Service proposes regulations to avoid estate tax “clawback” resulting from lifetime gifts made when gift and estate tax exclusion amount was higher than such amount was at decedent’s death.

In REG-106706-18 (Nov. 20, 2018), the Service proposed amendments to Regulations Section 20.2010-1 to prevent a decedent from owing unintended estate tax with respect to lifetime gifts made in excess of such decedent’s federal estate tax basic exclusion amount but which gifts were sheltered by a federal gift tax basic exclusion amount that was higher at the time. Such unintended estate tax has been commonly referred to as “clawback” and arose due to (i) the 2017 federal tax act increasing the gift and estate tax basic exclusion amount, but only for a period of eight years, and (ii) the method of calculating federal estate tax prescribed by the Code not accounting for the possibility of the gift and estate tax basic exclusion amount at the time of a decedent’s death being lower than such amount was at any point during the decedent’s lifetime. The proposed regulations remove the possibility of clawback. The proposed regulations also indicate that lifetime gifts made by a decedent during a time when the basic exclusion amount is higher than it is at the decedent’s death are deemed to have used the decedent’s gift and estate tax exclusion “bottom up” instead of “top down,” meaning that a decedent who has made a lifetime gift sheltered by gift tax exclusion the amount of which exceeds the basic exclusion amount as of the decedent’s death will owe estate tax if the decedent has a taxable estate regardless of whether the decedent’s lifetime gifts fully used the decedent’s available gift tax exclusion at the time of the gift. The chart below illustrates:

Unmarried decedent makes $7 million gift when basic exclusion amount is $10 million, then later dies with a $1 million gross estate when basic exclusion amount is $5 million.

<table>
<thead>
<tr>
<th>Rules</th>
<th>Estate Tax Owed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clawback (Existing Rules)</td>
<td>$1.2 million estate tax</td>
</tr>
<tr>
<td>Gift of $7 million plus estate of $1 = $8 million, less exclusion at death of $5 million = $3 million taxable, times 40% rate = $1.2 million, which is greater than the decedent’s $1 million gross estate, illustrating the problem of clawback.</td>
<td></td>
</tr>
<tr>
<td>No Clawback</td>
<td>$400,000 estate tax</td>
</tr>
<tr>
<td>Gift Tax Exclusion Used “Bottom Up” (Proposed Regulations)</td>
<td>Gift of $7 million deemed sheltered but exceeds $5 million exclusion at death, so $1 million estate is fully taxable, times 40% rate = $400,000.</td>
</tr>
<tr>
<td>No Clawback</td>
<td>No estate tax</td>
</tr>
<tr>
<td>Gift Tax Exclusion Used “Top Down” (Option Not Adopted by Proposed Regulations)</td>
<td>Gift of $7 million when exclusion was $10 million deemed to leave $3 million of exclusion, which is fully retained at death (being less than the $5 million limit at death) and fully shelters $1 million estate.</td>
</tr>
</tbody>
</table>

Service releases 2019 inflation adjustments.

In Revenue Procedure 2018-57 (Nov. 15, 2018), the Service released items subject to inflation adjustments for 2019, including the gift and estate tax basic exclusion amount of $11,400,000 and the gift tax annual exclusion amount of $15,000 per donee.

Service provides safe harbors for contributions by businesses to charitable organizations in return for state and local tax credits.

In Revenue Procedure 2019-12 (Dec. 28, 2018), the Service provided safe harbors under Code Section 162(a) for C corporations and pass-through entities that carry on trades or businesses to deduct as ordinary and necessary business expenses certain payments made to charitable organizations in return for state or local tax credits. For both C corporations and pass-through entities, the safe harbor deduction is limited to the amount of the tax credit received or anticipated to be received. For pass-through entities exclusively, the tax credit must be applicable to a tax that is imposed directly upon the entity and that is not an income tax.

New procedures for private letter ruling requests released.

On Jan. 2, 2019, the Service released Revenue Procedure 2019-1, which describes the procedures for obtaining private letter rulings in 2019. There are only a few changes from Revenue Procedure 2018-1, including raising user fees for private letter rulings from $28,300 to $30,000 and for substantially identical ruling requests from $2,700 to $3,000.

Treasury and Service’s Priority Guidance Plan updated.

