RECENT DEVELOPMENTS IN ESTATE PLANNING: PRIVATE LETTER RULINGS AND OTHER INTERNAL REVENUE SERVICE GUIDANCE UPDATE FOR LATE 2018 AND 2019

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I. Federal Estate, Gift and Generation-Skipping Tax Rates and Exemptions

In 2020 the top federal estate, gift and GST tax rates are 40%. This rate is, in effect, a flat tax rate. Technically, the tax code contains different tax rates that apply to different sizes of estates, and the highest marginal tax rates begin at about $1 Million. However, because the estate tax exemption is well over $1 Million, the top tax rate applies to all taxable estates.

The Tax Cuts and Jobs Act of 2017 ("TCJA"), which was signed into law on December 22, 2017 by President Donald Trump, doubled the basic exclusion amount for decedents dying or gifts made after December 2017 and before January 1, 2026. Pursuant to Rev. Proc. 2019-44, the inflation-adjusted estate, gift and GST tax exemption for 2020 is $11,580,000 per individual. The annual exclusion for gifts remains $15,000. The annual exclusion for gifts to noncitizen spouses in 2020 will be $157,000.

II. Clawback

The TCJA provisions establishing the gift, estate and GST tax exemption amounts sunset on January 1, 2026, which raised concerns that there could be a "clawback" in the estates of donors who make gifts before 2026 but die after 2025. To illustrate, if a donor uses up $11.4 Million of exemption in 2019 and dies in 2026, will part of the gift be taxed anyway ("clawed back") in the estate tax calculation? Congress addressed the clawback issue in the TCJA but left the detail to Treasury Regulations. Section 2001(g)(2) of the Internal Revenue Code of 1986, as amended (referred to in this outline as the "Code"), provides that "the Secretary 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."

Until the passage of regulations, the wording of the statute left some uncertainty regarding the clawback issue. To answer this concern, the Internal Revenue Service (referred to in this outline as the "Service") released proposed regulations on November 20, 2018 and published them in the Federal Register on November 23, 2018, and released final regulations on November 22, 2019 and published them in the Federal Register on November 26, 2019. The regulations add a new paragraph (c) to Treasury Regulation § 20.2010-1 (with the current paragraphs (c) through (e) redesignated as (d) through (f)). The final regulations provide, in relevant part, that if the total of the amounts allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts exceeds the credit allowable in computing the estate tax, then the portion of the credit allowable in computing the estate tax on the decedent's taxable estate is the sum of the

amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on the post-1976 gifts.

In addition, the final regulations make it clear that a decedent dying after 2025 who made gifts prior to 2026 will not benefit from post-2025 inflation adjustments to the basic exclusion amount if it would cause the total exemption allowable in the computation of gift tax payable to exceed the date of death exemption amount as adjusted for inflation. The basic exclusion amount is applied first against the decedent's gifts as taxable gifts were made, and then against the estate tax if any exemption remains. Therefore, in the case of a decedent who made gifts in an amount sufficient to cause the total exemption allowable in the computation of gift tax payable to equal or exceed the date of death exemption as adjusted for inflation, there is no remaining exemption available to be applied to reduce the estate tax.

The final regulations also make it clear that the increased basic exclusion amount as adjusted for inflation is a "use or lose" benefit and is available to a decedent who survives the increased basic exclusion period only to the extent the decedent "used" it by making gifts during the increased basic exclusion period. Example 2 in the final regulations (described below) demonstrates that the application of the anti-clawback rule is based on gifts actually made and is inapplicable to a decedent who did not make gifts in excess of $5,000,000, adjusted for inflation, prior to 2026.

The final regulations confirm that even if the exemption decreases after 2025, a deceased spousal unused exclusion amount (DSUE amount) elected before 2026 is not affected by the anti-clawback rule and is still added under Code Section 2010(c)(2)(b). This would generate an additional credit of its own in cases where the anti-clawback rule applies. Examples 3 and 4 (described below) were added to clarify the calculation of the exemption when a DSUE amount applies, including how the regulation addresses the DSUE ordering rules.

The Service opted not to provide gift tax examples in the final regulations, indicating that the discussion in the preamble of the proposed regulations provided a detailed description of the steps involved in calculating gift and estate taxes that was sufficient enough. Thus, a donor who exhausted his exclusion amount with gifts made before 2018 and paid gift tax and then makes a further gift or dies within the period of the higher exclusion amount would not be able to use the higher exclusion towards the earlier gifts and reduce the amount currently available for gift or estate tax purposes.

