ESTATE TAX UPDATE

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THE BLUM FIRM, P.C.

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Gary V. Post, a Partner in The Blum Firm, P.C., with law offices in Fort Worth, Dallas, Houston, and Austin, specializes in the areas of estate planning and probate, asset protection planning, planning for closely-held businesses, and charitable planning. He received his J.D. from Southern Methodist University School of Law and his B.B.A. magna cum laude/Beta Alpha Psi from Texas A & M University. Mr. Post is a frequent speaker and author on various estate planning topics. He is Board Certified in Estate Planning and Probate Law, a Past President for the Tarrant County Probate Bar Association, past Chairman for the Estate Planning and Probate Law Exam Commission for the Texas Board of Legal Specialization, member of the Estate Planning and Probate Law Advisory Commission, is recognized as a Texas Super Lawyer by *Texas Monthly*, and is also a Fellow of the American College of Trust and Estate Council. Mr. Post is active in the community and served as Chairman of the Board of the American Cancer Society, receiving the *2004 Volunteer of the Year Award.*

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Emily K. Seawright is an associate attorney at The Blum Firm, P.C. in Fort Worth. She received her J.D. *cum laude* from Texas Tech University School of Law. While in law school, Ms. Seawright received American Jurisprudence Awards in Legal Practice I and II. She received her Bachelor of Science in Agricultural Economics *summa cum laude* and a Master of Science in Agricultural Economics from Texas A & M University, earning a 4.0 GPA in both degrees.

Ms. Seawright specializes in the areas of estate planning and probate, asset protection planning, planning for closely-held businesses, tax planning, and charitable planning. Ms. Seawright is admitted to practice law in the State of Texas. She is a member of the Tarrant County Probate Bar Association and a member of the Tax and Estate Planning and Fort Worth Business and Estate Council Sections of the Tarrant County Bar Association. Ms. Seawright currently serves on the Board of Directors for the Tarrant County Probate Bar Association.

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I. INTRODUCTION.

Tax and estate planning attorneys use various strategies to accomplish the estate planning goals and save estate taxes for their clients. Often, many details are overlooked when implementing these strategies. A proper understanding of the different tasks necessary to ensure the complete implementation and realization of a client's estate plan will ensure that the client's goals and tax planning objectives are met. A few of these tasks include (1) adequate disclosure of gifts on a gift tax return, (2) making a Section 645 election, (3) allocating GST exemption, (4) ensuring the proper elections are made to maintain an S election for clients with S corporations or receiving S corporation stock, and (5) preparing for new regulations that may impact the valuation of closely-held entities.

II. PREPARING THE GIFT/GENERATION-SKIPPING TRANSFER TAX RETURN—FINISHING THE PLAN/SECURING THE BENEFITS.

A. <u>Hard to Value Assets—Did You Really Trigger the Gift Tax Statute of Limitations</u>? The IRS has the ability to revalue adjusted taxable gifts reported on the Form 706 until the statute of limitations has run on the gift. Code Section 2001(f)(1) and Code Section 2504(c). In general, the statute of limitations for assessing the gift tax on a gift that was disclosed on a Form 709 is three years (see Code Section 6501). Section 2504(c) of the Code does not require the gift tax to be paid in order for the statute of limitations to begin to run. According to Code Section 6501, the statute begins to run at the later of the filing date or the due date of the return. Code Section 6501. To trigger the statute of limitations on gifted assets, adequate disclosure of the gift must be given to the IRS on a Form 709. After the statute of limitations has run, the value of the gift cannot be adjusted for later gift tax returns or estate tax returns. If adequate disclosure is not given, the statute of limitations does not begin to run and the taxpayer remains open to uncertainty and liability until the statute of limitations has run with regard to the Form 706 filed at death.

1. **What Constitutes Adequate Disclosure?** Adequate disclosure on a gift tax return occurs when the gift is reported "in a manner adequate to apprise the IRS of the nature of the gift and the basis for the value so reported." Treas. Reg. Section 301.6501(c)-1(f)(2). A gift is adequately disclosed only if the return provides a complete and accurate description of the transaction. Treas. Reg. Section 301.6501(c)-1(f). According to the Regulations, a complete and accurate disclosure includes:

a. A description of the transferred property and the consideration, if any, received by transferor;

b. The identity of the transferee and the relationship that exists between the transferor and the transferee;

c. For a gift in trust, the trust's taxpayer identification number and either a "brief description" of the terms of the trust or a copy of the trust instrument;

d. The identification of "any position taken that is contrary to any proposed, temporary or final Treasury Regulations or Revenue Rulings published at the time of the transfer;" and

e. Either a (i) description of the method used to determine fair market value or (ii) qualified appraisal, which contains certain prescribed elements.

2. **Fair Market Value Methods Disclosure**. Treasury Regulations Section 301.6501(c)-1(f)(2)(iv) gives guidance on what valuation information must be disclosed to satisfy the description of methods used for determining the fair market value of the reported gifts. These requirements include:

a. The financial data used in valuing the transferred property;

b. Any restrictions on the transferred property that were considered;

c. A description of any discounts claimed, such as discounts for blockage, minority or fractional interests, and lack of marketability;

d. For a gift of an interest in an entity, such as a corporation or partnership, that is not actively traded, a description of any discounts claimed in valuing any assets owned by the entity (as well as any discounts claimed in valuing the transferred interest itself);

e. For a transfer of an interest in an entity properly valued with reference to the value of the assets held by the entity, a statement regarding the undiscounted fair market value of 100 percent of the entity, the pro rata portion of the entity subject to the transfer, and the fair market value of the transferred property as reported on the return;

f. For a transfer of an interest in a non-actively-traded entity that itself directly or indirectly owns an interest in another non-actively-traded entity, a detailed description of the method used to determine the fair market value of that owned interest, including all the foregoing information, if the information is "relevant and material" in determining the value of the interest.

3. <u>Qualified Appraisal in Lieu of the Fair Market Value Methods</u>. A Qualified Appraisal may be submitted in lieu of the description of the method for determining fair market value. One of the requirements of a Qualified Appraisal is that the appraiser must satisfy all of the qualifications outlined in Treasury Regulations Section 301.6501(c)-1(f)(3)(i), including:

a. The individual performs appraisals on a regular basis or holds him or herself out to the public as an appraiser;

b. The appraiser must outline in the appraisal any and all of his or her background, experience, education, and professional memberships (if any) that qualified him or her to appraise the type of property involved;

c. The appraiser is (i) an independent third party and (ii) not the donor, donee, member of the donor or donee's family (as defined in Section 2032(A)(e)(2)), and (iii) an individual employed by the donor, donee or member of the donor or donee's family.

