2022 ANNUAL TRANSFER TAX UPDATE

ORANGE COUNTY ESTATE PLANNING COUNCIL

Presented By:
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6:45 p.m. – 7:45 p.m.

OVERVIEW

Calendar year 2022 introduced many Americans, and their estate plans, to inflation. AFR interest rates are up, the 7520 Rate is up causing retained interests have more value (e.g. unitrust interest in CRT) and future interests have less value (e.g. GRAT and QPRT remainders). Inflation is also causing transfer tax exclusions and exemptions to rise, yet 2026 looms large. In 2022, we also saw an important tax cases, including a transfer tax case all practioner should read, confirmation on how NOT to make lifetime gifts of cash, and anticipatory assignment of income. On the regulatory side, we saw developments in estate tax clawback, extended time to file portability only Forms 706, and proposed regulations under IRC section 2053. We will explore transfer tax developments from 2022 to guide our planning in 2023 and beyond.

A. REVENUE PROCEDURE 2022-38 – 2023 INFLATION ADJUSTMENTS [JWP]

i. Applicable Exclusion Amount: $12,920,000 (+860,000)

ii. Annual Exclusion Amount: $17,000 (+1,000)

iii. Gifts to Non-US Citizen Spouse: $175,000

iv. Section 2032A Special Use: $1,310,000

v. Section 6166 2-Percent Portion: $1,750,000

vi. Section 6039F (Form 3520) Gifts from Foreign Persons Exceed: $18,567

vii. Trusts and Estates Highest Income Tax Bracket: $14,450

B. RECENT TRANSFER TAX DEVELOPMENTS

1. Intergenerational Split Dollar Survives IRS Assault. Was It Worth IRS' New Legal Theory?

ESTATE OF LEVINE v. COMMISSIONER (2022) T.C. No. 2 [February 28, 2022]

Short Summary: This is yet another intergenerational split dollar case (see *Morrisette* cases and *Cahill*). There are three important lessons to learn from Levine: (i) intergenerational split dollar can work; (ii) proper planning and good facts matter, as such, everyone should read Levine as a model for good facts, even for planning other than intergenerational split dollar; and (iii) watch out when the same person is the decedent's agent and acting under other wealth planning documents.

Here, G1 (via her revocable trust) funded the $6.5 million single premium payment into an ILIT for $17.5 million in life insurance coverage on G1's daughter and son-in-law (two second-to-die policies). The split dollar arrangements provided that: (1) G1 would pay the premiums; (2) the ILIT would own the policies and possess all incidents of ownership, but have no right to the cash value; (3) collateral assignments secured repayment to G1 of an amount equal to the greater of the cash value of the policy or the total premiums paid, not to exceed the value of the policies; (4) they were intended to create economic benefit arrangements; (5) only the Investment Committee of the ILIT (a family advisor) could terminate the arrangements. Under the economic benefit arrangement, the gifts made by G1 were $1,689 and $955, respectively, for the two policies. At G1's death, the policies had a cash value of $6.2 million. The estate reported a $2.1 million value for what G1 would receive at termination of the arrangements. IRS argued gift tax and estate theories attempting to show a transfer by G1 of at least $6.2 million.

IRS first argued that the gift amount was $6.5 million, not the reported $1,689 and $955. The Tax Court rejected this argument because the gift amounts were determined pursuant to IRS rules (also

note that the ILIT never had a right to the cash values). Further, IRC 2703 could not apply to the gifts because that section only applies to restrictions on property transferred at death.

On the estate tax side, IRS argued the entire $6.2 million cash value should be included in G1's estate under IRC sections 2036, 2038 and/or 2703. The Court rejected these arguments. IRS argued that the family advisor was merely an agent of G1 and would do whatever G1 said. As a result, IRS argued, the full $6.2 million value should be included in G1's gross estate. IRS' argument stemmed from the family advisor's dual role as: (i) G1's agent under a power of attorney; and (ii) the sole member of the Investment Committee of the ILIT and owing fiduciary duties to the trust beneficiaries. The Court rejected this agency argument due to the fiduciary duties owed in each role and finding there was no conflict between the fiduciary duties. Perhaps importantly, the trust beneficiaries included G1's children and grandchildren. Even though this agency theory was rejected by the Tax Court, be prepared to see this argument again.