The final regulations provide four examples for a decedent dying after 2025 (described below in relevant part). Unlike the proposed regulations, the final regulations specifically provide that all basic exclusion amounts referenced in the examples include hypothetical inflation adjustments:

Example 1. 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 $11.4 million in basic exclusion amount allowable on the dates of the gifts. The basic exclusion amount on A's date of death is $6.8 million. 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 of basic exclusion amount used to determine those credits) exceeds the credit based on the $6.8 million basic exclusion amount

allowable on A's date of death, the credit for purposes of computing A's estate tax is based on a basic exclusion amount of $9 million.

Example 2. Assume that the facts are the same as in Example 1 except that A made cumulative post-1976 taxable gifts of $4 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts is less than the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, the special rule in section (c) of the regulation (the anti-clawback rule) does not apply and the credit to be applied for purposes of computing A's estate tax is based on the $6.8 million basic exclusion amount as of A's date of death.

Example 3. Individual B's predeceased spouse, C, died before 2026, at a time when the basic exclusion amount was $11.4 million. C had made no taxable gifts and had no taxable estate. C's executor elected, pursuant to § 20.2010-2, to allow B to take into account C's $11.4 million DSUE amount. B made no taxable gifts and did not remarry. The basic exclusion amount on B's date of death is $6.8 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on B's post-1976 gifts attributable to the basic exclusion amount (zero) is less than the credit based on the basic exclusion amount allowable on B's date of death, the special rule in section (c) of the regulation (the anti-clawback rule) does not apply and the credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount.

Example 4. Assume the facts are the same as in Example 3 except that, after C's death and before 2026, B makes taxable gifts of $14 million in a year when the basic exclusion amount is $12 million. B is considered to apply the DSUE amount to the gifts before applying B's basic exclusion amount. The amount allowable as a credit in computing the gift tax payable on B's post-1976 gifts for that year ($5,545,800) is the tax on $14 million, consisting of $11.4 million in DSUE amount and $2.6 million in basic exclusion amount. This basic exclusion amount is 18.6 percent of the $14 million exclusion amount allocable to those gifts, with the result that $1,031,519 (0.186 x $5,545,800) of the amount allowable as a credit for that year in computing gift tax payable is based solely on the basic exclusion amount. The amount allowable as a credit based solely on the basic exclusion amount for purposes of computing B's estate tax ($2,665,800) is the tax on the $6.8 million basic exclusion amount on B's date of death. Because the portion of the credit allowable in computing the gift tax payable on B's post-1976 gifts based solely on the basic exclusion amount ($1,031,519) is less than the credit based solely on the basic exclusion amount ($2,665,800) allowable on B's date of death, the special rule in section (c) of the regulation (the anti-clawback rule) does not apply and the credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount.

III. Trust Reformations and Modifications

1. **PLRs 201947001 - 201947006 (November 22, 2019).** In this series of rulings, the Service ruled that a modification of an irrevocable grandfathered trust extending it for the life of a beneficiary pursuant to a state statute (i) would not cause the trust to lose its exempt status for

purposes of the GST tax, (ii) would not result in the inclusion of the trust in the grantor's estate, and (iii) would not cause the grantor or any beneficiary to have made a gift.

The grantor created an irrevocable trust for his son and the son's issue. The son was to receive the net income and specified distributions of principal upon reaching certain ages. Upon the death of the son, the trust was to divide into equal shares for the son's children who are living or who are deceased with living issue. Each issue of the grantor's son was to receive the net income and all of the principal at age 21, and upon his or her death the issue's share was to be distributed to his or her estate. Successor trustees appointed by son or son's named successors were required to be corporate trustees not related or subordinate to the grantor or any beneficiaries of the trust, within the meaning of Code Section 672.

The settlor and all of the beneficiaries wanted to modify the trust by agreement pursuant to a state statute. The modified provisions would divide the trust upon son's death into shares for his issue, per stirpes, and would change the dispositive provisions of each share for the son's issue to (i) make each share a lifetime trust, with distributions to be made in the trustee's discretion subject to an ascertainable standard, (ii) grant the issue a general testamentary power to appoint the remaining trust property, (iii) divide the unappointed remainder into per stirpital shares for the issue of the deceased beneficiary, and if none, the son's issue. The beneficiary of the trust was named as trustee of his or her own share upon attaining age 45.

