By Timothy W. Jones

As this newsletter goes to press, the Governor has closed schools and we are all waiting to see what happens next, both in North Carolina and nationwide. Prior to the Covid-19 outbreak, the biggest issue estate planning attorneys were wrestling with was how we should respond to the SECURE Act. One of the biggest changes in estate planning law in recent memory seems awfully mundane now, but here's hoping it will soon again be the most pressing issue we are facing in our offices. On December 19, 2019, the SECURE Act was passed. For individuals dying on or after January 1, 2020, less than two weeks later, the Act changes key provisions for beneficiaries.

On January 2, Section member John R. Potter published an article on the blog for the Elder & Special Needs Law Section. That article is available through the NCBA website, even if you are not a member of the Elder & Special Needs Law Section. John and another Section member, Christina Hinkle, quickly put together a one-hour CLE that is currently available as the March edition of the NCBA's Expert Series. We anticipate an article on the SECURE Act in an upcoming edition of this newsletter. In addition, John and Christina will also present at our Section's annual meeting in July.

Speaking of our annual meeting, we will again be in Kiawah this year from July 23 through July 25. We are excited to be in the brand new West Beach Conference Center. A few of our Section's leaders had the opportunity to don hardhats and tour the conference center.
center while it was under construction last year. The new center promises to be bigger and more modern than the East Beach Conference Center, which sadly may be reduced to rubble following the 2021 PGA Championship.

Our Section along with the NCBA CLE department continuously looks to determine the ideal locations for our annual meeting, including locations in North Carolina. It is difficult to find a location that can satisfy three of our most basic requirements. First, we need a space that can accommodate our 300+ attendees. Second, we need a space that is appropriate for our sponsors and exhibitors. Our sponsors and exhibitors are essential to the success of our meeting each year. Third, we need a location that allows our program to end on Saturday. More and more locations are requiring groups like ours to have a program that runs through Sunday. Results from our member surveys reveal that our members overwhelmingly prefer the schedule we have used for years, with three half-day programs ending on Saturday. Our member surveys also reveal that the large majority of our members who attend our annual meeting simply prefer Kiawah to any other location. And our sponsors and exhibitors tend to agree.

If you have never been to our annual meeting, or if you have not been in a while, I encourage you to consider putting it on your calendar now. Although the CLE programs are available later through video replays and on-demand options, there is no better way to interact with hundreds of your fellow North Carolina estate planning attorneys than to attend our annual meeting. Although the CLE brochure is still being finalized and sign-ups for the actual CLE are not yet available, I am including the following information for our Section’s group rates at the Kiawah Island Resort:

- Scenic View Villas: $243 One Bedroom, $310 Two Bedroom, $432 Three Bedroom
- Ocean View Villas. (Note that the three bedroom villa requires a one-week reservation.)
- The Sanctuary: $389 One Bedroom, $565 Run of House
- Reservations: 800.654.2924
- Group code: 16383

Although the cut-off date for our group rate is June 19, 2020, the villas do tend to fill up. There are other options for renting villas and houses privately. Either way, don’t wait too long. I hope to see you there.
The Will & The Way

the “minimum connection” missing between the State and tax purposes. . . be rationally related to “values connected with the taxing State,”” Quill Corp. v. North Dakota, 504 U. S. 298, 306. That “minimum connection” inquiry is “flexible” and focuses on the reasonableness of the government’s action. Id., at 307. Pp. 5-6.

(b) In the trust beneficiary context, the Court’s due process analysis of state trust taxes focuses on the extent of the in-state beneficiary’s right to control, possess, enjoy, or receive trust assets. Cases such as Safe Deposit & Trust Co. of Baltimore v. Virginia, 280 U. S. 83; Brooke v. Norfolk, 277 U. S. 27; and Maguire v. Trefry, 253 U. S. 12, reflect a common principle: When a State seeks to base its tax on the in-state residence of a trust beneficiary, the Due Process Clause demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State’s tax. Safe Deposit, 280 U. S., at 91. Similar analysis also appears in the context of taxes premised on the in-state residency of settlors and trustees. See, e.g., Curry v. McCanless, 307 U. S. 357. Pp. 6-10.

(c) Applying these principles here, the residence of the Trust beneficiaries in North Carolina alone does not supply the minimum connection necessary to sustain the State’s tax. First, the beneficiaries did not receive any income from the Trust during the years in question. Second, they had no right to demand Trust income or otherwise control, possess, or enjoy the Trust assets during the tax years at issue. Third, they also could not count on necessarily receiving any specific amount of income from the Trust in the future. Pp. 10-13.

(d) The State’s counterarguments are unconvincing. First, the State argues that “a trust and its constituents” are always “inextricably intertwined,” and thus, because trustee residence supports state taxation, so too must beneficiary residence. The State emphasizes that beneficiaries are essential to a trust and have an equitable interest in its assets. Although a beneficiary is central to the trust relationship, the wide variation in beneficiaries’ interests counsels against adopting such a categorical rule. Second, the State argues that ruling in favor of the Trust will undermine numerous state taxation regimes. But only a small handful of States rely on beneficiary residency as a sole basis for trust taxation, and an even smaller number rely on the residency of beneficiaries regardless of whether the beneficiary is certain to receive trust assets. Finally, the State urges that adopting the Trust’s position will lead to opportunistic gaming of state tax systems. There is no certainty, however, that such behavior will regularly come to pass, and in any event, mere speculation about negative consequences cannot conjure the “minimum connection” missing between the State and the object of its tax. Pp. 13-16.

Under the pragmatic inquiry into the rights of trust beneficiaries required by the U.S. Supreme Court in North Carolina Dep’t. of Rev. v. The Kimberley Rice Kaestner 1992 Family Trust, 139 S. Ct. 2213 (2019), absent very unusual circumstances, is the trustee of any wholly-discretionary irrevocable trust for the benefit of North Carolina residents subject to North Carolina state income tax on annual non-source accumulated income under N.C.G.S. Section 105-160.2—a statute premised solely upon the residence of beneficiaries? After Kaestner, North Carolina state taxation of the annual accumulated income of wholly discretionary trusts appears to be unconstitutional under North Carolina’s current statute, except in aberrant factual circumstances. This result appears to be true regardless of where the trust’s trustees or grantor reside, and in spite of the principal place of administration of the trust, because the statutory scheme of taxation offered by N.C.G.S. Section 105-160.2 relies on none of those factors. This is not a cavalier expansion of the Kaestner holding; rather, it is a very conservative reading in light of a trustee’s fiduciary duty not to remit taxes that are not owed.

**Tax Nexus**

Forty-two states across the United States choose to constitutionally base their general jurisdiction to tax annual accumulated trust income on one or more of the following six connections, or points of nexus, with the state:

1. A resident grantor of inter vivos trusts,
2. A resident decedent of testamentary trusts,  
(State tax statutes described in 1 & 2 often are called “Founder” statutes.)
3. A resident beneficiary of a trust,
4. A resident trustee of a trust,
5. The location of the administration of the trust, and
6. In part, on a recitation in the trust agreement (Louisiana only).

Some state legislatures have chosen to use several of these factors in combination (e.g., North Dakota, N.D. Admin. Code Section 81.03-02.1-04(2)). By contrast, many states use only one point of nexus for the authority to tax. See Richard W. Nenno, *Bases of State Income Taxation of Nongrantor Trusts*, ACTEC 1, http://www.actec.org/assets/1/6/Nenno_state_nongrantor_tax_survey.pdf (last updated March 2019) (surveying all fifty states’ respective trust income taxation regimes).

North Carolina’s statute exclusively uses the residence of a beneficiary to provide the nexus to tax income. N.C.G.S. § 105-160.2. For purposes of Due Process, Kaestner holds that North Carolina only has jurisdiction to tax trustees on the trust income of trusts where a North Carolina resident holds beneficial interests having particularly narrow characteristics.

**Scope**

Following the Kaestner decision, commentators have wondered about the impact of the decision on the fiduciary income tax statutes of all forty-two taxing states. While the opinion will help shape the analysis of fiduciary income tax statutes in other states, the influence
of Kaestner may be limited in that broader, nationwide context. For trustees of trusts with North Carolina resident beneficiaries, though, the import of the Kaestner holding is difficult to overstate.

The Kaestner Court specifically “granted certiorari to decide whether the Due Process Clause prohibits States from taxing trusts based only on the in-state residency of trust beneficiaries.” Kaestner, at 2219. Despite suggestions to the contrary in earlier lower court opinions in other cases and in professional and academic writings, the Court declined to hold that the Due Process Clause unequivocally prohibits states from taxing trusts based only on the in-state residency of any trust beneficiaries with all forms of equitable rights. Cf. In Re Swift, 727 S.W.2d 880, 882 (Mo. 1987) (en banc) (declaring as unconstitutional a statute based solely on domicile of the settlor of testamentary trusts, and suggesting that a state fiduciary income tax statute needs more than just one contact to be constitutional, e.g., more than merely the domicile of the grantor at death or the domicile of beneficiaries). So, in Kaestner, the Court has held that—only in very specific and limited legal or factual circumstances—the residence of the beneficiary, alone, may be enough to convey jurisdiction to tax a trustee on accumulated trust income. Kaestner, at 2221.

Importantly, for statutes such as N.C.G.S. Section 105-160.2—which bases North Carolina’s power to tax solely on the residence of the beneficiary within that state—the Court clearly has limited the types of beneficial trust interests which create jurisdiction to tax. Specifically, the Court “[held] that the presence of in-state beneficiaries alone does not empower a State to tax trust income that has not been distributed to the beneficiaries where the beneficiaries have no right to demand that income and are uncertain ever to receive it. In limiting our holding to the specific facts presented, we do not imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here.” Id. (emphasis added).

Stare Decisis

That the holding of the U. S. Supreme Court in Kaestner is “as applied” to the respondent trustee does not make the holding inapplicable to the annual accumulated income of other trusts with North Carolina resident beneficiaries. To the contrary, Kaestner is particularly pertinent to a wide range of trusts with North Carolina resident beneficiaries. It has far-reaching ramifications for trustee-taxpayers of trusts with North Carolina resident beneficiaries even though the opinion was rendered on an “as applied” basis. (A discussion of facial constitutional challenges to statutes, including Washington State Grange v. Washington State Republican Party, 552 U.S. 442 (2008), appears in the 2018 article in this series.)

The doctrine of stare decisis—i.e., following legal precedent in case law—is a primary foundation of American jurisprudence. At a fundamental level, the U.S. Supreme Court repeatedly has supported the doctrine of stare decisis, especially in constitutional matters. “In constitutional cases, the doctrine [of stare decisis] carries such persuasive force that we have always required a departure from precedent to be supported by some ‘special justification.’” Payne v. Tennessee, 501 U.S. 808 (1991), citing Arizona v. Rumsey, 467 U.S. 203, 212 (1984); see Quill Corp. v. North Dakota, 504 U.S. 298 (1992) (concerning the application of stare decisis in the context of an unconstitutional state tax statute); cf. Burnet v. Coronado Oil & Gas Co., 285 U.S. 393, 405 (1932) (Brandeis, J., dissenting).

Recently, in the U.S. Supreme Court’s October 2018 term, which ended June 30, 2019, the Court reiterated the boundaries of its stare decisis jurisprudence in Knick v. Township of Scott, Pennsylvania, 139 S. Ct. 2162, 2177 (2019) (overruling the state litigation requirement in the context of an uncompensated governmental taking). “The doctrine of stare decisis reflects a judgment ‘that in most matters it is more important that the applicable rule of law be settled than that it be settled right.’” Id. (quoting Agostini v. Felton, 521 U. S. 203, 235 (1997), in turn quoting Burnet v. Coronado Oil & Gas Co., supra); see also Gundy v. U. S. at 55 (2019). In Kaestner itself, the principle was important enough to Justice Alito to file a concurring opinion: “I write separately to make clear that the opinion of the Court merely applies our existing precedent and that its decision not to answer questions not presented by the facts of this case does not open for reconsideration any points resolved by our prior decisions.” Kaestner, 139 S. Ct. at 2226 (Alito, J., concurring). Finally, in its petition to the North Carolina Supreme Court to review the Court of Appeals’ decision in Kaestner, the state of North Carolina accurately observed “the potential widespread impact of the Court of Appeals’ decision….” Petition in Kaestner, No. 307 P15-2, at 9 (N.C., July 22, 2016).