To be considered a Qualified Appraisal, the appraisal must meet specific requirements outlined in Treasury Regulations Section 301.6501(c)-1(f)(3)(ii) (A) through (H). These requirements are as follows:

a. the date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal;

b. a description of the property;

c. a description of the appraisal process;

d. a description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property that affect the analyses, opinions, and conclusions;

e. the information considered in determining the appraised value, (e.g., all financial data used in determining the value of an ownership interest in a business). Which is sufficiently detailed so that the process can be replicated and the same valuation conclusion reached by a third party;

f. the appraisal procedures and reasoning that supports the analyses, opinions, and conclusions;

g. the valuation method used, the rationale for such method, and the procedure used in determining the fair market value of the asset gifted; and

h. the basis for the valuation, such as specific comparable transactions, asset-based approaches, and merger-acquisition transactions.

If all of the above requirements for the appraiser and appraisal are met, the appraisal will be considered a Qualified Appraisal and may be submitted in lieu of the description of the methods used to determine the fair market value of the gifts. Treas. Regs. Section 301.6501(c)-1(f)(3)(ii).

4. Ensuring the Gift was Adequately Disclosed for Previous Gifts. For gifts that were previously reported on a gift tax return, but not adequately disclosed as provided in Treasury Regulations Section 301.6501(c)-1(f)(2), the taxpayer may file an amended Form 709 for the year in which the gift was initially reported. The amended Form must be filed in the IRS office where the previous gift tax return was filed and include the following words at the top of the new form: "Amended Form 709 for gift(s) made in [Year]—In accordance with Rev. Proc. 2000-34 I.R.B. 186." The Amended Form must also identify the inadequately disclosed gift and provide the required information that was not included in the previous Form. Rev. Proc. 2000-34.

III. THE SECTION 645 ELECTION.

A. Revocable Living Trusts—A Popular Tool. Revocable Living Trusts ("Living Trusts" or "Trusts") are often used by estate planning attorneys as a means of disability planning, asset management, and probate avoidance for the client. The Trust is funded by assets contributed by the grantor (who is often the client). By funding the Trust, the assets are no longer owned by the client and are instead owned by the Trustee of the Trust. The grantor, however, retains the power of revocation, among other powers, so that any income earned by the Trust is taxable to the grantor. As such, any Trust income is reported on the grantor's 1040.

Once the Trust is funded, it functions like a will in that the grantor directs how the assets in the Trust are to pass upon his or her death. Because the Trust owns the grantor's assets, probate of in-state assets and ancillary probate of assets in other states is avoided. Likewise, guardianship proceedings to gain control of the grantor's property are avoided because the trustee holds legal title to the property. Upon the grantor's death, the Trust becomes irrevocable and the assets in the Trust become protected from the beneficiaries' creditors. At that time, the Trust becomes a separate taxpayer and must obtain a taxpayer identification number to file the Trust's tax return (Form 1041).

B. **Making the Section 645 Election.** A Qualified Revocable Trust is defined in Section 1.645(b)(1) as a trust where the grantor retains the power of revocation and is treated as the Trust's owner for tax purposes. As such, during the grantor's lifetime, the grantor is taxed on any income that a Qualified Revocable Trust earns. Because the grantor of a Living Trust retains the power of revocation and was treated as owned by the decedent under Section 676, the Living Trust is considered as Qualified Revocable Trust. Treas. Reg. Section 1.645-1(b)(1). As such, the Trust may be treated as part of the decedent-grantor's estate upon election under Section 645. Treas. Reg. Section 1.645-1(a).

A Section 645 election is an irrevocable election that must be made by both the estate's executor and the trustee of each qualifying trust by signing and filing Form 8855, "Election to Treat Qualified Revocable Trust as Part of an Estate." Treas. Reg. Section 1.645-1(c)(1). The deadline for making the election is the due date (including extensions) for filing the income tax return for the first tax year of the estate. If the estate has no executor, the trustee must make the election by the due date (including extensions) for the Form 1041 of the first taxable year of the trust. Treas. Reg. Section 1.645-1(c)(2). The appointment of an executor subsequent to the election requires that the executor agree to the election and that a revised election be filed notifying the IRS of the change within 90 days of the executor's appointment. Treas. Reg. Section 1.645-1(g).

The election period begins on the decedent's date of death and terminates on the earlier of i) the distribution of all assets of the trust and estate or ii) on the date of the final determination of estate tax liability. Treas. Reg. Section 1.645-1(f)(1). The date of the final determination of estate tax liability (Treas. Reg. Section 1.645-1(f)(2)(ii)) occurs at any one of the following:

a. Six (6) months after IRS issues a letter closing the estate;

b. The final disposition of a claim resolving the estate tax due;

c. A settlement agreement with the IRS;

d. A court decree or judgment resolving the liability; or

e. At the expiration of the statute of limitations for the estate tax.

C. **Income Tax Filing Requirements Under the Section 645 Election.** Once an election is made, the qualified trust is treated as part of the decedent's estate during the estate administration. According to Treasury Regulations Section 1.645-1(e)(2)(i), the election allows the executor to combine the income earned from the estate and the trust into one return. Generally, the executor or trustee (if the estate has no executor) files a Form 1041 for each taxable year of estate administration. Treas. Reg. Section 1.645-1(e)(2)(ii).

If a trust has made or is making the Section 645 election, the trustee is not required to file a Form 1041 for the trust in the short taxable year that begins with the decedent's death and ends on December 31 of that year. Treas. Regs. Section 1.645-1(d)(2)(i). However, if the executor and trustee are uncertain as to whether the trust will make a Section 645 election, the trustee is then required to file a Form 1041 for the short taxable year. Treas. Reg. Section 1.645-1(d)(2)(i)(A). If the trust later makes a Section 645 election after the return for the short taxable year has been filed, the trustee is required to file an amended Form 1041 showing that the Section 645 election has been made. Treas. Reg. Section 1.645-1(d)(2)(i)(B).

D. **Reasons to Use the Section 645 Election.** A decedent's trust and estate that have made a Section 645 election may receive a number of tax benefits, including:

1. The ability of an estate to choose fiscal year income tax reporting under Code Section 644 (whereas a revocable living trust must utilize a calendar year for reporting income after the grantor's death),

2. The avoidance of the trust's need to make estimated tax payments for two years after the decedent's death (estates are not required to make estimated income tax payments),

3. The use of the $600 personal exemption that is available to an estate, rather than either a $300 or $100 exemption available to trusts (depending on whether the trust is a simple or complex trust),

4. The ability of the trust to hold S corporation stock for the duration of the administration of the estate without meeting special trust rules, instead of being limited to two years by Section 1361, (estate exception applies for the reasonable period of estate administration),

5. The deduction of the decedent's medical expenses that are paid out of the estate within one year after date of death,

6. The ability to obtain a charitable deduction for amounts permanently set aside for an ultimate distribution to charity (under Code Section 642(c)(2)),

7. The allowance of certain losses for income tax purposes (e.g., losses resulting from the funding of pecuniary bequests under Code Section 267(b)(13)),

8. The avoidance of the passive loss active participation requirement under Code Section 469 for rental real estate for two years after death,

9. The reduction in the number of tax returns prepared and filed, and

10. The deferral of the payment of income tax on income earned after the date of death until the due date of the estate's fiduciary return (which could result in up to eleven months of additional deferral).