The 2018-2019 Priority Guidance Plan issued by Treasury and the Service on Nov. 8, 2018 details certain projects intended to be undertaken from July 1, 2018 to June 30, 2019. In addition to the previously unfinished projects from the prior Priority Guidance Plan for gifts, estates, and trusts that continue to be included, the new Priority Guidance Plan indicates an initiative to develop Regulations under Code Section 7520 for “the use of actuarial tables in valuing annui-
ties, interests for life or terms of years, and remainder or reversionary interests.”

**Bad debt deduction is impermissible for loans to a political party.**

In ILM 201842006 (Sept. 17, 2018), the Service denied an income tax deduction for a worthless or unrecoverable debt because the debt was owed by an organization that was deemed to be a political party for purposes of Code Section 271, and such Code Section renders such deductions impermissible. The taxpayer had loaned funds to a civic organization purportedly described in Code Section 501(c)(4), but the organization spent funds to promote the election of a political candidate and thus was treated as a political party for purposes of Code Section 271.

**Modification of irrevocable trust that could increase possibility of elimination of general power of appointment had no gift, estate, or generation-skipping transfer tax consequences.**

In PLR 201845006 (Nov. 9, 2018), an irrevocable trust permitted a non-beneficiary trustee to limit or eliminate a beneficiary's testamentary general power of appointment. Because no non-beneficiary trustee was named in the trust, the beneficiaries of the trust petitioned for the modification of the trust to allow for the appointment of a non-beneficiary trustee. The Service found that the proposed modification had no generation-skipping transfer (“GST”) tax consequences because the modification did not result in the shift of a beneficial interest to a beneficiary occupying a lower generation and did not extend the vesting of any beneficial interest under Regulations Section 26.2601-1(b)(4)(i). The Service noted that even though the trust was not a pre-1985 grandfathered trust, at a minimum, the modification of a trust exempt from GST tax as the result of allocation of the grantor's GST tax exemption is permissible if it satisfies the provisions of Regulations Section 26.2601-1(b)(4)(i) applicable to grandfathered trusts. In addition, the Service found that the proposed modification had no gift or estate tax consequences under Code Sections 2501 and 2041 as the modification merely created a process for these powers to be exercised by a non-beneficiary trustee and did not change the rights of the beneficiary during his lifetime nor confer new rights to any beneficiary. The Service did not address the fact that the exercise of a non-beneficiary trustee's powers under the trust to eliminate the beneficiary's general power of appointment could reduce the value of the assets includible in the beneficiary's taxable estate at death.

**Allocation of GST tax exemption in excess of value of trust is void to extent of excess.**

In PLRs 201850008 and 201850009 (Sept. 12, 2018), the Service found that a credit shelter trust created under the decedent's revocable trust had an inclusion ratio of zero for generation-skipping transfer (“GST”) tax purposes when the executor of the decedent's estate incorrectly overstated the amount of the decedent's GST tax exemption that was allocated to the credit shelter trust. Because, pursuant to Regulations Section 26.2632-1(b)(4)(i), an allocation in excess of the amount of exemption necessary to achieve an inclusion ratio of zero is void to the extent of the excess, the decedent also had remaining GST tax exemption to allocate to the mother's trust created under his revocable trust. In addition, because the executor of the decedent's estate reasonably relied on an attorney in failing to make a qualified terminable interest property (“QTIP”) election with respect to the mother's trust on the decedent's estate tax return, the decedent's estate was granted an extension under Regulations Section 301.9100-3 to make a QTIP election with respect to the mother's trust.

**Irrevocable trust qualified as a designated beneficiary for purposes of retirement account regulations.**

In PLR 201840007 (July 9, 2018), the decedent established an irrevocable trust to which his retirement accounts were payable upon his death. Three of the decedent's children were beneficiaries of the trust, and each child was granted a testamentary limited power of appointment exercisable in favor of any person or charitable organization designated by such child. On September 30 of the calendar year following the decedent's death, each child executed an irrevocable partial release of such child's power of appointment, releasing such child's right to appoint to any person or entity other than a person who was younger than the decedent's oldest child who was a beneficiary of the trust. After the execution of these partial releases, the decedent's oldest child who was a beneficiary of the trust could be determined to be the beneficiary of the trust with the shortest life expectancy. Because the beneficiaries of the trust were identifiable for purposes of Regulations Section 1.401(a)(9)-4, Q&A-1, and because the remaining requirements of Regulations Section 1.401(a)(9)-4, Q&A-5(b), which determine whether a trust will be treated as designated beneficiary of the retirement account, were satisfied, the trust qualified as a designated beneficiary of the decedent's retirement accounts and the life expectancy of the decedent's oldest child, as the beneficiary with the shortest life expectancy, will be used for determining the applicable distribution period, as required by Regulations Section 1.401(a)(9)-5, Q&A-7(a).