Accordingly, fiduciaries should not ignore the Kaestner holding as meaningless or inapplicable to the trusts they oversee merely because the holding was rendered “as applied” to the Kaestner Trust.

Degree of Beneficial Possession, Control, or Enjoyment Required for a State to Tax Under A Statute Premised on the Residence of a Beneficiary

In Kaestner, the Court “granted certiorari to decide whether the Due Process Clause prohibits States from taxing trusts based only on the in-state residency of trust beneficiaries.” Kaestner, 139 S. Ct. at 2219. The Court answered this question by holding that, when tax residency of the trust is based on the residency of beneficiaries, only certain very narrow types of beneficial interests can give rise to a resident trust that is taxable under Due Process. See id. at 2222. For a tax year in question, if neither the trust terms nor distributions made from the trust convey those narrow, non-contingent types of taxable beneficial interests upon a North Carolina resident beneficiary, then the trust does not meet the prerequisite of being a resident trust. In particular, in a given tax year, the Constitution prohibits a state which predicates its tax solely upon the residence of a beneficiary within the state from taxing a resident beneficiary’s interest (if any) in the accumulated income of a wholly-discretionary trust.

In contrast, in a given tax year, if trust income has been distributed to a resident beneficiary, if a resident beneficiary has the right to compel the distribution of the income, or if a resident beneficiary is certain to receive the accumulated income, then the resident beneficiary’s interest rises to a level where the trustee is susceptible to taxation. Id. at 2222–24.

What Types of Trusts Remain Subject to North Carolina State Tax on Annual Accumulated Income?

In Kaestner, the Court helpfully defined the constitutional limits on a state’s taxation of annual accumulated income. Specifically, the Court held that a tax statute based solely on the residence of beneficiaries did not meet the Due Process requirements under the following circumstances:
1. Income has not been distributed to the resident beneficiaries,
2. The resident beneficiaries have no right to demand that income, and
3. The resident beneficiaries are uncertain ever to receive the accumulated income.

Id. at 2224. In reaching this holding about North Carolina’s constitutional authority to tax based on its current statute, the Court did not make further explicit observations about the existing application of well-established principles of trust taxation to those three special circumstances.

Tax Effect of Distributions. If a trustee distributes income to a beneficiary during the tax year in question, then I.R.C. Section 662 (or I.R.C. Section 652 for simple trusts) includes that income in the gross income of the beneficiary, and I.R.C. Section 661 (or I.R.C. Section 651 for simple trusts) provides a deduction to the trust for the distribution. In general, North Carolina follows these same rules. The first sentence of N.C.G.S. Section 105-160.2 states that “[t]he tax imposed by this Part applies to the taxable income of estates and trusts as determined under the provisions of the [Internal Revenue] Code except as otherwise provided in this Part . . . .” So, while North Carolina has the constitutional authority to tax a trustee on trust income that is distributed to a resident beneficiary, it instead taxes that income to the distributee-beneficiary by the operation of basic principles of Subchapter J of the I.R.C., as incorporated by N.C.G.S. Section 105-160.2.

For years in which some, but not all, trust income is distributed to a resident beneficiary, unless the facts and circumstances indicate otherwise, and absent peculiar trust terms, the fact that the undisbursed income was not distributed to the resident is compelling evidence that the accumulated income was not for the benefit of the resident in that tax year. In particular, even where a trustee might distribute some fiduciary accounting income to a beneficiary in a year, it does not follow that the state may tax 100% of the undisbursed capital gain and income of the trust. The statute must meet muster under the Commerce Clause (fair apportionment, substantial relationship, etc.). See South Dakota v. Wayfair, Inc., 138 S. Ct. 2080, 2091 (2018) (citation omitted).

Tax Effect of Demand Rights. If a resident beneficiary has a right to demand accumulated trust income, then principles of existing tax law concerning general powers of appointment may impact the state income taxation of that income.

For example, in a given tax year, a lapsing Crummey right—if still outstanding at year-end—could be viewed as a right to "demand" or "compel" a small portion of accumulated income. See N.C.G.S. § 37A-3-303 (suggesting in the comments that a blanket power to withdraw trust property in general should be proxated between trust income and principal). Usually, each year trust income is small in proportion to trust principal, so a pending withdrawal right might create some minor North Carolina income tax liability to the trust under the second prong of the Kaestner exceptions. See Kaestner, 139 S. Ct. at 2223.

An attempt by the Department of Revenue to collect revenue under this theory would be aggressive. The withdrawal right probably should not be elevated to a “mandatory income interest,” i.e., “the right of an income beneficiary to receive net income that the terms of the trust require the fiduciary to distribute.” N.C.G.S. § 37A-1-102(7). However, if a small portion of annual trust income truly can be “compelled” by a beneficiary to be distributed under the terms of the trust agreement, a counterargument might be made that the (unexercised) power also should be treated as a deemed distribution to that beneficiary of both distributable net income and fiduciary accounting income, and so the minor income tax liability would pass to the beneficiary.

Uncertainty Regarding Receipt of Future Distributions of Accumulated Income. For fiduciaries, advisors and the Department of Revenue, the question of whether beneficiaries are certain to receive accumulated income in the future may be the most salient inquiry in part III.B. of the Kaestner opinion.

As a threshold matter, absent special provisions, federal and state governments tax accumulated annual income only for the tax year in question.

“[W]ith income taxation, the focus of the due process analysis is on the tax year in question, which would be 2006 in this case.” See Gavin, 733 A.2d at 802 (noting the connection for the inter vivos trust was the fact a noncontingent beneficiary was an in-state resident during the tax year in question); see also In re Swift, 727 S.W.2d 880, 882 (Mo. 1987) (addressing income taxation on a testamentary trust and stating, “An income tax is justified only when contemporary benefits and protections are provided the subject property or entity during the relevant taxing period”).

Linn v. Department of Revenue, 2 N.E. 1203, 1210 (Ill. Ct. App. 2013) (holding unconstitutional a state fiduciary income tax based on the residence of the grantor of an inter vivos trust who had died thirty years previously) (citing Chase Manhattan Bank v. Gavin, 733 A.2d 782 (Conn. 1999), In re Swift, 727 S.W.2d 880, 882 (Mo. 1987)). See also N.C.G.S. § 37A-1-102(1) (generally defining “Accounting Period” for fiduciary accounting purposes as a calendar year).

In a fiduciary income tax context, so-called “throwback” taxes might be assessed on a resident beneficiary (not on the trustee) in a subsequent tax year on income accumulated by trustees in prior years. California and New York each employ a form of throwback tax on resident beneficiaries. See Cal. Rev. & Tax Code § 17745; N.Y. Tax Law § 605(b)(3)(D). However, some anecdotal evidence from California suggests that its five-year throwback tax is easily avoided and very expensive for the California Franchise Tax Board to administer. North Carolina does not (and in the authors’ opinions, in the future should not) employ a throwback tax.

Under wholly discretionary trusts containing typical spendthrift provisions, resident beneficiaries are uncertain to receive distributions of accumulated income in the future. Applying general principles of trust law, that uncertainty may be either a matter of law or a matter of fact.

Analogizing a beneficiary’s right to distributions from a wholly discretionary trust to a contingent interest under a will under traditional perpetuities jurisprudence suggests that the beneficiary’s right to a discretionary distribution is uncertain as a matter of law.

For example, in Knox v. Knox, the North Carolina Supreme Court analyzed whether the remainder interest of a residuary, per stirpital beneficiary was vested where the beneficiary survived the testator but predeceased the tenant for life. Knox v. Knox, 179 S.E. 610, 614 (N.C. 1935). In holding that the beneficiary’s interest was vested because the beneficiary was a surviving brother and next of kin to the testator at the testator’s death, the court reasoned that “[t]here must
be a postponement not only of the right to enjoy, but also of the right to take an interest in order to make it either a contingent interest or a substitutional or alternative interest.” Id. at 616 (emphasis added) (citation omitted). Conversely, the North Carolina Court of Appeals held that the interest of a remainder beneficiary was contingent where the beneficiary’s interest was expressly conditioned on the beneficiary’s survival of the life tenant—a hallmark condition precedent. Canoy v. Canoy, 520 S.E.2d 128, 131-32, 135 N.C. App. 326, 328 (1999) (“A remainder interest is not vested, but is contingent, ‘when it is either subject to a condition precedent (in addition to the natural expiration of prior estates), or owned by unascertainable persons, or both.’ ”) (quoting Hollowell v. Hollowell, 430 S.E.2d 235, 242 (N.C. 1993)).

The privilege of a trust beneficiary to receive a discretionary distribution is subject to the condition precedent that is the trustee’s exercise of discretion to distribute trust property. Thus, the beneficiary’s interest is contingent and, as a matter of law, uncertain to vest. See Thomas v. Harrison, 191 N.E.2d 862, 866 (Ohio Prob. Ct. 1962) (declaring a trust void under the rule against perpetuities because the trustee could conceivably exercise its “absolute discretion” to vest the trust property in the beneficiaries beyond the permissible period). The Court in Kaestner recognized the contingent nature of a beneficiary’s interest in a discretionary trust. Kaestner, 139 S. Ct. 2213, 2223 n. 10 (“In light of these features, one might characterize the interests of the beneficiaries ‘contingent’ on the exercise of the trustee’s discretion.”).

In many cases, in long term “legacy” discretionary trusts, the beneficiaries may not receive current income from the trust during any years in question, they have no right to demand trust income or otherwise control, possess, or enjoy the trust assets in the tax years at issue, and they also have no expectation of receiving any specific amount of income from the trust in the future. When a grantor creates a long-term trust in one of a majority of states which have wholly or partially eliminated the rule against perpetuities, including North Carolina in 2007, a material purpose of the trust often is its longevity. N.C.G.S. § 41-23; Howard M. Zaritsky, The Rule Against Perpetuities: A Survey of State (and D.C.) Law, ACTEC, https://www.actec.org/assets/1/6/Zaritsky_RAP_Survey.pdf (last updated March 2012). With some regularity, grantors choose to create pairs of trusts: one for the immediate benefit of living family members, and second, a wholly discretionary trust for the primary benefit of future generations, when needed.

Even under trust agreements giving the widest latitude to the trustee, a beneficiary may seek court review of the trustee’s exercise of discretion. Determining whether a trustee has abused the trustee’s discretion will depend on the findings of fact by the Department of Revenue or court in each case.

"Even with a pure discretionary trust in which the trustee’s discretion is “sole and absolute,” or “uncontrolled,” and the trust is without standards, the beneficiary may obtain judicial review to determine whether the trustee has abused that discretion. If there were no judicial review, and the terms were taken literally, the trustee would, in effect, be the owner of the trust property and the settlor’s trust terms would be precatory only.” Discretionary trusts, Bogert The Law Of Trusts And Trustees § 228.

In a suit against the trustee, the beneficiary has standing to obtain judicial review in the jurisdiction in which the trustee resides and principal place of administration is conducted. In limited circumstances, the beneficiary may have standing to obtain judicial review in the beneficiary’s domicile depending on the substantiality of the trustee’s contacts with that state. See Hanson v. Denckla, 357 U.S. 235, 251, 253 (1958). For many trusts with North Carolina resident beneficiaries, note that typically, the nature and scope of beneficiaries’ rights to future accumulated income are not governed by North Carolina law, but by the law of the state governing the administration of the trust, typically the domicile of the trustee. See id. at 255; see also N.C.G.S. § 36C-2-202 (jurisdiction over trustee and beneficiary). As a further complexity, where fiduciary authority is shared by multiple co-trustees residing in different states, the trustee charged with reporting income must assess which trustee or trustees hold distributive authority, administered in which state.