The Service reasoned that because each issue of son was the sole beneficiary for life and held a general power of appointment at death, the value of his or her share would be included in his or her estate at death and the beneficiary would be the transferor of the property for GST tax purposes. As such, the Service concluded that the proposed modifications would not shift a beneficial interest in the trust to any beneficiary occupying a lower generation than the person or persons who held the interest prior to the modification and would not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original agreement.

2. **PLRs 201941012 - 201941023 (October 11, 2019).** In this series of rulings, the Service ruled that the reformation of an irrevocable trust (i) would not cause any child of the settlor to have released a general power of appointment within the meaning of Code Sections 2514 and 2041 by reason of the lapse of a withdrawal right, and (ii) would not cause anyone other than the settlor, the settlor's spouse, and the settlor's parents to be transferors of the trust for GST tax purposes.

In these rulings, the settlor had created six separate trusts under one irrevocable agreement, one for each child of the settlor and his or her descendants. The trusts were to continue until termination at the end of twenty-one years after the death of the last to die of the settlor and all of the settlor's children. Upon any transfer to the trust, each beneficiary was permitted to demand for a period of 30 days up to the maximum amount allowable with respect to the donor as an annual exclusion gift. The settlor asserted that the Crummey withdrawal provisions contained a drafting error. Any lapse of the withdrawal right could be treated as a taxable transfer by that child under Code Section 2514 to the extent that the lapsed withdrawal right exceeds $5,000 or 5% of the value of the assets. Based on affidavits of the settlor and the drafting attorney, the trust was intended to be GST exempt and was not intended to be included in the gross estates of his children upon their

deaths. The trustee filed a petition to reform the trust retroactively to the date of the trust's creation. The court issued an order to reform the trust, contingent upon the issuance of a favorable private letter ruling by the Service. As reformed, the trust limits the annual lapse of each child's withdrawal right to the greater of $5,000 or 5% of the value of the trust assets.

In addition to the favorable gift and estate tax ruling, the Service concluded that transfers to the trust by the settlor, the settlor's spouse, and the settlor's parents were GST exempt by virtue of the automatic allocation rules, even though their gift tax returns reported no affirmative or automatic allocation of GST tax exemption.

3. **PLRs 201938004 - 201938006 (September 20, 2019).** In these rulings, the Service ruled that the GST tax exempt status of a grandfathered trust would not be adversely impacted following a judicial construction and modifications to the administrative and dispositive provisions.

The trust was created under the will of a decedent for the primary benefit of the decedent's grandson. All of the income was to be distributed to the grandson for life, and upon his death to his living issue, per stipes. Distributions of principal were not permitted. The trust was to terminate upon the earlier of (i) 21 years after the grandson's death, or (ii) the date that the youngest of the grandson's issue reached age 21. Upon termination, the trust was to be distributed to the grandson's then living issue, per stirpes.

The trust was modified by court order to terminate upon the grandson's death and be distributed at that time to the grandson's child. At the time of the first modification, the grandson had one son and two grandchildren, all of whom who over the age of 21. The trust was modified again to provide that any outright distribution to the grandson's child was instead to be held in further trust for the lifetime of the child. The child was eligible for distributions in the trustee's discretion and at his death, the trust was to be distributed to the grandson's grandchildren (or their respective estates, if not then living). Following the deaths of both the grandson and his child, a court further construed the trust to clarify that the grandson's child has a general power of appointment over the trust assets. The clarification was intended to ensure that the assets would be taxed as part of the grandson's child's gross estate and that there would be no extension of time for the vesting of interests in the trust.

The Service concluded that the decedent intended to give the grandson's child a general power of appointment under the trust's original terms and the court's construction clarified that right. As a result, the assets were included in the grandson's child's gross estate and the child was treated as the owner for GST tax purposes. The Service determined that after the judicial construction and modifications, the trust remains exempt from the application of the GST tax.

4. **PLRs 201932001 - 201932010 (August 9, 2019).** In this series of rulings, the Service determined that the termination of a grandfathered trust (i) would not cause the trust to lose its GST tax exempt status, (ii) would not cause any of the beneficiaries to be treated as making a taxable gift, and (iii) would cause the settlor's son and his grandchildren to recognize long-term capital gain on the unrealized appreciation of the assets received by them upon termination.

