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TOPIC: The Hits Just Keep on Coming: 2016 Gift, Estates & Trusts Priorities – IRS Names Grantor Trusts Among New Items.

APP TAG: IRS adds guidance on certain grantor trust issues to list of 2016 priorities.

MARKET TREND: The IRS continues to focus on estate planning transactions involving grantor trusts.

SYNOPSIS: Of the five new items added to the Gifts, Estates and Trusts section of the IRS's 2015-2016 Priority Guidance Plan, the majority of them address or could impact planning with grantor trusts, including planned guidance on (1) the determination of the tax basis of grantor trust assets at the grantor's death; (2) the valuation of promissory notes for transfer tax purposes; and (3) the gift tax effects of defined value formula clauses. In addition, while not related to grantor trusts, the deadline for the estate information reporting requirements related to the new basis consistency legislation is February 29, 2016. Clients and advisors currently dealing with taxable estates will want to pay close attention to the pending release of IRS guidance on this issue, as the penalties for non-compliance could be significant.

TAKE AWAY: The Priority Guidance Plan indicates that 2016 could be an eventful year for estate and life insurance planning. The potential uncertainty of the scope, content and timing of the planned guidance emphasizes the importance of having access to not only updated technical information but also to practical analyses of these tax developments, their real world application, and how advisors and clients should respond. The AALU will continue to track and report on these developments – stay tuned.

PRIOR REPORTS: 15-43; 15-37; 15-31; 15-09; 14-13; 12-52; 12-34.

MAJOR REFERENCE: Department of the Treasury 2015-2016 Priority Guidance Plan, First Quarter Update (Oct. 23, 2015, "Priority Guidance Plan").

The 2015-2016 Priority Guidance Plan added several new guidance projects to its gifts, estates and trusts section, many which appear to focus on grantor trusts and related issues. While items can remain on the Priority Guidance Plan year after year, recent statements and audit activities indicate that the IRS may be primed to move on guidance for these new items.[1]

1. ***Basis of Grantor Trust Assets at Death under Code § 1014.*** Conflicting positions regarding the determination of the tax basis of assets held by a grantor trust at the death of the grantor (when grantor trust status terminates) have been discussed among practitioners and commentators for some time, primarily as follows:

   - No Step-Up. A common position is that, at the grantor's death, the assets held by the grantor trust are not includible in the grantor's gross estate for estate tax purposes but also do not receive a basis step-up under Code §1014(b)(9).[2]

     - The reasoning in IRS Chief Counsel Advice (CCA) 200937028 supports this position, as it states that "it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to § 1014, unless the property is included in the gross estate for federal estate tax purposes as per § 1014(b)(9)." But CCAs only provide internal guidance and do not set precedent for IRS action on future cases.

   - Step-Up. An alternative position is that the grantor trust assets, while not includible in the grantor's estate, still receive a basis step-up under Code §1014(b)(1) as property "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." This position draws on the concept in Rev. Rul. 85-13 that the grantor is treated as the owner of the entire trust for all federal income tax purposes, which arguably includes determining income tax basis at death.[3] Thus, there would be no estate tax on the trust assets and a full basis step-up for income tax purposes.

- Support for this position potentially lies in IRS rulings providing that foreign assets left by foreign persons to U.S. beneficiaries, either directly or through a foreign grantor trust, received a basis step-up to date-of-death value even though they were not included in the foreign person's estate for U.S. estate tax purposes (see Rev. Rul. 84-139 and PLR 201245006, respectively). These rulings may be distinguishable, however, since there would have been U.S. estate tax inclusion if either case involved U.S. assets or a decedent who was a U.S. person.

Despite the limited and arguably conflicting guidance above, in June 2015, the IRS issued Rev. Proc. 2015-37, indicating that it would "no longer" rule on whether the assets in a grantor trust receive a basis step-up under Code § 1014 at the grantor's death.

✓ ***Practical Note:*** This "basis-at-death" issue has often arisen in the context of installment sales to grantor trusts, where there has been much debate regarding the tax treatment at the grantor's death if the note remains outstanding, not just regarding the trust's basis in the assets sold, but also, for example, whether any gain recognition is triggered from the sale at the time of the grantor's death due to the termination of grantor trust status.[4] Whether the IRS will address any other income tax issues is uncertain, but depending on the scope of the guidance, there could be more emphasis on ensuring the note's pay-off during the grantor's life. This could create a preference for shorter note terms or a greater use for life insurance to provide protection against the potential mortality exposure, all of which could impact the economics of grantor trust sales.