IV. ALLOCATION OF THE GST EXEMPTION.

The Generation Skipping Transfer (GST) Tax is a tax on gifts to skip persons. A "skip person" is a natural person assigned to a generation that is two or more generations below that of the transferor. Also, a trust is treated as a skip person if it is a trust in which (i) all of the interests are held by skip persons (i.e., a gift to a trust of which the only beneficiaries are grandchildren and/or more remote descendants of the trust's "transferor") or (ii) there is no person holding an interest in the trust (as defined in Code Section 2652(c)) and at no future time after the transfer could a distribution (including a distribution upon termination of the trust) be made to a non-skip person. Code Section 2613.

A. <u>GST Exemption</u>. For the year 2015, each individual is allowed a GST exemption of $5,430,000. The individual may allocate his or her exemption to the transfer of any property (during lifetime or at death) with respect to which he or she is the "transferor." An individual's GST exemption may be allocated at any time on or before the due date (including extensions actually granted) for filing the estate tax return for his or her estate. An allocation, once made, is irrevocable.

Once the GST exemption has been allocated to property transferred in trust, the property (and all income and appreciation with respect to the property after the effective date of the allocation) is exempted from the generation-skipping transfer tax (except that property transferred from a trust could ultimately be subject to GST again when the recipient transfers it, either outright or in trust). For example, if a parent forms a trust and transfers property to that trust with a gift tax value of $30,000 and effectively allocates $30,000 of his GST exemption to that transfer, then the trust (and all of the income and appreciation of the trust assets that accrues thereafter) will be exempt from the generation-skipping transfer tax. Thus, when the child dies and his interest in that trust passes to his children (a taxable termination), the fact that the trust is exempt from the generation-skipping transfer tax will cause there to be no tax due at the time of that otherwise taxable generation-skipping transfer.

1. <u>Inclusion of Trust Assets in Child's Estate</u>. Parents often use lifetime trusts for children to provide creditor protection, divorce protection, and spendthrift protection. In the case where a trustor has placed assets into a trust for the benefit of the child (with grandchildren as remainder beneficiaries) and the child dies before all trust assets have been distributed, the remaining trust assets would be subject to the GST Tax. This tax would be imposed at a flat 40% rate on the fair market value of the trust's assets. With careful planning, the GST Tax may be avoided by instead subjecting the assets to the estate tax in the child's estate. This method of planning provides the child with an opportunity to reduce or eliminate the applicable tax. For example, the trust assets could potentially be shielded from some or all of the estate taxes by the child's own estate tax exemption amount). To include the trust assets in the child's estate, a limited General Power of Appointment (GPOA) (e.g., among the child's descendants and one creditor of the child) is given to the child, exercisable with regard to such child's trust assets. (A broad GPOA can upset the decedent's distribution plan and is therefore not provided in all cases.) As such, the GST Tax that would otherwise be due is avoided and the affected assets are instead included in the deceased child's own estate and subject to estate tax at that time.

B. Automatic Allocations during Life.

With the passage of the 2001 Tax Act, gifts made to skip persons are automatically allocated GST exemption unless the Transferor opts out of these automatic allocations.

1. **Deemed Allocation – Direct Skip**. Code Section 2632(b) has long provided for an automatic allocation of GST exemption to a Direct Skip transfer made by an individual during her lifetime. A Direct Skip is a transfer subject to the gift or estate tax to a skip person. Code Section 2612. If an individual makes a Direct Skip transfer during a year and fails to allocate any (or allocates an insufficient amount) GST exemption to that gift on a timely filed gift tax return for that year, then there will be an automatic allocation of a sufficient amount of the individual's unused GST exemption to the extent necessary to fully exempt the property from the generation-skipping transfer tax. Just like an actual allocation of GST exemption on the gift tax return, the automatic allocation is effective as of the date of the transfer and thus allocates an amount of exemption up to the fair market value of the gift assets as of the date of the transfer and no more. The automatic allocation occurs and becomes irrevocable once the due date (including extensions actually granted) for the gift tax return passes.

The individual may elect to not have the automatic allocation of GST exemption apply to a Direct Skip transfer (i.e., election out of Code Section 2632(b)). This election is made on a timely filed gift tax return by describing the transfer and stating the extent to which the automatic allocation is not to apply. The election out of Code Section 2632(b) is irrevocable after the due date (including extensions granted) of the gift tax return. Reporting the Direct Skip on a timely filed Form 709 and paying the GST tax due on the Direct Skip qualifies as such a statement.

> **Example**: On August 15, 2015, Grandparent gifts $14,000 in trust to grandchild for life with remainder to charity. A gift tax return reporting other gifts is filed for grandparent on the due date of April 15, 2016, but that return does not report the gift to trust for grandchild and no GST exemption is allocated to the gift. Grandparent has her full $5,430,000 GST exemption remaining. Pursuant to the deemed allocation rules of Code Section 2632(b), $14,000 of grandparent's GST exemption is automatically allocated to the August 15, 2015, Direct Skip gift to the grandchild (wholly exempting that gift from the generation-skipping transfer tax). As of April 16, 2016, the automatic allocation of GST exemption is irrevocable.

2. Deemed Allocation – Other Transfers. By their nature, Direct Skip transfers trigger an immediate generation-skipping transfer tax due on or before the due date for filing a gift tax return for the year in which the transfer is made. It is for this reason that the Congress felt comfortable at the early stages of the generation-skipping transfer tax in providing a "safety net" for those individuals who fail to properly allocate GST exemption on a timely filed return and, thus, do not fully exempt the transfer from the tax. This safety net operates by allocating GST exemption for those individuals through the deemed allocation rules of Code Section 2632(b). If, for some reason, the individual did not want that allocation (i.e., wanted to pay the generation-skipping transfer tax), then he or she could elect out of the allocation on a timely filed gift tax return. Congress did not initially see a need to provide such a safety net with respect to other transfers (i.e., those that did not trigger an immediate generation-skipping transfer tax, but could trigger such tax in the future). However, by the year 2001, the perception (and reality) was that there existed a substantial number of cases in which transfers that should have received an allocation of GST exemption had received either an insufficient allocation or none at all. Thus, the 2001 Tax Act introduced Code Section 2632(c) to provide for a deemed allocation of GST exemption to certain lifetime transfers to trusts.