North Carolina, along with Arizona, Hawaii, and Louisiana, follow the Restatement (Second) of Trusts Section 187, and courts only will intervene if it is shown that an abuse of trustee discretion has taken place. Little v. Wachovia Bank & Trust Co., 113 S.E.2d 689, 708 (N.C. 1960) (“Where discretion is conferred upon the trustee with respect to the exercise of a power, its exercise is not subject to control by the court, except to prevent an abuse by the trustee of his discretion.”) (quoting Restatement (Second) of Trusts § 187 (1959)); Ivan Taback & David Pratt, When the Rubber Meets the Road: A Discussion Regarding a Trustee’s Exercise of Discretion, 49 Real Prop. Tr. & Est. L.J. 491, 497 (2015); see N.C.G.S. § 36C-8-814(a) (“A trustee abuses the trustee’s discretion in exercising or failing to exercise a discretionary power if the trustee acts with bad faith, acts dishonestly, acts with an improper motive, even though not a dishonest motive, or if the trustee fails to use the trustee’s judgment in accordance with the terms and purposes of the trust and the interests of the beneficiaries.”). "It should be noted that not one state in the United States allows a trustee truly uncontrolled discretion and . . . all states are willing to subject a trustee to some form of judicial review, regardless of the breadth of absolute discretion granted to a trustee.” Taback & Pratt at 491, 511 (2015) (surveying the limits of trust discretion under the laws of all fifty states); see Woody v. Christian, 172 S.E.210, 213 (N.C. 1934) (“When it appears that a trustee has exercised or proposes to exercise such discretion in good faith, and with an honest purpose to effectuate the trust, the courts will not undertake to supervise or control his actions.”); Heyer v. Bullock, 186 S.E. 356, 362 (N.C. 1936) (North Carolina trusts are "subject to the control of the court at all times," affirming the lower court’s decision to interfere with the trustee’s exercise of discretion).

Despite the uncertainty of a beneficiary’s right to a discretionary distribution from year to year as a matter of law, under Kaestner the existence or lack of a distribution in any one year should be a primary consideration in a pragmatic fact-based inquiry conducted by the trustee in fulfilling its duty to report income. See Kaestner, 139 S. Ct. at 2220; see also Richard C. Ausness, Discretionary Trusts: An Update, 43 ACTEC L.J. 231, 233 (2018) (“Discretion may be defined as the power or authority to choose among various alternatives.”). While North Carolina’s trust income tax statute lacks clarity for most discretionary trusts with resident beneficiaries, under Kaestner broad trustee discretion indicates that the state does not have a sufficient connection to the undistributed trust income to tax.
Under N.C.G.S. Section 105-160.2, Does the Residence of the Trustee Matter?

In addition to the constitutional questions, recent case law reminds practitioners not to forget to apply basic principles of statutory analysis. In curtailing the reach of its holding, the Court addressed North Carolina’s authority to tax wholly discretionary beneficial trust interests under N.C.G.S. Section 105-160.2, a tax statute premised solely on the residence of the beneficiaries. When determining whether a trust is a North Carolina resident trust subject to taxation under that statute, the inquiry is limited to whether the basis for taxation set forth in the statute is present. Kaestner, 139 S. Ct. at 2222. The Court did not suggest that facts irrelevant to and outside the scope of the statute can be considered when evaluating taxation under N.C.G.S. Section 105-160.2.

In particular, practitioners should view the Kaestner Court’s constitutional limitation in concert with its refusal (only a week after rendering the Kaestner opinion) to grant certiorari in Fielding v. Commissioner of Revenue, thereby letting stand the underlying Minnesota Supreme Court case. Fielding v. Commissioner of Revenue, 916 N.W.2d 323 (Minn. 2018), aff’g Fielding v. Commissioner of Revenue, 2017 WL 2484593 (Minn. Tax Ct. 2017), cert. denied, 139 S. Ct. 2773 (June 28, 2019) (holding unconstitutional under due process Minnesota’s fiduciary income tax statute premised solely on original residence of the founder). In Fielding, the opinions of the Minnesota Tax Court and Minnesota Supreme Court contain outstanding discussions of the relevance or irrelevance of certain facts when assessing the application of a statute. The Minnesota Tax Court held:

“We agree with the Commissioner that as-applied challenges are analyzed under all the relevant circumstances. See, e.g., Rew v. Bergstrom, 845 N.W.2d 764, 780 (Minn. 2014). The Commissioner simply assumes, however, that all the contacts between Minnesota and the Trusts are relevant when applying section 290.01, subdivision 7b(a)(2). We cannot agree…. Consequently, when analyzing the Trusts’ as-applied challenge to the grantor-domicile rule, we will ask whether the domicile of the grantor—standing alone—is a sufficient connection upon which to justify taxing the Trusts as Minnesota residents…. We will not, as the Commissioner requests, consider other (nexus) factors such as the storage in Minnesota of trust instruments or the Minnesota domicile of a beneficiary.”

Fielding v. Commissioner of Revenue, 2017 WL 2484593, at *24, *27 (emphasis added). In affirming the holding of the Minnesota Tax Court, the Minnesota Supreme Court refined the Tax Court’s analysis, agreeing that only relevant contacts should be considered when assessing the constitutionality of the tax statute on an as-applied basis. Suggesting that the residence of the trustee or activities of administration in the state might be relevant in some circumstances, that court stated:

“[W]e look beyond the statutory definition that identifies who is subject to a tax in order to evaluate the relationship between the income taxed and the benefits provided by the state. This analysis is not … a matter of adding language to the statute. We are not redefining a resident trust; we are simply evaluating, as we have in other cases, all the relevant facts when considering whether the application of the statutory definition would be consistent with due process in this case.”

Fielding v. Commissioner of Revenue, 916 N.W.2d at 329 (emphasis added).

The analysis required in Minnesota by its Supreme Court holding in Fielding is subtle and could be easily confused. So long as a court, commissioner, or fiduciary is assessing the state’s authority to tax a resident trust as defined by a state tax statute (and circumscribed by the Constitution), the court contended that it can weigh relevant extra-statutory facts, such as the residence of the trustee or activities of administration in the state, when determining the constitutional application of a tax. However, if a trust is not a “resident trust” under the statute—for instance, in Minnesota, if the grantor was not a resident when the trust was formed—then the tax does not apply and extra-statutory facts cannot be considered. A prerequisite to the applicability of an inquiry into extra-statutory facts is a determination of whether the trust is a resident trust under the statute.

When Kaestner was decided, the Court’s decision on the petition for certiorari in Fielding—the case in which the Minnesota courts had struggled over the shape and extent of the relevancy analysis of a tax statute in as-applied constitutional challenges—was pending. The Kaestner Court added meaningfully to that constitutional jurisprudence, providing a clearer framework for analyzing the relevance of facts such as the residence of the taxpayer-trustee in situations where the state legislature did not base its fiduciary income tax statute on the location of the trustee-taxpayer. Part III. A. of the Kaestner opinion is critically important to the relevancy analysis in an as-applied Constitutional challenge to a tax statute under the Due Process clause.

“All of the foregoing cases reflect a common governing principle: When a State seeks to base its tax on the instate residence of a trust beneficiary, the Due Process Clause demands a pragmatic inquiry into what exactly the beneficiary controls or possesses and how that interest relates to the object of the State’s tax…. When a tax is premised on the in state residence of a beneficiary, the Constitution requires that the resident [beneficiary] have some degree of possession, control, or enjoyment of the trust property or a right to receive that property before the State can tax the asset…. Otherwise, the State’s relationship to the object of its tax is too attenuated to create the “minimum connection” that the Constitution requires.”

Kaestner, 139 S Ct. at 2221–22 (citing Safe Deposit, 280 U. S., 83, 91 (1929), Quill, 504 U. S. 298, 306 (1992)). When a state relies solely on the residence of the beneficiary to justify taxation of annual accumulated non-source income, then this aspect of the statutory analysis focuses on the rights of the beneficiary and the beneficiary’s connections to the state. Kaestner holds that the Due Process clause of the Constitution requires that a threshold pragmatic inquiry limit the scope of statutes like N.C.G.S. Section 105-160.2 only to trusts in which beneficiaries (a) actually receive a distribution of annual trust income, (b) have a right to demand annual trust income, or (c) obtain a right to receive a current trust income in the future. Id. at 2223. If a trust with resident beneficiaries does not fall within those exceptions, then constitutionally, it is not a resident trust.
If the trust is not a resident trust, then other potential nexus factors such as the residence of the trust’s grantor, the location of the trustee’s law firm or accountant, or the place of custody of the trust agreement—factors upon which North Carolina’s tax statute is not premised—are not relevant. Just because a state could use a particular factor (and chooses not to) should not mean that the state’s department of revenue can pull irrelevant extra-statutory factors into the analysis.

North Carolina’s General Assembly has compelling legislative reasons to closely draft its tax statutes to exclude factors that are against its public policy. As a critical aspect of the State of North Carolina’s economic policy, worldwide trust grantors readily can secure North Carolina as the principal place of administration of a trust without the challenges that some jurisdictions present. Some trust settlors may have a strong desire or tactical planning reason to contract with well-established trust companies with a proud history of dedication to their customers. North Carolina is home to a meaningful concentration of the largest and most well-staffed private banks and trust companies in the United States (indeed, in the world), as well as numerous excellent mid- and small sized trust companies. See Carolyn Duren & Armughan Khawaja, Charlotte, NC, outpacing nationwide growth in banking, setfor further expansion, S&P GLOBAL (May 16, 2019), https://www.spglobal.com/marketintelligence/en/news-insights/trending/kdZhChEwDkYSXozJ7Z8gQA2. The headquarters of Bank of America, housing the largest private banking operations in the United States, is in Charlotte, North Carolina. See Matt Barthel, Top 40 Wealth Management Companies, Wall Street J. (Sept. 24, 2018), http://online.wsj.com/public/resources/documents/Top40WealthManagementFirms2018.pdf?mom=article_in-line. Wells Fargo Bank (fourth-largest private bank operations) administers its East Coast operations out of North Carolina. Id. The trust department of Brown Brothers Harriman (twenty-sixth) is administered in North Carolina. Id. In February 2019, SunTrust Bank (twenty-fifth largest private bank) and Branch Banking and Trust Co. (BB&T; thirty-first) announced a $66 billion merger, “the world’s largest bank merger in more than a decade” with headquarters in Charlotte, North Carolina. Id.; Hannah Levitt, BB&T to Buy SunTrust in Biggest Bank Merger in a Decade, Bloomberg (Feb. 7, 2019). The State of North Carolina strives to attract the business of the financial industry, and many North Carolina voters and stakeholders prioritize financial policy matters.

Where the North Carolina legislature has not acted to include certain bases for taxation in North Carolina’s tax statutes—in particular, the residence of trustees and principal place of trust administration—the courts and Department of Revenue must adhere to legislative intent and limitations as set forth in those statutes. “The primary indicator of legislative intent is statutory language; the judiciary must give clear and unambiguous language its plain and definite meaning. Tax statutes are to be strictly construed against the state and in favor of the taxpayer.” Wal-Mart Stores East, Inc. v. Hinson, 197 N.C. App. 30, 42 (2009) (citing Proposed Assessments v. Jefferson-Pilot Life Ins. Co., 161 N.C. App. 558, 560 (2003)).

As a tangential observation, although N.C.G.S Section 105-160.2 is premised upon the presence of resident beneficiaries, because the instructions to the NC Form D-407 State Fiduciary Income Tax Return are not clear, the duty to file a North Carolina fiduciary income tax return might apply in an important way to resident trustees who hold the duty to report a trust’s income. If a non-resident trustee determines that a trust does not have resident beneficiaries within the scope of the Due Process clause (and assuming no North Carolina source income), then such trustee likely does not need to file a North Carolina state fiduciary income tax return at all, and North Carolina has no jurisdiction over such trustees. By contrast, because North Carolina almost certainly has personal jurisdiction over resident trustees, resident trustees, if they are responsible to report a trust’s income, might have a duty to file and report information about a trust’s income and expenses, even if that trust owes no tax. See Cal. Rev. & Tax Code § 17745(d) (implying duty of California resident trustees to report the annual accumulated income of trusts with contingent resident beneficiaries for calculating throwback tax).

**Fiduciary Duty Not to Pay Taxes That Are Not Owed**

Trustees can breach their fiduciary duties if they remit taxes that are not owed. Accordingly, they must proceed with extreme caution.

Case law establishes that overpayment of tax can be a breach of the trustee’s fiduciary duty. See In re Estate of Ridl, 455 N.W.2d 188, 193 (N.D. 1990). The duty is more clearly breached when overpayment of tax is a result of fiduciary neglect rather than fiduciary caution. However, even where a fiduciary reasonably pays a tax out of caution, the fiduciary may still breach a duty by failing to file a claim for refund.

