

The Washington Report

Wealth Transfer Edition

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Highlights from the 2024 Heckerling Institute on Estate Planning

MARKET TREND: In 2023 wealthy taxpayers saw continued efforts by the federal government, specifically through the IRS, to seek revenue from them and contest their tax positions. Congress proposed legislation targeting successful families, and the IRS continued to issue guidance, and litigate cases, seeking to hamstring wealth transfer opportunities.

SYNOPSIS: Presenters at the 2024 Heckerling Institute on Estate Planning identified several recent developments that advisors should track, including developments related to the SECURE Act, trust modifications, gift disclosures, audit preparation, the Corporate Transparency Act, and recent court cases, including Connelly, all of which point toward a tightening of the rules surrounding wealthy taxpayers.

TAKE AWAYS: Advisors and clients need to prepare for increased scrutiny. The IRS will continue to aggressively pursue occasions to examine and challenge wealth transfers, even in situations similar to the Schlapfer case, where the taxpayer “substantially complied” with regulations. While the IRS has been unsuccessful in securing desired legislative changes and/or regulations, the IRS will continue to pursue its agenda to tax successful families through audits, appeals, and litigation. Advisors should surround clients with a competent and qualified team to ensure guidance, regulation, and caselaw are carefully considered and followed with anticipation of a potential future contest.

The following summarizes and supplements select insights from presenters at the 2024 Heckerling Institute on Estate Planning and also sets forth our views on developments and trends in legacy and life insurance planning. We note the trend in tightening tax policies and related actions.

RECENT DEVELOPMENTS 2023

As evidenced by the authority and cases summarized below, the IRS is increasing its efforts to aggressively challenge the tax positions of successful families. With the increased funding and staffing provided to the IRS, there will be more and more audits, challenges, and litigation in an effort to collect revenue from the wealthy. The IRS will continue this pursuit. Advisors should be mindful of the scenarios discussed below and advise their clients in a way to minimize exposure to increased IRS scrutiny.

Federal Legislation Enacted and Introduced. On April 18, 2023, Senator Bernie Sanders (Vermont) introduced the For the 99.5 Percent Act. This legislative proposal seeks to increase the estate and gift tax rate to 45% for estates valued from \$3.5 million to \$10 million, 50% for estates valued from \$10 million to \$50 million, 55% for estates valued from 50 million to \$1 billion, and 65% for estates valued over \$1 billion. This proposal also seeks to reduce lifetime estate tax exemptions to \$3.5 million and lifetime gift tax exemptions to \$1 million. Senator Jimmy Gomez (California) introduced a companion bill on the same day. These legislative proposals by Senator Sanders and Senator Gomez will possibly be a resource for their colleagues wanting estate tax reform.

ⁱ From Turney P. Berry, Ronald D. Aucutt, and Carlyn S. McCaffrey, "Recent Developments 2023," materials prepared for and presented at the 58th Annual Heckerling Institute on Estate Planning, January 8, 2024.

SECURE Act and SECURE 2.0 Act Guidance. Notice 2023-54 provides interim relief from the required minimum distribution rules applicable to a ten-year payout, but overall notes a strict adherence to its decision to limit tax deferred payouts. Upon passage of the SECURE Act, mainstream interpretation for individual's subject to the ten-year payout rule (i.e., the beneficiary has a total of ten years to fully withdraw funds from the participant's account, regardless of the beneficiary's life expectancy) was that they would be required to fully distribute funds by the end of the tenth year after the participant's year of death, but there would be no Required Minimum Distributions ("RMDs") in any given year. Contrary to this general understanding, on February 24, 2022, the Treasury issued proposed regulations that stated that when the ten-year payout rule applied and the participant had started taking RMDs prior to the participant's death, the beneficiary must start taking RMDs in the year after the year of death of the participant, with a full distribution required by the end of the tenth calendar year after the year of the participant's death. Due to ambiguity regarding required payments under the ten-year payout rule, Notice 2023-54 announced that final regulations to the aforementioned effect will apply no earlier than 2024 and there will be no penalties for RMDs not made in 2023 where the ten-year payout rule applies.