A settlor created an irrevocable trust for the benefit of the settlor's son. The son was to receive income for support for life, and upon his death, the remainder was to be distributed to his issue, per stirpes. No principal determinations were permitted during son's lifetime. The son has four living adult children and eight living grandchildren, half of whom are adults. The grantor's son and his adult descendants entered into a nonjudicial settlement agreement ("NJSA") providing for the trust's termination and distribution of its assets among the son, his children and his grandchildren in accordance with the actuarial value of each beneficiary's share. The NJSA provided that the continuance of the trust was no longer necessary to achieve a material purpose of the trust because the son's net worth had grown significantly such that he no longer needed the trust income for his support. State statute permitted a trust to terminate by NJSA, provided that court approval is obtained and the court must conclude that continuance of the trust is not necessary to achieve any material purpose of the trust. The court approved the NJSA, but the NJSA was contingent on a favorable private letter ruling from the Service.

The Service concluded that the termination of the trust and proposed distribution would not shift a beneficial interest in the trust to a beneficiary who occupied a generation lower than the beneficiaries who held the interest prior to the termination, nor extend the time for vesting of any beneficial interest in the trust provided for in the original trust, as long as the actuarial values accurately represent the actuarial value of each beneficiary's interest. Thus, the termination will not result in the loss of GST tax exemption. Furthermore, the Service concluded that no beneficiary is deemed to have made a gift because the beneficial interests, rights and expectancies of the beneficiaries will be substantially the same before and after the termination, as long as the actuarial values accurately represent the actuarial value of each beneficiary's interest.

The Service also characterized the termination as a sale of the interests of the son and his grandchildren to the son's children, and concluded that their gains would be long-term capital gains.

5. **PLRs 201920001 – 201920003 (May 17, 2019).** In a series of rulings, the Service ruled that the judicial reformation and modification of several trusts (i) did not grant the trusts' beneficiaries with general powers of appointment, and (ii) did not constitute the exercise or release of any general power of appointment resulting in a gift, and that GST tax was automatically allocated to each transfer to the trust.

In these rulings, the grantor created three irrevocable trusts (after September 25, 1985), one for the benefit of the children of each of the three children of the grantor. The grandchildren were eligible for distributions for their health, education, welfare and support, and to pursue a business or profession. Each trust provided that upon a transfer to the trust, the grandchild had the unrestricted right to withdraw the transferred property within 30 days, or the power lapsed. Each grandchild also had a testamentary power over his or her trust and in default of the power, the trust was to be distributed to the grandchild's descendants, per stirpes. The grantor and the grantor's spouse each made multiple gifts to the trusts and the grantor bequeathed property to them from his estate.

After the grantor's death, it was discovered that the powers could be construed as general powers, causing estate inclusion for the grandchildren, and did not contain language restricting

appointments to non-family members. The trustees petitioned a court to reform the trusts to narrow the powers of appointment and withdraw rights, contingent upon a ruling from the Service. The trustees offered three affidavits as support that the powers of appointment did not reflect the grantor's intent, one from each of the grantor's accountant, law firm and son, who was trustee of two of the trusts. The court reformed the trusts to (i) limit the class of appointees of the testamentary power to the descendants of the child who was the grandchild's parent, excluding the grandchild, the grandchild's estate, the grandchild's creditors and the creditors of the grandchild's estate, and (ii) limit the grandchild's withdrawal right to the greater of the amounts described in Code Sections 2514(e) and Code Section 2503(b). Upon examination of the submitted materials, the Service agreed that the grantor did not intend for the grandchildren to have general powers of appointment.

IV. No Gain Recognized on Sale to Spouse's Grantor Trust

PLR 201927003 (July 8, 2019). The Service cited Code Section 1041 and Rev. Rul. 85-13 in PLR 201927003 to rule that when one spouse sells a partnership interest to the grantor trust of his or her spouse, no gain or loss is recognized by the spouse and the basis of the partnership interest acquired by the grantor trust will be the same as the adjusted basis in the hands of the spouse. In the ruling, both Spouse 1 and Spouse 2 created and funded respective granted trusts. Each of Spouse 1 and the trustees of Spouse 1's grantor trust proposed a sale of limited partnership interests to Spouse 2's grantor trust. Pursuant to Rev. Rul. 85-13, the grantor of a grantor trust is treated as the owner of the assets, the trust is disregarded as a separate tax entity, and all income is taxed to the grantor. Furthermore, Section 2041(a)(1) of the Code provides that no gain or loss shall be recognized on a transfer of property from an individual to a spouse. Code Section 2041(b) provides that, in the case of any transfer described in 2041(a), the property shall be treated as acquired by gift and the basis of the transferee in the property shall be the adjusted basis of the transferor. Thus, the Service found that Spouse 1 will not recognize any gain or loss on the sale, and the basis acquired by the trust of Spouse 2 will be the same as the adjusted basis in the property in the hands of Spouse 1 and Spouse 1's trust, as applicable.

