent to which the law undermines the contractual bargain;
2. The extent to which the law interferes with a party's reasonable expectations; and
3. The extent to which the law prevents the party from safeguarding or reinstating his or her rights.

If those factors show a substantial impairment, the inquiry then turns to the second test of whether the state law is drawn in an "appropriate" and "reasonable" way to "advance a significant and legitimate public purpose."

The court only looked at the first test. In its opinion, the three aspects of Minnesota's law, taken together, showed that the law did not substantially impair pre-existing contractual arrangements. First, the law is designed to reflect the policyholder's intent. Thus, it supports, rather than impairs, the contractual scheme. The law applied a prevalent legislative presumption that a divorcee would not want his or her former partner to benefit from his or her life insurance policy and other will substitutes. As a result, the law honors and does not undermine the intent of the only contracting party to care about who the beneficiaries are.

Second, the law is unlikely to disturb any policyholder's expectations at the time of contracting because an insured cannot reasonably rely on a beneficiary designation staying in place after a divorce. The court noted that divorce courts have wide discretion to divide property upon the dissolution of a marriage, including the revocation of spousal beneficiary designations and life insurance policies or mandating that such designations remain in place. A life insurance purchaser

cannot know what will happen to that policy in the event of a divorce and, as a result, the purchaser's reliance interest is "next to nil." That fact cuts against providing protection under the Contracts Clause.

Finally, the law supplied a mere default rule, which the policyholder could undo at any moment. If the law's presumption about the desire of insured after divorcing is wrong, the insured could change it by sending a change of beneficiary form to the insurer. The court noted that it had long held that laws imposing such minimal paperwork burdens do not violate the Contracts Clause. Filing a change of beneficiary form is easy. And if an insured wanted his or her ex-spouse to stay as the beneficiary but did not send in the form, the result is only that the insurance is redirected to the contingent beneficiaries, not that the insured's contractual rights are extinguished.

Griffin v. Griffin, 62 Va. App. 736, No. 1177-13-1, Jan. 28, 2014, Virginia Court of Appeals, *affirmed* Cowser-Griffin v. Griffin, 2015 Va. LEXIS 15 (2/26/15). In a case involving a decedent's defined contribution plan, the Virginia Court of Appeals held that the decedent's retirement account would pass to his two children from a prior marriage and not his surviving spouse. On February 26, 2015, the Virginia Supreme Court affirmed the lower court's ruling for the reasons stated in the lower court's opinion.

The decedent had divorced in 1998. The final divorce decree required the decedent and his ex-wife to name their children as beneficiaries for all retirement accounts. Neither party applied for a qualified domestic relations order.

In 2002, the decedent named his children as beneficiaries of his defined contribution plan. By 2008, the decedent had remarried and he named his new wife as beneficiary of the plan, with his children as contingent beneficiaries.

After the decedent's death in 2012, the mother of his children sent a draft QDRO to the plan administrator, who rejected the QDRO and opted to hold the plan funds while the mother and the decedent's surviving spouse went to court.

The circuit court reinstated the divorce case and held that, under federal case law, the plan vested in the decedent's surviving spouse because she was the designated beneficiary. The mother of the decedent's children appealed, and the Court of Appeals reversed the trial court.

The Court of Appeals held that the decedent breached the terms of the divorce decree when he named his new wife as beneficiary. The court ruled that the right of the children to the plan benefits had vested when the divorce decree was entered; according to the court, it did not matter that a QDRO had not been entered at that time. Instead, the circuit court should issue a QDRO in order to enforce the divorce decree, which would require distribution of the plan assets to the children.

The surviving spouse appealed the appellate court's decision to the Virginia Supreme Court. On February 26, 2015, the Virginia Supreme Court issued an opinion affirming the Court of Appeals for the reasons stated in the majority opinion of the Court of Appeals. Cowser-Griffin v. Griffin, 2015 Va. LEXIS 15, Record No. 140350.

<u>Laborers' Pension Fund v. Miscevic</u>, No. 17-2022 (7th Cir. Jan. 29, 2018). ERISA does not preempt the Illinois slayer statue, and the Illinois slayer statute applies where the deceased was killed by an individual found not guilty by reason of insanity

Evidence produced at her criminal trial showed that Anka Miscevic killed her husband, Zeljko Miscevic, in January 2014; however, she was found not guilty by reason of insanity. Despite the finding that she was responsible for her husband's death, Anka then claimed she was entitled to her deceased husband's pension plan, which was governed by federal ERISA law. A claim was also made on behalf of their minor son for the benefits. Their minor son was awarded the benefits from the pension plan. Anka appealed.

Illinois has a "slayer statute," which provides that "a person who intentionally and unjustifiably causes the death of another shall not receive any property, benefit, or other interest by reason of the death." However, neither federal ERISA law nor the pension's governing documents contains an express slayer provision; therefore, if federal law governs, the named beneficiary would receive the assets, despite the operation of a slayer statute under state law.

On appeal, the Court of Appeals for the Seventh Circuit upheld the interpretation that a slayer is precluded from obtaining the benefits payable under the decedent's pension plan even if they were found not guilty by reason of insanity. The Court reasoned that slayer statutes are traditionally an area of state regulation, and it rejected Anka's argument that Congress intended to preempt the slayer statutes through ERISA. ERISA was enacted after it was well established that an individual who kills another individual cannot benefit as a result of that death. Therefore, Congress could have clearly stated that it intended to change that result in certain situations, but their failure to explicitly state that intent results in a determination that it was not their intent.

Further, the Court held that Illinois' statute that provides that "a person who intentionally and unjustifiably causes the death of another" is broad enough to encompass a situation where an individual is found not guilty by reason of insanity. They deferred to state law decisions to interpret the statute. Anka argued that the killing was justifiable because she was found not guilty. The Court rejected this argument on the grounds that an insanity defense is an "excuse" defense, not a "justification" defense. The decision rests on lower court decisions interpreting the statute, and therefore the Court does acknowledge that the interpretation may be different in other states.

<u>Ethical Issues in Representing Multiple Parties</u>

Often lawyers are requested to represent two or more family members in a particular transaction, even though the interests of the family members may differ. There are two views on multiple representation in the estate planning and tax areas.

One view is that common representation should be avoided. In the event of a genuine dispute, a lawyer's liability for representing clients with conflicting interests is likely to arise.[2] The other view is that multiple representation is often appropriate. Among the reasons given are the following:

[2] Patricia A. Wilson. Avoiding Ethical Pitfalls for Estate Planning Lawyers. 331 PLI/EST 589 (Nov. 2004).

- Cost savings;
- The impracticality of requiring independent representation of all who have potentially conflicting interests; and
- The possibility of losing one or more clients, unless the representation is actually impermissible, could have negative economic consequences for the lawyer.[3]

Ethical Rules. Model Rule 1.7(a), which governs whether a lawyer may represent multiple parties, reads as follows:

> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
>
> (1) the representation of one client will be directly adverse to another client; or
>
> (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client, or a third person or by a personal interest of the lawyer.

While Model Rule 1.7(a) creates the presumption that the lawyer cannot provide common representation, this presumption can be overcome. Model Rule 1.7(b) permits a lawyer to represent multiple clients, despite the existence of a conflict of interest, in certain situations. Model Rule 1.7(b) reads:

> (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
>
> (1) The lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
>
> (2) The representation is not prohibited by law;
>
> (3) The representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
>
> (4) Each affected client gives informed consent, confirmed in writing.

Thus, in representing a husband or wife or multiple generations in a tax or estate planning transaction, a lawyer needs to determine the following:

- Whether there is a concurrent conflict of interest:

[3] Wilson, supra, at p. 593.

- If there is a concurrent conflict of interest, whether his or her representation of one or more clients will be materially limited by the lawyer's responsibilities to another client.

- If there is a concurrent conflict of interest whether and the representation of each client will not be materially limited, whether the lawyer believes that he or she will be able to provide competent or diligent representation to each affected client and each affected client gives informed written consent.

Among the factors to be used in determining whether representation of one client forecloses the lawyer's ability to recommend or carry out appropriate courses of actions on behalf of another client are:

- The lawyer's relationship with the clients involved.

- The functions the lawyer will perform.

- The likelihood of consent.

- The prejudice that will occur if a conflict arises.[4]

To obtain informed written consent, the attorney must describe the risks of multiple representation and the possible effects of representation, including the possible effect on the attorney's independent judgment.

The attorney should also consider whether information disclosed by one client might have to be disclosed in order to obtain consent or as part of the representation. The client whose confidences are to be disclosed will have to give consent to this disclosure.[5]

Advice in ACTEC Commentaries. The ACTEC Commentary on Model Rule 1.7 gives the following advice. ACTEC believes that it is often appropriate for a lawyer to represent more than one member of the same family in connection with their estate planning or more than one of the investors in a closely held business. The reasons for this include:

- The clients may actually be better served by such a representation.

- Such a representation can result in an economical and better coordinated plan because the lawyer will have a better over all understanding of all the relevant family and property considerations.

- In addition, estate and tax planning is, according to ACTEC, fundamentally nonadversarial in nature.

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[4] Model Rules of Professional Conduct, Rule 1.7, comment 11.
[5] Wilson, supra, at p. 595.

- With respect to obtaining consent, ACTEC suggests that the lawyer consider meeting with the prospective clients separately. This may allow each of them to be more candid and perhaps reveal conflict or problems that might affect the relationship.

Representing Husband and Wife. The most common multiple representation situation encountered by estate planners and tax professionals is representing a husband and wife. Much has been written on this topic and the consensus seems to be that the best way to handle the potential conflicts inherent in representing spouses is to anticipate them by making clear to both spouses at the beginning of the representation that, as between the spouses, the attorney will not preserve confidences revealed in the course of the representation.

Some attorneys do represent husbands and wives as separate clients. If an attorney is going to represent a husband and a wife as separate clients and information communicated by one spouse will not be shared with the other spouse, then each spouse must give informed consent under Model Rule 1.7(b)(4). Such separate representation raises the same issues as those discussed below that arise with the representation of different generations of family members in the same estate planning matter.

A good summary of the issues involving the representation of spouses is found in Jeff Pennell's case book.[6] Some of the factors that may cause the interests of spouses to be different include:

- Separate assets;
- Children from a different marriage or relationship;
- The risk of creditors of one spouse acquiring access to the assets of the other spouse; and
- The potential use of gift splitting.

The ACTEC Commentary to Model Rule 1.7 also discusses the representation of a husband and wife. It indicates that the representation should only be taken with the informed consent of each of husband and wife confirmed in writing. The Commentary suggests the writing be contained in an engagement letter that covers other subjects as well.

A 1994 report by an American Bar Association Real Property, Probate and Trust Section Task Force[7] also discussed the signs of potential conflict arising between multiple clients such as a husband and wife and which, ,in turn, could imperil a joint representation. These signs include:

- Action related confidences that ask the lawyer to reduce or defeat the other spouse's rights or interests in the confiding spouse's property.

[6] Jeffrey Pennell. Wealth Transfer Planning and Drafting (Thomson West 2005), ch. 3, p. 6.

[7] Report of the Special Study Committee on Professional Responsibility. Comments and Recommendations on the Lawyer's Duties in Representing Husband and Wife.

- Prejudicial confidences that reveal adversity between the spouses (such as a plan to file for divorce following receipt of a transfer of property from the unknowing donor spouse).

- Confidences indicating that one spouse's reliance on the plan of the other is misplaced.

Every joint representation carries the risk that one or more clients might feel betrayed or that the lawyer might be compelled to withdraw from representing all of the clients. These risks can be reduced by the lawyer properly creating and defining the joint representation.

The first issue to deal with is the issue of loyalty. As noted above, Model Rule 1.7 requires disclosure and written client consent only in the case of a "concurrent conflict of interest," which is a situation involving a direct adversity or a "significant risk" that a lawyer's representation of one client will be "materially limited" by the lawyer's responsibility to another client. This means that the Model Rules do not require full disclosure and consent until the conflict is nearly upon the lawyer.

Restatement (Third) of the Law Governing Lawyers, Sec. 130 Illustration 1, provides a good example of this dilemma:

> Husband and Wife consult Lawyer for estate-planning advice about a will for each of them. Lawyer has had professional dealings with the spouses, both separately and together, on several prior occasions. Lawyer knows them to be knowledgeable about their respective rights and interest, competent to make independent decisions if called for, and in accord with their common and individual objectives. Lawyer may represent both clients in the matter without obtaining consent. While each spouse theoretically could make a distribution different from the others, including a less generous bequest to each other, those possibilities do not create a conflict of interest, and none reasonably appears to exist in the circumstances.

Restatement (Third) of the Law Governing Lawyers, Sec. 130, Illustration 2, shows when the conflict would arise.

> The same facts as in Illustration 1, except that Lawyer has not previously met the spouses. Spouse A does most of the talking in the initial discussions with Lawyer. Spouse B, who owns significantly more property than Spouse A, appears to disagree with the important positions of Spouse A but to be uncomfortable in expressing that disagreement and does not pursue them when Spouse A appears impatient and peremptory. Representation of both spouses would involve a conflict of interest and Lawyer may provide legal assistance only with the consent of both.

Restatement (Third) of the Law Governing Lawyers, Sec. 130, Illustration 3, shows the steps that a lawyer could take to determine whether the situation in Illustration 2 actually presents a conflict.

> The same facts as in Illustration 1, except that Lawyer has previously met the spouses. But in this instance, unlike in Illustration 2, in discussions with the spouses, Lawyer asks questions and suggests options that reveal both Spouse A and Spouse B to be knowledgeable about their respective rights and interests, competent to make independent decisions if called for, and in accord on their common and individual objectives. Lawyer has adequately verified the absence of a conflict of interest and thus may represent both clients in the matter without obtaining consent.

Even if consent is not required, as the above illustrations indicate may be the case in representing a husband and wife, the better practice is to obtain consent and describe the scope of the joint representation.

Summary of Rules on Representing Husband and Wife

- The default position under the Model Rules is that there can be no secrets among jointly represented clients. Instead, the lawyer must tell all clients any material fact that the lawyer learns with respect to any client.[8]

- The other approach is for the clients to agree on separate representations in the same matter. The problem with this, obviously, is that the lawyer must exercise extreme vigilance and the lawyer may find himself or herself paralyzed by knowledge that the lawyer learns from one client, but is unable to share with others. The ACTEC Commentaries to Model Rule 1.6, using some understatement, indicate that "some experienced estate planners" might enter into such a relationship with spouses planning their estate, but must proceed with "great care."

- A middle ground in establishing the representation might be for the lawyer to state that the lawyer will share all material information about the representation from any client, but will withdraw from the entire representation if any client balks at such sharing.[9] This, of course, puts the burden on the attorney of determining what is and is not material information.

[8] Model Rule 1.7, comments 30 and 31.