**Surviving spouse is able to roll over retirement account payable to surviving spouse's revocable trust.**

In PLR 201844004 (Aug. 8, 2018), a decedent's retirement account designated the decedent's surviving spouse's revocable trust as the beneficiary upon the decedent's death. The Service found that because the surviving spouse was the sole trustee and beneficiary of the revocable trust and was entitled to all of the income and principal of the revocable trust, the surviving spouse was effectively the person for whom the retirement account was maintained. Therefore, provided that the surviving spouse otherwise satisfied the requirements of Code Section 408(d)(3) regarding spousal rollovers, the retirement account could be distributed from the surviving spouse's revocable trust to the surviving spouse and rolled over by the surviving spouse.

**Independent trustee's power to redirect unitrust payments from grantor to charitable recipients and grantor's power to designate class of charitable recipients eligible for such redirections did not prevent trusts from qualifying as charitable remainder unitrusts; distributions of redirected unitrust payments to charities were deductible gifts by grantor.**

In PLR 201845014 (Aug. 9, 2018), a grantor created two trusts intended to qualify as charitable remainder unitrusts that included the
The Trustee's power to distribute a portion of the unitrust amount to charitable beneficiaries, (b) the grantor (or the grantor's spouse, if the grantor could not act) was permitted to remove the independent trustee and appoint a successor independent trustee, (c) the grantor was permitted to designate permissible charitable beneficiaries of the unitrust amount, and (d) with respect to the second trust ("Trust 2"), the grantor was permitted to revoke the grantor's spouse's right to receive unitrust payments after the grantor's death. The Service found that none of these provisions prevented the trusts from qualifying as charitable remainder unitrusts and clarified certain tax consequences of the provisions, as further described below:

1. The Trustee's power to distribute a portion of the unitrust payments to charitable beneficiaries did not cause the trusts to be grantor trusts under Code Section 674(a), which generally provides that for income tax purposes, the grantor is treated as the owner of any trust with respect to which a non-adverse party may exercise a power of disposition, because the power was exercisable only by an independent trustee and therefore fell under the exception of Code Section 674(c). If the trusts were grantor trusts, they would not have qualified as charitable remainder unitrusts.

2. Because the ability of the grantor (or the grantor's spouse, if applicable) to substitute trustees was limited to the ability to replace an independent trustee with another independent trustee, such ability did not prevent the trusts from qualifying as charitable remainder unitrusts.

3. Because the grantor could only designate charitable beneficiaries to be eligible for any redirected portions of unitrust payments, such power of designation did not cause the trusts to be grantor trusts under Code Section 674(a) due to the exception under Code Section 674(b)(4) permitting grantors to allocate trust proceeds exclusively among charitable beneficiaries without causing grantor trust status.

4. Because the grantor's power under Trust 2 to terminate his spouse's unitrust interest was exercisable only by will, such power did not cause Trust 2 to be a grantor trust under Code Section 674(a) due to the exception under Code Section 674(b)(3) permitting grantors to have the power to appoint trust property (other than income accumulated for the grantor) by will without causing grantor trust status.

5. Distributions of portions of the unitrust amount to charitable beneficiaries will be completed gifts by the grantor at the time of such distributions and will be eligible for charitable gift tax deductions.

6. The assets remaining in Trust 2 at the grantor's death will be includible in grantor's gross estate for estate tax purposes, but because the grantor's spouse and charities are the only beneficiaries of Trust 2 after the grantor's death, the entire value of Trust 2 will be eligible for either the marital deduction or the charitable deduction for estate tax purposes.

Stock subject to SEC insider trading restrictions was qualified appreciated stock for purposes of charitable income tax deduction.