Basis of Grantor Trust Assets. Under the Rev. Rul. 2023-2, the IRS declared that assets in a grantor trust do not get a new income tax basis at the grantor's death if such assets are not included in the grantor's gross estate. Some scholars and practitioners have previously concluded that assets in an irrevocable grantor trust should receive a new income tax basis at the grantor's death, because until that time the trust assets were deemed owned by the grantor for income tax purposes (see Rev. Rul. 85-13, 1985-1 C.B. 184), and after the grantor's death they are "acquired from a decedent" by someone else for income tax purposes, including the determination of income tax basis. By issuing this ruling, the IRS has tried to eliminate the taxpayer's ability to take this more beneficial tax position.

CCA 202352018. This internal IRS guidance is a course reversal relative to grantor trusts (a continual target of the IRS). In this instance, the trustee of the trust at issue (an irrevocable grantor trust) judicially modified the terms of the existing trust to give the trustee discretionary power to reimburse the grantor for the income tax attributable to the grantor from the trust's income (the provision added by the modification is often referred to as a tax reimbursement clause). The CCA concluded that the modification, which was consented to by each of the beneficiaries, resulted in a gift by each of the beneficiaries of their beneficial interest in the trust. The CCA also stated that "the result would be the same if the modification was just pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object." Note that this CCA appears to contradict Rev. Rul. 2004-64, which provided that the trustee's discretionary reimbursement to the grantor for the payment of the grantor's income tax from the trust's income (i.e., a tax reimbursement clause) "is not a gift by the trust beneficiaries."

ⁱⁱ See e.g., Jonathan G. Blattmachr, Mitchell M. Gans & Hugh Jacobson, "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," 97 J. TAX'N 149 (Sept. 2002).

Gift Tax Disclosure. In this case, the IRS pursues a taxpayer who substantially followed its rules almost to the letter. As a general matter, the IRS cannot revalue gifts adequately disclosed on a gift tax return once the gift tax return statute of limitations has expired. Adequate disclosure is governed by Treas. Reg. §301.6501(c)-1(f)(2) and generally requires the following: (i) a description of the transferred property and any consideration received by the transferor; (ii) the identity of and relationship between, the transferor and each transferee; and (iii) a detailed description of the method used to determine the fair market value of the property transferred. In *Schlapfer v. Commissioner*, T.C. Memo. 2023-65, the taxpayer did not strictly comply with Treas. Reg. §301.6501(c)-1(f)(2). Despite this, the court found that the IRS was provided with enough information and the taxpayer "substantially complied" with the adequate disclosure requirements.



Buy/Sell Agreements. In *Connelly v. United States*, 2021 WL 4281288 (E.D. Mo. 2021), the IRS successfully argued that the value of company shares, for estate tax purposes, should include the life insurance proceeds paid to the company on the shareholder's death that were to be used to effect a redemption-based shareholder buyout. It is important to note that, contrary to the result in *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005), the court in *Connelly* concluded that there would be no offsetting liability for the purchase obligation in the buy-sell agreement, meaning the gross face amount of the life insurance policy would be included in the company valuation. Note, however, that the *Connelly* case will be heard, and subject to additional review, by the US Supreme Court.

Observations.