2. Wait, What, There Is Clawback After All? Proposed Regulations Detail Exceptions To The General Rule Of No Clawback For Deaths On Or After April 27, 2022

PROPOSED REGULATIONS 20.2010-1(C)(3) [April 27, 2022]

Short Summary: IRC section 2001(g) was included Trump's tax package and was intended to prevent clawback, i.e., taxpayers would not be taxed on lifetime gifts made in excess of the basic exclusion amount (BEA) available at death. Treasury issued final regulations in 2019 confirming how these rules would work (see Treas. Reg. 20.2010-1(c)(1) and (2)). Those Regulations avoided clawback by stating the BEA of an estate is the greater of the BEA <u>used</u> on lifetime gifts and the BEA available in the year of death. Treasury reserved section (c)(3) for exceptions to the general rule of no clawback.

These Proposed Regulations would fill-in the reserved exceptions by allowing clawback for: (i) lifetime transfers includible in the gross estate under IRC sections 2035, 2036, 2037, 2038 and 2042; (ii) transfers made by enforceable promise to extent satisfied as of decedent's date of death (see Rev. Rul. 84-25); (iii) certain transfers described in IRC sections 2701 and 2702; and (iv) transfers that would have fallen within i, ii or iii, but for a transfer, relinquishment, or elimination of an interest within 18 months of decedent's date of death (whether by decedent alone or in conjunction with any other person). These exceptions have important implications for lifetime planning and the fall in the BAE starting under current law in 2026. Consider the 3-year rule of IRC section 2035 and the 18 months in the Proposed Regulations (i.e., June 30, 2024).

3. "Portability Only" Estate Tax Returns – May Now File Late Until Fifth Anniversary Of Decedent's Death

REVENUE PROCEDURE 2022-32 (2022) [July 8, 2022]

Short Summary: IRC section 9100 allows IRS to grant relief for late filing for regulatory deadlines (not statutory deadlines). Thus, if an estate tax return (Form 706) must be filed under IRC section 6018, then there is no relief under IRC section 9100 for a late filing for portability.

However, if a Form 706 is not required to be filed under IRC section 6018 and a portability election is desired (a so-called "portability only" return), then the deadline to file the Form 706 is by regulation (by Regulation, same filing date as a required Form 706). Under Rev. Proc. 2017-34, an estate was allowed to file a portability only return late; provided, however, it was filed on or before the second anniversary of the decedent's date of death. Now, under Rev. Proc. 2022-31 an estate is allowed to file a portability only return late if it is filed on or before the fifth anniversary of the decedent's date of death. If filed later than that, then a PLR is required to obtain the benefits of portability. Note that if it is later determined that a Form 706 was required to be filed under IRC section 2018, then the late filing relief is unavailable. Make sure you quickly determine all assets and all lifetime gifts made by a decedent.

4. Can't Assign The Income, Can't Take A Charitable Deduction, Don't Receive The Cash – The Trifecta Tax Calamity! KEEFER v. U.S. (2022) 130 AFTR 2d 2022-5002 (N.D. Texas) [July 6, 2022]