[9] For further discussion of this, see Thomas Spahn, Creating and Defining Joint Representations, ABA Experience, Spring 2007, p. 45.

<u>PLANNING FOR THE VULNERABLE</u>

***"Family Ties"*, Virginia Lawyers Weekly, Vol. 29, No. 38, Feb. 23, 2015. Step-Father Files Petition Seeking Filial Support from Step-Children. Virginia Lawyers Weekly ran an article examining section 20-88 of the Code of Virginia, which is Virginia's rarely-invoked filial support statute. The statute, first enacted in 1920, provides that adult children can be required to support parents in "necessitous circumstances." The article recounts a few prior cases involving the statute and mentions the following petition.**

Glenn Johnson and his wife, Ruth, are in their 80s. Ruth has eight children ranging in age from the mid-40s to the mid-60s. Ruth has been in assisted living for almost two years with monthly expenses exceeding $5,000 per month. Johnson had mortgaged the couple's property and sold off stock to pay expenses.

Johnson filed petitions under Va. Code 20-88 against each of his step-children seeking contributions for the support of their mother. The Virginia Beach J&DR court entered orders and assigned amounts for each child to contribute. The court also found the children liable for certain prior expenses.

The children filed a petition for guardianship of their mother and are defending Johnson's petitions filed under the filial support statute.

<u>Louisiana Filial Responsibility Law</u>

Alimony for support from children or grandchildren; summary proceedings; award.

> When any person is in necessitous circumstances, that person may demand from his or her children or grandchildren alimony for support, and proceedings for that purpose may be instituted in any district court and shall be tried summarily. After hearing the parties, if the court finds the plaintiff to be in need and the defendant or defendants able to contribute to the support of the ancestor claiming it, the court shall award such amount as may be deemed proper, and shall order same payable weekly or monthly, and the judgment shall be at all times subject to the control of the court, by either increasing, decreasing or entirely canceling, as circumstances may require. All proceedings subsequent to the rendition of the judgment may be by rule.
>
> La. R.S. § 13:4731

For more on filial responsibility laws, including the history of their enactment and current uses, see Sylvia Macon, Comment, Grow Up Virginia: Time to Change our Filial Responsibility Law, 51 U. Rich. L. Rev. 265 (2016).

The Young, the Old, the Incapacitated, and the Infirm

Estate and related planning for minors, the elderly, and those suffering short- or long-term impairment presents unique challenges. On the non-tax front, there may be the reality or questions of the individual's competence, or ability to understand the alternatives being considered. There may be questions of influence by other family members. In addition, the clients often have special concerns related to health care and extended care arrangements for themselves.

The Elderly or Incapacitated

Planning for Disability and Assisted Care. There are several disability-related documents that should be part of every person's estate plan. For an elderly client, it is particularly important to have them in place and up-to-date. Even for younger clients, disability and incapacity pose as much a risk to financial and emotional health as death, but in many cases these documents are overlooked with younger client.

Power of Attorney for Property. With a Power of Attorney for Property, the client can designate someone to handle the client's financial affairs if he or she is unable to. The financial affairs may range from the routine (such as paying bills or depositing checks when the client is traveling or in the hospital) to the significant (selling the client's house if he or she has been placed in a nursing home.).

If a revocable trust is part of the estate plan, the power of attorney should authorize the agent to add property to the client's revocable trust. It may be possible for the agent to have the power to amend a revocable, *inter vivos* trust in the event of changes in the tax laws. In most cases, that power must be specifically granted in the power of attorney. For wealthier clients, it usually is advisable to empower the agent to make gifts. See, e.g., Estate of Goldman v. Comm'r., T.C. Memo 1996-29 (1996); Estate of Swanson v. Comm'r., 46 Fed.Ct.Cl. 38 (2000). The gift power can be extensive, allowing the agent to transfer property in trust for the benefit of family members and to create trusts.

Power of Attorney for Health Care, Health Care Proxy, or Advance Medical Directive. These documents allow an individual to make two important decisions about their personal health care and treatment, specially:

- the nature and extent of the individual's preference for withholding or withdrawing life-prolonging procedures when the individual is facing a terminal condition, and
- the identify of one or more agents to make decisions regarding the individuals health care in the event the individual is incapable of doing so for him- or herself.

The availability of a separate health care power of attorney is the result of state legislatures recognizing an individual's right to control his or her own medical care, including the right to decline medical treatment. To that end, most states allow an individual to grant the agent broad powers to make any decision, including the withdrawal of food and water, consistent with any intentions expressed in a document. The absence of such direction or intention usually does not limit the agent's authority.

Much has been written about the need to modify health care powers to allow the agent access to medical information about the principal, notwithstanding the privacy rules enacted as part of HIPAA. A well-drafted medical directive will include the necessary language allowing the agent access to otherwise-protected health information in order to make a fully-informed decision.

Revocable Living Trust Lifetime Provisions. A Power of Attorney for Property can authorize an agent to handle virtually all of an individual's financial affairs. Nevertheless, most estate planners prefer to use the Power of Attorney in conjunction with a revocable living trust, especially for elderly clients. The trust can provide more comprehensive protection.

The distinct advantage of a trust is that the trustee, unlike an agent, is obligated by law to act, and the trust (or state law) will provide a mechanism for naming a successor trustee. By contrast, the agent under a power of attorney can decline to act, and, if no successor is named, the power of attorney becomes ineffective.

A sample of lifetime distribution provisions in a revocable trust are below:

> "During my lifetime, the trustee shall administer the trust as follows:
>
> The trustee shall distribute to my wife, JANE DOE ("my spouse"), or me, or apply for either of our benefit, such amounts of the net income and principal of the trust, even to the extent of exhausting principal, as the trustee determines from time to time to be required for my health, support, and best interests, and for the health and support of my spouse, adding any undistributed net income to principal from time to time, as the trustee determines.
>
> Unless I have been declared to be disabled, the trustee also shall distribute to me such amounts of the net income and principal of the trust as I may direct in writing, adding any undistributed net income to principal from time to time, as determined by the trustee."

The draftsperson can add other provisions as appropriate. It may be advisable to give the trustee authority to make gifts. Or, if the trust holds a residence, provisions about its use and who makes decisions regarding a sale, should be added. It is becoming increasingly common to include in a revocable trust provisions for the appointment of a third party as the "trust protector," who can modify the terms of the revocable trust if the client were disabled in response to unanticipated changes in the tax laws. This may be especially helpful in light of the continued uncertainty with respect to the estate, gift, and generation-skipping taxes caused by the provisions of current federal tax law.

- This power can be given to one person or to a committee of persons.
- Provisions should be included for naming a successor.
- If the client is unwilling or unable to determine who should be a trust protector now, trust protector provisions still can be included along with a mechanism for appointing a successor at a later date.

Practical Considerations. In considering who to name and when and how an agent should serve under a power of attorney, medical directive, guardianship designation, or as successor trustee, clients should consider:

- the professional and personal acumen of the named agent and alternates,
- the relationship of the agent to members of the principal's family and others with whom the agent will interact,
- the intimate and personal nature of the acts to be undertaken by the agent,
- coordinating with the named agent before incapacity to establish clear expectations,
- communicating the decision about the designation of the named agent, where appropriate, to reduce confusion during a time of great stress, and
- maintaining important personal and financial information in a secure means available to the agent when needed.

Disability Determination Provisions. In both a revocable living trust and a power of attorney, the question of how the client's disability is determined can arise. With a power of attorney, the best approach usually is to make it effective immediately, without regard to the client's disability. The agent under a power of attorney often must act on short notice, and a required disability determination procedure might unduly delay the actions that must be taken. In the case of a power of attorney for property, the agent sometimes needs to act simply because the principal is unavailable, not disabled.

If the client insists on the power of attorney not being effective until a determination of disability is made, a provision such as the following can be used:

> "*Receipt by my agent of written notice that I am disabled*. I shall be deemed disabled for purposes of this instrument if such of [^], [^] and [^], who are not then under legal disability, certify in writing to my agent that advanced age, illness, or other cause has impaired my ability to transact ordinary business. My attorney may rely upon such certification without obligation to make any further inquiry into my condition and any person dealing with my attorney may rely without inquiry upon my attorney's certification that I have been determined to be disabled as provided under this power of attorney."

A client may also chose to escrow a power of attorney with the drafting attorney or other responsible person, with instructions to release the instrument upon similar terms as provided above with respect to the determination of a disability.

For a revocable living trust, a determination of disability provision is more important. The client usually has powers under the trust agreement (such as a power to withdraw assets) that should cease if the client is disabled. In many cases, the client acts as initial trustee. If the client is incapacitated and cannot sign a resignation as trustee, a procedure is needed to remove him or her and designate a new trustee. A sample provision is below:

> "For purposes of this instrument, there is hereby constituted a "Committee" which shall consist from time to time of such of my spouse and my children who are not then disabled. The Committee, by majority vote, and with the written concurrence of a physician who has examined or treated me within the previous three months, at any time can declare me to be disabled, or subsequently declare that my disability has ended, in each case by written notice signed by that majority and delivered to me and to the trustee. During any period in which I have been declared to be disabled, unless the Committee designates otherwise in its declaration of disability or a subsequent notice, or a court of competent jurisdiction has determined that I am legally competent to act, I shall be (i) restricted from making withdrawals and giving directions under this Article, (ii) removed as trustee, (iii) prohibited from amending or revoking this instrument, and (iv) disqualified from removing trustees, appointing successor fiduciaries and approving trustee accounts, in which event the persons who would exercise those rights if I were then deceased shall exercise them in my place. No person shall have a duty to seek a judicial determination regarding my legal competency."

Note that the revocable living trust lifetime provisions in the section above are drafted so that a successor trustee or co-trustee can act on the client's behalf without actually having to affirmatively declare the client disabled.

From an emotional standpoint, the family often prefers this approach. The family wants to avoid actually declaring the person disabled, even if he or she in fact is no longer capable of managing his or her affairs.in many cases, it is possible in this situation to appoint a co-trustee, or have the client sign a resignation of trustee, and so the successor can take over. Even if the client never formally resigns or is removed, the lifetime provisions allow the other trustee to make distributions for the benefit of the client and, if appropriate, his or her family.

Directions on Care. Some clients want to make sure the Power of Attorney or revocable living trust expresses their wishes about the nature of medical and assisted living care to be provided them. This is particularly important to wealthier clients, who know their assets are sufficient to provide home care, and who do not want their children to ship them off to a nursing home in an attempt to save the estate from depletion. One example of a provision that can be used to address this concern is below.

> "In making discretionary distributions for me or my spouse under this instrument, the trustee shall consider my strong desire that medical care, nursing care, and the other types of care and assistance that are necessary for me or my spouse be provided to me or my spouse in the familiar environment of our home to the greatest extent practicable, without regard to the additional cost of such home care and assistance."

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What We Don't Talk About When We Talk About Estate Planning

Annual Mardi Gras LSBA Tax Section Meeting
February 22, 2019
New Orleans, Louisiana

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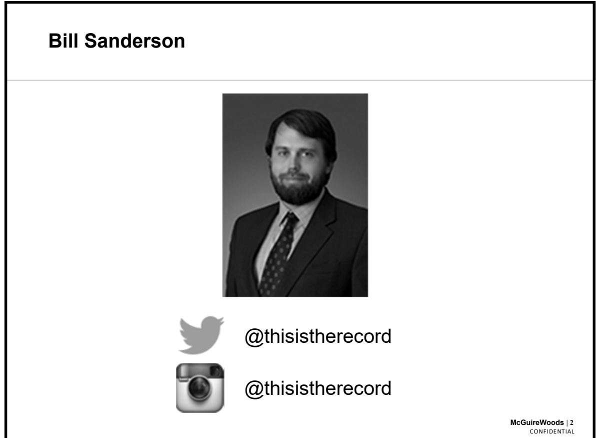

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I really did meet my wife here

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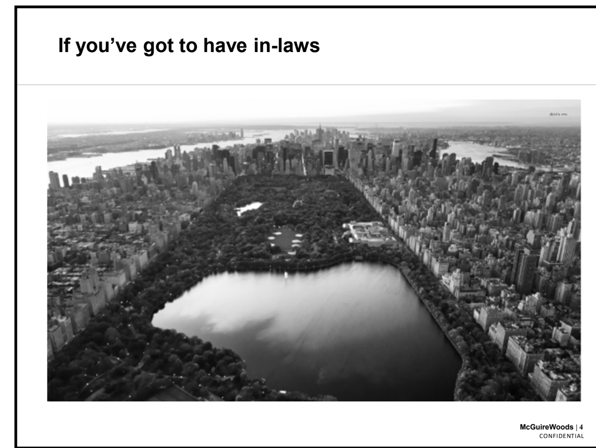
If you’ve got to have in-laws



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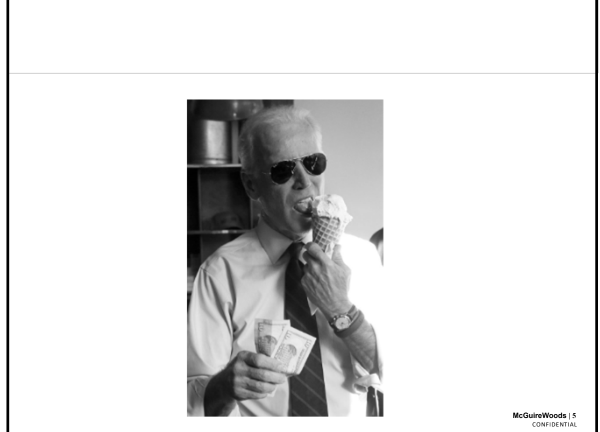

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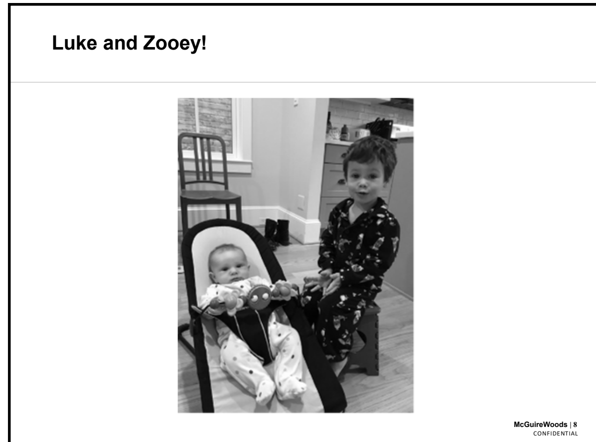