For example, in In re Estes’ Estate, an executor was surcharged for overpayment of estate tax resulting from inclusion of life insurance policies in the decedent’s gross estate where the insurance policy was owned by the decedent’s ex-wife. 654 P.2d 4 (Ariz. Ct. App. 1982). In the couple’s separation agreement executed about eight months prior to the decedent’s death, the decedent had agreed to maintain the life insurance policies for the benefit of their children, and thus the decedent might not have had incidents of ownership at death. Id. at 11. However, the executor refused to file for a refund. Id. at 12–13. The Court of Appeals of Arizona held that the executor’s inclusion of insurance proceeds in the gross estate without ascertaining the legal effect of the property settlement agreement and subsequent refusal to file a claim for refund was a breach of the executor’s duty to preserve the property of the estate. Id. The court reasoned that even though the “case law establish[d] a genuine question as to whether Mr. Estes retained sufficient incidents of ownership in the insurance policies,” the executor’s refusal to file for a refund was “inconsistent with its duty to minimize estate taxes where Mrs. Estes’ challenge to the tax return was credible under the facts and the law.” Id.

North Carolina law addresses the impact of a fiduciary’s underpayment of property tax but not the impact of a fiduciary’s erroneous or prudent overpayment of income tax. By statute, a trustee “who suffers property in his care or control to be sold by reason of his negligence in failing to pay the taxes thereon when available funds were in his hands shall be liable to his . . . cestui que trust for all actual damages incurred as a result of his neglect.” N.C.G.S.§ 105-383(c). The North Carolina Supreme Court in Rose v. Bank of Wadesboro refused to surcharge a guardian for penalties incurred in failing to list the minor’s property for local taxes because the penalties were lower than the tax would have been, and the minor “was not damaged thereby.” 9 S.E.2d 2, 5 (N.C. 1940). N.C.G.S. Section 105-383(c) and Rose comport with the element of damages in a successful breach of fiduciary duty claim. See also Wilkins v. Safran, 649 S.E.2d 658, 662 (N.C. Ct. App. 2007) (“Breach of fiduciary duty is a species of negligence or professional malpractice.”); In re Wills of Jacobs, 370 S.E.2d 860, 865 (N.C. Ct. App. 1988) (“[D]amages for breach of
trust are designed to restore the trust to the same position it would have been in had no breach occurred.

Conversely, a trustee can uphold its duties by making a good faith legal argument against trust tax liability. Newcomer v. National City Bank discusses a trustee’s duty not to pay tax that is not owed. 19 N.E.3d 492 (Ohio Ct. App. 2014). One of the disputes in Newcomer was whether the trustee’s failure to file tax returns and pay California state fiduciary income taxes constituted a breach of fiduciary duty. Id. at 511. California’s income tax would not have applied if the interest of the beneficiary was “contingent.” Cal. Rev. & Tax Code § 17742(a); 18 Cal. Reg. § 17742(a)-(b). The Court of Appeals of Ohio affirmed the trial court ruling that the beneficiary’s interest in the trust was contingent and did not create any California income tax liability. “Furthermore, given the existence of a good faith legal dispute on the issue with reasonable legal analysis supporting arguments on both sides of the California tax dispute, we conclude that even were the resolution of the tax dispute otherwise, the trustee’s failure to file tax returns and to pay California income taxes cannot be held to have been undertaken in bad faith, in willful default, or reckless indifference.” Id. at 515 (emphasis added). A good faith, honest, reasoned determination, even if ultimately incorrect, may shield the trustee from surcharge. Note again that determining whether a trustee’s erroneous payment of North Carolina’s income tax constitutes a breach of trust will depend on the jurisdiction of the trust’s principal place of administration.

Practice Tip: For trusts with a North Carolina resident beneficiary and which have a filing requirement, the trustee with the duty to report income should include a statement with the Form D-407. The statement should clarify whether or not the resident beneficiaries held any rights that would cause the trust to be treated as a resident trust under Kaestner’s pragmatic inquiry.

Conclusion

The U. S. Supreme Court’s decision in Kaestner reaffirmed the significant limits on the application of North Carolina’s trust income tax that has existed since at least 2015, the year of the Business Court decision, and really since 1923, the inception of North Carolina’s taxation of trust income based on the presence of in-state beneficiaries. Act of March 3, 1923, ch. 4, § 205, 1923 N.C. Sess. Laws 67, 128 (cited by the Department of Revenue in its March 9, 2017 brief to the North Carolina Supreme Court). Under Kaestner, if a North Carolina beneficiary does not receive income from the trust during the year in question, has no right to demand trust income or control trust assets, and is uncertain to receive trust distributions in the future, North Carolina cannot constitutionally tax non-source trust income that year. Kaestner, 139 S. Ct. at 2223. Where discretionary trusts inherently entail uncertainty as to distributions, as the Court recognized by adopting a pragmatic test, uncertainty as to the trust’s income tax is a necessary consequence when the state’s fiduciary income tax is premised on the residence of trust beneficiaries.

The trustee must use its discretion to balance its twin duties to administer the trust for the benefit of the current beneficiaries and preserve the trust corpus. Each year, the trustee of a discretionary trust must review the North Carolina beneficiaries’ relationship, if any, to income accumulated by the trustee. If the beneficiaries’ interests in the annual accumulated income of the trust are remote and no trust distribution would be appropriate, then the trust income is not likely subject to tax in North Carolina. The trustee should also keep an ear to the ground for changes to N.C.G.S. Section 105-160.2, because changes could be coming soon, conforming the statute to the limits mandated by the Kaestner Court.

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Notwithstanding IRS Scrutiny, Conservation Easements Still Work

By Kerri L.S. Mast

Introduction

From the mountains to the coast, some of North Carolina’s most beloved and iconic landmarks, including Chimney Rock, Grandfather Mountain, and Nags Head Woods, have been protected by conservation easements. Recognizing the importance of protecting landmarks like these, in 1980, following a number of temporary provisions, Congress made the conservation easement deduction a permanent part of the Internal Revenue Code. See Powell on Real Property §34A.04(2) (Michael Allan Wolf ed., Matthew Bender 2013).

Tax Benefit

Generally, a taxpayer is permitted to take a charitable income tax deduction for any charitable contribution made within the taxable year. I.R.C. § 170(a)(1). If a taxpayer makes a charitable contribution of property other than money, the amount of the contribution is generally equal to the fair market value of the property at the time the gift is made. Treas. Regs. § 1.170A-1(c)(1). A taxpayer is generally not permitted to take a charitable contribution deduction for the donation of an interest in property which consists of less than the taxpayer’s entire interest in such property. I.R.C. § 170(f)(3)(A).

There is, however, an exception for a “qualified conservation contribution,” which allows a landowner to take an income tax deduction for contributing: (1) a qualified real property interest, (2) to a qualified organization (such as a governmental unit or public charity), (3) exclusively for conservation purposes. I.R.C. § 170(h).

A qualified real property interest includes a restriction granted in perpetuity on the use which may be made of the real property. I.R.C. § 170(h)(2)(C). Conservation purposes include the preservation of land for outdoor recreation, the protection of natural habitat, and the preservation of open space. There also are special rules relating to historic structures and districts.

The value of the charitable contribution of a perpetual conservation restriction is its fair market value at the time of the contribution. Treas. Regs. § 1.170A-7(c). Generally, the Regulations provide for a “before and after” valuation methodology, whereby the fair market value is equal to the difference between the market value of the land it encumbers before the granting of the restriction and the market value of the encumbered land after the granting of the restriction. Treas. Regs. § 1.170A-14(h)(3)(i).

Increased Scrutiny and Issues with Abusive Transactions

In recent years, the IRS has increased its focus on conservation easement contributions. In fact, since 2006, the Tax Court, District Courts and Circuit Courts have issued more than one hundred opinions relating to conservation easements. See Nancy A. McLaughlin, Trying Times: Conservation Easements and Federal Tax Law (Oct. 1, 2019), University of Utah College of Law Research Paper No. 312. Issues raised include “floating” reserved development rights and the ability to amend easement deeds. Issues relating to valuation, though not covered in this article, have also been raised.

In Pine Mountain Preserve, the Tax Court, citing its prior approach in Belk v. Commissioner, considered “floating” development rights and denied a conservation easement deduction for two conservation easements with certain reserved development rights. In one easement, the taxpayer reserved the right to develop a few building areas within the parcel, but the specific building areas were not defined. In the other easement, the taxpayer reserved the right to develop a few building areas within the parcel, and the plat attached to the easement defined each building area. However, the easement provided that the boundaries of each of the building areas could be modified by mutual agreement. In other words, the reserved building areas were “floating” - they were defined but could be relocated. The Tax Court reasoned that, because the reserved building areas were either not defined or were floating, the easements, when granted, did not create a perpetual restriction on a defined parcel of land, as required by I.R.C. Section 170(h)(2)(C). Pine Mountain Preserve, LLP, et al. v. Commissioner, 151 T.C. 247 (Dec. 27, 2018), aff’d, (11th Cir. June 5, 2019); Belk v. Commissioner, 140 T.C. No. 1 (2013), supplemented by Belk v. Commissioner, T.C. Memo. 2013-154, aff’d, Belk V. Commissioner, 774 F.3d 221 (4th Cir. 2014).

In Pine Mountain Preserve, the Tax Court also considered a third easement that contained a provision which allowed the easement deed to be amended by mutual agreement. The property subject to this easement was not subject to any retained commercial development rights. The IRS argued that this amendment provision could enable the parties to amend the easement in violation of the perpetuity requirement, such as by reducing the size of the conservation area or by permitting residential construction within it. The Tax Court, citing numerous Tax Court and Court of Appeals cases, rejected this argument and upheld the third conservation easement. Pine Mountain Preserve, 151 T.C. 247.

In addition to its focus on traditional conservation easements, the IRS has scrutinized syndicated conservation easement donations. These syndicated conservation easements involve pass-through-entities that market to investors and promote return in the form of charitable income tax deductions that far exceed their investment. The IRS is focusing on taxpayers, promoters, and appraisers. There are more than 80 syndicated conservation easement cases on the Tax Court docket. The Kiplinger Tax Letter, Vol. 94, No. 24 (Nov. 27, 2019). In Dec. 2017, the IRS issued Notice 2017-10, which designated syndicated conservation easements as listed transactions. In 2019, syndicated conservation easements were included on the IRS’s Dirty Dozen list. Separately, the IRS’s Criminal Investigation division has initiated investigations and the Department of Justice has filed a complaint in federal court seeking an order to stop certain individuals from promoting and selling syndicated conservation easements. U.S. Dept. of Justice v. Zak, et al., Case No. 1:18-cv-05774-AT (N.D. Ga. Dec. 18, 2018).
Given Enhanced Scrutiny, Do Conservation Easements Still Make Sense?

With regard to syndicated conservation easements, such transactions should be carefully considered, if not completely avoided, by attorneys advising landowners in light of the increased scrutiny by the IRS. Taxpayers who have participated in syndicated conservation easements have been encouraged by the IRS to take corrective action. IRS Notice 2017-10.

Notwithstanding IRS scrutiny, traditional conservation easements still make sense. With respect to traditional conservation easements, the IRS has been successful in certain arguments, such as floating development rights. However, the IRS has promulgated other arguments without success, such as the right to amend easements by mutual consent. Practitioners might appreciate clarifying guidance on these issues, and the need for such guidance has been recognized. In fact, the Conservation Easement Task Force of the American Bar Association’s Real Property, Trust and Estate Law Section, which was convened in 2015, has prepared recommendations which include requests for safe harbor provisions and guidance regarding appropriate amendments. The Task Force also recommended that certain syndicated conservation easements continue to be listed transactions as specified in IRS Notice 2017-10.

 Until additional guidance is issued, practitioners should not avoid planning with traditional conservation easements, but should stay abreast of IRS guidance and case law developments in this area in order to plan well for clients. In addition, practitioners and their clients who are considering a conservation easement should work with a recognized organization whose conservation efforts are transparently documented and communicated in their public filings. See, e.g., Adam Looney, Charitable Contributions of Conservation Easements (May 2017), The Brookings Institution.

In addition to being an effective planning technique, conservation easements have contributed meaningfully towards protecting and conserving land for the purposes of outdoor recreation, protection of natural habitat, and the preservation of open space.