3. **Deemed Allocation – Indirect Skip**. Code Section 2632(c) provides that there will be an automatic allocation of an individual's GST exemption to each gift that qualifies as an Indirect Skip. For this purpose, an Indirect Skip is a transfer of property (other than a Direct Skip), subject to the gift tax, to a trust that could have a generation-skipping transfer with respect to the transferor, unless the trust qualifies under one of the six exceptions provided in Code Section 2632(c)(3)(B). The purpose of the six exceptions is to prohibit the automatic allocation of GST exemption to trust arrangements that, though they could trigger a generation-skipping transfer tax, are structured so that they are not expected to incur such a tax. For example, exceptions are provided for (though the following are not the only situations subject to an exception):

a. A trust that requires that more than 25% of the trust principal be distributed to a non-skip person before that person reaches the age of 46 – Code Section 2632(c)(3)(B)(i);

b. A trust that requires that more than 25% of the principal be distributed to a non-skip person if that person is living on the date of death of another individual identified in the instrument who is more than 10 years older than such person (e.g., trust property is to pass outright to a child of the donor if such child is living upon the death of the donor/parent) – Code Section 2632(c)(3)(B)(ii); and

c. A trust that is structured so that any portion of the principal would be included in the gross estate of a non-skip person (other than the transferor) if that person died immediately after the transfer (e.g., a non-exempt trust that is structured to last for the lifetime of a child of the donor/parent, with that child granted a general power of appointment exercisable under his Will that causes the trust estate to be taxable in his or her estate) – Code Section 2632(c)(3)(B)(iv).

Code Section 2632(c)(5) provides for three elections:

a. An election to have Code Section 2632(c) not apply to an otherwise subject transfer. To be effective, this election must be filed on a timely filed gift tax return for the calendar year in which the transfer was made.

b. An election to have Code Section 2632(c) not apply to any or all transfers made to a specific trust. This election will be timely if made on a timely filed gift tax return for the calendar year for which the election is to become effective.

c. An election to subject any or all transfers made to a specific trust to the automatic allocation rule of Code Section 2632(c). This election is made on a timely filed gift tax return for the calendar year for which the election is to become effective.

> **<u>Example</u>**: Parent gifts $14,000 to a trust for child, with the trust to last for the child's lifetime and then pass to her children. The gift qualifies for the Annual Gift Tax Exclusion and does not have to be reported for gift tax purposes. However, the preparer's duties do not stop there. There is an intentional Taxable Termination that will trigger a generation-skipping transfer tax at the death of the child, so it is intended that the gift be allocated GST exemption to fully exempt it from that tax. Prior to the deemed allocation rules of Section 2632(c), a common mistake was to neither report the gift on the Form 709 nor allocate to the trust $14,000 of GST exemption (most likely because reporting was not required for gift tax purposes or a mistaken belief that Annual Exclusion gifts were also exempted from the generation-skipping transfer tax). As a result, the trust would be subject to the imposition of the generation-skipping transfer tax upon the death of the child. Under the rules of Code Section 2632(c), if no Form 709 is filed, there will be an automatic allocation of $14,000 to the trust, thus protecting it from GST exposure.

> **<u>Example</u>**: Assume the same facts as the preceding example, except that the gift is $15,000. In this case, the Annual Exclusion shelters only $14,000 from the gift tax and there is a $1,000 taxable gift. Another mistake is a tendency at this point to allocate only $1,000 of GST exemption to the gift. This fails to recognize that the $14,000 Annual Exclusion is a gift tax function and does not apply in the generation-skipping transfer tax context. An allocation of only $1,000 of GST exemption in this case causes 1/15th of the trust to be exempt, with the remaining 14/15^{ths} subject to the tax (an undesirable outcome). The proper action is to allocate enough GST exemption to cover the total value of the gift to the trust ($15,000 in this case). Again, the deemed allocation rules would correct this error and avoid the generation-skipping tax exposure for the trust by providing an automatic allocation of the $15,000 of GST exemption needed to fully exempt the trust.

C. <u>Allocation of Decedent's Unused GST Exemption with a Form 706</u>. The decedent's executor may allocate any unused GST Exemption by timely filing a Form 706 on or before the Form's due date (nine (9) months after the decedent's date of death). Form 706, however, is **not required to be filed** in order for the decedent's unused GST Exemption to be allocated. Section 26.2642-1(d)(2) of the Treasury Regulations provides for the automatic allocation of the decedent's unused GST exemption. Such allocations occur pro rata on the basis of value, first to direct skips that are treated as occurring after the date of death, then to the nonexempt portion of trusts for which a taxable termination may occur. A taxable termination is a generation-skipping transfer that occurs when there is a termination of an interest in a trust that does not result in trust property being subject to estate or gift tax and after which (a) all of the property is held either outright or in trust by skip persons (e.g., a parent places property in trust for the benefit of a child for life and then upon the child's death the property passes to a grandchild – a taxable termination occurs upon the death of the child) or (b) no person holds an interest in the trust and there is less than a 5% likelihood that a distribution to a non-skip person will ever occur. See Code Section 2612(a) and Treas. Regs. Section 26.2612-1(d)(2).

V. HOW TO PROCEED WHEN GST EXEMPTION WAS NOT ALLOCATED.

A. <u>What situations require GST exemption allocations</u>? The deemed allocation rules under Section 2632(c) apply to transfers subject to the gift or estate tax made after December 31, 2000, and to estate tax inclusion periods ending after December 31, 2000. Thus, the Code Section 2632(c) "safety net" does not apply to gift transfers made prior to January 1, 2001 and as such, the GST exemption may not have been allocated for such gift transfers. Other examples in which GST exemption may need to be allocated include:

1. A trust created after January 1, 2001 that is not eligible for automatic allocation;

2. A client intentionally did not allocated GST exemption for a transfer;

3. A trust created after January 1, 2001, elected out of deemed allocations; or

4. Changing circumstances where the allocation of the GST exemption becomes appropriate. For example:

    a. A client owns an ILIT where the proceeds are to be applied to the family business. Circumstances changed, however, and the business is sold.

    b. A Trustor created a trust for his or her child until the child turned 50 years old. However, the child died at age 45 and the trust assets are distributed to the Trustor's grandchildren.

    c. A grandfathered GST exempt trust loses its status by gift or otherwise.

Bottom Line: A trust that is wholly or partially subject to GST Tax will need to be allocated the client's unused GST exemption to avoid the GST Tax. The Code provides four methods to resolve the problem of unallocated GST exemption, including (1) retroactive allocations, (2) qualified severance, (3) late allocations, and (4) true late allocations.

B. <u>Retroactive Allocations</u>. Code Section 2632(d) allows a late allocation of GST exemption for a specific type of trust arrangement that, though it is not intended to result in a generation-skipping transfer, can operate to skip a generation in the event there is an unnatural order of deaths (e.g., a child predeceases a parent).