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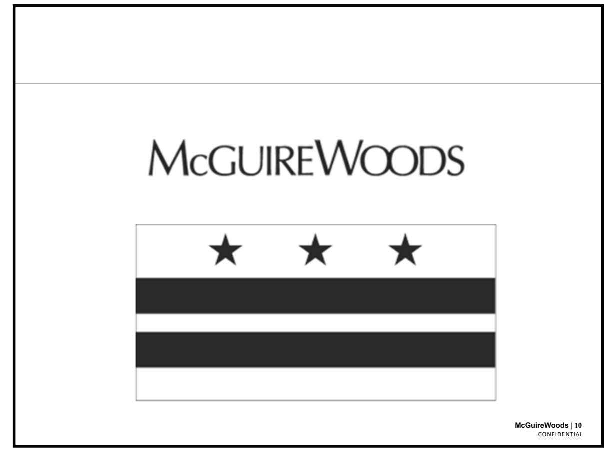

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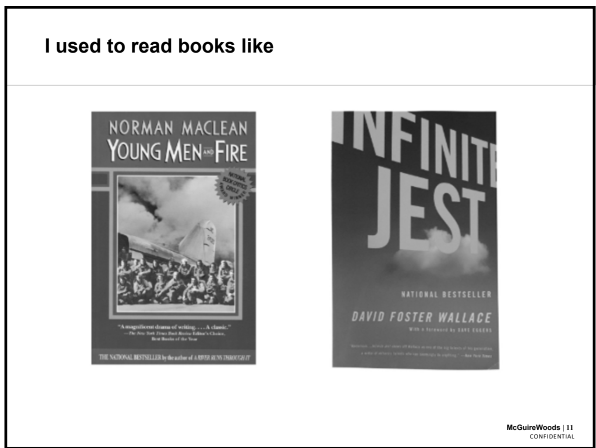

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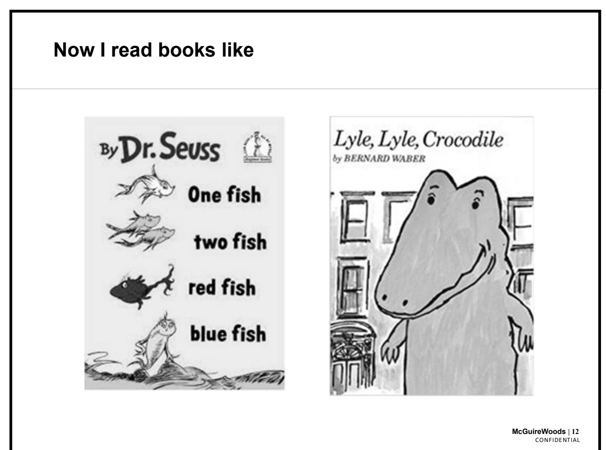

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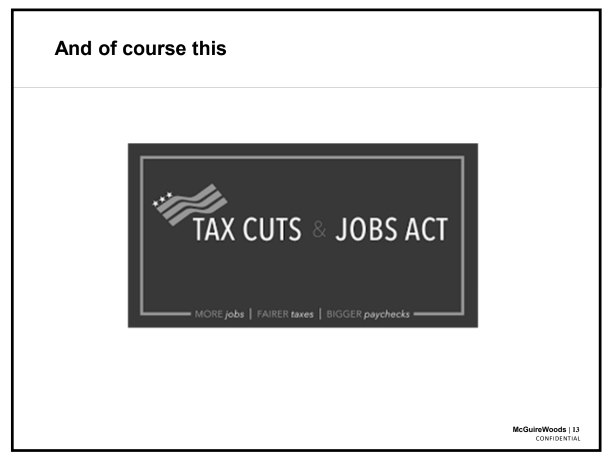

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What We Don't Talk About… The Future of Estate Planning

We Do

Jonathan G. Blattmachr, *Looking Back and Looking Ahead: Preparing Your Practice for the Future: Do Not Get Behind the Change Curve*, 36 ACTEC L.J. 1 (Summer 2010).

Dennis I. Belcher, *2016 Joseph Trachtman Memorial Lecture, March 19, 2016: Do We Need A Canary or Did the Canary Stop Singing and We Missed It?*, 43 ACTEC L.J. 7 (Fall 2017).

And We Don't

Automation in 2018 and Beyond
Tax Cuts and Jobs Act

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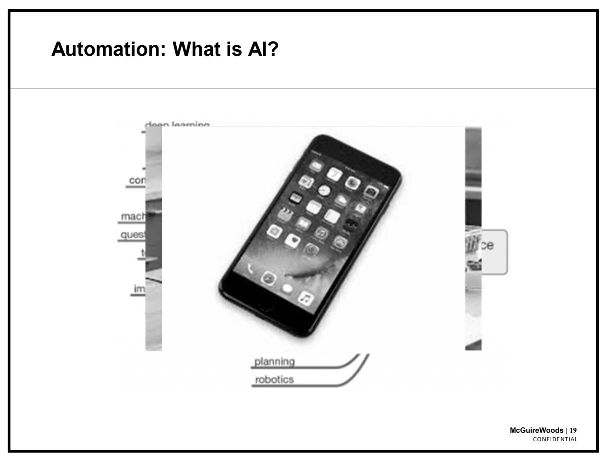

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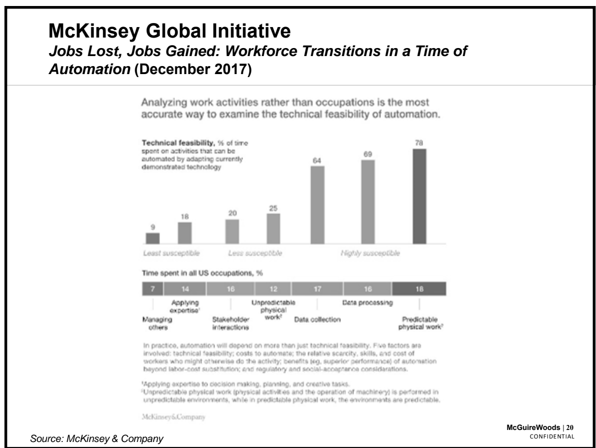

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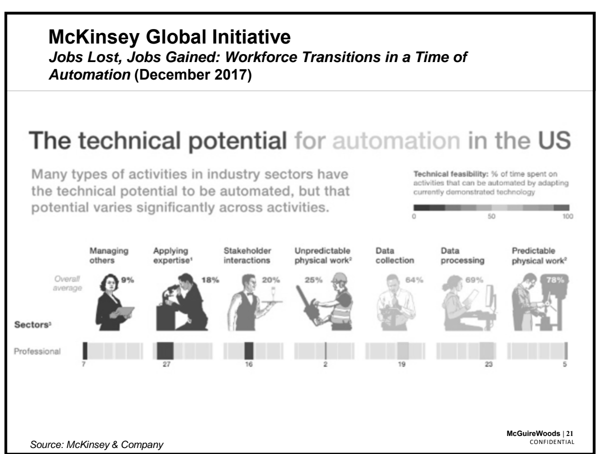

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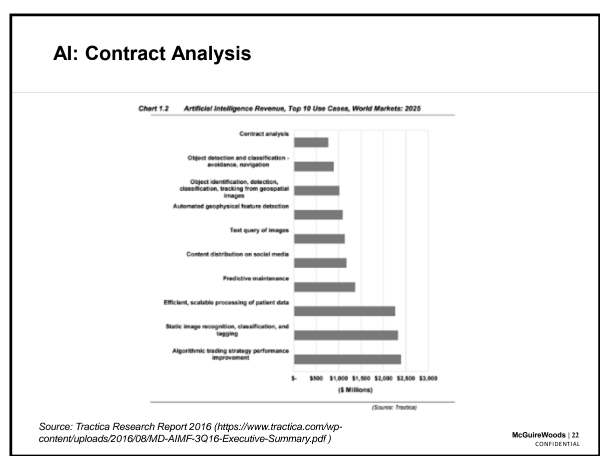

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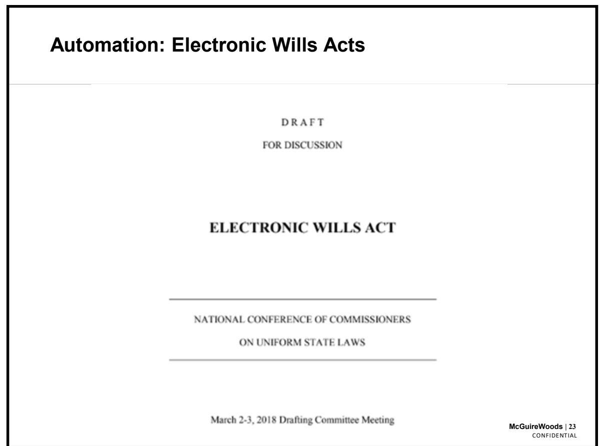

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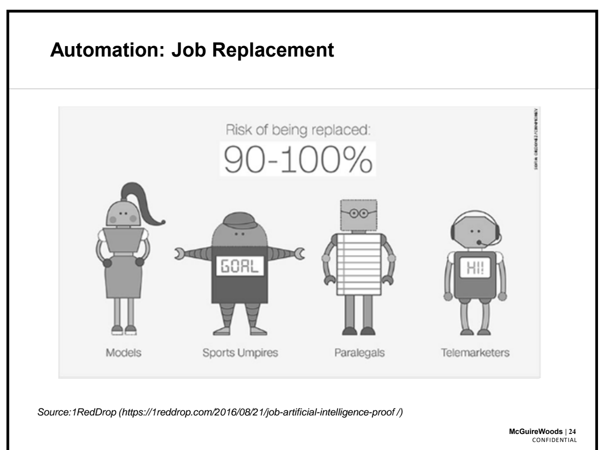

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What We Don't Talk About…
The Future of Estate Planning: Estate Tax Stats

2012 All Estate Tax Returns		
2012 Estate Tax Returns	Number of Returns	Gross Estate ($000s)
All Returns	9,412	124,320,687
Under $5 million	988	3,556,727
$5 million – $10 million	5,804	38,960,265
$10 million – $20 million	1,723	23,040,271
$20 million or more	896	58,763,424

- *Source: IRS Statistics of Income Division*

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What We Don't Talk About…
The Future of Estate Planning: Estate Tax Stats

All Estate Tax Returns		
2016 Estate Tax Returns	Number of Returns	Gross Estate ($000s)
All Returns	12,411	192,218,976
Under $5 million	1,218	4,072,525
$5 million < $10 million	7,052	49,292,743
$10 million < $20 million	2,635	35,824,103
$20 million < $50 million	1,073	31,586,989
$50 million or more	434	71,442,616

- *Source: IRS Statistics of Income Division*

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What We Don't Talk About…
The Future of Estate Planning: Estate Tax Stats

Taxable Estate Tax Returns		
2016 Estate Tax Returns	Number of Returns	Gross Estate ($000s)
All Returns	5,219	107,791,347
Under $5 million	611	1,963,909
$5 million < $10 million	2,402	17,254,148
$10 million < $20 million	1,293	17,973,504
$20 million < $50 million	611	18,285,224
$50 million or more	300	52,314,561

- *Source: IRS Statistics of Income Division*

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What We Don't Talk About…
The Future of Estate Planning: Estate Tax Stats

Executors' Fees Reported on All Estate Tax Returns		
2016 Estate Tax Returns	Number of Returns	Fees Claimed ($000s)
All Returns	2,725	542,715
Under $5 million	243	13,290
$5 million < $10 million	1,372	126,613
$10 million < $20 million	652	120,385
$20 million < $50 million	318	103,035
$50 million or more	140	179,393

- *Source: IRS Statistics of Income Division*

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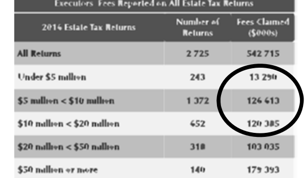
What We Don't Talk About…
The Future of Estate Planning: Estate Tax Stats



Executors' Fees Reported on All Estate Tax Returns		
2016 Estate Tax Returns	Number of Returns	Fees Claimed ($000s)
All Returns	2 725	542 715
Under $5 million	243	13 290
$5 million < $10 million	1 372	126 613
$10 million < $20 million	652	120 385
$20 million < $50 million	318	103 035
$50 million or more	140	179 393

Assumptions on Executors' Fees:

- **Non-Family Executors (Lawyers?) Take Commissions**
- **Estates Under $10 million: $140 million in commissions**
- **Estates Under $20 million: $260 million in commissions**

- *Source: IRS Statistics of Income Division*

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What We Don't Talk About…
The Future of Estate Planning: Estate Tax Stats

Attorneys' Fees Reported on All Estate Tax Returns		
2016 Estate Tax Returns	Number of Returns	Fees Claimed ($000s)
All Returns	6,984	593,822
Under $5 million	766	25,535
$5 million < $10 million	3,700	188,079
$10 million < $20 million	1,508	123,371
$20 million < $50 million	703	118,702
$50 million or more	307	138,135

- *Source: IRS Statistics of Income Division*

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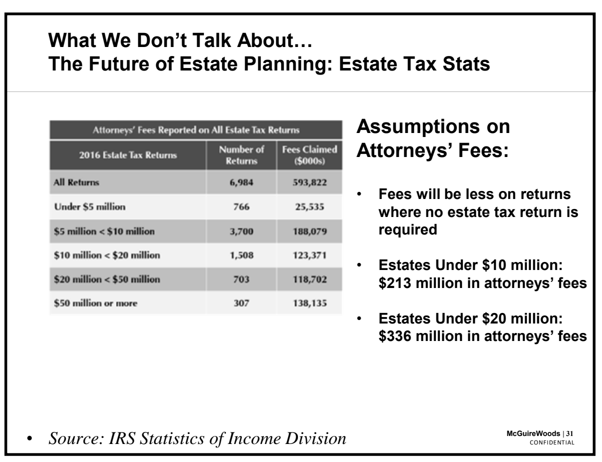
What We Don't Talk About…
The Future of Estate Planning: Estate Tax Stats



Attorneys' Fees Reported on All Estate Tax Returns		
2016 Estate Tax Returns	**Number of Returns**	**Fees Claimed ($000s)**
All Returns	6,984	593,822
Under $5 million	766	25,535
$5 million < $10 million	3,700	188,079
$10 million < $20 million	1,508	123,371
$20 million < $50 million	703	118,702
$50 million or more	307	138,135

Assumptions on Attorneys' Fees:

- **Fees will be less on returns where no estate tax return is required**
- **Estates Under $10 million: $213 million in attorneys' fees**
- **Estates Under $20 million: $336 million in attorneys' fees**

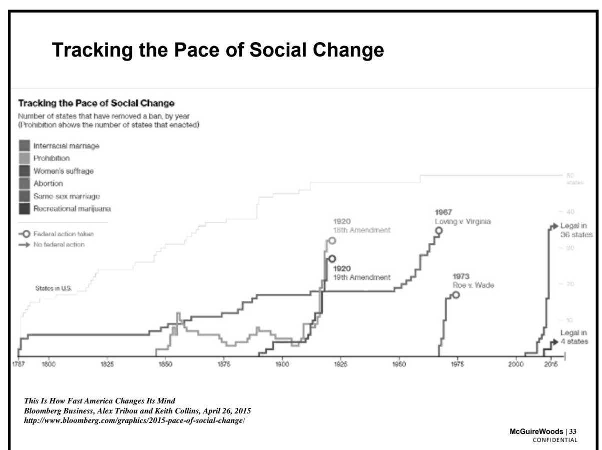
- *Source: IRS Statistics of Income Division*