In PLR 201848005 (Nov. 30, 2018), the taxpayer was permitted an income tax deduction equal to the full fair market value of marketable securities contributed to a private foundation because the SEC insider trading restrictions to which the taxpayer was subject with respect to the stock under SEC Rule 10b5-1 and SEC Rule 144(e) did not materially affect the value of the shares, and all other requirements of Code Section 170(e)(5)(A), which in general permits a deduction equal to the fair market value of qualified appreciated stock contributed to a private foundation, were satisfied.

Service clarifies private foundation's relationship to business interests owned by a trust of which private foundation is the remainder beneficiary.

In PLR 201849009 (Aug. 24, 2018), a private foundation requested rulings regarding the imposition of tax on unrelated business income under Code Sections 512 and 514 and the self-dealing rules for private foundations under Code Sections 4941-4947 with respect to transactions involving closely-held business interests owned by a trust of which the private foundation was the sole remainder beneficiary after the death of the grantor's surviving spouse. First, the Service ruled that, even though the trust became irrevocable at the time of the grantor's death and thus would have been irrevocable for a significant period of time at the time of the surviving spouse's death when the private foundation's interest would become effective, the estate administration exception under Regulations Section 53.4941(d)-1(b)(3) to the self-dealing rules could apply to transactions undertaken immediately following the surviving spouse's death because, at the time of the surviving spouse's death, the trust would be similarly situated to an estate or a revocable trust that had become irrevocable at the time of the grantor's death with the surviving spouse treated as the grantor for this purpose.

In addition, the Service found that any business interests distributed to the private foundation from the trust would be excess business holdings. Nevertheless, the private foundation would have five years following the death of the surviving spouse to eliminate the excess business holdings as the surviving spouse should be treated as the decedent for purposes of Code Section 4943(c), which states that a private foundation has five years to eliminate excess business holdings when such holdings were acquired by the private foundation as a result of the decedent's death. Furthermore, the Service ruled that the rents received from one of the closely-held businesses in the operation of an apartment community constituted rents from real property for purposes of Code Section 1702(b)(3)(A)(i) because no services were rendered to the occupants for purposes of Regulations Section 1.512-1(c)(5) and the rents were thus excludible from unrelated business income. Finally, the Service ruled that the mortgages on the property owned by some of the businesses would not constitute acquisition indebtedness for purposes of including rents from real property as unrelated business taxable income as the property would be received by the private foundation upon the surviving spouse's death and thus should be treated as a bequest or devise exempt from unrelated business taxable income for ten years under Code Section 514(c)(2)(B).

Federal Cases

Income tax deductions for donations of stock denied when taxpayers failed to submit appraisal and unsubmitted appraisal relied upon did not value minority interests donated; summary judgment denied as to whether donations constituted assignments of income.
In Chrem v. Comm’r, T.C. Memo 2018-164 (Sept. 26, 2018), the shareholders of a closely-held corporation sold most of their shares to a third-party buyer. In close proximity, the shareholders transferred the rest of their shares in the corporation to a charity, with the provisions that (i) the shareholders would attempt to convince the charity to sell its shares to the same buyer, and (ii) if the charity did not so sell its shares, the buyer’s purchase of the shareholders’ undonated shares would be reversed. The charity did sell, and the buyer thus acquired all of the corporation’s shares. The shareholders reported income with respect to the sale of the undonated shares and claimed a charitable deduction for the contribution of the donated shares. The Service assessed a deficiency, claiming that under the assignment of income doctrine, the shareholders in effect sold all their shares to the buyer and donated a portion of the proceeds to the charity. In this ruling, the Tax Court found that a genuine issue of material fact existed with respect to whether the shareholders owed income tax with respect to the buyer’s acquisition of the donated shares. The core question was whether the buyer’s purchase of the donated shares was a virtual certainty at the time of the donation. The dates of the various agreements and transfers among the parties were not explicitly clear, and some evidence suggested that the charity may have agreed prior to receiving the shares to sell them to the buyer in connection with the buyer’s acquisition of the undonated shares. The Service also denied the shareholders’ charitable deductions with respect to the contribution of the donated stock, claiming that the appraisal they relied upon did not meet the requirements of a “qualified appraisal” under the Code. The appraisal was prepared for the buyer, not the shareholders, for the buyer’s own business valuation purposes and valued 100% of the company’s shares together (thus applying no minority interest valuation discounts). The Tax Court found that the interest valued in the appraisal was not the same as the interests transferred by the shareholders (being minority stakes subject to valuation discounts). Also, none of the shareholders submitted the appraisal with their tax returns, and the Tax Court agreed with the Service that the four shareholders who claimed deductions of more than $500,000 could not receive deductions due to failure to attach the appraisal if no other reason.