- *There will be more legislative proposals, similar to the For the 99.5 Percent Act, that will continue to target successful families.*
- *The IRS continues to provide guidance on the SECURE Act and the SECURE 2.0 Act. Much of the guidance is the result of the IRS tightening the deferral of plan payouts.*
- *The IRS continues to issue guidance and rulings, such as Rev. Rul. 2003-2 and CCA 202352018, that seek to limit planning opportunities for successful families. Advisors should carefully navigate such guidance.*
- *Even though the taxpayer ultimately won in *Schlapfer*, this case exhibits the IRS' aggressive pursuit of successful families even when there has been "substantial compliance" with guidance and regulation. Advisors should anticipate that the IRS may contest even the most minor or insignificant non-compliance of existing guidance or regulation.*
- *Business owners should regularly review their buy-sell agreements in light of evolving law. If their buy-sell agreement happens to be a redemption agreement, a restructuring or review of the economics may be wise given the *Connelly* case. Further, if an agreement is in place, it should be followed to the letter.*

ⁱⁱⁱ For additional detail, see Douglas E. Murphy, Jonathan M. Forster, "Connelly v. United States," *Finseca*, *The Washington Report* (July 27, 2023).



Preparing for an Audit. As a result of increased challenges brought by the IRS, presenters at Heckerling provided insights on preparing for an audit. With the recent additional funding provided to the IRS, the IRS is ramping up its staff and its estate and gift tax department. Additionally, the IRS has added a number of appeals officers. Accordingly, successful families should expect estate and gift tax audits with more frequency.

A few specific IRS favorites include the following:

- Estate inclusion under Section 2036 of the Internal Revenue Code is the most hotly litigated issue. This section essentially provides that transferred assets will be brought back in the taxpayer's gross estate if the taxpayer (i) retains an interest in the property transferred or (ii) has the ability to designate who will benefit from the property transferred. The best way to avoid the application of Section 2036 is to ensure that the taxpayer has relinquished all dominion and control over the transferred asset. Additionally, the taxpayer may avoid this section by entering into a transaction where full and adequate consideration is received for the asset (e.g., the asset is purchased by a trust or family member). As a recent example, in *Estate of Marion Levine v. Commissioner* (158 T.C. No. 2), the IRS sought to include a life insurance policy in the decedent's estate under Section 2036 by asserting that the decedent retained an interest in such policy. The Tax Court ruled against the IRS and expressed praise for Mrs. Levine's advisors. The advisors were cautious and thorough in the implementation and operation of an intergenerational split-dollar plan, which was pivotal in this case.
- Other contested areas are asset valuations and formula transfers. The IRS continues to contest valuation positions taken by taxpayers. There are various decisions related to asset valuation and discounts. These case results are often based on whether a qualified appraiser accurately valued the asset. Advisors often encourage clients to implement formula transfers when gifting an asset. A formula transfer allows for the transfer of assets that are difficult to value. For example, rather than transferring a set number of shares in a closely-held business, a formula transfer clause may provide for the transfer of shares in an amount equal to a specified dollar value as finally determined for federal gift tax purposes. Fairly recent decisions in *McCord*, *Hendrix*, *Christiansen*, *Petter*, and *Wandry* provide taxpayers with optimism about using formula transfer clauses and provide guidance to advisors in their use and implementation.



Observations.

- *As estate and gift tax audits become more frequent, advisors should consider conservative approaches for wealth transfers and manage implementation and post-transaction follow-through.*
- *For valuation related matters, hiring a trusted, qualified appraiser is key. The appraiser and advisor should ensure that all relevant data is included in the valuation report. Best practice is to have a report dated as of the date of the transfer.*
- *A formula transfer is intended to be self-correcting for an asset that is difficult to value. Despite the self-correcting feature and the taxpayer's attempt to ensure the transfer of the asset for its actual value, the IRS continues to contest formula transfers. If a formula transfer clause is the basis for a wealth transfer, consider language used in McCord, Hendrix, Christiansen, Petter, and Wandry.*
- *Many contests occur because a taxpayer is trying to retain or later access a transferred asset. Advisors should carefully determine a client's lifestyle capital needs prior to engaging in a wealth transfer to ensure transferred assets are not needed to support their lifestyle.*

^{iv} From John W. Porter, "A View from the Front Lines – Current Issues in Estate and Gift Tax Audits and Litigation," materials prepared for and presented at the 58th Heckerling Institute on Estate Planning, January 10, 2024.