What We Don't Talk About…
The Future of Estate Planning: Estate Tax Stats

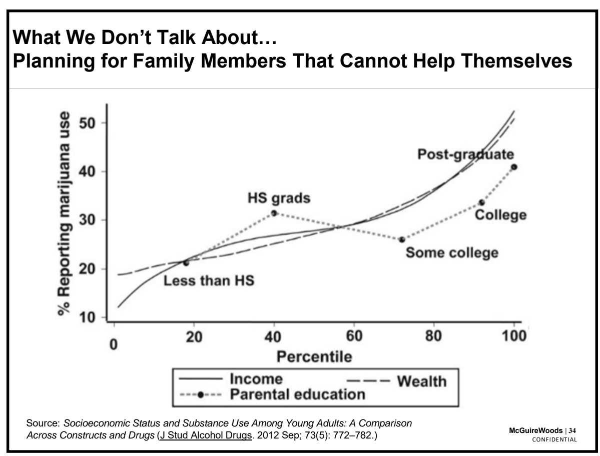
2016 All Estate Tax Returns			Art	
2016 Estate Tax Returns	**Number of Returns**	**Amount (000s)**	**Percent or Returns Reporting**	**Amount ($000s)**
All Returns	12,411	192,218,976	17%	2,226,200
Under $5 million	1,218	4,072,525	10%	15,245
$5 million < $10 million	7,052	49,292,743	12%	138,227
$10 million < $20 million	2,635	35,824,103	20%	185,106
$20 million < $50 million	1,073	31,586,989	30%	329,817
$50 million or more	434	71,442,616	50%	1,557,805

- *Source: IRS Statistics of Income Division*

Tracking the Pace of Social Change



This Is How Fast America Changes Its Mind
Bloomberg Business, Alex Tribou and Keith Collins, April 26, 2015
http://www.bloomberg.com/graphics/2015-pace-of-social-change/



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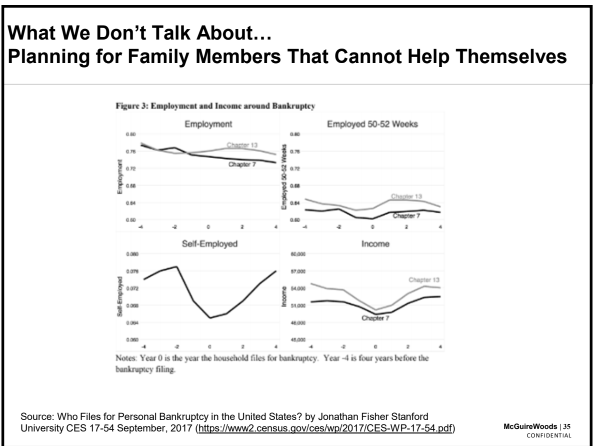

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What We Don't Talk About…
Planning for Family Members That Cannot Help Themselves

Distributions

Governance

Flexibility

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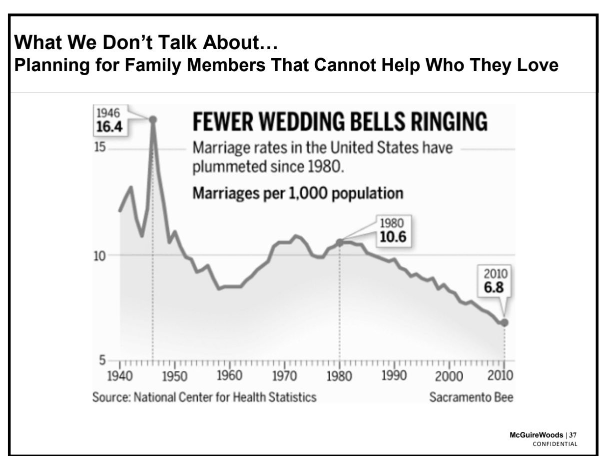

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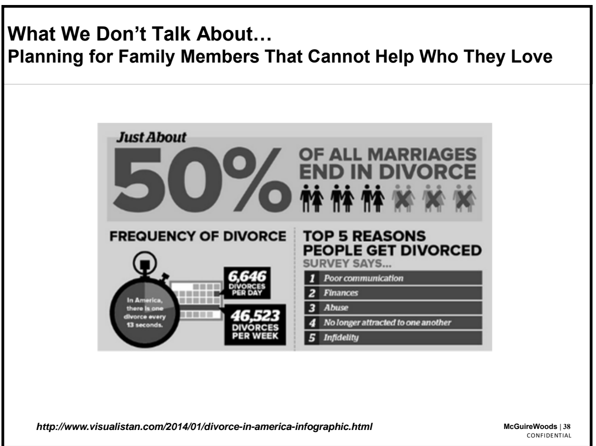

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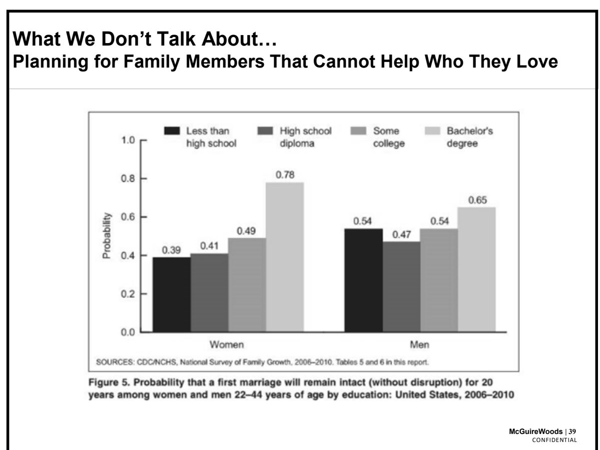

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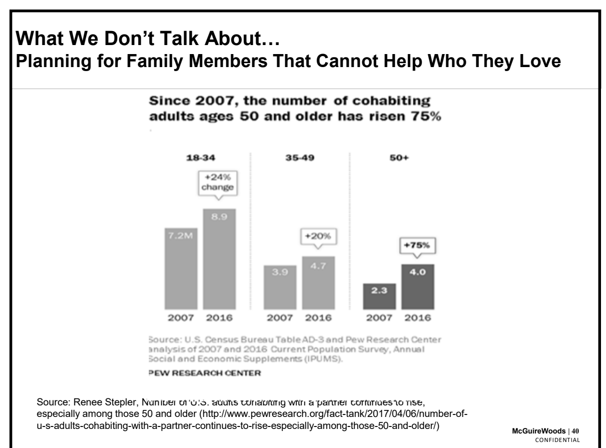

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What We Don't Talk About…
Planning for Family Members That Cannot Help Who They Love

Changing Dynamics of Intimate Relationships

Ethical Issues Facing Lawyers

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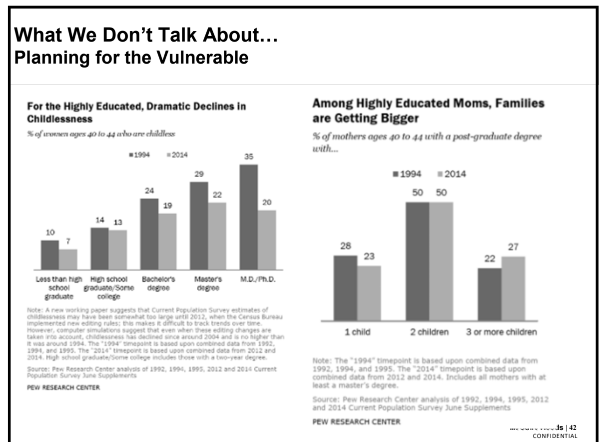

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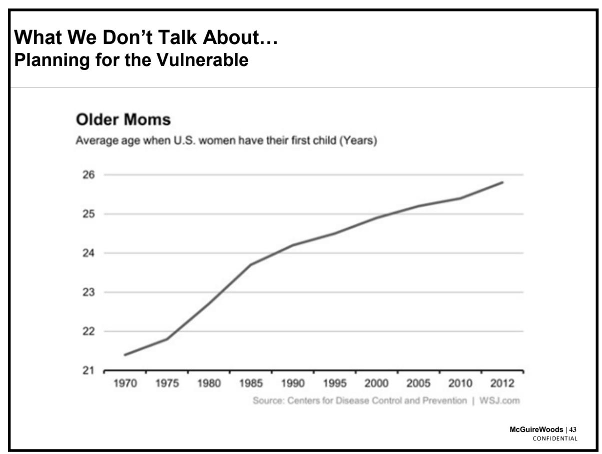

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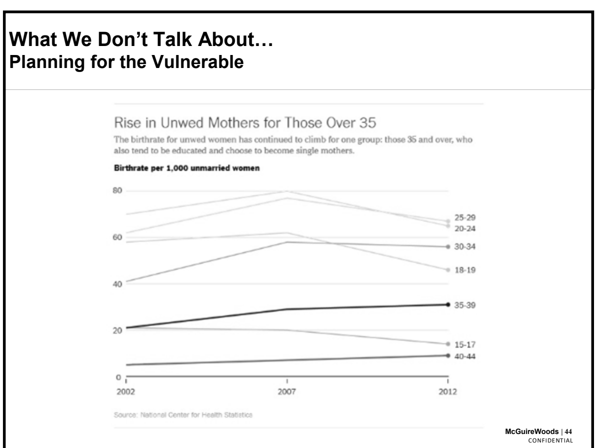

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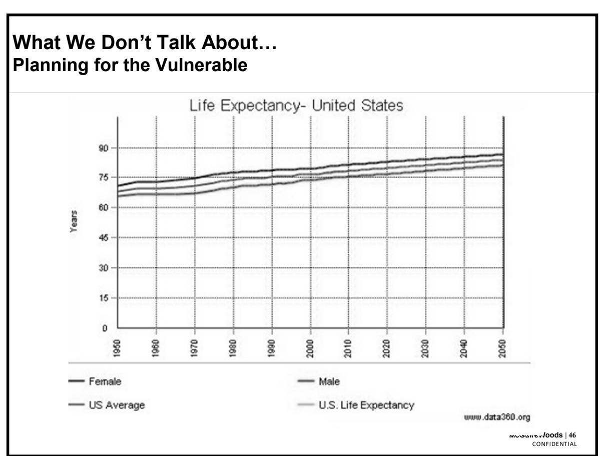

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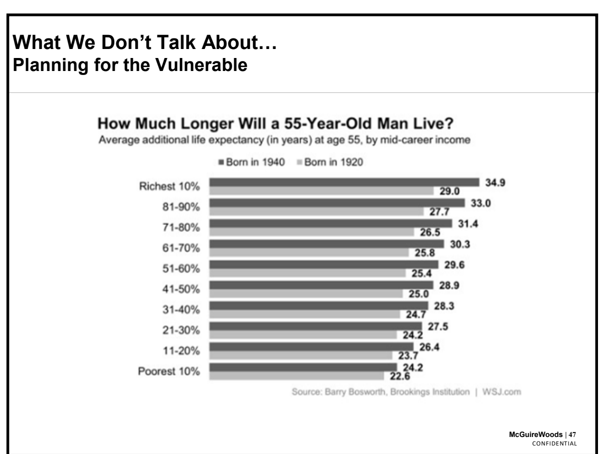

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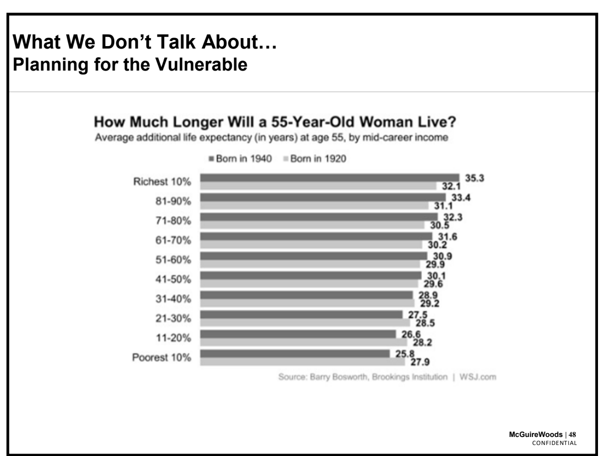

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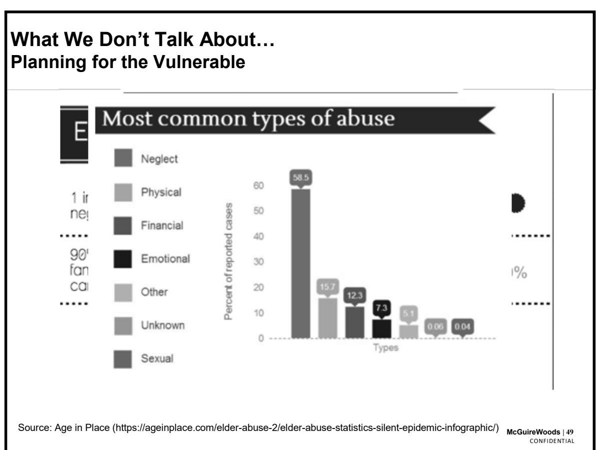
What We Don't Talk About…
Planning for the Vulnerable



Source: Age in Place (https://ageinplace.com/elder-abuse-2/elder-abuse-statistics-silent-epidemic-infographic/)

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What We Don't Talk About…
Planning for the Vulnerable

Filial Responsibility

Va. Code § 20-88. Support of parents by children.

It shall be the joint and several duty of all persons eighteen years of age or over, of sufficient earning capacity or income, after reasonably providing for his or her own immediate family, to assist in providing for the support and maintenance of his or her mother or father, he or she being then and there in necessitous circumstances.

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What We Don't Talk About…
Planning for the Vulnerable

Filial Responsibility

La. R.S. § 13:4731. Alimony for support from children or grandchildren; summary proceedings; award

When any person is in necessitous circumstances, that person may demand from his or her children or grandchildren alimony for support, and proceedings for that purpose may be instituted in any district court and shall be tried summarily. After hearing the parties, if the court finds the plaintiff to be in need and the defendant or defendants able to contribute to the support of the ancestor claiming it, the court shall award such amount as may be deemed proper, and shall order same payable weekly or monthly, and the judgment shall be at all times subject to the control of the court, by either increasing, decreasing or entirely canceling, as circumstances may require. All proceedings subsequent to the rendition of the judgment may be by rule.