Short Summary: Taxpayer assigned his 4% limited partnership interest to a donor advised fund (DAF). The assignment specifically limited what was assigned to the proceeds from the sale of real estate owned by the partnership. As of the date of transfer, there was a letter of intent to sell the real estate owned by the partnership. After the transfer to the DAF, a contract for sale of the real estate was executed, and the real estate sold. The good news is that this timing did not trigger the anticipatory assignment of income doctrine. What did trigger the doctrine is that Taxpayer did not transfer his entire interest in the property to the DAF. As such, the income related to the partnership's sale of real property remained taxable to the taxpayer (even though Taxpayer would receive none of the proceeds). What's more, Taxpayer failed to meet the added charitable deduction requirement for gifts to DAFs. When gifts are made to DAFs, the contemporaneous acknowledgement of the gift must state that the charity has exclusive legal control over the assets contributed. Thus, Taxpayer trifecta was: (1) received the taxable income; (2) received no income tax charitable deduction; and (3) received none of the sales proceeds related to the real estate. The Trifecta Tax Calamity!

5. When Is A Gift By Check Completed For Transfer Tax Purposes? It Depends On The State DEMUTH V. COMMISSIONER (2022) No. 18724-19 (U.S.T.C.) [Jul. 12, 2022]

Short Summary: Decedent's son, acting under a power of attorney, wrote 11 checks totaling $464,000 from Decedent's account to make gifts to family. Decedent died 5 days later. Of the 11 checks, 1 was paid by Decedent's bank before death, 3 were deposited on date of death (apparently prior to death). Under PA law, a stop order is allowed on a check until the check is paid. That was the case with 10 of the checks. However, IRS conceded the 3 checks ($70,000) deposited on date of death were completed gifts during life. Thus, at issue were the 7 remaining checks ($366,000). For a gift to be complete, Treasury Regulation § 25.2511-2(b) requires the donor to gift up dominion and control and PA law requires the donor to surrender dominion by irrevocable delivery. The Tax Court found these 7 checks were not completed gifts during life because

Decedent could stop payment until the moment of death. Thus, the money was includible in Decedent's estate for estate tax purposes.

6. Formula General Power Of Appointment – A Multi Generational Tax Planning Opportunity

PLR 202206008 (2022) [February 11, 2022]

Short Summary: This PLR involves a grandfathered GST Trust for the lifetime benefit of Settlor's Son, remainder to Son's descendants, and if none, to the heirs at law of Settlor's wife. Trust requires distribution of all income to Son, and trustee can withdraw principal for the maintenance, education, welfare and comfort of any beneficiary or beneficiaries (in sole and absolute discretion of Trustee not subject to question by any person or persons). Disputes arose as to how Settlor's intent could best be fulfilled. After negotiations, the parties obtained a court approved settlement agreement that would, subject to a favorable PLR, modify the trust to grant Son a formula general power of appointment (GPOA). The formula worked so that Son had a general power of appointment over the largest portion of the trust possible that would not cause estate tax to be due in Son's estate. IRS made three rulings regarding modification of the trust pursuant to the court approved settlement agreement granting Son the testamentary formula GPOA: (i) it will not cause the trust to lose its grandfathered GST status or otherwise become subject to the GST tax; (ii) it will not cause trust property to be includible in Son's gross estate; and (iii) it will cause the trust property subject to the GPOA to be included in Son's gross estate under IRC section 2041(a)(2).

7. IRC Section 2053 Deductions – More Limitations On The Way

PROPOSED REGULATIONS 20.2053-1(C)(3) (2022) [June 28, 2022]

Short Summary: In 2009 Treasury issued final Regulations under IRC section 2035 limiting deduction for expenses and claims against the estate to the amounts actually paid in settlement or satisfaction of the item. Those Regulations resolved a split in the Circuit Courts of Appeal, and Treasury specifically reserved space for present value concepts in the computation of IRC section 2053 deductions. These Proposed Regulations, if made final, would do the following: (i) require a present value discount to date of death for certain amounts paid more than 3 years from decedent's date of death; (ii) deny a deduction for interest on unpaid estate tax (non-6166 interest) to the extent the interest is attributable to executor's negligence, disregard of applicable rules or regulations or fraud with intent to evade tax; (iii) deny a deduction for interest on loans incurred by an estate to pay estate tax or expenses of administration unless certain criteria are met (e.g., necessary to incur loan and a bona fide loan – limiting use of *Graegin* loans); and (iv) impose limits on deductions related to decedent's personal guaranties. These Regulations will be effective for estate of decedent's dying on or after the date the Final Regulations are published (so not yet in effect).