V. Alternate Valuation Date

CCA 201926013 (June 28, 2019). The value of a decedent's estate for estate tax purposes is determined as of the date of the decedent's death, or the executor can choose to value the estate as of the "alternate valuation date" (6 months after the decedent's death), if the result is to lower the value of the decedent's estate and the sum of the decedent's estate and gift taxes. In CCA 201926013, the Chief Counsel's office informally advised that despite a valid Code Section 2032(b) election by an estate to use the alternate valuation date, alternate values can only be used if it results in a lower gross estate and lower combined estate and GST tax. If for whatever reason, that is not the case, the taxpayer must use date of death values. In the case at hand the taxpayer made the election with the assumption that based on the values he reported, the taxes at alternate valuation date would be less than the taxes at date of death. However, after further examination and adjustments, the date of death value actually resulted in the lower value of combined estate and GST taxes, and the date of death value must be used. The Chief Counsel's office analogized this to the situation in Treas. Reg. Section 20.2032-1 which mentions protective elections. There, an executor can make a protective election to use the alternate valuation date, even though the date

of death value produces the lower combined taxes. The purpose of the protective election is to allow for the alternate valuation date to be used if it is subsequently determined that the combined taxes will be lower based on the alternate valuation date than based on the date of death. The Chief Counsel reasoned that this certainly contemplates lower values that result after an IRS examination.

VI. Incomplete Gift Non-grantor Asset Protection Trusts

In late 2018 and 2019, the Service has continued to give favorable rulings for grantors who create incomplete gift non-grantor asset protection trusts (colloquially referred to as "DINGs" when created under Delaware law). DINGs can be a valuable state income tax planning tool for grantors residing in certain jurisdictions. The Service has ruled that a DING trust may qualify as a nongrantor trust if the trust is structured as follows with respect to distributions: (i) distributions must be made at the direction of any one or a majority of the members of a distribution committee comprised of adverse parties, with the grantor's consent, (ii) the distribution committee, acting unanimously, may direct a distribution to the grantor or any other beneficiary, and (iii) at any time, the grantor, in a nonfiduciary capacity, may appoint to any one or more of the beneficiaries such amounts of the principal, for their health, education, maintenance and support. The grantor should also retain a testamentary limited power of appointment in order to cause transfers to the trust to be treated as wholly incomplete gifts. For recent examples of such favorable rulings see:

1. **PLRs 201925005 – 201925010 (June 21, 2019)**
2. **PLRs 201908003 – 201908008 (February 22, 2019)**
3. **PLRs 201852009 (December 28, 2018)** (involving community property)
4. **PLR 201852014 (December 28, 2018)** (involving community property)
5. **PLRs 201850001 – 201850006 (December 14, 2018)** (involving community property)

VII. FOREIGN PERSONS

1. **ESBTs With Nonresident Aliens as Beneficiaries.** On June 18, 2019, the Service issued final regulations regarding the addition of nonresident aliens to the class of potential current beneficiaries of an electing small business trust (ESBT). The final regulations adopted in their entirety the proposed regulations issued in April of 2019. The final regulations generally confirm that a grantor trust deemed to be owned by a nonresident alien may own stock in a corporation without causing the corporation to fail to qualify as an S corporation, as long as the trust validly elects to be an ESBT. Ultimately, the goal of the regulations is to prevent non-U.S. source income from flowing through an S corporation and escaping U.S. taxation in the hands of a nonresident alien. The regulations ensure that an S corporation's income will be subject to federal income tax when a nonresident alien is a deemed owner of a grantor trust that elects to be an ESBT. The regulations are applicable to all ESBTs after December 31, 2017.

A nonresident alien is not a permitted shareholder of an S corporation. Certain trusts are permissible shareholders, including certain grantor trusts and ESBTs. Generally, the deemed owner of a grantor trust and each potential current beneficiary of an ESBT is treated as a shareholder for purposes of determining if a corporation may qualify as an S corporation. Prior to

the issuance of these regulations, it was questionable whether a grantor trust with a nonresident alien as a deemed owner could be a permissible S corporation shareholder by making an ESBT election.

2. **Residents of U.S. Possessions.** In PLR 201924009, the Service ruled that a person who was born outside of the United States, who became a U.S. citizen only after residing in a U.S. possession, and whose parents were not, at the time of his birth, citizens, nationals or residents of the U.S. or any of its possession or territories, is to be considered a “nonresident not a citizen of the United States” for purposes of federal estate, gift and GST taxes.