2. ***Valuation of Promissory Notes for Transfer Tax Purposes under Code §§ 2031, 2033, 2512, and 7872***. Whether the promissory note provided in an intra-family loan or sale transaction charges adequate interest (e.g. at the appropriate applicable federal rate ("**AFR**")) and, if applicable, provides fair market value for the assets sold, is a key component of determining the gift, estate, and GST tax treatment of the transaction. In some cases, the IRS has found itself in the difficult position of not wanting to value intra-family AFR notes at their face amounts for gift tax purposes, but also not wanting to allow discounts in the face value of similar notes for estate tax purposes. This note valuation issue is one of the many challenges raised in the grantor trust sale transactions involved in the *Estate of Marion Woelbing v. Commissioner* and the *Estate of Donald Woelbing v.*

Commissioner, related cases currently pending in the U.S. Tax Court.[5] Thus, the addition of this issue likely is related to the IRS's ongoing focus on grantor trust sale transactions, as discussed in prior *WRMarketplaces* (see *Nos. 14-13, 15-09, 15-31, 15-43*).

✓ ***Practical Note:*** When combined with the grantor trust basis item above, it appears the IRS may be attempting to take a "global" approach to its guidance on grantor trust sales.

3. Gift Tax Effects of Defined Value Formula Clauses under Code §§2512 and 2511. As discussed in *WRMarketplaces Nos. 12-34* and *12-52*, clients and advisors have sought to use defined value formula clauses to make gifts of difficult-to-value assets ("**DTV assets**"), like closely-held business interests, to minimize concerns associated with possible, later IRS valuation adjustments. Generally, defined value clauses fall into two categories:

- *Formula Allocation Clauses.* These clauses typically allocate the value of a DTV asset among various taxable and non-taxable donees (*e.g.*, charities, spouses, marital deduction trusts, etc.). The client makes a completed gift of the DTV asset, such that a valuation increase only results in an adjusted allocation of the DTV asset among the classes of donees; nothing is allocated to the client. While several cases upheld these formula allocation clauses,[6] administrative complexities and the perceived need for a charitable component made them unappealing to some clients and somewhat difficult to implement.

- *Formula Transfer Clauses.* These clauses typically limit the DTV asset transferred to a donee to a fixed dollar amount. Any valuation increase in the DTV asset would not change this dollar amount, ***but would result in an adjustment of the allocation of the DTV asset among the donee and the client*** (***not*** another class of donees, as with the formula allocation clause). This formula presumably can be designed as a simpler clause, because it does not require multiple and/or taxable and non-taxable donees.

The 2012 Tax Court decision in *Wandry v. Commissioner*[7] upheld the use of a simple formula transfer clause involving gifts of interests in a family-owned entity. The IRS, however, did not acquiesce in *Wandry* and indicated that it would not follow the decision in other cases.[8]

✓ ***Practical Note:*** Without proper lifetime planning, the family of a client with DTV assets can face illiquidity and a possible "fire sale" of those assets at the client's passing, resulting in the loss of a family business or the wholesale transfer of DTV assets at far less than market value. A *Wandry*-type formula transfer clause, however, may encourage more clients with DTV assets to execute recommended lifetime estate and business succession plans because of the clause's potentially simpler implementation and administration. Life insurance often complements this planning by providing needed liquidity to the asset owner's estate. However, as defined value clauses—including *Wandry*-type clauses—often go hand-in-hand with gifts and sales to grantor trusts, it is not surprising that these clauses would be added to the Priority Guidance Plan at the same time as the issues noted above.

✓ ***<u>Potential Implications of Guidance</u>**:* Assume the IRS eliminates the use of *Wandry*-type formula clauses. Subsequently, John makes a gift of his full federal gift tax exemption to a dynasty trust for his descendants, including 100 shares in his family business "FamCo," with a total appraised value of $3 million ($30,000 per share). The trust also acquires a life insurance policy on John, relying on gifted funds to pay the premiums. John files his federal gift tax return, allocating both his federal gift and GST tax exemption to the transfer. The IRS later asserts that the FamCo shares are worth $4 million total ($40,000 each), resulting in a taxable gift to the trust of $1 million. Not only could John face a gift tax of $400,000 (which he may, as a closely-held business owner, have difficulty finding the liquidity to pay), but the trust is no longer fully GST tax-exempt. If a *Wandry*-type formula clause was still allowed, however, the number of FamCo shares allocated under the gift would have been limited to a value of $3 million (i.e., 75 shares or $3,000,000 / $40,000 (the per share value as finally determined for gift tax purposes), possibly protecting John from this potential loss.