8. IRS Changes The Rules On Toggle CRTs – There Is Now Transfer Tax Exposure

ILM 202233014 (2022) [July 12, 2022]

Short Summary: This PLR deals with a testamentary CRUT. CRUTs are split interest trusts. There is: (i) a life or term interest (referred to for purposes of this ILM as the "unitrust"); and (ii) a remainder that passes to charity at the end of the unitrust. At least of portion of the unitrust must be payable to a non-charitable beneficiary. What happens from an estate tax perspective when you force at least 25% of the unitrust to be paid to the grantor's surviving spouse, and allow the other 75% of the unitrust (the "Toggle Amount") to be paid among the surviving spouse and charity? Well, IRS now says that there is no estate tax charitable deduction and no estate tax marital deduction for the Toggle Amount. Thus, the estate will receive a marital deduction for 25% of the unitrust, a charitable deduction for the CRUT remainder, and no deduction for the Toggle Amount (the other 75% of the unitrust amount). Why no estate tax deduction for the Toggle Amount? Because the amount passing to charity and the amount passing to the surviving spouse cannot be determined. This conclusion is contrary to many prior private letter rulings (see PLRs 200813006, 200832017, 201117005 and 201845014).

9. 9100 Relief Available For Late Form 706-QDT

PLR 202202006 (2022) [January 14, 2022]

Short Summary: A QDOT is a marital deduction trust created for the benefit of a surviving spouse who is not a U.S. citizen. If that surviving spouse later becomes a U.S. citizen, then the surviving spouse needs to file a Form 706-QDT. That form must be filed on or before April 15th of the calendar year following the year the surviving spouse becomes a U.S. Citizen. This filing date is set by Treas. Reg. section 20.2056A-10(a)(2). Since the deadline is regulatory (and not statutory), IRS has authority to grant late-filing relief under 9100. In this PLR, IRS granted an extension of time to file until 120 days from the date of the PLR. Note that an extension of time to file Form 706-QDT can be obtained under IRC section 6081 (but one must know to file the form before one knows to request an extension).

10. Is The Life Insurance Valuation Language In Treasury Regulation Section 25.2512-6(a) Mandatory?

DEMATTEO V. COMMISSIONER (2022) No. 3634-21 (U.S.T.C.) [Jul. 21, 2022]

Short Summary: This Tax Court case involves valuation of life insurance policies Taxpayer gifted to trusts for the benefit of Taxpayer's children. Taxpayer filed a motion for summary judgment to determine whether a different valuation method may be used for gift tax purposes. Taxpayer argued that language in Treas. Reg. Section 25.2512-6(a) is discretionary and not mandatory, while IRS argued it is mandatory. The Tax Court found that granting summary judgment would not expedite litigation or avoid an unnecessary trial (depending on certain evidence and findings the issue could become moot), and thus denied the motion for summary judgment.

11. Ability To Be Reimbursed For Income Taxes Paid From IDGT Does Not Make Grantor A Beneficiary Under California Law

AB 1866 – Irrevocable trusts: limitations (2022) [June 21, 2022]

Short Summary: California law generally offers no creditor protection for self-settled creditor protection trusts. Said another way, if the Settlor is a beneficiary of a trust created by the Settlor any provision restraining the voluntary or involuntary transfer of the settlor's interest is invalid against transferees and creditors of the Settlor. This is critical for estate tax purposes because assets subject to claims by decedent's creditors are includable in the decedent's gross estate for estate tax purposes. There was some question as to whether a provision for income tax reimbursement could be included in California IDGTs consistent with Revenue Ruling 2004-64, i.e., does the ability to be reimbursed make the Settlor a beneficiary and thus cause estate inclusion? We thought the answer was "no", but helpfully Probate Code section 15304 is now modified to clarify the question. Now, section (c) provides that, "the settlor shall not be considered to be a beneficiary of an irrevocable trust created by the settlor solely by reason of a discretionary authority vested in the trustee to pay directly or reimburse the settlor for any federal or state income tax on trust income or principal that is payable by the settlor, and a transferee or creditor of the settlor shall not be entitled to reach any amount solely by a reason of that discretionary authority."