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What We Don't Talk About…
Planning for the Vulnerable

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Louisiana State Bar Association

Tax Section Annual Mardi Gras Meeting

Don't Discount Discounts: Valuation of Closely Held Businesses in a Changing Regulatory Environment

February 22, 2019

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Portions of these materials were prepared by William I. Sanderson for a presentation titled "They're Finally Here! Unpacking the Proposed Regulations under Section 2704(b)" delivered at the ABA Tax/RPTE Joint Fall CLE Meeting on September 30, 2016. Other portions of these materials were prepared by Ronald D. Aucutt. They are used here with permission. I thank them for their valuable contributions to this presentation.

Don’t Discount Discounts:
Valuation of Closely Held Businesses in a Changing Regulatory Environment

Michael H. Barker

1) Introduction to Valuation Discounts

a) Valuation plays a key role in planning lifetime transfers. The first steps in planning lifetime transfers are to determine which property will be subject to the transfer tax and to determine the value of the property. Property transferred by gift must be valued to determine whether a taxable gift has been made. For gift tax purposes, the value of the property transferred is its fair market value. Cash and marketable securities are easily valued, although if an individual owns a large block of marketable securities, discounts may be available based on restrictions imposed by the securities laws. With closely held business interests and real property, valuation is more difficult and requires special consideration.

b) Determining the fair market value of interests in a family’ business is one of the more difficult and complex issues confronting the owner when planning to transfer the business. For estate and gift tax purposes, the fair market value of property, including an interest in a family business, is defined as the price at which the 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 the relevant facts. Treas. Reg. section 20.2031-1(b).

c) Revenue Ruling 59-60, 1959-1 C.B. 237, sets forth the specific factors to be considered in valuing an interest in a family business for transfer tax purposes. These factors include:

i) The nature of the business and history of the enterprise;

ii) The economic outlook in general and the economic outlook of the specific industry;

iii) The book value of the stock and the financial condition of the business;

iv) The earning capacity of the business;

v) The dividend capacity of the business;

vi) The good will and other intangible value of the business;

vii) The size of the block of stock to be valued; and

viii) The value of companies engaged in similar businesses whose stock is publicly traded.

d) The valuation of interests in family businesses is further complicated by the application of various discounts available to reduce the value of such interests under certain circumstances. These discounts may be available if:

i) There is no market for the sale of the business interest, resulting in a lack of marketability.

ii) The business interest represents a minority interest in the business.

iii) The death of the owner results in the loss of a key man crucial to the financial well-being of the business.

e) By careful planning, the ownership of the business may be structured to make available these discounts, for example, by ensuring that the owner does not own a controlling interest in the business at his death.

2) Background of Chapter 14

a) Chapter 14 was enacted as part of the Omnibus Budget Reconciliation Act of 1990 on November 5, 1990. The effective date was October 9, 1990, the reported date of relevant Senate Finance Committee action. In addition to what became sections 2701, 2702, and 2703, the Senate version included a provision that would have (1) determined the value of property without regard to any restriction other than a restriction which by its terms will never lapse and (2) provided that, in valuing property for estate tax purposes, any right held by the decedent with respect to the property would be deemed exercisable by the estate even if it lapsed on the decedent's death. The House-Senate Conference Report modified this provision to the current content of section 2704.

b) In 1990, Congress enacted I.R.C. § 2704, titled "Treatment of Certain Lapsing Rights and Restrictions," in an effort to limit the valuation discounts for gift and estate tax purposes applicable in the case of intra-family transfers of interests in family-owned, or "closely held," corporations and partnerships. If an individual and the individual's family hold voting or liquidation control over a corporation or partnership, I.R.C. § 2704(a) provides, in general, that the lapse of a voting or liquidation right shall be taxed as a transfer subject to gift or estate tax. I.R.C. § 2704 (b) provides, in general, that when an interest in a family-owned corporation or partnership is transferred within the family, if a restriction limits the ability of the corporation or partnership to liquidate and that restriction can be removed by the family, that restriction is disregarded in valuing the transferred interest for gift or estate tax purposes.

c) Finally, in I.R.C. § 2704(b)(4), Congress authorized Treasury to issue regulations providing "that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee."

3) Background and Administrative Details of Proposed Regulations

a) Released August 2, 2016 as Proposed Regulations only (not as Temporary Regulations).

b) Proposed effective date: date of publication of final regulations, with a 30 day delay for transfers subject to disregarded restrictions.

c) The Treasury Department's Preamble to the proposed regulations (the "Preamble") indicated that the proposed regulations concern "the valuation of interests in corporations and partnerships for estate, gift, and generation-skipping transfer (GST) tax purposes," specifically dealing with the treatment of certain lapsing rights and restrictions on liquidation in determining the value of the transferred interest.

d) I.R.C. 2704 provides special valuation rules for valuing intra-family transfers of interests *subject to lapsing voting or liquidation rights and restrictions on liquidation.*

e) Treasury and the IRS have determined that the current regulations "have been rendered substantially ineffective in implementing the purpose and the intent of the statute" by changes and state laws and other subsequent developments.

   i) In discussing the relevant changes in state law, the Preamble provided that:

      (1) I.R.C. § 2704(b)(3)(B) explicitly provides that "any restriction imposed, or required to be imposed, by any Federal or State law" is not an "applicable restriction" that would be disregarded under I.R.C. § 2704.

      (2) Current regulations provide that an applicable restriction is one which is "more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction." In *Kerr v. Commissioner*, 113 T.C. 449 (1999), aff'd 292 F.3d 490 (5th Cir. 2002), the court viewed this as a regulatory expansion of I.R.C. § 2704(b)(3)(B).

      (3) The Preamble noted that, "[s]ince the promulgation of the current regulations, many state statutes governing limited partnerships have been revised to allow liquidation of the entity only on unanimous vote of all owners (unless provided otherwise in the partnership agreement), and to eliminate the statutory provision that had allowed a limited partner to liquidate his or her limited partner interest." The Preamble goes on to state:

         (a) "Instead, these jurisdictions typically now provide that a limited partner may not withdraw from the partnership unless the partnership agreement provides otherwise." (Citing the Texas Business Organizations Code and the Uniform Limited Partnership Act.)

         (b) Or states create "elective restrictions" on liquidation. (Citing the Nevada Uniform Limited Partnership Act.)

         (c) As a result of such state law changes, many liquidation restrictions in partnership agreements are "no more restrictive than those under state law," and therefore are not "applicable restrictions"

   ii) In addressing "other subsequent developments" that have rendered the regulations "substantially ineffective," the Preamble put special emphasis on the case of *Kerr v. Commissioner* (cited above). The *Kerr* court held that I.R.C. § 2704(b) applied only to restrictions on the ability to liquidate an entire entity; not to restrictions on the ability

to liquidate a transferred interest. "Thus, a restriction on the ability to liquidate an individual interest is not an applicable restriction under the current regulations."

4) Stated Intent of Regulations.

a) Amend Treas. Reg. § 25.2704-1 to (i) address deathbed transfers that result in the lapse of a liquidation right; and (ii) clarify that a transfer that results in the creation of an assignee interest is a lapse;

b) Amend Treas. Reg. § 25.2704-2 to refine the definition of "applicable restriction" by eliminating the comparison to the liquidation limitations of state law; and

c) Add a new Treas. Reg. § 25.2704-3 (Disregarded Restrictions) to address (i) restrictions on the liquidation of an individual interest; and (ii) the effect of "insubstantial interests" held by nonfamily members.

5) Source of Authority.

a) Under I.R.C. § 2704(b)(4), "the Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of any interest in a corporation or partnership transferred to a member of the transferor's family if the restriction has the effect of reducing the value of the transferred interest for transfer tax purposes but does not ultimately reduce the value of the interest to the transferee."

i) Questions as to the validity of the regulations have largely focused on whether they "do not ultimately reduce the value of the interest to the transferee."

ii) Before they were released, it was widely assumed based on prior Greenbook proposals that the proposed regulations would include a deemed put right or provide substitute valuation assumptions. It was speculated that this would have rendered them invalid.

6) The Three Year Lookback Rule.

a) Under the current deemed gift/estate inclusion provisions of I.R.C. § 2704(a):

b) If there is a lapse of a voting or liquidation right; and members of the individual's family control the entity before and after the lapse; then the lapse is treated as a transfer. An inter vivos lapse is treated as a gift; a lapse at death is includable in the gross estate. I.R.C. §2704(a)(1).

i) "Liquidation right" is "the right or ability, including by reason of aggregate voting power, to compel the entity to acquire all or a portion of the holder's equity interest, whether or not its exercise would result in complete liquidation of the entity." Treas. Reg. § 25.2704-1(a)(2)(v).

c) The lapse is valued as the fair market value of all interests held immediately before the lapse (determined as if voting and liquidation rights were nonlapsing) over the fair market value of all interests after the lapse. I.R.C. § 2704(a)(2).

d) Current regulations provide an exception: "a transfer of an interest that results in the lapse of a liquidation right is not subject to this section if the rights with respect to the transferred interest are not restricted or eliminated." Treas. Reg. § 25.2704-1(c)(1).

i) The net result is that a majority owner can transfer minority interest inter vivos, and it is not treated as a lapse -- even though it results in the loss of the transferor's controlling interest:

> D owns 84 percent of the single outstanding class of stock of Corporation Y. The by-laws require at least 70 percent of the vote to liquidate Y. D gives one-half of D's stock in equal shares to D's three children (14 percent to each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y, because voting rights are not restricted or eliminated by reason of the transfer. Treas. Reg. § 25.2704-1(f), Ex. 4.

ii) Citing *Estate of Murphy v. Commissioner*, T.C. Memo. 1990-472, the Preamble indicates that the exception in the present rule should not apply to an inter vivos transfer that results in the loss of the power to liquidate on a decedent's deathbed. In *Murphy*, the decedent transferred a small amount of stock in a closely-held corporation that reduced the size of her remaining stock to less than 50 percent of the total outstanding stock. The court concluded that the substance of the transaction was to generate a minority discount for transfer tax purposes.

iii) Prop. Reg. § 25.2704-1 would create a bright line test to eliminate this result for transfers occurring within three years of death. Instead, transfers within three years of death that result in the lapse of a liquidation right would be treated as transfers occurring at death for the purposes of I.R.C. § 2704(a):

> D owns 84 percent of the single outstanding class of stock of Corporation Y. The by-laws require at least 70 percent of the vote to liquidate Y. More than three years before D's death, D gives one-half of D's stock in equal shares to D's three children (14 percent to each). Section 2704(a) does not apply to the loss of D's ability to liquidate Y, because voting rights are not restricted or eliminated by reason of the transfer, and the transfer occurs more than three years before D's death. However, had the transfers occurred within three years of D's death, the transfers would have been treated as the lapse of D's liquidation right occurring at D's death. Prop. Reg. § 25.2704-1(f), Ex. 4.

iv) In addition, the proposed regulations:

(1) Adopt the proposed regulations elimination of the comparison to local law in determining restrictions on ability to liquidate;

(2) clarify that manner in which liquidation may be achieved is irrelevant; and

(3) conform to proposed regulation for disregarding certain nonfamily interests (discussed below).

v) Many commentators have speculated that this section of the proposed regulations is unnecessary at best, and has the potential to result in double taxation at worst. As a result of the "disregarded restrictions" discussed below, it appears that the value of an interest would be computed as if the transferee could liquidate the interest and receive the underlying value, regardless of percentage owned. As a result, if that same value were taxed under the three year look back, the result would be double taxation.

vi) The value to be included in the gross estate under this provision is unclear. Treasury Regulations Section 25.2701-1(d) provides that the amount of the transfer is the excess, if any, of—(1) the value of all interests in the entity owned by the holder immediately before the lapse (determined immediately after the lapse as if the lapsed right was nonlapsing); over (2) the value of the interests described in the preceding paragraph immediately after the lapse (determined as if all such interests were held by one individual. The date as of which the interest is to be valued (date of transfer or date of death) is unclear.

(1) The value determined immediately after the lapse – *as if such interests were held by one individual* - would presumably be the same as the value determined before the lapse, resulting in taxable inclusion valued at zero.

(2) Alternatively, the Proposed Regulations might clarify that the value of *all interests* owned by the transferor within three years of his or her death should be included in the taxable estate. It is unclear how this might account for gifts subject to marital or charitable deduction.

vii) That the effect of this provision would be taxation of a phantom asset.

viii) This provision may require a statutory change to I.R.C. § 2035.

7) Disregarding Provisions of Code Section 2704(b) (Applicable Restrictions).

a) I.R.C. § 2704(b)

i) The overall effect of I.R.C. § 2704(b) is that specified restrictions are disregarded in valuing such an interest for gift or estate tax purposes when that interest is transferred to a family member.

ii) Subsection (1) provides: "For purposes of this subtitle, if **(A)** there is a transfer of an interest in a corporation or partnership to (or for the benefit of) a member of the transferor's family, and **(B)** the transferor and members of the transferor's family hold, immediately before the transfer, control of the entity, ***any applicable restriction shall be disregarded in determining the value of the transferred interest***."

iii) Subsection (2) defines the applicable restriction as one "which effectively limits the ability of the corporation or partnership to liquidate, and **(B)** with respect to which either of the following applies: **(i)** [t]he restriction lapses, in whole or in part, after the transfer referred to in paragraph (1) [or] **(ii)** [t]he transferor or any member of

the transferor's family, either alone or collectively, has the right after such transfer to remove, in whole or in part, the restriction."

iv) Subsection (3) provides an exception to the rule for disregarding applicable restrictions in valuing an interest transferred to a family member. If an otherwise applicable restriction is "a commercially reasonable restriction which arises as part of any financing by the corporation or partnership with a person who is not related to the transferor or transferee, or a member of the family of either" or is a "restriction imposed, or required to be imposed, by any Federal or State law" the restriction can be considered in determining the value of the interest transferred.

b) Existing Treasury Regulations Section 25.2704-2

i) Current regulations define an applicable restriction as "a limitation on the ability to liquidate the entity (in whole or in part) that is more restrictive than the limitations that would apply under the State law generally applicable to the entity in the absence of the restriction."

ii) Many state laws regarding withdrawal from a partnership, or the right of a partner to compel liquidation of the partnership, are as restrictive as possible. In the Preamble to the proposed regulations, Treasury specifically cites: Tex. Bus. Orgs. Ann. § 153.110 (West 2016) (limited partner may withdraw as specified in the partnership agreement); Uniform Limited Partnership Act (2001) § 601(a), 6A U.L.A. 348, 448 (Supp. 2015) (limited partner has no right to withdraw before completion of the winding up of the partnership); Nev. Rev. Stat. § 87A.427 (2016) (limited partnership electing to be restricted limited partnership may not make any distributions for a 10-year period). Under most default state laws pertaining to partnerships and limited liability companies, owners cannot withdraw or dissociate in some cases at all, or in many cases without the unanimous consent of all other owners. Similar restrictions exist with respect to the right of an owner to compel liquidation. Any restrictions imposed by governing documents would be more restrictive than state law, and since they would be as restrictive as or less restrictive than state law, they are not "applicable restrictions" under the existing regulations and can be considered in determining the value of the entities.

c) Proposed Regulations at Prop. Reg. § 25.2704-2

i) The proposed regulations would make significant changes to the valuation for transfer tax purposes of interests in a family-controlled entity that are subject to applicable restrictions on redemption or liquidation – that is, subject to limitations on the ability of the owner of the interest to require the entity or other owners to redeem or buy out that owner.

ii) In the background discussion of the proposed regulations, Treasury acknowledges that state law has essentially gutted the meaning of "applicable restriction," and the proposed regulations are responding directly to those changes that have provided for

the most restrictive possible default terms with respect to withdrawal and liquidation:

iii) "Since the promulgation of the current regulations, many state statutes governing limited partnerships have been revised to allow liquidation of the entity only on the unanimous vote of all owners (unless provided otherwise in the partnership agreement), and to eliminate the statutory default provision that had allowed a limited partner to liquidate his or her limited partner interest. Instead, statutes in these jurisdictions typically now provide that a limited partner may not withdraw from the partnership unless the partnership agreement provides otherwise…[T]hese statutes [are] designed to be at least as restrictive as the maximum restriction on liquidation that could be imposed in a partnership agreement. The result is that the provisions of a partnership agreement restricting liquidation generally fall within the regulatory exception for restrictions that are no more restrictive than those under state law, and thus do not constitute applicable restrictions under the current regulations."

iv) The implication in the background discussion to the proposed regulations is that family controlled entities have relied on these very restrictive default provisions in state law to provide cover for otherwise illusory restrictions imposed in the governing documents of those same entities to create the best possible valuation discounts.

v) The proposed regulations seek to substantively changes the definition of applicable restriction to address the evolution of state statutes with very restrictive default provisions.