Tax Court disallows income tax deductions for contributions of conservation easements when easement area included “building areas” not subject to primary easement restrictions and location of such building areas could be changed.

In Pine Mountain Preserve, LLLP v. Comm’r, 151 T.C. No. 14 (Dec. 27, 2018), an eleven-judge Tax Court panel voted 10-1 to disallow income tax charitable deductions for two out of three conservation easement contributions made by a partnership. The easements with respect to which the deductions were disallowed each provided for a number of unconserved building areas to be reserved within the outer bounds of the overall area subject to the easement but did not specify the precise locations of those building areas. The Tax Court held that the failure to define the locations of the building areas caused the restrictions of the use of the property to not be granted in perpetuity (because a previously conserved area could be unconserved if a building area were later located there). The Tax Court had previously reached the same conclusion in Bosque Canyon Ranch, L.P. v. Comm’r, T.C. Memo 2015-130, but that decision was overturned by the Fourth Circuit. Since Pine Mountain Preserve was appealable to the Eleventh Circuit, and no Supreme Court precedent existed, the Tax Court was not obligated to follow the Fourth Circuit and reiterated its judgment from Bosque Canyon Ranch. The dissenting judge thought that because the building areas in Pine Mountain Preserve were technically subject to the conservation easement but were just subject to fewer restrictions than the easement area at large, whereas the building areas in Bosque Canyon Ranch were defined out of the easement area, the cases were distinguishable and the deductions in Pine Mountain Preserve should not be overturned on the basis of the ability of the building areas to be moved. (The dissenting judge would have overturned one of the disallowed deductions on other grounds.) The majority held that the distinction between Pine Mountain Preserve and Bosque Canyon Ranch was not material because all of the meaningful restrictions of the conservation easement did not apply to the building areas in Pine Mountain Preserve.

In a separate opinion at T.C. Memo 2018-214, written perhaps coincidentally by the dissenting judge, the Tax Court ruled on the proper deduction amount for the easement for which a deduction was allowed. The partnership contended that the value of the easement was approximately $9.1 million, based on a valuation by an appraiser of the partnership’s property both before and after the contribution of the easement. The Service contended that the deduction should only have been approximately $450,000, based on a similar before-and-after valuation by its own appraiser. The appraisers disagreed regarding the highest and best use of the conserved property before its conservation by the easement: the partnership’s appraiser contended the property could have been developed, while the Service’s appraiser contended that the property’s highest and best use was open space. The court found that the property could have been developed. However, the court also found that the partnership’s appraiser improperly concluded that the value of partnership property adjacent to the conserved area was not enhanced by the easement. Then, instead of requiring further expert valuation analysis consistent with its findings, the court ruled that the proper deduction amount was the average of the conclusions of the two appraisals it found faulty.

Unsolicited contributions from congregation members treated as income to pastor.

In Felton v. Commissioner, T.C. Memo 2018-168 (Oct. 10, 2018), the Tax Court found that regular contributions received by a pastor from members of his congregation were taxable income to the pastor rather than gifts. The court focused on four factors in determining whether the contributions were income or gifts: (i) whether the donations were provided in exchange for continued services, (ii) whether the donations were requested, (iii) whether the donations were part of a structured system, and (iv) whether the pastor received a salary in addition to the contributions and, if so, the amount of the salary compared to the amount of the contributions. Unlike prior cases in which contributions made to retiring clergymen were treated as gifts, the pastor in Felton was still preaching every week, and members of the congregation continued to receive religious benefits in exchange for their contributions, which tended to show that the contributions were income instead of gifts. The contributions at issue were received in a manner separate from other contributions to the church. The envelopes used to make the contributions at issue were not addressed in church services after their initial introduction, and congregants had to explicitly ask for such
an envelope in order to make a contribution, as opposed to the envelopes used to collect other donations which were specifically mentioned at each service and voluntarily handed out by ushers. The fact that the contributions at issue were not solicited tended to show that they were gifts instead of income. Nevertheless, the church had a set structure in place to collect these contributions, including the use of designated envelopes. Although the program was not specifically publicized, the court determined that the program must have been well known to the congregants given the amount of contributions received in the special envelopes, as opposed to other donations made to the church or the pastor. This structure tended to show that the contributions were income instead of gifts. Finally, the amount that the pastor received from the contributions at issue was more than double his parsonage allowance and his salary, indicating that such contributions were a portion of his compensation rather than mere gifts. As three of the four factors tended towards income, the court found that such contributions were taxable income to the pastor. In addition, because the tax underpayment well exceeded the greater of $5,000 and 10% of the required tax, and there was no evidence that the pastor reviewed or relied on relevant authority in preparing his tax returns that would support a finding for the reasonable cause exception to such penalty, the court upheld the Service's issuance of an accuracy related penalty.