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Springing the Delaware Tax Trap Under North Carolina Law to Obtain an Income Tax Basis Step-Up

By Graham D. Holding, Jr. and Paul M. Hattenhauer

The significant increase in the federal estate tax exclusion amount, $11,580,000 for 2020, has caused estate planners to look at techniques to have assets in an irrevocable trust included in the taxable estate of the beneficiary in order to provide a basis step-up for appreciated assets under I.R.C. Section 1014.

Inclusion of the assets in the beneficiary’s gross estate may be desirable to obtain the income tax savings of the basis step-up when, for example, a spouse-beneficiary holds a nongeneral power of appointment over a traditional bypass trust, or a beneficiary has a nongeneral power of appointment over a trust exempt from the federal generation-skipping transfer tax, and the spouse or beneficiary has sufficient remaining federal estate tax exemption left to prevent a portion or all of the assets of the trust from being subject to estate tax.

There are four ways to cause trust assets to be included in the beneficiary’s taxable estate: (i) the Delaware Tax Trap, (ii) the use of an independent trustee’s power of distribution, (iii) a contingent general power of appointment, and (iv) a trust protector or independent trustee’s power to create a general power of appointment. Lester Law and Howard M. Zaritsky, Basis After the 2017 Tax Act – Important Before, Crucial Now, 1-84 (Fundamental Program Focus Series, Univ. of Miami Heckerling Institute on Estate Planning (2019)).

The objective of this article is to analyze whether and under what circumstances the Delaware Tax Trap can be used under North Carolina law to cause inclusion of the trust assets subject to a nongeneral power in the beneficiary’s gross estate.

The Delaware Tax Trap – I.R.C. Section 2041(a)(3)

Historically, the rule against perpetuities typically provided that a trust was void if it caused a suspension of the power of alienation or vesting of an interest for longer than a permissible period, usually lives in being plus twenty-one years.

Under a former Delaware statute, the permissible period for measuring an interest created by a nongeneral power of appointment was the date of the exercise of the power of appointment. See 38 Del. Laws 198, § 1 (1933). This allowed for indefinite successive exercises of nongeneral powers of appointment within the permissible period, thereby avoiding a violation of the rule against perpetuities and the imposition of estate tax for generations. See the discussion in Estate of Murphy v. Comm’r, 71 T.C. 671 (1979), action on dec., 1979-87 (May 30, 1979).

Congress responded by enacting I.R.C. Section 811(f)(4), the predecessor of I.R.C. Section 2041(a)(3), to prevent successive exercises of nongeneral powers of appointment from avoiding the rule against perpetuities. Although I.R.C. Section 2041(a)(3) was originally enacted to prevent estate tax avoidance through successive exercises and creation of nongeneral powers of appointment, it also applies to the creation, by the exercise of a nongeneral power, of a presently exercisable general power of appointment which under the law of most states begins a new permissible perpetuities period without regard to the creation of the original power. See Jonathan G. Blattmachr and Jeffrey N. Pennell, Using Delaware Tax Trap to Avoid Generation-Skipping Taxes, 68 J. TAX’N 242 (1988).

Under I.R.C. Section 2041(a)(3) assets subject to a beneficiary’s nongeneral power of appointment will be included in the beneficiary’s gross estate at the beneficiary’s death if the beneficiary:

Exercises a power of appointment created after Oct. 21, 1942, by creating another power of appointment which under the applicable local law can be validly exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power. [Emphasis added.]

Thus, I.R.C. Section 2041(a)(3) requires inclusion of trust assets in a beneficiary’s gross estate if (i) the beneficiary exercises the power of appointment (the “first power”) to create a transfer into a second trust, (ii) the terms of the second trust give someone else a new power of appointment (the “second power”), and (iii) the second power can be exercised to postpone the vesting or suspension of ownership or power of alienation of property for a period ascertainable without regard to the date of the creation of the first power. See Howard M. Zaritsky, Obtaining a Basis Adjustment for an Irrevocable Trust, PROB. PRAC. REP., Oct. 2014, at 5.

To include assets in the beneficiary’s gross estate, I.R.C. Section 2041(a)(3) only requires that the second power can be exercised to postpone the vesting or suspension of ownership or the power of alienation of trust property. There is no requirement that the second power actually be exercised in this manner.

The fact that a beneficiary’s exercise of a nongeneral power of appointment may inadvertently cause inclusion of assets in the beneficiary’s gross estate under I.R.C. Section 2041(a)(3) has led to the name “Delaware Tax Trap” for I.R.C. Section 2041(a)(3). The Delaware Tax Trap is “sprung” or “triggered” when it causes inclusion of assets in the beneficiary’s gross estate.

Murphy v. Commissioner and the I.R.S. Action on Decision

In Estate of Murphy v. Comm’r, 71 T.C. 671 (1971), action on dec. 1979-87 (1979), the only reported case on I.R.C. Section 2041(a)(3), the I.R.S. attempted to include under I.R.C. Section 2041(a)(3) trust assets in the decedent’s estate where the decedent exercised a nongeneral power of appointment over a Wisconsin trust by ap-
pointing assets to a trust for her husband and granting him a nongen-
eral power of appointment.

Wisconsin by statute eliminated the common law rule against per-
petuities. The applicable statute, which remains in effect, instead
provided that a trust is void if it suspends the power of alienation for
longer than the permissible period of thirty years. Wis. Stat. Ann. §
700.16(1)(a). The statute also provided:

If a . . . trust is created by the exercise of a power
of appointment, the permissible period is com-
puted from the time the power is exercised if
the power is a general power . . . ; in the case of
other powers, the permissible period is computed
from . . . the time the power is created. Wis. Stat.
Ann. § 700.16(1)(c).

Although in Murphy, the I.R.S. contended that I.R.C. Sec-
tion 2041(a)(3) applied if the exercise of the first power postponed
vesting, suspended absolute ownership, or suspended the power of
alienation, the Tax Court ruled that I.R.C. Section 2041(a)(3) only
required an examination of the applicable rules of state law which
under Wisconsin law provided rules for the suspension of the power
of alienation.

The Tax Court then held that because the decedent’s power was
not a general power it was governed by the second clause of Wiscon-
sin Statutes Section 700.16(1)(c) and therefore was not taxable under
I.R.C. Section 2041(a)(3) because the permissible period is measured
from the date that the first power of appointment was created. I.R.C.
Section 2041(a)(3) applies whenever the permissible period is ascer-
tainable “without regard” to the date of creation of the first power.

Wisconsin law also provided that there is no suspension of the
power of alienation if the trustee has the power to sell assets. Wis.
Stat. Ann. § 700.16(2), (3). The Murphy Tax Court did not base its
decision on that provision although its opinion did make note of
it. The I.R.S. acquiesced to the Tax Court conclusion in an Action
on Decision and agreed that I.R.C. Section 2041(a)(3) cannot apply
because the Wisconsin rule measured the permissible period for
suspension of the power of alienation from the creation of the first
nongeneral power. The I.R.S. A.O.D. then went further, stating:

Finally, under Wisconsin law ownership had not
been suspended because the trustee was given a
power to sell assets. The regulation, as it is written,
appears to say that because local law is phrased
in terms of its suspension of ownership/power of
alienation, and there is no such suspension under
local law, then section 2041(a)(3) cannot apply.

North Carolina Law Applicable to the Delaware Tax Trap

In 2007 North Carolina enacted N.C.G.S. Section 41-23, repea-
ting the common law rule against perpetuities as applied to trusts and
replacing it with a prohibition against the suspension of the power of
alienation of property. The drafters of N.C.G.S. Section 41-23 based it
on the Wisconsin statutes which were the subject of the Murphy de-
cision and which are substantially similar to N.C.G.S. Section 41-23.

N.C.G.S. Section 41-23(a) provides that a trust is void if it sus-
pends the power of alienation beyond the permissible period of sus-
pension as follows:

A trust is void if it suspends the power of alien-
ation of trust property, as that term is defined in
G.S. 36C-1-103, for longer than the permissible
period. The permissible period is no later than 21
years after the death of an individual then alive or
lives then in being plus a period of 21 years.

N.C.G.S. Section 41-23(c) provides for when the permissible
period is computed if a trust is created by the exercise of powers of
appointment as follows:

If a trust is created by exercise of a power of ap-
pointment, the permissible period under subsection
(a) of this section is computed from the time
the power is exercised if the power is a general
power even if the power is only exercisable as a
testamentary power. In the case of other powers,
the permissible period is computed from the time
the power is created....

N.C.G.S. Section 41-23(e) provides, however, that the provi-
sions for voiding a trust that suspends the power of alienation be-
Yon the permissible period do not apply as follows:

Notwithstanding subsection (a) of this section,
there is no suspension of the power of alienability
by a trust or by equitable interests under a trust if
the trustee has the power to sell, either expressed
or implied, or if there exists an unlimited power
to terminate the trust in one or more persons in
being.

It is not clear whether “the trustee has the power to sell” within
the meaning of N.C.G.S. Section 41-23(e) if the trustee could do so
only at the direction of a third party, but, nevertheless, there may be
no suspension under N.C.G.S. Section 41-23(d), which provides that
the power of alienation is suspended only when no person, alone or
in combination with others, can convey ownership of property. [Em-
phasis added.]

If a beneficiary is given a presently exercisable general power of
appointment over the entire trust principal, this could be the equiva-
 lent of having “an unlimited power to terminate the trust” within
the meaning of N.C.G.S. Section 41-23(e). Arguably, the beneficiary
would not have unlimited power to terminate the trust if the exercise
of the power was subject to the consent of a third party.

Springing the Delaware Tax Trap Under North Carolina Law

Under G.S. 41-23(c) if a nongeneral power of appointment is
exercised to create a transfer to a second trust granting a general
power of appointment to a beneficiary, whether presently exercis-
able or exercisable as a testamentary power, the permissible period
of suspension of the power of alienation is measured from the time
the general power is exercised and not from the date of the creation
of the nongeneral power. Accordingly, the Delaware Tax Trap would
appear to be sprung because the general power can be exercised to
postpone the power of alienation for a period ascertainable “without
regard to the creation of the first power.”

One commentator has concluded, however, that in states like
Wisconsin and North Carolina that have adopted an alienation rule for the Delaware Tax Trap cannot be sprung because there is no suspension of the power of alienation when the trustee has the power to sell. See Robert J. Kolasa, Problems in Springing the Delaware Tax Trap, Tr. & Est. April 12, 2018, at 12. The commentator stated that the I.R.S. embraced this position in the A.O.D. to Murphy “by concluding that the ‘Tramp couldn’t be sprung because the power of sale meant the power of alienation wasn’t suspended.” As noted above, N.C.G.S. 41-23(e) provides for no suspension of the power of alienation if the trustee has the power to sell and also if a person has the unlimited power to terminate the trust. The conclusion that the Delaware Tax Trap cannot be sprung because of the trustee’s power to sell assumes, incorrectly, that the trustee will always have the power to sell. If a nongeneral power of appointment is exercised to create a transfer to a second trust granting a general power of appointment, the exercise of the general power of appointment could provide that the trustee of the trust created by it does not have the power to sell and no one has the unlimited power to terminate the trust.

If the general power is exercised to create a second trust in which the trustee does not have the power to sell and no one may terminate the trust, the rules of N.C.G.S. Section 41-23 providing for a permissible period for suspension of the power of alienation would apply and the Delaware Tax Trap would be sprung because the exercise of the general power could postpone the suspension of the power of alienation for a period measured from the time of the exercise of the power and not from the creation of the nongeneral power. As noted above, to spring the Delaware Tax Trap, I.R.C. Section 2041(a)(3) does not require that the second power be actually exercised in a way to postpone the suspension of the power of alienation, only that it can do so.

Since the primary focus of I.R.C. Section 2041(a)(3) is on whether the exercise of the second power can suspend the power of alienation, the authors do not think that it is necessary that the trustee of the trust created by the exercise of the first power not have the power of sale or that no one has the unlimited power to terminate the trust. Such a provision would prevent the exercise of the first power from granting a presently exercisable general power of appointment which would be the equivalent of the power to terminate the trust. Commentators have noted that postponement of vesting could be further extended by newly created powers of appointment, in each case creating new presently exercisable general powers of appointment—“all kicked in” by the exercise of the original nongeneral power of appointment. See Blattmachr & Pennell, supra. This would also be the result under North Carolina law with respect to the postponement of the suspension of the power of alienation if there were successive exercises of testamentary general powers or, possibly, presently exercisable general powers of appointment subject to a third party’s consent.