(1) Applicable Restriction redefined. The definition of applicable restriction under the proposed regulations would include all applicable restrictions, regardless of whether they are as restrictive, more restrictive, or less restrictive than state law:

(a) "The term *applicable restriction* means a limitation on the ability to liquidate the entity, in whole or in part (as opposed to a particular holder's interest in the entity), if, after the transfer, that limitation either lapses or may be removed by the transferor, the transferor's estate, and/or any member of the transferor's family, either alone or collectively." Prop. Reg. § 25.2704-2(b)(1).

(i) Source of limitation. Rather than focusing on applicable restrictions defined in the governing documents of the entity, under the proposed regulations, applicable restrictions will be disregarded, no matter the source of the restriction. If an owner's rights to withdraw or liquidate are limited by state law, governing documents, or side agreements, the limitation will be disregarded for transfer tax valuation purposes. According to the background material provided, "this proposed rule is intended to ensure that a restriction that is not imposed or required to be imposed by federal or state law is disregarded without regard to its source."

(b) "An applicable restriction includes a restriction that is imposed under the terms of the governing documents (for example, the corporation's by-laws, the partnership agreement, or other governing documents), a buy-sell agreement, a redemption agreement, or an assignment or deed of gift, or any other document, agreement, or arrangement; and a restriction imposed under local law regardless of whether that restriction may be superseded by or pursuant to the governing documents or otherwise. For this purpose, local law is the law of the jurisdiction, whether domestic or foreign, that governs the applicability of the restriction. For an exception for restrictions imposed or required to be imposed by federal or state law, see paragraph (b)(4)(ii) of this section." Prop. Reg. § 25.2704-2(b)(2)

(c) The proposed regulations include four exceptions to the definition of applicable restriction.

(i) Prop. Reg. § 25.2704-2(b)(4)(i) – Commercially Reasonable Exception. Maintaining language from the existing regulations, a restriction that is commercially reasonable restriction will be not be disregarded when valuing an interest for transfer tax purposes. This acknowledges that family businesses, like any commercial arrangement, may be compelled to restrict its activity during the normal course of business to attract capital. A commercially reasonable restriction is a "restriction on liquidation imposed by an unrelated person providing capital to the entity for the entity's trade or business operations, whether in the form of debt or equity." Prop. Reg. § 25.2704-2(b)(4)(i).

(ii) Prop. Reg. § 25.2704-2(b)(4)(ii) – Required by Law Exception. Expanding the language of the existing regulations, the proposed regulations would provide an exception to a definition of applicable restriction, so that a restriction that is imposed or required to be imposed by state or federal law would not be disregarded in valuing the interest for transfer tax purposes. The proposed regulations make much effort to avoid the impact of state law restrictions that are default restrictions only, and that can be removed or overridden by the later action of family members. Prop. Reg. § 25.2704-2(b)(4)(ii).

1. For purposes of this exception, federal and state law include the laws of the United States, any state of the United States, and the District of Columbia. The laws of territories or foreign jurisdictions will not meet the test for this exception.

2. The proposed regulations identify the following as laws that are not imposed or required to be imposed by federal law, and as such, would not meet the exception set out in

a. A law that applies only in the absence of a contrary provision in the governing documents is not a restriction that is imposed or required to be imposed by federal or state law.

b. A law that may be superseded with regard to a particular entity (whether by the shareholders, partners, members and/or managers of the entity or otherwise) is not a restriction that is imposed or required to be imposed by federal or state law.

c. A law that is limited in its application to certain narrow classes of entities, particularly those types of entities (such as family-controlled entities) most likely to be subject to transfers described in I.R.C. § 2704 is not a restriction that is imposed or required to be imposed by federal or state law.

d. If law allows for an entity to be created, organized, or governed under a different set of statutes that does not mandate the restriction, makes the restriction optional, or permits the restriction to be overridden it is not a restriction that is imposed or required to be imposed by federal or state law. In this case the restriction is optional because, under the theory of the proposed regulations, the transferor or the transferor's family could change the law by which the entity is governed after the transfer to remove the effect of the restriction.

(iii)Prop. Reg. § 25.2704-2(b)(4)(iii) – 2703 Exception. As in the existing regulations, an exception exists for an option, the right to use property, or an agreement that is subject to section 2703. Such rights are applicable restrictions that are disregarded for purpose transfer tax purposes under section 2704. Prop. Reg. § 25.2704-2(b)(4)(iii)

(iv)Prop. Reg. § 25.2704-2(b)(4)(iv) – Put Right Exception. The proposed regulations provide a put-right exception. Some believe it is intended to be a safe harbor, as discussed below. If state law or the governing documents include a restriction that would otherwise be deemed to be an applicable restriction to be disregarded in valuing the interest for transfer tax purposes, the restriction will not be disregarded if the holder of the interest has a put right as described in § 25.2704-3(b)(6). This put right would ensure that the holder of the interest has the right to convert his or her interest to real value, at least equal to "minimum value" as described later, without interference, and as such, would allow any otherwise stated restriction to be considered. Prop. Reg. § 25.2704-2(b)(4)(iv)

vi) In keeping with the existing regulations and the statute, an applicable restriction is only such if it lapses after the transfer or can be removed after the transfer by the transferor, the transferor's estate, or members of the transferor's family. Prop. Reg. § 25.2704-2(b)(3)

8) **The "Assignee" Issue.**

a) Under state law, an assignee of a membership or partnership interest is generally not automatically admitted as a member or partner, but instead is merely entitled to a share of profits. As a result, the assignee has no power to liquidate the entity.

b) The Preamble indicates that Treasury views this change as being in line with the change to the elimination of the test of whether an applicable restriction is "no more restrictive than state law."

c) Under Prop. Reg. § 25.2704-1(a)(5), a "transfer that results in the restriction or elimination of the transferee's ability to exercise the voting or liquidation rights that were associated with the interest while held by the transferor is a lapse of those rights. For example, the transfer of a partnership interest to an assignee that neither has nor may exercise the voting or liquidation rights of a partner is a lapse of the voting and liquidation rights associated with the transferred interest."

d) The proposed regulation does not distinguish between a temporary lapse (i.e., the period between the death of the partner and the time his or her estate is admitted as a substitute partner) and permanent lapses.

9) **Nonfamily Interests.**

a) The Preamble suggests that taxpayers have avoided the application of I.R.C. § 2704(b) through the transfer of a nominal partnership interest to a nonfamily member, such as a charity or an employee, to ensure that the family alone does not have the power to remove a restriction, again citing *Kerr*.

b) To avoid such results, the Preamble notes that Treasury and the IRS have concluded that the grant of "an insubstantial interest" to a nonfamily member should not preclude the application of I.R.C. § 2704(b) because "in reality, such nonfamily member interest generally does not constrain the family's ability to remove a restriction on the liquidation of an individual interest" and "does not affect the family's control of the entity, but rather, when combined with a requirement that all holders approve liquidation, is designed to reduce the transfer tax value of the family-held interests."

c) Accordingly, Prop. Reg. § 25.2704-3(a)(4) would create a bright-line test to determine whether a nonfamily member's interest should be disregarded for purposes of determining whether the family acting alone may remove a disregarded restriction following a transfer. The stated purpose of the bright-line test is to ensure that a nonfamily member's interest is an economically substantial and longstanding one that is likely to have a substantive effect, and to avoid the fact intensive inquiry underlying a determination of whether the interest of a nonfamily member effectively constrains the family's ability to liquidate the entity.

d) Under Prop. Reg. § 25.2704-3(a)(4), a nonfamily member's interest will be disregarded for purposes of determining whether the family acting alone may remove a disregarded restriction following a transfer unless all of the following requirements are met:

i) The interest has been held by the nonfamily member for at least 3 years immediately before the transfer.

   (1) The 3 year requirement seems excessive and can cause very different tax results based on an arbitrary period. For example, if members of a family and an unrelated party (X) form a business in which each collectively owns 50% and that requires the consent of both the family and X for partial liquidations or redemptions, then X's interest will be disregarded if one of the family members dies or transfers an interest in the business within 3 years of formation. As a result, the family will be treated as if they can remove the restriction on partial liquidation and redemptions without anyone else's approval or consent, and the interest transferred will be valued as if the transferor and transferee have the right to redeem the interest. On the other hand, if the family member is fortunate enough to live at least 3 years after formation, or if the family member makes the transfer 3 years and 1 day after formation, then X's interest will not be disregarded and the family member will have a very different tax result.

   (2) Does the three year period restart if a nonfamily member sells or otherwise transfers an interest to another nonfamily member? If so, the time requirement might never be satisfied. Or, is there a mechanism for "tacking" ownership?

ii) On the date of the transfer: (a) the nonfamily member's interest constitutes at least 10% of the value of all equity interests <u>and</u> (b) the total equity interests held by <u>all</u> nonfamily members constitutes at least 20% of the value of all equity interests.

   (1) Requiring both a single nonfamily owner to own 10% <u>and</u> all nonfamily owners to own 20% is excessive. If nonfamily members are investors in the entity of this magnitude (either one with 10%, or several aggregating to 20%), it can hardly be said their interests are insubstantial.

   (2) In applying the 10% and 20% tests, the attribution rules of Prop. Reg. § 25.2704-3(d) and Treas. Reg. § 25.2701-6 apply in determining the interest held by a nonfamily member and in measuring the interest such person owns indirectly through other entities. <u>However</u>, the interest of a nonfamily member and all of the interests held by such nonfamily member's family in the same entity are not aggregated for purposes of the 10% and 20% tests.

   By way of example, assume the following scenario: A and B, unrelated parties, go into business together. A owns 70%; B owns 30%. Assume both interests are entirely legitimate, but B does not have the same access to capital as A (and therefore owns less of the entity). Because A and B wish to have a "check and balance," their agreement provides that the entity cannot be liquidated without the consent of 85% of the interests.

   As part of her estate plan, B makes four separate, completed gifts, each of 7% of the entity to each of her four nieces and nephews. After B's gifts under the regulations as proposed, B's family's 30% interest is disregarded (because no single

non-family member owns greater than 10%). A's interest is therefore deemed to hold 100% of the value, and, it would seem, A's interest is ascribed a liquidation right that it does not – and has never – actually had. Thus, A is penalized for B's estate planning.

iii) All nonfamily members have a "put right" (not just the nonfamily member whose consent is required to ensure that the family alone does not have the power to remove a restriction) to receive cash and/or other property with a value at least equal to the "minimum value" of such interest within 6 months of providing notice of the intent to withdraw.

(1) Requiring a family that enters into a business arrangement with unrelated third parties to provide the third parties with put rights is an unrealistic and unworkable way to structure a business, and it has the effect of disregarding virtually all nonfamily held interests. It would be impossible to attract investors to an entity if the other investors can withdraw their share of the business at any time. Similarly, a long-term business plan is inconceivable while under immediate threat of withdrawal at all times. In addition, put rights may be entirely disallowed, such as in regulated entities (*i.e.,* banks).

(2) If a holder were to withdraw, the entity or family must pay them the "minimum value," which is the full value of the company multiplied by their percentage interest. A great portion, if not most, of the value of many businesses lies in the goodwill, hard assets and expected future returns. Amazon.com Inc. has a market capitalization of more than $300 billion, but if a 10% owner wanted his $30 billion, the liability itself would greatly impact Amazon's cash flow, ability to invest and obtain future financing. The same would be true for any other business on a smaller scale. A business just can't promise to pay any non-family investor who wants his money back.

10) Additional Proposed Regulations Under I.R.C. § 2701: Control and Attribution.

a) Control. Under I.R.C. § 2704(c)(1), "[t]he term "control" has the meaning given to such term by section 2701(b)(2). Section 2704 only applies if a family "controls" the entity before and after the transfer/event.

i) Prop. Reg. §§ 25.2704-2(c) and 25.2704-3(c) each provide: "For the definition of the term controlled entity, see § 25.2701-2(b)(5). For the definition of the term member of the family, see § 25.2702-2(a)(1)."

ii) Treas. Reg. § 25.2701-2(b)(5) & Prop. Reg. § 25.2701-2(b)(5).

(1) "Control" means holding at least 50% by vote or value of the stock in the corporation or holding at least 50% of the capital or profits interests in the partnership or any interest as a general partner of the partnership. Treas. Reg. § 25.2701-2(b)(5). There is currently no separate test for LLCs.

(2) Prop. Reg. § 25.2701-2(b)(5)(i) expands the description of a "controlled entity" to include not only corporations and partnerships, but any other entity or arrangement that is classified as a business entity under Treas. Reg. § 301.7701-2(a) that is controlled by the transferor, applicable family members, or lineal descendants of the parents of the transferor or the transferor's spouse immediately before a transfer.

(a) This section of the Proposed Regulations also clarifies that an entity other than a corporation is classified in accordance with local law, regardless of how the entity is classified for federal tax purposes (including entities disregarded for federal tax purposes).