Transfer of partnership interest to revocable trust did not cause revocable trust to only be an “assignee” of partnership interest without the rights of a partner.

In Streightoff v. Comm’r, T.C. Memo 2018-178 (Oct. 24, 2018), the Service disagreed with a decedent’s estate regarding the valuation of an interest in a limited partnership held by the decedent’s revocable trust at the time of the decedent’s death. The decedent owned an 88.99% limited partnership interest in the partnership at the time the partnership was formed. The decedent then transferred that interest to his revocable trust. The assignment met all the criteria identified in the partnership agreement for the revocable trust to be a substituted limited partner of the partnership, though the assignment did not specifically recite that conclusion. Under the partnership agreement, a limited partner owning at least a 75% interest in the partnership could remove the general partner, which would trigger the termination of the partnership unless the limited partners agreed to continue it with a new general partner. The decedent’s estate argued that the revocable trust never became a substituted limited partner of the partnership and therefore was only an “assignee” under the partnership agreement and did not have the right to remove the general partner and terminate the partnership. As such, the estate claimed that a 13.4% lack of control discount and a 27.5% lack of marketability discount applied to the revocable trust’s interest in the partnership. The Service claimed, and the Tax Court agreed, that the revocable trust was a substituted limited partner of the partnership because the criteria for that condition had been met, or even if not, a limited partnership interest, and not an assignee interest, was properly includable in the decedent’s gross estate because the decedent transferred a limited partnership interest to the revocable trust and could revoke the transfer under the terms of the revocable trust (presumably becoming a limited partner again). Accordingly, the Service argued and the court agreed that no lack of control discount applied to the limited partnership interest and a lower lack of marketability discount of 18% applied because the limited partner’s powers made the interest more marketable. The court also believed that the Service’s appraiser used more recent and more applicable comparables in determining the lack of marketability discount.

Marital deduction was not reduced by estate taxes payable when the executor sought reimbursement for tax attributable to Code Section 2036 property.

In Est. of Turner v. Commissioner, 151 T.C. No. 10 (Nov. 20, 2018), the Tax Court found that the marital deduction available for a decedent’s estate was not diminished by estate taxes paid by the estate when such taxes were attributable to property transferred during the decedent’s lifetime but includible in his taxable estate under Code Section 2036 and when the executor sought recovery of the taxes paid from the transferees of such property as permitted under Code Section 2207B. Once such recovery was complete, the value of the estate assets passing to the decedent’s surviving spouse would not be diminished and thus the full value of the claimed marital deduction would pass to the surviving spouse. The court found that because neither the decedent’s will nor Georgia law prohibited the application of Code Section 2207B, the executor was permitted to seek such recovery. Furthermore, such approach satisfied the decedent’s stated intention in his will that his surviving spouse receive her share of assets undiminished by estate tax. In addition, the court found that the estate could not increase the marital deduction by income earned by assets passing to the surviving spouse during the administration of the estate because such items of income were not includible in the decedent’s estate for estate tax purposes and thus could not be considered for the marital deduction under Code Section 2056(a).

Death benefit payable to employees pursuant to contract between employer and third-party benefits provider is split dollar life insurance arrangement when funded by life insurance; economic benefit of arrangement is taxable income and is treated as distribution (and not employment compensation) when employer is S corporation and employee is shareholder.