Conclusion

Under North Carolina law, if a beneficiary of an irrevocable trust has a nongeneral power of appointment and exercises it by a transfer to a second trust granting another beneficiary a general power of appointment, whether presently exercisable or testamentary, the Delaware Tax Trap will be sprung causing the assets of the original trust to be included in the beneficiary’s estate for federal estate tax purposes, and therefore, under I.R.C. Section 1014 providing a stepped-up basis for appreciated assets in the trust.

Although the details of the technique are beyond the scope of this article, it may be possible for a beneficiary to spring the Delaware Tax Trap by exercising a nongeneral power of appointment to appoint trust property to an existing irrevocable trust that gives some person a nongeneral power of appointment. This technique is apparently available in states which, like North Carolina, have adopted section 2(c) of the Uniform Statutory Rule Against Perpetuities. See N.C.G.S. § 41-16(c); Les Raatz, USRAP Surprise Trigger of Delaware Tax Trap, Tr. & Est., May 2015, at 22.

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Recent Developments
By the Trusts and Estates Team of Young, Moore and Henderson, P.A.

Federal Legislation

“Setting Every Community Up for Retirement Enhancement (SECURE) Act” signed into Law.

On Dec. 20, 2019, President Trump signed into law the “Setting Every Community Up for Retirement Enhancement (SECURE) Act” (the “Act”) as part of the “Further Consolidated Appropriations Act, 2020” (H.R. 1865, as amended). The SECURE Act makes substantial changes to the required minimum distribution (“RMD”) rules applicable to inherited qualified accounts. Section 401 of the Act eliminates the ability to “stretch” RMDs over the life expectancy of most beneficiaries and instead mandates a 10-year period for beneficiaries to take RMDs. Section 401(b) of Title V of the Act provides that the amendments “apply to distributions with respect to employees who die after Dec. 31, 2019.” Accordingly, the Act largely spares inherited qualified accounts for decedents dying on or before Dec. 31, 2019. Designated beneficiaries of pre-2020 inherited accounts may utilize the life-expectancy payout method in compliance with pre-SECURE Act law. However, the Act applies the 10-year rule at the death of the pre-2020 designated beneficiary. Key provisions of the SECURE Act include:

• No change to the “5-year rule” that applies upon the death of a participant prior to his or her required beginning date when there is no designated beneficiary (“RBD”).
• The Act does not amend the life expectancy payout method for non-designated beneficiaries of accounts in which the participant died after his or her RBD.
• The Act applies a 10-year rule to all designated beneficiaries, except for a limited subset of “eligible designated beneficiaries” (discussed below) whether or not the participant has reached his or her RBD. Accordingly, the 10-year rule contains the same parameters that apply for the 5-year rule in the case of a non-designated beneficiary except that the period in which to take the RMD is expanded to 10 years.
• The Act provides for five potential classes of “eligible designated beneficiaries” (“EDB”) that are excepted from the 10-year rule and remain eligible to use the options existing under old law with respect to their benefit in the account, including the use of the life expectancy payout method. Those five classes of EDBs are (i) the surviving spouse, (ii) a child of the participant who has not reached the age of majority (but only until the child reaches the age of majority), (iii) a disabled beneficiary, (iv) a chronically-ill beneficiary, or (v) an individual not more than 10 years younger than the participant.

Federal Administrative Developments

Service Rules on Trust Reformation to Correct Scrivener’s Error.

In Private Letter Ruling 201941008 (Oct. 11, 2019), the settlor created a trust for the benefit of his six children. The terms of the trust provided that each child had a separate trust and was the primary beneficiary of his or her separate trust for life. Thereafter, the remaining trust property was held in further trust for the benefit of child’s issue. Each child possessed a withdrawal right for a period of 30 days for contributions made to the trust. The withdrawal right lapsed at the conclusion of the 30 day period. Due to a scrivener’s error, the lapse was not limited to the greater of $5,000 or 5% of the property subject to the withdrawal right. Settlor made gifts to each separate trust and settlor’s spouse elected to gift split with settlor. The grandparents of each child beneficiary made similar gifts. However, the Forms 709 filed for settlor and grandparents did not properly report the gifts as being an indirect skip or direct skip and therefore no GST exemption was allocated to the gifts. The settlor changed estate planning attorneys and learned of the errors on Form 709 as well as the impact of the failure to make the lapsing withdrawal right subject to the greater of $5,000 or 5% of the property. The trust was judicially modified to include the limitation on the withdrawal right subject to a favorable ruling from the Service on the gift, estate and GST tax consequences of the reformation. The Service ruled that (i) as a result of the reformation, no child would be deemed to have released a general power of appointment or have made a taxable gift to the trust and no part of the trust would be included in his or her estate; (ii) the only transfers to the trusts for GST tax purposes were the settlor, the settlor’s spouse, and grandparents; and (iii) that each transferor is deemed to have automatically allocated GST exemption to the transfers. In reaching the result, the Service determined that under Bosch the reformation was made to carry out the settlor’s intent and correct a scrivener’s error, not to modify the trust.

Service Rules that Inherited IRA Maintains IRA Status After Trustee-to-Trustee Transfer when Charitable Organization is Beneficiary.

In PLR 201943020 (Oct. 25, 2019), the Service ruled that a Decedent’s IRA which named a charitable beneficiary (i) remained an IRA when the assets were transferred to an inherited IRA for the charitable beneficiary after the decedent’s death, (ii) the new IRA was not a taxable trust, and (iii) that the distribution from the original IRA to the inherited IRA was not subject to federal income tax.

Service Rules that IRA Paid to Trust for Spouse and Withheld by Spouse Qualifies for Rollover.

In PLR 201944003 (Nov. 1, 2019), the Service ruled that an IRA paid to a trust for the benefit of the spouse, and for which the spouse held an unrestricted lifetime general power of appointment, could be withdrawn by the surviving spouse and rolled over to the spouse’s own IRA. The allocation of the IRA to the trust for the spouse was not a deemed sale or other disposition of property under Section 1001, the IRA was treated as acquired from the decedent by the spouse, and the spouse was able to roll over the IRA to the same extent as if the spouse received the IRA directly from the deceased spouse.
Service Announces Intention to Issue Proposed Regulations Regarding the Treatment of Certain Interests in Corporations as Stock or Indebtedness, Withdraws Documentation Regulations.

In T.D. 9880 (Nov. 4, 2019), the Treasury Department (Treasury) removed final regulations setting forth minimum documentation requirements for certain related party interests in corporations to be treated as indebtedness for federal tax purposes, and announced in REG-123112-19 that it intends to issue proposed regulations with respect to the treatment of certain interests as stock or indebtedness of the corporation. Section 385 of the Code authorizes the Secretary to prescribe rules to determine whether an interest in a corporation is treated as stock or indebtedness. In Oct. 2016, Treasury issued final and temporary regulations under I.R.C. Section 385 regarding such minimum documentation requirements (Documentation Regulations) and regulations that treat as stock certain debt that is issued by a corporation to a controlling shareholder in a distribution or in another related party transaction that achieves a similar result, including a "per se" rule with respect to debt instruments funding certain distribution (Distribution Regulations). In Sept. 2018, Treasury issued proposed regulations removing the Documentation Regulations, and T.D. 9880 adopts those regulations as final effective as of Nov. 4, 2019. REG-123112-19 announces that Treasury intends to make the Distribution Regulations more streamlined and targeted including withdrawal of the per se rule. The proposed regulations would not treat a debt instrument as funding a distribution or similar transaction solely because of their temporal proximity.

Service Provides Tax Inflation Adjustments for Tax Year 2020.

In IR-2019-180 (Nov. 6, 2019), the Service announced tax inflation adjustments for tax year 2020. Estates of decedents who die during 2020 have a basic exclusion amount of $11,580,000, up from a total of $11,400,000 for estates of decedents who died in 2019. The annual exclusion for gifts remains $15,000.

Service Releases Proposed Regulations on Eligible Terminated S-Corporations.

In REG-131071-18 (Nov. 7, 2019), the Service released proposed regulations providing rules concerning the definition of an “eligible terminated S corporation” (ETSC), distributions of money by an ETSC after the post-termination transition period (PTTP), and revisions to existing regulations to extend the treatment of distributions of money to the PTTP to all shareholders of the corporation and to update and clarify the allocation of current earnings and profits to distributions of money and other property. The proposed regulations are intended to ease the transition of S corporations to C corporations that have revoked their S corporation status within two years of the enactment of the Tax Cuts and Jobs Act (Pub. L. No. 115-97). The TCJA added I.R.C. Section 481(d) (relating to accounting method changes as a result of the termination of an S election) and Section 1371(f) which extends the period during which shareholders of a C corporation can benefit from the corporation’s accumulated adjustments account (AAA) generated during such C corporation’s former status as an S corporation with respect to distributions from the corporation generally resulting in more tax-favorable treatment to the shareholder (qualified distributions).

For purposes of both provisions, for a corporation to be an ETSC, the following requirements must be met: (1) the corporation was an S corporation on Dec. 21, 2017; (2) during the two-year period beginning on Dec. 22, 2017, the corporation revoked its S election, (revocation requirement); and (3) the owners of the stock of the corporation on the date of the revocation of its S election are the same owners in identical proportions as on Dec. 22, 2017 (shareholder identity requirement). The proposed regulations clarify that the revocation requirement would be satisfied if the revocation is validly made during the two-year period beginning on Dec. 22, 2017, even if the effective date for the revocation occurs after that two-year period.

Further, with respect to the shareholder identity requirement, the proposed regulations specify five categories of stock transfers that do not result in an ownership change for the purposes of the shareholder identity requirement: (1) transfers from a shareholder to a trust treated as wholly owned by that shareholder under Subpart E of Subchapter J under Chapter 1 of the Code (a grantor trust); (2) transfers to an entity that is disregarded for federal tax purposes; (3) an election by a shareholder trust to be treated as a part of a decedent’s estate under IRC Section 645 or the termination of such election; (4) change in status of a shareholder trust from one type of eligible S corporation shareholder trust to another eligible trust; and (5) a transaction that includes one or more of the events described in (1) through (4). Additionally, the proposed regulations do not impose a “no newcomer rule”; thus, recipients of qualified distributions to shareholders acquiring stock of an ETSC after the date the S election revocation was made may receive qualified distributions all or some of which may be from AAA.

The proposed regulations make clear that the corporation must have AAA in order for I.R.C. Section 1371(f) to apply since the ETSC period is transitory in nature and that such a transition would be naturally concluded when the corporation’s AAA balance reaches zero. Moreover, the proposed regulations adopt a “snapshot approach” in order to determine the amount of distributions made during the ETSC period that are allocated to AAA or accumulated earnings and profits using the effective date of the revocation of the PTSC’s S election.

Service Issues Proposed Updated Life Expectancy and Distribution Period Tables Used for Purposes of Determining Required Minimum Distributions.

In REG-132210-18 (Nov. 7, 2019), the Service issued proposed regulations to update the life expectancy and distribution period tables used for purposes of determining minimum required distributions under Section 409(a) and accompanying regulations. The tables were developed based on mortality rates for 2021 and update the Single Life Table, Uniform Lifetime Table, and Joint and Last Survivor Table. If the proposed regulations become final, the tables would apply for distribution calendar years beginning on or after Jan. 1, 2021. A transition rule applies if an employee dies before Jan. 1, 2021, and, under the rules of 1.401(a)(9)-5, Q&A-5, the distribution period that applies for the calendar years following the calendar year of the employee’s death is equal to a single life expectancy calculated as of the calendar year of the employee’s death (or, if applicable, the year after the employee’s death), reduced by one for each subsequent year. Under this transition rule, the initial life expectancy used to determine the distribution period is reset by using the new Single Life Table for
the age of the relevant individual in the calendar year for which life expectancy was set under 1.401(a)(9)-5, Q&A 5(c). For distribution calendar years beginning on or after Jan. 1, 2021, the distribution is determined by reducing the initial life expectancy by one for each year subsequent to the year for which it was initially set.