(3) Prop. Reg. § 25.2701-2(b)(5)(iv) provides the applicable test for control of entities other than corporations or partnerships, such as limited liability companies. Consistent with the test for partnerships and corporations, "control" means the holding of at least 50% of the capital or profits interests in the entity. An additional definition of control includes the holding of any equity interest with the ability to cause the liquidation of the entity in whole or in part.

iii) The Integration of Prop. Reg. §§ 25.2701-2(b)(5), 25.2704-2(c), 25.2704-3(c), and Treas. Reg. § 25.2702-2(a)(1)

(1) Prop. Reg. §§ 25.2704-2(a) (relating to applicable restrictions) and 25.2704-3(a) (relating to disregarded restrictions) each disregard certain restrictions if an interest is transferred in an entity and "the transferor and/or members of the transferor's family control the entity immediately before the transfer."

(2) Because "control" is defined with reference to existing Treas. Reg. § 25.2701-2(b)(5), which already explicitly governs the identities of the persons whose interests should be considered, the additional test as to whether "members of the transferor's family" control the entity is not entirely clear.

(3) Prop. Reg. § 25.2704-2(c) and 25.2704-3(c) provide that the phrase "member of the family" is as defined in Treas. Reg. § 25.2702-2(a)(1) which identifies such persons as being an individual's "spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any brother or sister of the individual, and any spouse of the foregoing."

b) Attribution

i) Under I.R.C. § 2704(c)(3), "[t]he rule of section 2701(e)(3) shall apply for purposes of determining the interests held by any individual."

ii) Prop. Reg. §§ 25.2704-2(d) and -3(d) provide that "An individual, the individual's estate, and members of the individual's family are treated as also holding any interest held indirectly by such person through a corporation, partnership, trust, or other entity under the rules contained in §25.2701-6"

iii) Treas. Reg. § 25.2701-6 contains unique attribution rules with respect to trusts that cannot be superimposed on I.R.C. § 2704:

(1) Unascertainable Beneficiaries. Under Treas. Reg. § 25.2701-6(a)(4), a person is considered to hold an interest held in trust to the extent that his or her beneficial interest in the trust may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, based on the assumption that the trustee will exercise maximum discretion in favor of the person. However, a beneficiary who cannot receive any distribution with respect to an equity interest (including the income therefrom or the proceeds of a disposition) is not considered a holder of the interest, as would be the case, for example, if such an interest was earmarked for one or more beneficiaries at the exclusion of all others. Accordingly, it is possible that, for I.R.C. § 2701 attribution purposes, an equity interest may be fully attributed to the remainder beneficiaries of a trust, even though they have no right to receive current distributions and no rights to accumulated income.

(2) In addition, an individual is treated as holding any equity interest held by or for a trust if the individual is the owner of the trust under subpart E. As such, without the application of "tie-breaker" rules in Treas. Reg. § 25.2701-6(a)(5), the application of the "basic" attribution rules could result in an equity interest being 100% attributed to the grantor and each current and remainder beneficiary of a discretionary grantor trust. The tie breaker presuppose the existence of senior and junior equity interests by attributing interests among generations based on the class of equity.

11) Voting Right as Including the Right of LLC Member to Participate in Company Management.

a) If there is a lapse of a voting right and members of the individual's family control the entity before and after the lapse, then the lapse is treated as a transfer. An inter vivos lapse is treated as a gift and a lapse at death is includable in the gross estate. I.R.C. §2704(a)(1).

b) While I.R.C. § 2704 speaks only in terms of corporations and partnerships, the proposed regulations clarify that "partnerships" are broadly defined to include any "business entity" within the meaning of Treas. Reg. § 301.7701-2(b)(1), regardless of how that entity is classified for federal tax purposes. Thus, for example, the term "partnership" includes a limited liability company whether or not it is disregarded as an entity separate from its owner for federal tax purposes.

c) In the case of limited liability companies, the proposed regulations modify the definition of a "voting right" in Treas. Reg. § 25.2704-1(a)(2)(iii) to include the "right of a member to participate in company management."

i) This is incongruous with the treatment of partners and shareholders. In the case of a corporation, certain classes of shareholders may not have voting rights while others do not. Similarly, in the case of a limited partnership, limited partners typically do not have voting rights (but see, e.g. Florida Statutes section 620.1303, allowing limited partners to participate in the management and control of the limited partnership). In either a corporation or partnership, if a shareholder or limited partner does not have the right to vote according to the governing documents of the entity, there will be no voting right ascribed to that shareholder or limited partner. On the other hand, there would be such a voting right ascribed to a member in a limited liability company. We do not understand the purpose for the distinction between the default voting rights of members of LLCs and the default voting rights of shareholders of a corporation.

ii) The first sentence of current Treas. Reg. § 25.2704-1(a)(2)(iii) ("Voting right means a right to vote with respect to any matter of the entity.") amply captures the right of a member of an LLC to vote with respect to any matter of the entity as being a voting right. And thus, the reference to "the right of a member to participate in company management" is presumably not limited to participation in the member's capacity as a member.

(1) If an LLC member happens to be a manager, officer, or executive of the LLC, would the member be treated as having a voting right for purposes of I.R.C. § 2704(a)?

(2) If so, when the executive or manager resigns or quits, a lapse would occur but the value of their LLC interest would not have changed so there would be no taxable transfer by reason of the lapse. Given the fact that no taxable transfer would result in such scenario, what is the purpose of the additional "participation in company management" language for LLCs? Is it merely extraneous?

12) Disregarded Restrictions.

a) Prop. Reg. § 25.2704-3 creates a new class of disregarded restrictions for transfer tax purposes. Like an "applicable restriction," any of these "disregarded restrictions" will be ignored for purposes of valuing an interest conveyed that is subject to transfer tax.

b) Treasury identifies I.RC. § 2704 for its authority to create this new class of restrictions. That section provides: "The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle but does not ultimately reduce the value of such interest to the transferee." Treasury also cites the Tax Court's position that Congress granted Treasury discretion under this section to create regulations that identify restrictions not already covered by section 2704(b) that should be disregarded for transfer tax valuation purposes because those restrictions adversely impact the transfer tax value of an interest but that do not reduce the value of the interest to the family-member transferee. Kerr v. Commissioner, 113 T.C. 449, 473 (1999), aff'd, 292 F.3rd 490 (5th Cir. 2002)

c) In the Preamble to the proposed regulations, Treasury distinguishes these new disregarded restrictions under I.R.C. § 2704 from the restrictions and limitations addressed in § 2703. Section 2703 addresses the sale or use of family controlled entities; Section 2704(b), and the new disregarded restrictions under Prop. Reg. § 25.2704-3 would address the liquidation or redemption of interests in family-controlled entities.

d) In carrying out the discretion to create new kinds of disregarded restrictions, and thus further limit nature and extent of valuation discounts available to family-controlled entities, IRS and the Treasury Department take aim at any restriction on the ability of a partner, shareholder, member, or owner to liquidate the transferred interest and any restrictions "attendant upon the nature or extent of the property to be received in exchange for the liquidated interest, or the timing of the payment of that property."

e) The threshold element of the new type of disregarded restriction is still the fact that after the transfer of an interest in a family-controlled entity, the restriction will lapse or can be removed by the transferor or any member or members of the transferor's family. But rather than describing the *kinds* of such lapsing or removable restrictions that will be disregarded in making valuations, the proposed regulations define those restrictions with reference to the *effect* they would have on gift or estate tax value.

f) The disregarded restrictions will apply to any transfer of an interest in a corporation or partnership from a transferor to or for the benefit of a member of the transferor's family if the transferor and/or the transferor's family control the entity immediately before the transfer. Prop. Reg. § 25.2704-3.

    i) The disregarded restrictions apply for all transfer tax purposes, which are defined to include estate tax, gift tax, and generation-skipping transfer tax.

    ii) Corporation and partnership are defined broadly, to include all forms of entities. A corporation includes (1) any business entity described in Reg. § 301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8) of this chapter, (2) an S corporation within the meaning of section 1361(a)(1), and (3) a qualified subchapter S subsidiary within the meaning of section 1361(b)(3)(B). A qualified subchapter S subsidiary is deemed to be separate from its parent corporation for this definition. A partnership is defined to include any other business entity within the meaning of § 301.7701-2(a), regardless of entity classification. The regulations specifically clarify that "partnership" includes a limited liability company organized under state law that is not an S corporation, regardless of its entity classification or disregarded status.

g) The effect of disregarding a restriction under Prop. Reg. § 25.2704-3(f) is that the fair market value of the interest is determined assuming the restriction did not exist, either in the governing documents or applicable law. Many commentators have expressed concern about the application of the new disregarded restrictions.

h) Prop. Reg. § 25.2704-3(b) identifies four specific limitations on the right to redeem or liquidate an entity that will be classified as disregarded restrictions, if the limitation either

lapses after the transfer or can be removed by the transferor or any member of the transferor's family. The four disregarded restrictions are:

i) Prop. Reg. § 25.2704-3(b)(i) – Limitation on Liquidation or Redemption. If a provision limits or permits the limitation of the ability of the holder of the interest to compel liquidation or redemption of the interest, the restriction will be classified as a disregarded restriction.

ii) Prop. Reg. § 25.2704-3(b)(ii) – Minimum Value. If a provision limits *or permits the limitation of* the liquidation or redemption proceeds to an amount that is less than minimum value, as later defined, the restriction will be a disregarded restriction. For a more complete discussion of "minimum value," see below.

iii) Prop. Reg. § 25.2704-3(b)(iii) – Deferral of Payment. If a provision defers or permits the deferral of payment of liquidation or redemption proceeds for more than 6 months after the holder of the interest gives notice of the liquidation or redemption action, the restriction will be a disregarded restriction.

iv) Prop. Reg. § 25.2704-3(b)(iv) – Manner of Payment. If a provision permits the payment of liquidation or redemption proceeds in any manner other than with cash or property, the restriction will be a disregarded restriction.

(1) Notes and obligations of related parties are not considered property for purposes of these provisions. The proposed regulations provide that a note issued by the entity, the holder of an interest, or a related party to the entity or a holder will not suffice to be considered property. The purposes of carving out notes as an unacceptable form of redemption or liquidation proceeds must be to prevent disguised restrictions in debt instruments that could otherwise mirror disregarded restrictions.

(2) Active Trade or Business Exception for Notes. An exception to the "no note" rule is made for active trade or businesses, with a cross-reference to I.R.C. § 6166(b)(9)(B), provided the note is adequately secured, has market interest, requires payments, and has a fair market value on the date of issue to the value of the redemption or liquidation proceeds.

i) "Other Property"

(1) Prop. Reg. § 25.2704-3(b)(iv) contains the general rule that "<u>property</u>" does <u>not</u> include a note or other obligation issued directly or indirectly by the entity, holders of an interest in the entity, or persons related to either the entity or any of holder of an interest in the entity. For this purpose, "related" persons are persons having a relationship described in I.R.C. § 267(b), with a carve out for publicly held corporate fiduciaries.

(2) An exception to this general rule is made for entities engaged in an active trade or business, at least 60% of whose value consists of the non-passive assets of that trade or business. For such entities, "to the extent the liquidation proceeds are not attributable to passive assets," proceeds may include a note or other obligation if

such note or other obligation is (a) adequately secured, (b) requires periodic payments on a non-deferred basis, (c) is issued at "market interest rates", and (d) has a fair market value on the date of liquidation or redemption equal to the liquidation proceeds.

(a) For an entity engaged in an active trade or business, a note may be used to pay the liquidation proceeds but only up to to the percentage of the entity's non-passive assets.

(b) "Passive assets," as defined in I.R.C. § 6166(b)(9)(B), are all assets other than those used in carrying on the trade or business.

(i) This typically includes stock in another corporation unless that corporation is engaged in an active trade or business and at least 80% of each corporation is attributed to the trade or business and either the parent corporation owns 20% or more in value of the subsidiary stock or the subsidiary has 45 fewer shareholders. I.R.C. § 6166(b)(9)(B)(iii).

(ii) Whether real property will qualify as an active or passive asset depends on the person's activities with respect to the property, as well as the activities (or lack thereof) of management companies and third parties. See, e.g., Rev. Rul. 2006-34, 2006-26 I.R.B. 1171 (June 26, 2006) (containing a list of factors the IRS will consider to determine whether an interest in real property is an interest in an asset used in an active trade or business).

(c) What is meant by "market interest rates" (AFR or something else) and fair market value equal to liquidation proceeds?

(d) After stating that the note must be market rate, adequately secured, require periodic payments and have a fair market value equal to the liquidation proceeds, the proposed regulation says to "See Reg. § 25.2512-8" without further explanation. This regulation generally states that when consideration is given for the transfer, but the consideration is worth less than the value of the transferred property, a gift is made of the excess value. This regulation also provides that insufficient consideration will not result in a gift if the transaction was made in the ordinary course of business. Without further explanation, it is unclear what is meant by the citation in the proposed regulations.

j) "Minimum Value" Defined

i) Prop. Reg. § 25.2704-3(b)(1)(ii) includes a provision that "limits or permits the limitation of the amount that may be received by the holder of the interest on liquidation or redemption of the interest to an amount that is less than a *minimum value*" as a restriction that may become a disregarded restriction, meaning the interest's share of the "net value of the entity determined on the date of liquidation or redemption."

(1) The proposed regulation goes further to define the "net value of an entity" as "the fair market value … of the property held by the entity," determined under I.R.C. §§

2031/2512 and the regulations thereunder, reduced by certain "obligations of the entity.".

(a) The only outstanding obligations that may be taken into account are those that would be allowable if paid as deductions under 2053 if they were claims against an estate.

(b) It is unclear what this really means for an operating business or, for example, a business that holds significant real estate or other illiquid assets.

ii) There is concern that this definition would penalize those who hold their non-business interests in LLC or other entity format, as opposed to co-tenancy. In the absence of an entity, owners would be entitled to fractional interest discounts.

(1) Example: Assume two sisters each own an equal and undivided interest in farmland. If the sisters own the farmland as tenants-in-common, each sister's interest in the farmland would be valued based on the fair market value of the underlying farmland, discounted for the fractional interest ownership. If the sisters transfer the farmland to an entity, no such fractional interest discount would be allowable upon a transfer. In addition, because of the definition of minimum value as "net value of the entity **determined on the date of liquidation,"** it is unclear the extent to which lack of marketability discounts should be allowed in valuing the interest.

(2) The net effect of this may be to:

(a) Deprive family-owners of the management efficiencies offered by a structure;

(b) Deprive or minimize the creditor protection available to family owners; and

(c) Favor unrelated individuals who co-own property over families.

(3) It would be appropriate to note that, in some cases, the IRS may successfully argue that a co-tenancy is an association that should be characterized as a partnership, for example, if the co-tenants are carrying on a trade or business. See, e.g., *Cusick v. C.I.R.*, 76 T.C.M. (CCH) 241, 243 (1998) (finding rental real estate activities created a partnership).

iii) Application to Operating Businesses

(1) By referring to the fair market value of property held by the entity, the proposed regulations imply that the entity value is based on a liquidation sale of the assets of the operating business.