In De Los Santos v. Comm’r, T.C. Memo 2018-155 (Sept. 18, 2018), a taxpayer owned a medical practice, organized as an S corporation, that employed both himself and his wife. The corporation contracted with a third party to provide employee benefits, including death benefits to be funded by life insurance purchased by the third party (the “benefits provider”). The corporation and the benefits provider arranged for the taxpayer and his wife to be entitled to a $12.5 million joint and survivor death benefit and for each of the other employees of the corporation to be entitled to a $10,000 accidental death benefit. After several years of payments to the benefits provider, the $12.5 million death benefit to the taxpayer and his wife was vested. The taxpayer and his wife reported no income with respect to the death benefit, but the Service assessed a deficiency, asserting that the arrangement was a split-dollar life insurance arrangement and that the annual economic benefit of the arrangement to the taxpayer and his wife constituted taxable income under Regulations Section 1.61-22(b)(2). The court agreed with the Service, finding that even though the corporation was not entitled to recover any of its investment in the death benefit (as described in the general split dollar definition in Regulations Section 1.61-22(b)(1)), because the arrangement was a compensatory arrangement, the arrangement was treated as split dollar under the special rule of Regulations Section 1.61-22(b)(2).
The court rejected the taxpayer’s argument that the benefits provider serving as an intermediary made the corporation’s acquisition of the death benefits not life insurance; the court noted that the contract between the corporation and the benefits provided required life insurance to be purchased to fund the death benefits.

In Machacek v. Comm’r, 906 F.3d 429 (6th Cir. Oct. 12, 2018), under a similar fact pattern, the Sixth Circuit found that the economic benefit provided to a shareholder employee of an S corporation from a compensatory split dollar arrangement is properly regarded as a distribution to such shareholder under Regulations Section 1.301-1(q)(1)(i), rather than being treated as employment compensation.

Retirement account interest obtained pursuant to divorce was not protected from bankruptcy creditors.

In Lerbakken v. Sieloff & Assoc., P.A., 590 B.R. 895 (Bankr. 8th Cir. Oct. 16, 2018), the court ruled that an individual’s interests in retirement accounts obtained from his ex-spouse incident to divorce were not “retirement funds” exempt from the claims of creditors in a bankruptcy proceeding under 11 U.S.C. 522(d)(12) because the funds in those accounts were not contributed thereto by the individual for his own retirement. The funds were rather obtained by the individual through a property settlement and were thus treated as any other typical asset so obtained. This ruling followed the Supreme Court’s ruling in Clark v. Rameker, 134 Sup. Ct. 2242 (2014), that an inherited retirement account was also not exempted from creditors’ claims as “retirement funds.”

Proof of claim in estate proceeding satisfied statute of limitations for Service’s income tax claim against decedent.

In U.S. v. Est. of Chicorel, 907 F.3d 896 (6th Cir. Oct. 25, 2018), the Service assessed an income tax deficiency against a taxpayer, and the taxpayer died without satisfying the deficiency. The Service timely filed a proof of claim in the probate proceeding with respect to the taxpayer’s estate, but the taxpayer’s personal representative did not respond to the proof of claim. More than ten years after the original assessment of the deficiency, the Service filed a collections proceeding against the taxpayer’s estate. The estate argued that the claim was time-barred due to the ten-year statute of limitations for the Service to initiate a proceeding in court to collect an assessed deficiency. However, the court ruled that the proof of claim satisfied the statute of limitations because it was a legally material proceeding in court under the laws of the state of Michigan, where the taxpayer resided. The court also found that after the initial proceeding in probate court, the ten year statute of limitations was completely satisfied, with no time limit for subsequent collections actions with respect to the same deficiency.

North Carolina Cases

Holographic codicil written on will may refer to provision in will by article number.

In In the Matter of the Will of James Paul Allen, N.C. Sup. Ct. No. 227PA17 (Dec. 7, 2018), a testator had attempted to modify his will by writing “beginning 7-7-03 do not honor Article IV void Article IV” on one of the will’s pages and signing his name underneath. The trial court found the handwritten phrase to be a valid holographic codicil to the testator’s will, but the North Carolina Court of Appeals later disagreed, finding that the purported codicil’s meaning could not be interpreted using only the words of the purported codicil due to the reference to “Article IV” of the will, and therefore the purported codicil was disqualified under existing case law. In this opinion, the North Carolina Supreme Court disagreed with the Court of Appeals, ruling that the reference to “Article IV” of the will was consistent with the nature of a codicil as a supplement to an existing will and did not disqualify the purported holographic codicil. However, the Supreme Court found that due to the presence of the words “beginning 7-7-03” and the lack of evidence as to when the testator wrote the purported codicil, there was a genuine issue of material fact as to whether the testator was expressing the present testamentary intent required for the codicil to be valid or was rather expressing some intent to change his will in the future (such expression not being valid to constitute a codicil). The Supreme Court remanded the case for the determination of that issue.