Service Rules Favorably on Tax Treatment of QTIP Severance Followed by Non-qualified Disclaimer.

In PLR 201956009 (Nov. 15, 2019), the Taxpayer requested multiple rulings regarding a proposed qualified severance of a GST nonexempt QTIP trust into Trust A and Trust B followed by a nonqualified disclaimer of Trust A by the surviving spouse. The Service ruled that the severance of the trust which was permitted under state law would not cause Trust A and Trust B to lose their QTIP status. Further, the spouse would be deemed to have made a gift of her entire interest in the property in Trust A (other than the value of her qualifying income interest) on account of the nonqualified disclaimer of Trust A, but Trust B was a distinct interest and no gift resulted of an interest in Trust B.

Service Rules that Proposed Trust Modification Won't Trigger Estate, Gift, GST Taxes.

In PLR 201947001-201947006 (Nov. 22, 2019), the Taxpayer requested multiple rulings regarding a proposed modification of a grandfathered GST exempt trust. All beneficiaries of the trust consented to a modification of the trust whereby upon the current beneficiary's death the trust shares would be divided in the same trust shares as the original governing instrument but included a general power of appointment for each succeeding beneficiary rather than a distribution to his or her estate. The Service ruled that the modification did not cause the loss of the trust's GST exempt status and that no gift of an interest occurred as no change to a contingent or non-contingent beneficiary's interest had occurred.

Service Addresses Reformation of Defective Charitable Remainder Unitrust.

In PLR 201947007 (Nov. 22, 2019), the Taxpayer requested multiple rulings related to the reformation of a trust intended to qualify as a charitable remainder unitrust (“CRUT”). The trust provided for a unitrust interest of less than 4% to be paid annually to the settlor’s charitable remainder unitrust (“CRUT”). The trust provided for a unitrust interest of less than 4% to be paid annually to the settlor’s charitable remainder unitrust (“CRUT”). The service ruled that the reformation constituted a “qualified reformation” within the meaning of 2055(e)(3)(B), namely that (i) the actuarial value of the “qualified interest” and the actuarial value of the reformation interest did not exceed five percent of the actuarial value of the reformation interest; (ii) the nonremainder and remainder interest terminated at the same time, and (iii) the reformation was effective as of the decedent’s date of death.

Treasury Releases Final Regulations Eliminating “Clawback” Potential, Clarifying Issues Raised by Increased Basic Exclusion Amount under the TCJA.

In T.D. 9884 (REG-10606-18) (Nov. 22, 2019), the Treasury Department released final regulations as guidance regarding the basic exclusion amount (BEA) used in determining estate and gift taxes in the wake of the TCJA. For estates of decedents dying, and gifts made, before Jan. 1, 2018, the BEA for taxable gifts and estates was $5 million indexed for inflation beginning in 2011. For estates of decedents dying, and gifts made, after Dec. 31, 2017 and before Jan. 1, 2026, the TCJA doubled the BEA to $10 million indexed for inflation after 2011. After Dec. 31, 2025, the BEA reverts to $5 million indexed for inflation after 2011.

The final regulations adopt, with certain revisions, proposed regulations published by Treasury on Nov. 23, 2018, including a special rule to address potential “clawback” of the increased BEA with respect to taxpayers who made gifts before 2026 but die after 2025. The special rule adopted in the final regulations in cases where the portion of the credit against estate tax is based on the BEA is less than the sum of the credit amounts attributable to the BEA in I.R.C. Section 2001(b)(2). The special rule provides that the portion of credit against net estate tax that is attributable to the BEA is based on the greater of those two credit amounts, which will ensure that the estate of a decedent is not inappropriately taxed with respect to gifts that did not incur any gift tax due to the increased BEA when made. Treas. Reg. § 20.2010-1(c)(2).

Additionally, the final regulations include examples that confirm that even if the BEA decreases after 2025, the amount of a deceased spouse’s unused exclusion amount (DSUE) elected during the increased BEA period under IRC § 2010(c)(4) will not be reduced as a result of the sunset of the increased BEA. Treas. Reg. § 20-200-1(c)(2)(iii) and (iv), examples 3 and 4 respectively. The examples illustrate that if a spouse dies during the increased BEA period, and the deceased spouse’s executor makes the portability election, the surviving spouse’s applicable exclusion amount includes the full amount of DSUE that is based on the deceased spouse’s increased BEA. The summary of the final regulations confirms that this DSUE amount is available to offset the surviving spouse’s transfer tax liability irrespective of if the transfers are made during or after the increased BEA period.

In response to comments received by Treasury regarding inflation adjustments, the final regulations also include examples confirming the following: (i) that the term BEA includes inflation adjustments; (ii) to demonstrate that the increased BEA is “use it or lose it” in nature and is available to a decedent who survives the increased BEA period only to the extent the decedent “used” it by making gifts during the increased BEA period; (iii) under the special rule a decedent dying after 2025 will not benefit from post-2025 inflation adjustments to the BEA to the extent the decedent made gifts in an amount sufficient to cause the total BEA allowable in the computation of gift tax to equal or exceed the date of death BEA as adjusted for inflation.

The final regulations further clarify how to determine the extent to which a credit allowable in computing gift tax is payable based solely on the BEA. First, the credit may not exceed the amount necessary to reduce the gift tax for the calendar period to zero. Second, any DSUE amount available to the decedent for that calendar period is deemed to be applied to the decedent’s gifts before any of the decedent’s BEA is used for those gifts. Third, in a calendar period
in which the applicable exclusion amount allowable with regard to gifts made during that period includes both DSUE and BEA, the allowable BEA may not exceed the amount necessary to reduce the tentative gift tax to zero after the application of the DSUE amount. Fourth, in a period in which the applicable exclusion amount allowable with regard to gifts made during that period includes both DSUE and BEA, the portion of the credit based solely on the BEA for that period is determined by dividing the BEA allocable to those gifts by the applicable exclusion amount for those gifts. Treas. Reg. § 20.2010-1(c)(1)(ii).

Treasury declined to address comments received regarding the impact of the increased BEA on the generation-skipping transfer tax as beyond the scope of this rulemaking. The final regulations will affect donors making gifts after 2017 and decedents dying after 2025.


The revenue procedure provides four listed items that do not require additional disclosure of facts relevant to, or positions taken with respect to, such items, provided that all tax forms and attachments required to be filed with respect to such items are completed in a clear manner in accordance with their instructions and the taxpayer is able to verify the amounts entered on the forms on audit and can show good faith in entering such amounts on the return. The listed items which do not include additional disclosure are: (1) Form 1040, Schedule A Itemized Deductions; (2) certain trade or business expenses; (3) differences in book and income tax reporting; and (4) foreign tax items. Any items not included in the revenue procedure will require additional disclosures attached to the return. In addition, there are several specifically non-listed items which require additional disclosure, including transactions between related parties under IRC § 267(b). Further, the Service warns that while a taxpayer may literally comply with the disclosure requirements of the revenue procedure such disclosure will have no effect if the item or position on the return (i) does not have a reasonable basis, (ii) is attributable to a tax shelter item as defined in IRC Section 6662(d)(2)(C)(ii) or (iii) is not properly substantiated or the taxpayer failed to keep adequate books and records with respect to the item or position on the return.

Service Proposes Regulations for Treatment of Payments to Charitable Entities in Return for Consideration.

In REG-107431-19 (Dec. 13, 2019), the Service proposed regulations to address the treatment of payments to certain charitable entities in return for consideration. Following the passage of Section 164(b)(6), which limited the amount of deductions for real property and other state taxes, various state and local tax credit programs were created to provide tax credits in return for contributions by taxpayers to entities described in Section 170(c). Prior to issuing the current proposed regulations, the IRS issued proposed REG-112176-18 indicating that the receipt of state or local tax credit in return for the payment or transfer to a 170(c) organization would constitute consideration and reduce the taxpayer's charitable contribution deduction. After receiving considerable comments and concerns, the Service issued the current proposed regulation which: (i) clarifies payments by business entities in exchange for state or local tax credits may qualify for a Section 162 deduction rather than a charitable deduction; (ii) provides a safe harbor for individuals who make a payment to or for the use of an entity under Section 170(c) in return for a state or local tax credit by allowing a Section 164 deduction for the portion of the payment that is disallowed as a charitable contribution; and (iii) clarifies that "consideration" includes benefits provided by someone other than the donee organization.

Federal Cases

District Court Holds Donees Personally Liable for Unpaid Estate Tax.

In United States v. Estate of Sidney Elson, 2019 WL 5061321 (D.N.J. Oct. 9, 2019), the Court held that under IRC Section 6324(b), in addition to the lien for unpaid gift taxes against the gift for a period of ten years running from the date the gift was made, a donee can be held personally liable even after such lien has expired so long as the government could bring a timely action against the donor. The donor in this case made gifts in 2004 but failed to file a gift tax return and did not file a gift tax return prior to his death in 2006. In 2009, the donor's estate filed a gift tax return that failed to report additional gifts made by the donor, and after an audit, the Service assessed the donor's estate additional gift taxes in the amount of $374,131 in 2011. The donor's estate made certain payments toward the gift tax liability, however, as of Dec. 2017 a deficiency in the amount of $684,217.79 allegedly remained. In July 2018, the government filed suit for collection of the deficiency against the donor's estate and the donees of the gifts. The donees moved for dismissal on the grounds that (i) the action was not timely filed since the ten-year period of the lien for gift taxes had expired and (ii) no individual assessment for the unpaid gift tax was made against the donees pursuant to IRC Section 6901, which requires an individual assessment against donees of a gift for transferee liability must be made one year after the expiration of the period for assessment against the donor, and that any such assessment would be untimely. The Court rejected both arguments holding (i) that the lapsing of the ten year lien provisions of IRC Section 6324(b) does not prevent the Service from collecting tax deficiencies under the personal liability provisions of IRC Section 6324(b) and (ii) the government's action was timely filed within ten years of the 2011 assessment for the unpaid tax pursuant to IRC Section 6501 and that IRC Section 6901 is not a prerequisite to maintain an action for transferee liability under IRC Section 6324(b).

Court Finds Funds were Received by Taxpayer Despite Fraudulent Diversion.

In Nice v. U.S., 124 A.F.T.R.2d 2019-6403 (E.D. La. 2019), the U.S. District Court for the Eastern District of Louisiana found that taxpayer received the retirement income for which she was taxed despite son's fraudulent diversion of such funds for his own benefit...
after its receipt. Taxpayer sought a refund of federal income taxes on the grounds that her son had financially exploited her by gaining fraudulent access to her retirement accounts, causing distributions to be made from said retirement accounts, and then diverting said distributions for his own personal control and use. The Court, however, determined that the taxpayer (1) was the sole owner of the checking account into which the distributions were made, (2) had access to the account, (3) made withdrawals from the account for her personal use, (4) wrote checks on the account, and (5) knew the account existed. The fact that the taxpayer’s son misappropriated the funds after they were received by the taxpayer did not negate taxpayer’s receipt of such funds.

**Tax Court Rules Whistleblower May Not Require Service to Re-litigate Estate and Gift Tax Valuations with Underlying Target.**

In *Appruzzese v. Comm.*, T.C. Memo 2019-141 (Oct. 21, 2019), the Tax Court granted summary judgment to the Service against a whistleblower seeking to require the Service to re-visit the assets that were the subject to a whistleblower award under Section 7623(b). The whistleblower was involved in litigation against an estate and filed Form 211, Application for Award for Original Information, to the IRS Whistleblower Office. The application alleged that the estate had significantly undervalued assets. The Estate and Gift Tax Unit was preparing to issue a “No Change” letter but changed course after receiving the allegations. Ultimately, the Service collected $424,019.00 from the target and determined that the whistleblower was entitled to a payment of $44,424 (22% of one-half of the collect-ed proceeds less a 6.9% sequestration reduction). The whistleblower petitioned the Tax Court on the basis that the Service failed “to fully comprehend the scope of the failure of the representatives of the target to accurately reflect the assets and liabilities of the target...” The Tax Court found that the whistleblower did not allege any error in computation of the award but desired the court order the Service to re-examine the target’s estate tax. The Tax Court ruled that it lacked jurisdiction to do so under Section 7623.