(2) However, Prop. Reg. § 25.2704-3(b)(1)(ii) continues: …if the entity holds an operating business, the rules of §20.2031-2(f)(2) or §20.2031-3 of this chapter apply in the case of a testamentary transfer and the rules of §25.2512-2(f)(2) or §25.2512-3 apply in the case of an inter vivos transfer.

(3) Treas. Reg. § 20.2031-2(f)(2) provides as follows with respect to the value of stock in a corporation where bid and ask prices are not readily available:

> (2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.
>
> Some of the 'other relevant factors' referred to in subparagraphs (1) and (2) of this paragraph are: The good will of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. In addition to the relevant factors described above, consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company, to the extent such nonoperating assets have not been taken into account in the determination of net worth, prospective earning power and dividend-earning capacity.

(4) Treas. Reg. § 20.2031-3 provides as follows:

> The fair market value of any interest of a decedent in a business, whether a partnership or a proprietorship, is the net amount which a willing purchaser whether an individual or a corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The net value is determined on the basis of all relevant factors including -
>
> > (a) A fair appraisal as of the applicable valuation date of all the assets of the business, tangible and intangible, including good will;
> >
> > (b) The demonstrated earning capacity of the business; and
> >
> > (c) The other factors set forth in paragraphs (f) and (h) of § 20.2031-2 relating to the valuation of corporate stock, to the extent applicable.
>
> Special attention should be given to determining an adequate value of the good will of the business in all cases in which the decedent has not agreed, for an adequate and full consideration in money or money's worth, that his interest passes at his death to, for example, his surviving partner or partners. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of examinations of the business made by accountants, engineers, or any technical experts as of or near the applicable valuation date.

(5) The above sections relate to valuation rules for testamentary transfers, and Treas. Reg. § 25.2512-2(f)(2) and -3 provide comparable rules for the valuation of inter vivos transfers.

(6) This seems to imply that the net asset value will not be the sole determination of minimum value in the case of an operating business. Nonetheless, the circular references in the Regulations under I.R.C. §§ 2512 and 2031 back to I.R.C. § 2704 make the actual impact less than clear.

iv) Minimum Value as a Safe Harbor

(1) To the extent that the proposed regulations intended minimum value to be a safe harbor, there may be unintended consequences of these valuation determinations. If family-owned businesses chose to impose restrictions on liquidation or redemption value for valid business purposes, notwithstanding that the restrictions may be disregarded, transactions based on the governing agreements may create unintended transfer tax consequences.

(a) Trustees of trusts, acting in a fiduciary capacity, may only be permitted under state law to pay fair market value for stock it intends to acquire, based on valid restrictions on redemption or liquidation value.

(i) If the restrictions are disregarded for transfer tax purposes, the trustees may have "underpaid" for the stock for transfer tax purposes, and the seller may have made an additional gift to the trust, even though the restriction on redemption or liquidation value may be a valid state law or governing agreement restriction.

(ii) The fiduciaries could be the board of directors of the corporation who would be unable to redeem stock at a value higher than fair market value.

(iii) On the other hand, a family shareholder forced to sell stock to the company for fair market value would face adverse gift tax consequences if he or she did so when the artificial value under I.R.C. § 2704(b) is higher.

v) Reconciliation of Minimum Value with Value of Interests Subject to Disregarded Restrictions

(1) The following table contrasts the concept of minimum value with the valuation provision in Prop. Reg. §25.2704-3(f), which applies to disregarded restrictions:

Valuation Issue	Minimum Value	3(f) Disregarded Value
Basic Valuation	Interest's share of net value of the entity	Perhaps implied
Net value	Fair market value of the property held by the entity	See potential meanings of liquidation value
Operating business valuation	References to Treas. Reg. §20.2031-2(f)(2) and §20.2031-3 that imply consideration of earning capacity	Unclear
Allowed obligations	Only obligations allowed for federal estate tax purposes are allowed	Not implicit or explicit
Lower tier entity valuation	I.R.C. §2704 applied to lower tier entities that would be subject to I.R.C. §2704 if owned directly	Not explicit or implicit
Adjust for income taxes on liquidation	Unanswered Question	Unanswered Question
Valued as if fractional assets distributed	No	Maybe

13) Exceptions to the New Disregarded Restrictions.

a) Prop. Reg. § 25.2704-3(b) identifies restrictions that will be disregarded if certain factors are present. If a restriction in a governing instrument for an entity does not meet the test of a disregarded restriction, that restriction may be considered when determining the value of an interest for transfer tax purposes.

i) If a redemption of liquidation provision provides that the full amount of redemption or liquidation proceeds must be paid within 6 months after the holder of an interest gives notice of intent to liquidate all or part of the interest or withdraw from the entity, the restriction is not a disregarded restriction.

ii) If a redemption or liquidation provides that the property to be used to satisfy the redemption or liquidation action does not include a note or obligation issued directly or indirectly by the entity, by one or more holders of interests in the entity, or by a person related either to the entity or any holder, the restriction is not a disregarded restriction.

iii) While these restrictions may still qualify and be considered in determining value, it is unclear how such provisions may impact value. It is possible that the restrictions would have some impact on value but would it would be expected to be far less than is currently available under the existing regulations.

b) In addition to substantively meeting the requirements of Prop. Reg. § 25.2704-3(b)(5) includes 5 exceptions to the new class of disregarded restrictions. One of the exceptions is definitional and the other four are identical to the exceptions for. Those exceptions are:

i) Prop. Reg. § 25.2704-3(b)(5)(i) – Applicable Restriction Exception. If a restriction is an "applicable restriction" under Prop. Reg. § 25.2704-2(b)(4), the restriction is not a disregarded restriction.

ii) Prop. Reg. § 25.2704-3(b)(5)(ii) – Commercially Reasonable Restriction. If a restriction is commercially reasonable, the restriction is not a disregarded restriction.

iii) Prop. Reg. § 25.2704-3(b)(5)(iii) – Required by Law Restriction. If a restriction is imposed or required to be imposed by federal or state law, the restriction is not a disregarded restriction.

iv) Prop. Reg. § 25.2704-3(b)(5)(iv) – 2703 Exception. If a restriction related to an option right, the right to use property, or any other agreement subject to I.R.C. § 2703, the restriction is not a disregarded restriction.

v) Prop. Reg. § 25.2704-3(b)(5)(v) – Put Right Exception. If a restriction is in place but the holder of the interest has a put right as described in the proposed regulations, the restriction is not a disregarded restriction.

vi) See Section 5(c)(v)(1)-(4) (above) for additional discussion on the exceptions identified in (ii)-(v) above.

14) Coordination with Marital and Charitable Deductions.

a) I.R.C. § 2704(b) applies to all intra-family transfers for purposes of estate, gift and GST taxes, including transfers that qualify for the gift or estate tax marital deduction. Thus, *Chenoweth* issues should be negated. For example, if 100% of a corporation's stock was includible in decedent's estate and 30% was transferred to decedent's surviving spouse and 70% to decedent's children, the minority interest transferred to the surviving spouse should not be discounted at the date of funding, and an underfunding of the marital deduction amount should not occur.

b) I.R.C. § 2704(b) does <u>not</u> apply to transfers to nonfamily members such as charities, so assets passing to non-family will be subject to discounts for both gift and estate tax valuation purposes (amount included) and for computing the gift or estate tax charitable deduction. However, if a controlling interest passes among multiple charities, then "additional considerations (not prescribed by section 2704) may apply, resulting in a different value for charitable deduction purposes." Citing, *Ahmanson Foundation v. United Stated,* 674 F.2d 761 (9th Cir. 1981). For example, if 100% of a corporation's stock was includible in decedent's estate and the stock was transferred equally among 4 separate charities, then the discounted value of the stock passing to each charity may result in the underfunding of the charitable deduction amount.

c) Under Prop. Reg. § 25.2704-2(e), if part of an interest in an entity passes upon a person's death to family members and part to nonfamily members, then the part passing to family members is treated as a single, separate property interest valued using the special valuation assumptions under I.R.C. § 2704(b) and the part passing to nonfamily members is also treated as a single, separate property interest valued without the special valuation assumptions under I.R.C. § 2704(b).

   i) Valuing an interest differently depending on the recipient presents complexities in administering estates. If a fiduciary has the authority under a testamentary instrument to allocate section 2704 assets to family or nonfamily members, should the fiduciary seek to reduce the estate's overall estate tax burden? Is it fair for a fiduciary to apportion a higher percentage of the estate tax to family members receiving section 2704 assets than would have been apportioned to nonfamily members that could have received the same assets? What if the fiduciary has not determined (or cannot determine) how the section 2704 assets will be distributed at the time the estate tax return is required to be filed?

   ii) Consider the following: decedent's estate includes $25 million of marketable securities and a minority interest in a family owned corporation that would be valued for estate tax purposes at $10 million if the special valuation assumptions of section 2704(b) apply (*i.e.,* no discounts) or $6.5 million if the special valuation assumptions of section 2704(b) do not apply (*i.e.*, discounts are applied).

      Decedent's estate plan leaves 50% of his estate to family members and 50% to friends. However, depending on how the stock is allocated, the amount allocated to the family members and friends may not be equal.

Assume all of the stock is allocated to the family's share of the estate

Gross Estate	$35,000,000 ($25m securities + $10m stock)
Estate Tax Rate	40%
Estate Tax Payable	$14,000,000
Residue of Estate	$21,000,000

Stock to Family	$10,000,000
Other Assets to Family	$500,000
Stock to Friends	$0
Other Assets to Friends	$10,500,000

Assume all of the stock is allocated to the friend's share of the estate

Gross Estate	$31,500,000 ($25m securities + $6.5m stock)
Estate Tax Rate	40%
Estate Tax Payable	$12,600,000
Residue of Estate	$18,900,000

Stock to Family	$0
Other Assets to Family	$9,450,000
Stock to Friends	$6,500,000
Other Assets to Friends	$2,950,000

Assume the stock is divided equally among the family's share and friend's share of the estate

Gross Estate	$33,250,000 ($25m securities + $5m non-disc stock+ $3.25m disc stock)
Estate Tax Rate	40%
Estate Tax Payable	$13,300,000
Residue of Estate	$19,950,000

Stock to Family	$5,000,000
Other Assets to Family	$4,975,000
Stock to Friends	$3,250,000
Other Assets to Friends	$6,725,000

So, the family and friends each received 50% of the stock but the family only received $4.975m of securities while the friends received $6.725m.

15) **Assessing the Impact of the Proposed Regulations. To the extent the Regulations are enacted in a format substantially similar to what has been proposed:**

a) How will fiduciaries calculate fees based on the value of trust assets or trust distributions?

b) Will we see more Preferred Partnerships under I.R.C. § 2701?

c) What level of disclosure will be required on gift tax returns with respect to transfers in family-controlled entities occurring after 8/2/16?

d) How many more entities will turn to commercial financing (so as to have legitimate restrictions respected under Treas. Reg. § 25.2704-2(b)?

e) Will this impact charitable giving?

f) Will it impact choice of law and entity formation?

16) **Epilogue and Burdensome Regulations**

a) The drama that defines Washington politics these days has implicated a closely-watched estate and gift tax guidance project in an unprecedented review. The regulations on valuation discounts under section 2704, proposed a year ago, are one of eight regulation projects selected for reexamination in response to an Executive Order to identify unduly burdensome or complex regulations issued since the beginning of 2016.

b) The Proposed Regulations were released on August 2, 2016, and published in the Federal Register on August 4. They were instantly controversial. They produced severe contention, not only between estate planning professionals and the IRS, but among estate planning professionals themselves, who have not reached a consensus on what effect the Proposed Regulations would have if finalized or what the Proposed Regulations even mean. The IRS reportedly received over 28,000 comments from members of the public, many very cursory and clichéd of course, but many deeper and broader and sometimes bitter. There were 36 speakers at the all-day public hearing on December 1.

c) Executive Order 13789 was issued on April 21, 2017, and published in the Federal Register on April 26. It directed the Treasury Department to identify tax regulations issued on or after January 1, 2016, "that (i) impose an undue financial burden on United States taxpayers; (ii) add undue complexity to the Federal tax laws; or (iii) exceed the statutory authority of the Internal Revenue Service." It directed that such regulations be identified in an interim report to the President within 60 days, or by June 20, 2017.

d) Notice 2017-38 was the initial response of Treasury and the IRS to the Executive Order. It was issued on July 7, about two and a half weeks after its due date (although it may have been submitted to the President earlier). It identified eight regulations, including the section 2704 Proposed Regulations, that it said "meet at least one of the first two criteria specified by … Executive Order 13789" – that is, undue financial burden or undue complexity. The Notice included this about the section 2704 Proposed Regulations:

Commenters expressed concern that the proposed regulations would eliminate or restrict common discounts, such as minority discounts and discounts for lack of marketability, which would result in increased valuations and transfer tax liability that would increase financial burdens. Commenters were also concerned that the proposed regulations would make valuations more difficult and that the proposed narrowing of existing regulatory exceptions was arbitrary and capricious.

e) Understandably, the IRS did not concede that any of its regulations met the third criterion in the Executive Order because they "exceed the statutory authority of the Internal Revenue Service." But it would be at least noteworthy, if not surprising, that the IRS would admit that the Proposed Regulations impose "undue" financial burden or add "undue" complexity to the tax laws. That would beg the question of why the IRS ever issued the Proposed Regulations in the first place. But, to be fair, an IRS response that "we don't think anything we have done was undue" would not really have captured the spirit of the Executive Order. One way to read Notice 2017-38 is merely as an acknowledgment that if *any* regulations *potentially* create undue burdens or complexity, then the eight regulations identified in the Notice are the *most likely* candidates. Another way to read the Notice is that it simply measures undue burden by the intensity of the public reaction, which, in the case of the section 2704 Proposed Regulations, is reflected in the Notice's focus on what "commenters" have said.

f) The Notice asked for comments from the public by August 7, 2017. Many features of the Proposed Regulations have been severely criticized, in professional meetings, in the press, in communications to Congress, and in the tsunami of over 28,000 public comments.

g) Executive Order 13789 also directed the Treasury Department to "prepare and submit a report to the President that recommends specific actions to mitigate the burden imposed by the regulations identified in the interim report." It directed that this second report be submitted within 150 days of the Executive Order, or by September 18, 2017.

h) Secretary Mnuchin issued the "Second Report to the President on Identifying and Reducing Tax Regulatory Burden" on October 2, 2017. The report proposed the full withdrawal of the proposed regulations. The proposed regulations were subsequently withdrawn later that year.

i) Beware of Zombie Regulations! Multiple Democratic presidential hopefuls have made substantive estate tax proposals in a lead-up to the 2020 primaries. Some, including Senator Bernie Sanders, have proposed reviving the regulations under section 2704.

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