Subject matter jurisdiction for pre-2003 equitable distribution claim against deceased former spouse lies with District Court, with claim to be enforced under equitable distribution statute.

In Watson v. Joyner-Watson, N.C. Ct. App. No. 18-524 (Dec. 18, 2018), an individual sought to enforce an equitable distribution award from 1999 against her deceased former spouse’s estate in North Carolina Superior Court under the procedures governing estate administration, but the Superior Court found itself to lack subject matter jurisdiction over the action, and here, in a split decision, the Court of Appeals agreed. The Court of Appeals determined that the action should have been brought in North Carolina District Court under the procedures governing equitable distribution. The Court of Appeals noted that had the equitable distribution award been made after Jan. 1, 2003, the Superior Court would have had subject matter jurisdiction pursuant to North Carolina General Statutes Section 50-20(I)(2). However, because the award predated 2003, the Court of Appeals followed its own precedent from Painter-Jamieson v. Painter, 594 S.E.2d 217 (N.C. App. 2004), which ruled that the District Court retained jurisdiction over equitable distribution claims even when brought against the estate of one of the former spouses. The dissenting judge argued that Painter-Jamieson was incorrectly decided, reasoning that obligations of a decedent’s estate were most practically determined in Superior Court under the procedures governing equitable distribution. The dissenting judge further questioned whether the District Court had the proper jurisdiction to compel the executor of the former spouse’s estate to make a distribution to the claimant to enforce the award.

Other State Developments

California enacts Uniform Trust Decanting Act.

The California Uniform Trust Decanting Act, effective as of Jan. 1, 2019, is based on the Uniform Trust Decanting Act and is largely similar to the North Carolina Uniform Trust Decanting Act. Nevertheless, there are a couple of substantive differences between the two acts. As an example, the notice provisions of the California act are more stringent than those in the North Carolina act, as the settlor must always be notified of the decanting, and a specific warning
regarding the beneficiaries' right to challenge the decanting must be displayed on the required notice to beneficiaries.

**Beneficiary designation of a life insurance policy was invalidated as a result of divorce.**

In **Blalock v. Sutphin**, Ala. Sup. Ct. No. 1170879 (Oct. 26, 2018), the Alabama Supreme Court found that the beneficiary designation of a decedent’s life insurance policy, which named the decedent’s ex-wife as a 50-percent beneficiary, was invalidated upon the divorce of the decedent and his ex-wife. The court followed the United States Supreme Court’s decision in **Sveen v. Melin**, 138 S. Ct. 1815 (June 11, 2018), in finding that the invalidation did not violate the contracts clause of the Alabama Constitution, which is substantially similar to the United States Constitution. In addition, the court found that the decedent and his ex-wife were not common law married at the time of his death even though they had reconciled and were planning to re-wed; the court found that the intent to re-wed indicated that the decedent and his ex-wife did not consider themselves to be married at the time of the decedent’s death, which consideration is required for common law marriage in Alabama. This case differs from **Gordon v. Fishman**, 253 So. 3d 1218 (Fla. Ct. App. Aug. 24, 2018), in which the Florida Court of Appeals found that provisions made for a decedent’s fiancée under the decedent’s will were not invalidated by the decedent’s subsequent divorce from the fiancée, whom the decedent had married after the execution of his will but before the date of his death. The Florida Court of Appeals specifically noted that, at the time the decedent’s will was drafted, the decedent was not married. Therefore, Florida statutes invalidating bequests to the spouse of a decedent named in a will whom the decedent later divorces were inapplicable. As in **Sveen** and unlike **Gordon**, at the time the decedent in **Blalock** completed the life insurance beneficiary designation form, the decedent was married and not merely engaged to the named beneficiary, whom he subsequently divorced.

Published by the North Carolina Bar Association Estate Planning & Fiduciary Law Section • February 2019