Specifically, Code Section 2632(d) provides that (1) if a non-skip person has an interest in a trust, is a lineal descendant of a grandparent of the transferor (or of a grandparent of the transferor's spouse or former spouse), is a member of a generation below the transferor, and predeceases the transferor, (2) then the transferor may allocate his or her unused GST exemption to previous transfers he or she has made to the trust. The transferor only has to allocate an amount of GST exemption equal to the Fair Market Value of the gift on the date of the transfer.

If the allocation is made on a gift tax return filed on or before the due date for gifts made within the calendar year in which the non-skip person dies, then:

1. The amount of the exemption that will need to be allocated to fully exempt each gift to the trust from the generation-skipping transfer tax will be the value of the gift as of the date it is transferred to the trust (i.e., the allocation is treated as if made on a timely filed gift tax return with respect to the gift);

2. The allocation is effective immediately before the death of the non-skip person, so that the trust is fully exempted from the generation-skipping transfer tax at the time of the death; and

3. The unused portion of the transferor's GST exemption is determined at the point immediately before such death.

> **Example**: Parent transfers $100,000 cash in trust for child in 2003 when the child is age thirty-two. Child is to receive distributions of income and principal, subject to the Trustee's discretion, until the child reaches the age of 60, at which time the trust is to terminate and the property is to be distributed outright to the child. In the event the child should die prior to reaching age 60, then the trust property is to be retained in trust for the benefit of his children. The trust arrangement is not designed to, or expected to, cause the trust property to pass to the transferor's grandchildren; however, due to the death of the child prior to age 60, at the time of his death a taxable termination occurs as the trust property passes to trust for his children. The parent allocated no GST exemption to the trust and elected out of an automatic allocation under Section 2632(c), but, assuming the parent survives the child and has sufficient unused GST exemption, the parent can avoid having the trust suffer a generation-skipping transfer tax by making a Code Section 2632(d) retroactive allocation of GST exemption to the trust. If the allocation is made on a gift tax return filed on or before the due date for gifts made in the year in which the child dies, the amount of GST exemption necessary to fully exempt the trust from the tax will be an amount equal to $100,000, the value of the gift to the trust as of the date such gift was made (thus avoiding the normal "late allocation" rules that would require an amount of GST exemption equal to the value of the property on the date that the return is filed).

C. Qualified Severance. A qualified severance is a GST fix. Essentially, it is the process of dividing a single trust with an inclusion ratio greater than zero but less than one into two separate trusts with the same succession of interests and beneficiaries, except that one trust has a GST inclusion ratio of one and the other has a GST inclusion ratio of zero. Code Section 2642(a)(3). A qualified severance may be made at any time (Code Section 2642(a)(3)(C)), but the return and Notice of Qualified Severance should be filed by April 15th of the year immediately following the year in which the severance occurred or by the last day of the period covered by an extension. Code Section 2642(e). A qualified severance should be reported by filing a Form 706-GS(T), or any subsequent form specified by the IRS. The filer should write "Qualified Severance" at the top of the return and attach a Notice of Qualified Severance to the return that clearly identifies the trust that is being severed and the new trusts created as a result of the severance. The Notice is required to include the inclusion ratio of the trust that was severed, the inclusion ratios of the new trusts resulting from the severance, and certain other information such as the name of the transferor, the name and date of creation of the original trust, the tax identification number of the original trust and the new trust, the date of severance, the fraction of assets received by the new trust, and the details related to the basis for funding the new trust. Treas. Reg. Section 26.2642-6(e).

In order for a division of a trust into two separate trusts to be a "qualified severance" for transfer tax purposes, the following conditions must be met. Code Section 2642(a)(3)(B).

1. The division must be accomplished in accordance with the terms of the trust agreement or local law. Texas Trust Code Section 112.057 allows a trustee to divide a trust into two or more separate trusts.

2. The trust must be divided on a fractional basis. This does not require that each trust receive a fractional share of each asset. Similar to the funding of testamentary trusts from an estate, a non-pro rata division of assets is allowed so long as the funding is based on the fair market value of the assets on the date of severance. Treas. Regs. Section 26.2642-6(d)(4).

3. The terms of the new trusts must, in the aggregate, provide for the same succession of interests of beneficiaries as provided in the original trust. For generation-skipping planning, a qualified severance is used to divide a partially exempt trust into two separate trusts, one that is exempt from the GST tax and one that is not exempt. Further, for tax reasons, the terms of those separate trusts will often be different. There are two ways to justify the differing terms for these trusts. First, Treasury Regulations Section 26.2642-6(d)(5) discusses criteria for satisfying the succession of interest requirement. Second, other provisions of the original trust agreement may support the differences in the trusts' terms. For example, the power of a trust protector/special trustee to grant a general power of appointment to a beneficiary could support allowing the beneficiaries of the nonexempt trust to have a testamentary general power of appointment and the beneficiaries of the exempt trust to not have that power.

D. Late Allocation of GST Exemption. Section 2642(g)(1) of the 2001 Tax Act allows a taxpayer to request an extension of time to make a timely "late allocation" of GST exemption. The Section further directs the Secretary to identify circumstances and procedures through which extensions of time will be granted to make an allocation of GST exemption, elect out of an automatic allocation of GST exemption to a Direct Skip transfer, and elect in or out of the Code Section 2632(c) automatic allocations with respect to transfers to trusts (that are not Direct Skips). This discretion is to be exercised after considering all relevant circumstances, including evidence of intent contained in the trust agreement.

If it is believed that the requirements to achieve a late allocation are satisfied, the request is made by filing a Private Letter Ruling request or by using the simplified procedure outlined in Revenue Procedure 2004-46.

1. **<u>Notice 2001-50</u>**. The IRS issued Notice 2001-50, 2001-2 CB 189, 8/02/2001, *modified by*, Revenue Procedure 2004-46, 2004-31 I.R.B. 142, in response to its direction in Code Section 2642(g)(1) to provide guidance with respect to relief from late allocations of GST exemption. That Notice establishes that:

> **a.** A taxpayer is to follow the provisions of Treasury Regulations Section 301.9100-3 of the Procedure and Administration Regulations in seeking an extension of time to make an allocation of GST exemption, an election under Code Section 2632(b)(3) [election out of the automatic allocation to Direct Skip], or an election under Code Section 2632(c)(5) [election out of the automatic allocation to other transfers to trust].
>
> **b.** Generally, relief will be granted under that Treasury Regulations Section 301.9100-3 if the taxpayer can show that he or she acted reasonably and in good faith, and that such relief would not prejudice the interests of the government.
>
> **c.** The taxpayer's request should follow the procedures for requesting a private letter ruling under Treasury Regulations Section 301.9100 (contained in Section 5.02 of Revenue Procedure 2001-1 (or its successor), 2001-1 I.R.B. 1, 28).
>
> **d.** The Notice is effective as to requests pending on, or filed after, December 31, 2000.