4. ***Code §§ 1014(f) and 6035 on Consistent Basis Reporting between Estate and Person Acquiring Property from Decedent.*** As discussed in *WRMarketplace No. 15-37*, the IRS recently issued Notice 2015-57 to provide initial guidance on the new tax basis consistency requirements for recipients of inherited assets and the new information reporting requirements for executors of taxable estates.[9] Technically, both requirements became effective for property reported on an estate tax return filed after July 31, 2015, even if the decedent died before that date. As the IRS must still draft new regulations and forms, however, the deadline for information statements that would otherwise be due from an executor to estate beneficiaries and the IRS is delayed until February 29, 2016. Notice 2015-57 specifically states that executors and others required to file information reporting forms should not do so until issuance of forms and/or further guidance by the IRS.

   ✓ ***Practical Note:*** Although not related to grantor trusts, both the basis consistency rules and the information reporting requirements are very technical and will likely generate new administrative burdens for estate fiduciaries and beneficiaries. Clients and advisors currently dealing with taxable estates should ***pay close attention to the pending release of future IRS guidance in this area, as the penalties for non-compliance could be significant***, especially if the failure to comply is deemed intentional.

TAKE-AWAY

The Priority Guidance Plan indicates that 2016 could be an eventful year for estate and life insurance planning. The potential uncertainty of the scope, content, and timing of the planned guidance emphasizes the importance of having access to not only updated technical information but also to practical analyses of these tax developments, their real world application, and how advisors and clients can respond. The AALU will continue to track and report on these developments – stay tuned.

NOTES

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[1] The other new item added not discussed herein is guidance on qualified contingencies of charitable remainder annuity trusts under Code §664.

[2] See discussions in Cantrell, "Gain Is Realized at Death," *Trusts & Estates* at 20 (Feb. 2010); and Dunn & Handler, "Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates," *Journal of Taxation* (July 2001).

[3] *See e.g.,* Zaritsky & Aucutt, *Structuring Estate Freezes: Analysis With Forms* at ¶ 12.02[5][b][ii] (Thomson Reuters/Tax & Accounting, 2d ed. 1997, with updates through November 2015) (online version accessed on Checkpoint (www.checkpoint.riag.com)), citing Blattmachr, Gans & Jacobson "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death," *Journal of Taxation*, Sept. 2002 (although this 2002 article was written prior to issuance of CCA 200937028, as Blattmachr and Gans note in their subsequent article, "No Gain at Death," *Trusts & Estates* at 34 (Feb. 2010), and may impact the analysis.

[4] A full discussion of all the potential issues is beyond the scope of this report. For a general discussion of the potential income tax issues and positions associated with installment sales to grantor trusts, see Zaritsky & Aucutt, *Structuring Estate Freezes: Analysis With Forms* at ¶ 12.02[5][b][ii] (Thomson Reuters/Tax & Accounting, 2d ed. 1997, with updates through November 2015) (online version accessed on Checkpoint (www.checkpoint.riag.com)). *See also* "The debate continues. See, e.g., Cantrell, "Gain Is Realized at Death," *Trusts & Estates* at 20 (Feb. 2010); Gans & Blattmachr, "No Gain at Death," *Trusts & Estates* at 34 (Feb. 2010)" as quoted from Aucutt, *Grantor Retained Annuity Trusts (GRATs) and Sales to Grantor Trusts*, Art. X.A.5, updated through February 26, 2015.

[5] T.C. Docket No. 30260-13 and T.C. Docket No. 30261-13, respectively. Note that, as of Dec. 2, 2015, the court ordered the parties to file a joint status report by Jan. 15, 2016, based on the court's review of a Nov. 30th joint status report, which indicated that the parties were "actively engaged in ongoing discussions."

[6] *See e.g.*, *McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006); Est. of Christiansen v. Commissioner, 586 F.3d 1061 (8th Cir. 2009); Est. of Petter v. Commissioner, 653 F.3d 1012 (9th Cir. 2011); Hendrix v. Commissioner, T.C. Memo 2011-133.*

[7] T.C. Memo 2012-88.

[8] Action on Decision 2012-004, 2012-46 IRB (11/13/2012).

[9] As enacted in July under the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.