**District Court Denies Post-Judgment Relief After Dismissal of Refund Claim.**

In *Carter v. United States*, 2019 WL 5309630 (N.D. Ala. Oct. 21, 2019), the Plaintiff Elizabeth R. Carter, personal representative of the Estate of Frances E.P. Roper, filed a motion for relief from final judgment pursuant to Rules 59 and 60 of the Federal Rules of Civil Procedure after dismissal with prejudice in Aug. 2019 of her claim for a refund of estate taxes. The Court dismissed the refund claim due to the Estate’s failure to timely file a claim for the refund with the Service, and alternatively the Court ruled against the estate on the merits of its refund claim. Prior to hearing on the government’s motion to dismiss the refund claim, Carter received a letter dated June 17, 2019 from the Service requesting additional information to proceed with examination of the subject estate tax return. In her motion, Carter contended the letter served as evidence that the Service had not completed its administrative examination of her claim thus rendering the lawsuit as premature and her refund claim should be dismissed without prejudice. Carter, however, did not bring this letter to the Court’s attention prior to or at the hearing on the government’s motion to dismiss the refund claim, and in response to the estate’s motion for relief from the dismissal the Service presented evidence that the letter was sent in error. The Court held that Rules 59 and 60 would afford relief to Carter because Carter did not raise the issue of the letter prior to entry of the dismissal and that sufficient evidence existed to determine that the letter was sent in error.

**Tax Court Finds IRS Expert Overvalued Gifts.**

In *Cavallaro v. Comm.*, T.C. Memo 2019-144 (Oct. 24, 2019), the Tax Court found that the Service’s expert valuation was arbitrary with respect to one aspect of the valuation. The ruling was the latest in a series of rulings by the Tax Court and the First Circuit Court of Appeals in litigation arising from disguised gifts. The donor husband and wife owned KT Corp. and their three sons owned CS Corp. In 1995, the two corporations merged. The taxpayers’ accounting firm and lawyers disagreed over the ownership of certain crucial intellectual property between the two companies. The merger valuation was eventually based on the assumption that the intellectual property was owned by CS Corp. In 2010, the Service conducted a gift tax examination and issued a notice of deficiency to the donors for tax year 1995 in the amount of $23,085,000. The taxpayers challenged the deficiency primarily on the basis that the intellectual property was owned by CS Corp and not KT Corp as claimed by the Service. After trial, the Tax Court ruled in favor of the Service and found that the intellectual property was owned by KT Corp and upheld the deficiency as calculated by the Service’s expert valuation. In doing so, the Tax Court ruled that the donors did not offer any contrary evidence to the Service’s expert valuation and therefore did not rule on the taxpayer’s arguments concerning the Service’s valuation. The taxpayers appealed and the First Circuit reversed on the narrow ground that the Tax Court should have considered the taxpayer’s arguments concerning the Service’s expert valuation.

On remand, the Tax Court evaluated arguments raised during the trial as well as arguments not raised during the trial. With respect to arguments raised by the taxpayers during the trial, the Tax Court found that those arguments attempting to claim a discount for a “cloud on the title” of the intangible assets were an attempt to re-litigate the already decided ownership issue and lacked merit. Further, the Tax Court found that any claim that the Service’s expert was “biased” for failing to interview the taxpayers or visit the corporations was without merit, particularly when the expert’s valuation was less than the taxpayer’s valuations. The Tax Court also rejected arguments that the expert employed an unnecessary profit reallocation and methodology as well as their argument that the discounted cashflow calculation was inappropriate. Finally, the Tax Court rejected claims that key man discounts, lack of control, and lack of marketability discounts should be applied on the grounds that the claims were waived by not being alleged in the trial and that the taxpayer’s own valuations did not apply those discounts.

The Tax Court found in favor of the taxpayer on a single argument. The Service’s expert valuation employed a 90th percentile profit margin calculation. However, the taxpayer pointed out, and the Service acknowledged, that the data on which the expert relied would not result in a 90th percentile profit margin calculation. As a result, the valuation was overvalued by $6.9 million.

**Decedent’s Military Service is not an Exception to Estate Tax Assessment.**

In *United States v. Estate of James H. Lafave*, 2019 WL 5457701 (N.D. Ind. Oct. 24, 2019), the Service was granted summary judg-
ment by the U.S. District Court for the Northern District of Indiana on the basis that the decedent's estate did not meet its burden of showing that there was an incorrect assessment of taxes or that the decedent's military service, even though it contributed to his death, amounted to an “extraordinary circumstance” sufficient to qualify his estate for injunctive relief to avoid collection of the taxes.

Tenth Circuit Affirms Denial of Charitable Deductions and Imposition of Accuracy-related Penalties.

In Presley v. Comm., 790 Fed. Appx. 914, 124 A.F.T.R. 2d 2019-6470 (10th Cir. 2019), the Tenth Circuit affirmed the denial of individual charitable deductions and the imposition of accuracy-related penalties. In 2008 and 2009, the taxpayers, a minister and his wife, paid for construction and reconfiguration of water ponds for Presley Family Ministries, Inc., a 501(c)(3) nonprofit organization where the taxpayer served as minister. In 2010, the taxpayers contributed a Toro tractor-mower to PFM and, in Oct. 2010, PFM's board of directors approved receipt of the 2008, 2009 and 2010 donations. With the assistance of a CPA, the taxpayers claimed a charitable deduction in 2010 for the donations. However, the return did not separately list or disclose the specific donations.

In 2012, the taxpayers conveyed their residence to PFM and claimed a charitable deduction for the gift. Form 8283 was prepared with the assistance of an attorney and CPA, but included only the second page and contained no declaration of appraiser, or donee acknowledgment.

The Tax Court denied the land-improvement donation for 2010 on the grounds that the payments were not made during 2010. The Tenth Circuit found that the taxpayers did not dispute the finding and therefore any challenge to that ruling was waived. Further, the Tenth Circuit held that, with respect to the mower, the taxpayers failed to comply with the regulatory requirements to describe the property contributed.

The denial of the contribution for the residence was similarly affirmed. The Court found that the Tax Court did not clearly err by finding that the taxpayers failed to substantially comply with the regulatory requirements to obtain a timely appraisal. The Court found that the date of the appraisal was Dec. 5, 2013, which was after Oct. 15, 2013—the date the appraisal must have been obtained.

The taxpayers claimed that the deductions for the mower and residence should be permitted as any failure to comply with the regulatory reporting requirements was due to reasonable cause and not willful neglect given the taxpayers' reliance on professional tax preparers. The Tenth Circuit found, however, that the taxpayers did not rely in good faith on the tax preparers as the evidence showed that an attorney for PFM informed the taxpayers of the need to file Form 8283 and obtain PFM's acknowledgement and the taxpayers did not question why the description of the property was left blank. In addition, the Court found that the taxpayers knew that the appraisal had not been provided on a timely basis and could not rely on the tax professional in good faith. Finally, the Tenth Circuit upheld the accuracy-related penalties given no reasonable cause was found.

Tax Court Denies Charitable Deduction for Conservation Easement.

In Coal Property Holdings, LLC, v. Comm., 153 T.C. No. 7 (Oct. 28, 2019), the Tax Court held that: (1) an easement donated by a partnership was not protected in perpetuity, and thus was not a qualified conserva-
Beneficiary and Owner of Foreign Trust Obtains Refund for Improperly Assessed Penalty.

In Wilson v. United States, 124 A.F.T.R.2d 2019-6693, 2019 WL 6118013 (E.D.N.Y. Nov. 18, 2019), Joseph Wilson established a foreign trust in 2003 in anticipation of a divorce from his then spouse. He funded the trust with approximately $9 million in U.S. Treasury Bills accruing annual interest at five percent or less. All principal had been previously taxed in the United States, and Wilson was the sole grantor and beneficiary of the trust. Upon conclusion of his divorce proceedings in 2007, Wilson terminated the trust and transferred the assets of $9,203,381 back to his bank accounts in the United States. Wilson was late in filing his Form 3520 for calendar 2007, which is an annual report disclosing distributions from a foreign trust, with different requirements for trust grantors/owners and for trust beneficiaries. After filing the 2007 Form 3520, the Service assessed a late penalty of $3,221,183, representing thirty-five percent (35%) of the total trust assets, pursuant to IRC Section 6048(c) which applies to trust beneficiaries; however, IRC Section 6048(b), which applies to the sole owner or grantor of a trust, provides that a five percent (5%) penalty would be applicable. Wilson paid the penalty plus statutory interest and brought a refund suit in the Court of Federal Claims, which dismissed the suit without prejudice, citing that his refund claim was improperly executed and therefore not duly filed. Wilson then filed amended refund claims and died while waiting for a determination by the Service. His estate commenced this action after his death seeking a refund of the penalty on the grounds that (i) reasonable cause existed for the untimely filing of Form 3520 and (ii) the Service erroneously applied the thirty-five percent (35%) penalty under IRC Section 6048(b), the Service should have only imposed a five percent penalty under IRC Section 6048(b), and the penalty should have been based on the value of the trust assets at the close of the taxable year, which would have been zero under IRC Section 6677(c)(2). The Court agreed with the Estate holding that when the sole beneficiary of a foreign trust is also treated as the owner of the trust, only the five percent penalty applied for the taxpayer's late filing of Form 3520 and the penalty was to be assessed on the value of the trust assets as of the close of the taxable year, which was zero since Wilson had distributed all assets of the trust to himself prior to the close of 2007.

Partnership Denied Multi-Million Dollar Charitable Deduction for Conservation Easement.

In TOT Property Holdings LLC et. al. v. Commissioner, No. 5600-17 (Dec. 13, 2019), the Tax Court sustained the Service’s denial of a charitable contribution deduction for a partnership’s easement donation as it was not “protected in perpetuity” within the meaning of IRC Section 170(h)(5)(A). The Court concluded that the fair market value of the easement was $496,000. The Court also imposed penalties and noted that the striking difference between the $6.9 million deduction petitioner claimed for the easement alone and the $1.05 million actually paid for the entire property in a recent transaction should have been obvious to the petitioner.

Ninth Circuit Denies S Corporation Shareholder Loss Deductions.

In Messina v. Comm., --- Fed. Appx. ----, 2019 WL 7209828 (Dec. 27, 2019), the Ninth Circuit affirmed the Tax Court’s denial of S corporation shareholders’ claimed loss deductions. The taxpayers claimed debt basis in Club One, an S corporation, based on loans Club One made to another S corporation owned by the same taxpayers. The Court affirmed the Tax Court’s holding that shareholder debt basis applied only to a shareholder’s loan to the applicable S corporation and not a loan from the S corporation to another related S corporation. The Court refused to find that the “substance over form” doctrine was available to taxpayers rather than the government and further found that, even if the doctrine was available, it did not apply in this case. The related S corporation had independent functions and benefits and therefore the debt owed by Club One to the related S corporation was different in both substance and form from a loan by the applicable shareholder to Club One.

Selected Other State Cases

South Dakota Supreme Court Denies Full Faith and Credit to California Child Support Order against Asset Protection Trust.

In In the Matter of the Cleopatra Cameron Gift Trust, 931 N.W.2d 244 (S.D. 2019), the South Dakota Supreme Court held that a California family court order compelling the direct payment of a beneficiary’s child support obligation from the beneficiary’s trust was not entitled to full faith and credit considerations as such order was not the judgment itself, but rather a means of enforcing the underlying judgment. A sister-state’s judgment can only be executed in the forum state as its laws may permit. As South Dakota law expressly prohibits a child support creditor from reaching trust funds protected by a spendthrift provision, the lower court was not required to submit to the California order.

California Appellate Court Addresses Effectiveness of Handwritten Revocable Trust Amendment.

In Pena v. Dey, 39 Cal. App. 5th 546, 252 Cal. Rptr. 3d 265 (2019), the California Court of Appeals for the Third Appellate District affirmed the Trial Court’s determination that the settlor’s handwritten interlineations on a revocable trust instrument did not effectively amend the trust. The instrument provided that any amendment to the trust would be made by a written instrument signed by the settlor and delivered to the trustee. Though the interlineations constituted a separate written instrument and were “delivered” at the time the settlor made them as he was also the trustee, the settlor did not sign the interlineations, but rather sent them to his attorney to be formalized into an amendment to his trust and prepared for the settlor’s signature, which did not occur prior to his death.

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