2. **<u>Revenue Procedure 2004-46</u>.** Revenue Procedure 2004-46 outlines the simplified procedure for requesting an extension of time for a late allocation. To use the simplified procedure, the following requirements must be met:

a. The gift was made prior to December 31, 2000,

b. The transfer is covered by the Annual Gift Tax Exclusion under Section 2503(b),

b. The transfer involves a trust where no taxable distributions or taxable terminations have occurred,

c. No GST exemption was allocated to the transfer, and

d. The taxpayer has unused GST exemption available.

If the above requirements are met, the taxpayer <u>may request an extension of time</u> by complying with the following procedure:

a. File Form 709 for the year of the transfer. At the top of the Form, the following statement must be included: "FILED PURSUANT TO REV. PROC. 2004-46;"

b. Include the value of the transfer as of the date of the transfer on the Form 709; and

c. Allocate GST exemption to the trust by attaching a statement titled "Notice of Allocation" containing the following information:

i. Identification of the trust,

ii. Value of the property transferred as of the transfer date,

iii. The taxpayer's unused GST exemption amount as of the transfer date,

iv. Amount of GST allocated to the transfer,

v. Inclusion ratio of the trust after the transfer, and

vi. Statement that the requirements of Rev. Proc. 2004-46 have been met.

If the extension is granted, the allocation would then constitute a timely allocation so that the GST exemption requested equals the fair market value as of the date of the transfer. Code Section 2642(g)(1).

3. <u>Proposed Regulation Section 26.2642-7</u>. In response to Code Section 2642 (g)(1), the IRS issued Proposed Treasury Regulations Section 26.2642-7 on April 17, 2008. These proposed regulations have not been finalized. Pursuant to the proposed regulations, a request to file a late allocation is achieved through filing a private letter ruling. The request will be granted if (1) the taxpayer acted reasonably and in good faith, and (2) there will be no prejudice to the interests of the government in granting the extension.

a. <u>Reasonably and in Good Faith Factors</u>. According to Proposed Treasury Regulations Section 26.2642-7(d)(2), factors that the IRS will consider in determining if the transferor/executor acted reasonably and in good faith include (but are not limited to): (1) the transferor's or executor's intent to make a timely allocation or election as evidenced by the trust or transfer instrument or contemporaneous documents; (2) the occurrence of intervening events beyond the transferor's or executor's control that caused the failure to allocate GST exemption to a transfer or make an election under Code Section 2632(b)(3) or Code Section 2632(c)(5); (3) the transferor's or executor's lack of awareness of the need to allocate or make the election after exercising reasonable diligence (taking into account the transferor's or executor's experience and the complexity of the GST tax issue); (4) evidence of the transferor's consistency in making or not making the allocation or election; and (5) the transferor's or executor's reasonable reliance on a qualified tax professional's advice.

This last factor ("reliance on a qualified tax professional's advice") is the most frequently used factor, but requires the return preparer to admit that a mistake was made.

b. <u>Factors indicative of whether the Government's interests would be prejudiced</u>. Pursuant to Proposed Regulation Section 26.2642-7(d)(3), factors (nonexclusive) indicative of whether the Government's interests would be prejudiced include whether: (1) granting relief will permit the use of hindsight to produce an economic advantage or other benefit that would not have been available if the allocation or election had been timely made; (2) the transferor or executor delayed filing the request for relief to deprive the IRS of sufficient time to challenge certain issues; and (3) granting relief would be unreasonably disruptive or difficult because a taxable termination or distribution occurred between the time for making the timely allocation or election and the time of the request for relief.

Bottom line: The "no prejudice to the government" requirement will be met if the taxpayer (Transferor/Transferee) can show that he is not attempting to achieve a benefit in hindsight, but rather, is trying to achieve the original tax result.

4. <u>Substantial Compliance</u>. Code Section 2642(g)(2) addresses the case in which there was an allocation of GST exemption that was ineffective to fully exempt the transfer from the generation-skipping transfer tax. Under that Section, if there was substantial compliance with the rules for allocating GST exemption, then there is a deemed allocation of the transferor's unused GST exemption to the extent necessary to fully exempt (or exempt to the greatest extent possible) such transfer from the tax. Again, all relevant circumstances are to be considered in determining whether "substantial compliance" is present, including evidence of intent contained in the trust agreement.

The relief available under Code Section 2642(g)(2) applies to transfers subject to the estate or gift tax made after December 31, 2000. For pre-December 31, 2000 transfers where the IRS has granted relief from ineffective allocations of GST exemption on "substantial compliance" grounds, see PLR 200017013 and PLR 199919027.

5. <u>Late Allocation without an Extension of Time</u>. If the late allocation does not meet the requirements for an extension of time, and is therefore, not granted the extension, the allocation may still be made. However, the effective date for the allocation will not be the effective date of the transfer. Instead, the effective date is the date of allocation, which occurs on the date of filing the Form 709. To address the difficulty in determining the fair market value of an asset on the date a Form 709 is filed, Treasury Regulations Section 26.2642-2(a)(2) provides that for determining the fair market value of the property, the taxpayer may elect to treat the allocation as having been made on the first day of the month in which the Form 709 is filed.

E. <u>True Late Allocation</u>. A true late allocation may be appropriate in instances where (1) the extension request for an allocation of GST exemption for a lifetime transfer was denied or (2) when the decision was made to not request an extension and the taxpayer has GST exemption remaining. A true late allocation may allocate any of the taxpayer's unused GST exemption and must be filed by the due date (with extensions) for filing the transferor's Form 706. To fully GST exempt a trust, the allocation of the GST exemption must equal the fair market value of the nonexempt trust assets as of the date of the allocation. For late allocations of lifetime transfers, the allocation equals the fair market value of the transfer as of the date of allocation (the date the Form is filed). Similar to the late allocations for lifetime transfers on the Form 709, the taxpayer may elect to treat the allocation as having been made on the first day of the month in which the Form 706 is filed. Treas. Regs. Section 26.2632-1(d)(1). For allocations of GST exemption for property included in a decedent's gross estate, the effective date of allocation is the date of the decedent's death.

> **Example:** In 1997, Taxpayer gifted $1,500,000 to a trust for his grandchildren and did not realize the need to affirmatively allocate his GST exemption to the transfer. At the time of the gift, the GST exemption was $1,000,000 and Taxpayer had not used any of his exemption. Taxpayer died on July 31, 2015. Provided the transfer meets the above requirements and the executor follows procedure of Rev. Proc. 2004-46, Taxpayer is allowed to allocate all of his GST exemption ($1,000,000) to the exempt trust (the value of the gift on the date of the transfer and the amount of his GST exemption as of the date of the transfer), and $500,000 to the nonexempt trust. The executor of the Taxpayer's estate may properly allocate Taxpayer's GST exemption to the gift to the trust by filing Form 709 by April 30, 2016.