ADDITIONAL TOPICS OF DISCUSSION

With the government seeking to increase visibility over business entities, the implications of the Corporate Transparency Act were discussed at length. Additionally, with the increased use and popularity of directed trusts, there was discussion on the operation and benefits afforded by the implementation of directed trusts.

Corporate Transparency Act. Advisors are now likely familiar with the Corporate Transparency Act ("CTA") (which is effective January 1, 2024, for new entities, and January 1, 2025, for existing entities) that a so-called reporting company must file with the Financial Crimes Enforcement Network ("FinCEN") a beneficial owner information report ("BOI report") disclosing the legal name, date of birth, and current residential or business street address of, and a unique identifying number for, each of its beneficial owners. Many may not appreciate, however, that this requirement is ongoing, costly, and removes anonymity. The CTA requires a reporting company not only to file a BOI report, but also to keep that report current. A reporting company has 30 days after any change in a beneficial owner's reported information.



Observations. *Reporting companies and advisors should immediately identify and develop policies and procedures needed to collect required information from beneficial owners (especially those which include trusts and so-called nested entities, given their complexity). Further, existing entities shouldn't wait until the last minute to file the BOI report. Since the CTA is already law, advisors can plan ahead and file the BOI report well before 2025.*

^v For additional detail, see Douglas E. Murphy, Jonathan M. Forster, "The Corporate Transparency Act's Impact to Legacy Planning Structures," *Finseca Marketplace* (November 24, 2022).

Directed Trusts. Directed trusts are becoming more common because they operate like a private trust company due to the flexibility of unbundling trustee roles. As a result, the Uniform Directed Trust Act (the "UDTA") has been adopted in fifteen states. The UDTA recognizes that a trust may grant a power of direction to a trust director (or trust advisor) and, unless the trust provides otherwise, a trust director (or trust advisor) may exercise, or not exercise, a power of direction granted to such trust director. Typically, a directed trust will contain one or more of the following trust directors (or trust advisors):

1. Investment Direction Advisor: This advisor has the ability to give the trustee direction on the investment of trust assets.
2. Business Holdings Advisor: This advisor has the ability to give the trustee direction on the investment and management of business trust assets (like a closely-held family business interest).
3. Distribution Advisor: This advisor has the ability to give the trustee direction on when and how distributions are to be made.
4. Trust Protector: The trust protector is typically given powers to change the trust situs, to remove or replace fiduciaries, and even amend the trust in certain circumstances.

Observations. In many ways this approach allows the trust creator to manage different asset classes, multi-advisor platforms, and distributions separately. Directed trusts provide clients with the opportunity to bifurcate traditional trustee powers. If the client would like to bifurcate investment decisions, closely-held business management, distributions decisions, and/or administrative functions among multiple individuals or entities, a directed trust is a great approach. Now that the UDTA has been implemented in many states, advisors can have assurance with the implications and legalities associated with this type of trust by selecting a jurisdiction that has codified the UDTA or a similar statute.



TAKE AWAY

Advisors and clients need to prepare for increased scrutiny. The IRS will continue to aggressively pursue occasions to examine and challenge wealth transfers, even in situations, similar to the Schlapfer case, where the taxpayer “substantially complied” with regulations. While the IRS has been unsuccessful in securing desired legislative changes and/or regulations, the IRS will continue to pursue its agenda to tax successful families through audits, appeals, and litigation. Advisors should surround clients with a competent and qualified team to ensure guidance, regulation, and caselaw are carefully considered and followed with anticipation of a potential future contest.

^{vi} From Michael M. Gordon, “Slicing and Dicing Fiduciary Duties and Responsibilities Through Directed Trusts,” materials prepared for and presented at the 58th Heckerling Institute on Estate Planning, January 11, 2024).

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