12. Non-Resident Trusts Taxed On Income From S Corporation's Sale Of Goodwill

J.P. MORGAN TRUST CO. OF DELAWARE V. FRANCHISE TAX BD. (2022) 79 Cal. App. 5th 245. [May 27, 2022]

Short Summary: This case involves California income taxation of two trusts, the "Family Trust" and the "Evan Trust." Each trust was a shareholder in Pabst, a Delaware corporation taxed as an "S" corporation. Further, Pabst was a "unitary" business, meaning it was two or more business entities commonly owned and integrated in a way that transfers value among the affiliated entities. Unitary businesses are subject to special rules to determine the amount of value or income taxable in California.

Pabst sold its wholly owned subsidiary "Holdings" (which in turn wholly owned two subsidiaries). Pabst treated the sale as an asset sale, classified the income as "business income," and apportioned income from the sale 6.6% to the State of California. Each trust received a California K-1 from Pabst with 99% of the income reported to each trust identified as long-term capital gain from the sale of brand and intangibles, i.e. intangible goodwill.

Each trust was a nonresident of California, i.e., neither had a California resident fiduciary and neither had any California resident noncontingent beneficiary. After receiving the California K-1's, the trustee filed Forms 541 with the State of California and paid $3.6 million in California income tax. The trusts subsequently filed amended Forms 541seeking refunds of the amounts paid.

The FTB denied the refunds, the Office of Tax Appeals issued a decision upholding the FTB's decision to deny the refunds. The trusts then filed action in the California Court of Appeal against the FTB for the refunds. The trusts and the FTB each filed motions for summary judgment.

The trusts argued that as nonresidents of California, the income was not taxable to them. Further, even if the income was California source income, it was not taxable to them. This is because it was from the sale of intangibles and Rev. & Taxation Code section 17952 (and the 2001 *Valentino* case) applies. That section reads as follows:

"For purposes of computing "taxable income of a nonresident or part-year resident" under paragraph (1) of subdivision (i) of Section 17041, income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this state unless the property has acquired a business situs in this state, except that if a nonresident buys or sells such property in this state or places orders with brokers in this state to buy or sell such property so regularly, systematically, and continuously as to constitute doing business in this state, the profit or gain derived from such activity is income from sources within this state irrespective of the situs of the property."

The Appellate Court denied the trusts' motion for summary judgment, and granted the FTB's motion for summary judgment, finding as follows: (1) California taxes nonresidents on income derived from sources within this state; (2) the California Regulations (Reg. 17951-2) defines income from sources within California to include income from goodwill, trademarks, or trade-brands having a taxable or business situs in California; (3) the California Regulations (Reg. 17951-4) require the distributive share of business income of an S corporation be apportioned at the corporate level in accordance with the Uniform Division of Income for Tax Purposes Act ("Uniform Act", § 25120 et seq.) and is taxable to the shareholder under the Unform Act as if the income producing activity were undertaken by the shareholder; (4) the distributive share of income that is not business income is determined under the rules of Sections 17951 through 17955 and taxable to the shareholder under those rules as if the income producing activity were undertaken by the shareholder; and (5) even if section 17952 were the applicable section for this business income, the goodwill had a business situs in California because the S corporation's corporate headquarters were in California, the underlying businesses based marketing and sales departments in California, and the S corporation localized the goodwill in connection with its California business.