VI. MAKING THE S ELECTION.

An S corporation is "a small business corporation" that has taken a Section 1362 election (the "S election"). A small business corporation has strict ownership requirements, including: (1) the corporation must have no more than 100 shareholders, (2) the corporation must have only one class of stock, (3) all shareholders must be persons that are not eligible shareholders, and (4) no shareholder may be a nonresident alien. Code Section 1361. A violation of any one of these requirements will cause the corporation's S election to terminate. Code Section 1361(a).

A. Eligible shareholders. The shareholders of a small business corporation are limited to the following:

1. Individuals,
2. Estates, as long as reasonable measures are taken to administer the estate, and
3. The following trusts:
   a. Grantor trust,
   b. Grantor trust after the death of the grantor,
   c. Testamentary Trust, and
   d. Ineligible trusts that make a proper QSST or ESBT election.

The estate is deemed to be the owner of a grantor trust in which the grantor has died, and of a testamentary trust that has received shares from the will of the decedent. The estate may hold the stock for two years, from the date of the receipt of the stock, plus an additional two (2) months and sixteen (16) days from the expiration of the previous two year period. Upon the expiration of this time period, the trust becomes an ineligible trust. As such, an ESBT or a QSST election must be made prior to the expiration of the two (2) years, two (2) months, and sixteen (16) days. Treas. Reg. Section 1.1361-1(j)(6)(iii).

Trusts are not generally considered eligible shareholders, other than the above exceptions. Ineligible trusts, such as a non-grantor dynasty trust for heirs, can become eligible shareholders by making an Electing Small Business Trust (ESBT) or a Qualified Subchapter S Trust (QSST) election. The trustee of the ineligible trust must make the ESBT election. Conversely, the trust beneficiaries must make the QSST election. Such elections must be made within two (2) months and sixteen (16) days of acquisition of the S corporation shares. Treas. Reg. Section 1.1361-1(j)(6)(iii).

Furthermore, the ownership of stock by a foreign trust also terminates an S election. Treas. Reg. Section 1.1361-1(h)(2). A trust is classified as a foreign trust when a non-resident alien is named as a fiduciary of a trust, even if all assets and remaining fiduciaries of the trust are located within the United States. Code Section 7701(a)(31)(B). This provision is a trap for the unwary that many tax practitioners could easily overlook.

B. Income Tax Picture. The S election can be critical to a client's income tax picture. Because of the strict ownership requirements of S corporations, The receipt of S corporation stock by an unqualified person will cause the corporation to lose its S election and the corporation will then be treated as a C corporation for tax purposes. As such, the continued viability of the S election is put at risk each time the stock changes owners, especially to trusts.

> **Example**: Carrie Client makes a gift of assets (including S corporation stock) to a non-grantor dynasty trust for her children and grandchildren. The assets are transferred to the trust on December 31, 2015. The Trust is not an eligible S corporation shareholder. Thus, an ESBT or QSST election must be filed for the trust by March 15, 2016, to prevent the termination of the S election and the taxation of the corporation as a C corporation.

C. Inadvertent Termination. A corporation will cease operating as an S corporation and be treated as a C corporation if any of the following occur:

1. More than one-half of the shares consent to revocation of the S election;
2. The corporation ceases to be a small business corporation;
3. The corporation has earnings and profits for three (3) consecutive years, and more than twenty-five percent (25%) of the corporation's income is passive investment income.

Code Section 1362(d)(2). Upon termination of the S election, the corporation must wait at least five years after terminating the S election before the shareholders can again elect to be an S corporation. Code Section 1362(g).

Terminations can be forgiven by the IRS in circumstances where the IRS determines that the termination was inadvertent, the disqualifying event is corrected within a reasonable period of time, and the shareholders agree to be treated as an S corporation during the time period in which the S election was terminated. Code Section 1362(f).

However, there is a savings opportunity for an inadvertent termination. Terminations can be forgiven by the IRS in circumstances where the IRS determines that the termination was inadvertent, the disqualifying event is corrected within a reasonable period of time, and the shareholders agree to be treated as an S corporation during the time period in which the S election was terminated. Code Section 1362(f).

VII. FINISH THE PLANNING—IMPLEMENTATION.

Any time that S corporation stock changes owners, there is a risk that the S election will terminate if the ownership is not properly transferred or if it is transferred to an ineligible shareholder. Thus, when an individual's estate plan includes the transfer or change of ownership for S corporation stock, it is important to ensure that the corporation's S election is secure.

A. <u>Gift Plan—Trap</u>. As mentioned in the previous section, a non-grantor trust is an ineligible S corporation shareholder, and the transfer of S corporation stock to such trust will terminate the S election if a QSST or ESBT election is not made within two (2) months and sixteen (16) days of the trust's receipt of the S corporation stock. Therefore, it is important to ensure that the election is properly made. A common trap for many practitioners is the failure to make a proper ESBT or QSST election. As a reminder, a proper ESBT election is made by the trust's trustee. Conversely, a proper QSST election is made by the trust's beneficiaries.

B. <u>Drafting.</u> In order for beneficiaries to make a QSST election, the trust agreement must be properly drafted to provide for a separate trust to hold the S stock. The separate trust must contain the requirements for a QSST outlined in Section 1.1361-1 of the Treasury Regulations, including:

1. The trust has only one income beneficiary during the life of the current income beneficiary.

2. The sole income beneficiary is the only recipient of the trust corpus during the life of the current income beneficiary.

3. The interest of the current income beneficiary will terminate upon the earlier of the termination of the trust or that beneficiary's death.

4. The Trust distributes all of its assets to the current income beneficiary if such trust terminates during the life of that beneficiary.

Treas. Reg. 1.1361-1(j)(ii). The terms of the trust must be clearly stated to preclude any other possibility from occurring that may be contrary to the QSST qualification requirements. Treas. Reg. 1.1361-1(j)(1)(iii). In addition, the trust and the beneficiary of the trust must meet the shareholder requirements of the "Small Business Corporation." As such, the trust cannot be a foreign trust (i.e., no fiduciary of the trust may be a foreign citizen) and the beneficiary must be a resident or citizen of the United States. Treas. Reg. 1.1361-1(j)(1)(i).

The requirements for an ESBT are less stringent than for a QSST. However, all of the trust's income related to S corporation stock is taxed at the highest marginal tax rate for the trust. To become an ESBT, the beneficiaries of the trust must be eligible shareholders of an S corporation, such beneficiaries must hold a contingent interest in the trust and not be potential current beneficiaries, the beneficiary's interest in the trust must not have been purchased, and the trustee of the trust must make a timely filed ESBT election. Treas. Reg. 1.1361-1(m).

C. **Estate owns S stock.** As mentioned above, a decedent's estate will be the deemed owner of S corporation stock in two situations: upon the death of the grantor of a grantor trust holding S corporation stock, and upon the funding of a testamentary trust with S corporation stock. Treas. Reg. 1.1361-1. Upon the receipt of the stock (either at the grantor's death for the grantor trust, or upon the transfer to the testamentary trust), the estate has a two year grace period in which the trust holding the S corporation stock is deemed as an eligible shareholder. Upon the expiration of the two year period, the trust becomes an ineligible shareholder unless an ESBT or QSST election is timely made. A QSST election can only be made by the current income beneficiary of the trust. Treas. Reg. 1.1361-1(j)(6)(ii). Therefore, it is important to ensure that testamentary trust and the former grantor trust meet the requirements of a QSST and that the current income beneficiary's make the election within 2 months and sixteen days after the receipt of the S corporation stock. Treas. Reg. 1.1361-1(j)(6)(iii).

D. **QTIP Trust.** A QTIP trust inherently qualifies as a QSST, as this form of trust meets all of the requirements to qualify as a QSST. Namely, a QTIP trust has only one income beneficiary (the surviving spouse), and such beneficiary receives distributions of all of the annual income and is entitled to the trust corpus during the surviving spouse's life. Although the QTIP trust meets the requirements of a QSST, the income beneficiary (surviving spouse) must still make the QSST election to prevent the trust from being an ineligible shareholder. The QSST election must be made within two (2) months and sixteen (16) days of the receipt of the S corporation stock. Treas. Reg. Section 1.1361-1(j)(6)(iv).

E. **Beneficiary Trustee.** A common practice in estate planning is to allow the beneficiary of a dynasty trust to also serve as the trustee of his or her respective trust. This practice, however, could trigger the beneficiary to have a general power of appointment. A GPOA is triggered when the beneficiary trustee has the authority in the trust agreement to make the ESBT or QSST election. A GPOA can disrupt the decedent's distribution plan and cause the assets to become subject to the beneficiary's estate tax. If the trust agreement provides for a special trustee to make the ESBT or QSST election, the GPOA will not be triggered and the decedent's distribution plan will be preserved.

VIII. PROPOSED REGULATIONS FOR SECTION 2704.

Family limited partnerships are often used as an estate planning tool to reduce estate and gift taxes for high net worth clients. Courts have routinely recognized valuation discounts for lack of marketability and lack of control in limited partnership interests. As such, assets in these closely-held entities are often discounted to a value that is below the actual value of the assets. Code Section 2704(b) places a limitation on the discounts available to closely-held entities whose interests are transferred to family members.

A. <u>Section 2704(b)</u>. Internal Revenue Code Section 2704(b) states that if a corporation or partnership interest is transferred to a member of the transferor's family *and* the transferor and family hold control of the entity immediately before the transfer, then any "applicable restriction" is disregarded when determining the fair market value of the assets. An applicable restriction is a restriction, in excess of any State law restrictions, that limits the ability of the entity to liquidate, and lapses after the transfer or can be removed by a family member. Code Section 2704(b). The applicable restriction does not include any commercially reasonable restriction on liquidation imposed by an unrelated party that supplied capital for an entity's trade or business operations. Treas. Reg. 25.2704-2.

In addition to the applicable restrictions above, 2704 gives the Secretary broad authority to identify other restrictions to be disregarded, as long as such restrictions reduce the transfer tax value and not the value of such entity interest to the transferee. Code Section 2704(b)(4).

B. <u>New Regulations</u>. The initial regulations under Code Section 2704 left open an exception for restrictions on transfers that were imposed under state law. Thus, state legislators were petitioned to pass laws imposing state law restrictions on the transfer of limited partnership interests and those laws were in fact enacted. As a result, the Section 2704 Regulations became moot from a practical standpoint. The new anticipated regulations, however, are expected to address valuation discounts upon the transfer of interests in family owned partnerships and are expected to attempt to avoid existing or potential loopholes to the Section 2704 limits on valuation discounts. Specifically, it is anticipated that the new regulations will contain any and possibly all of the following items:

1. New disregarded restrictions as determined by the Secretary. The interests of closely held businesses transferred to family members will be valued based on assumptions provided by the Secretary, if restrictions on liquidation are more strict than the standards provided in the new regulations.

2. The assignment of a partnership or membership interest in which the assignee becomes a full partner is anticipated to be a new disregarded restriction.

3. As stated above, the ability of a family member to remove a restriction on liquidation is considered an applicable restriction that is disregarded. Under the new regulations, "certain interests (to be identified in regulations) held by

charities or others who are not family members of the transfers would be deemed to be held by the family."

4. The new regulations may provide a safe harbor for taxpayers to draft governing documents of entities in such a way as to meet standards provided for in the Regulations that would avoid the application of Section 2704.

5. New regulations may include a taxpayer friendly provision that provides that a taxpayer may use the greater of the FMV of an interest or its higher value (if) applicable for marital deduction and charitable deduction purposes.

Akers, Steve. "Speculation About Upcoming 2704 Proposed Regulations." (June 2015). The issuance of Section 2704 Regulations is number five on a list of priority action steps for the IRS. Two of the items on that list have been accomplished, including the recent issuance of the portability regulations. Two more items on that list will be issued prior to the issuance of Code Section 2704 Regulations, those items being regulations on charitable remainder trust basis adjustments and regulations on Code Section 2801, addressing the gift tax impact on gifts by ex-patriates to U.S. citizens. This last item, in particular, is very complex and the IRS has been working on these proposed regulations for years. It is anticipated that the Section 2704 Regulations would not come before these other two sets of regulations have been issued and, as such, will not likely be issued until late summer or fall of this year. Akers, Steve. "Speculation About Upcoming 2704 Proposed Regulations." (June 2015).

IX. CONCLUSION.

Many different tools are used to meet the estate planning goals of clients. Along with these tools comes the responsibility of adequately implementing and following through with the requirements for each tool. Just a few of these requirements have been covered above, including the necessity for adequate disclosure of gifts on a gift tax return, the procedure for making a Section 645 election with revocable living trusts, the allocation of GST exemption when an allocation may not have been previously made, and the requirements to maintain an S election for an S corporation, including the intricacies of making an ESBT and QSST election. Finally, new regulations are expected to be issued later this year that could drastically impact the valuation of closely-held entities that transfer interests to family members, a popular tool that is frequently used to help reduce estate taxes for high net worth individuals. It is important to keep these tools and topics in mind so that we can best serve the needs of our clients, both now and in the future.