

# The Will & The Way

**NORTH CAROLINA  
BAR ASSOCIATION**  
seeking liberty + justice

## The Chair's Comments



By Jessica Hardin

It is my great honor to serve as Chair of the Estate Planning and Fiduciary Law Section for the 2020-2021 bar year. I look forward to working with all of you to continue our section's important work. However,

before we look forward to new opportunities, we cannot miss the opportunity to thank those who made last year – and particularly the last few months – so successful.

First, thanks to Tim Jones, who capped off a year of dedicated service by navigating a pandemic. Tim's responsiveness and thoughtful leadership allowed our section to continue essential programs despite constantly changing circumstances.

Most of us spent March and April scrambling to set up remote workspaces, balance family obligations and preserve client service. Tim, Kemp Mosley, Judy Linville and others on the Legislative Committee did all that AND worked tirelessly with various stakeholders to pull together remote notary and remote witness legislation. All of us who now offer clients this contact-free option owe a debt of gratitude to Tim, Kemp, Judy and many others who navigated such uncharted territory.

Caitlin Horne, B.J. Kilgore and the CLE Committee planned a terrific CLE for July... and then did it all again in a matter of weeks when we learned we could not be together in Kiawah. Caitlin and B.J. rearranged the schedule into a single-day virtual event and – with lots of help from the NCBA's Andi Bradford and Coleta Bell – pulled off a flawless event for our section. We so appreciate the program's speakers who

Continued on page 2

## Selecting the Right Philanthropic Vehicle: Private Foundations vs. Donor Advised Funds

By Doug Benson and Whitney Feld

We are facing unprecedented challenges as a result of COVID-19 as the pandemic has impacted virtually every aspect of society. With business closures, historic unemployment and profound stress on the public education system, the community, including many nonprofits, is experiencing tremendous challenges. In response to this crisis, we are also witnessing the American spirit of generosity. With so many individuals of modest and great wealth looking for ways to make a difference, charitable giving is as important as ever.

Private foundations and donor advised funds (DAFs) are two important vehicles often considered by donors looking to create greater structure for their charitable giving. Both enable donors to give strategically over time, while involving family members and creating a lasting legacy. There are a number of important considerations in choosing between a private foundation and DAF. This article examines the questions that frequently arise in comparing these options with the goal of helping you assist your clients in selecting the right vehicle to meet their philanthropic objectives.

### What is a Private Foundation? How is it Created?

Section 501(c)(3) of the Internal Revenue Code (the Code) generally defines two types of charitable organizations: public charities and private foundations. All 501(c)(3) organizations are presumed to be private foundations unless they can demonstrate that they are a public charity. This is generally accomplished through the "public support test" under Section 509(a)(2) of the Code.

Private foundations are generally created and controlled by a small number of people, usually an individual, family or business. They offer donors a great deal of control; however, this control comes with more rules and regulations. The activities of private foundations are typically focused on making charitable grants. A small percentage of private foundations operate their own charitable programs and are classified by the IRS as private operating foundations. Many of the more favorable public charity rules apply to these private operating foundations. Donors interested in creating a private *operating* foundation probably would not be able to accomplish their goals through a private

Continued on page 3

## The Will & The Way

Published by the Estate  
Planning & Fiduciary  
Law Section of the North  
Carolina Bar Association

Section Vol. 40, No. 1  
September 2020

### EDITORS

Heidi E. Royal  
Sara Page H. Waugh

### CHAIR

Jessica M. Hardin

### IMMEDIATE PAST CHAIR

Timothy W. Jones

### VICE-CHAIR

David T. Lewis

### TREASURER

Elinor J. Foy

### SECRETARY

Paula A. Kohut

### SECTION COUNCIL

Ansley C. Cella  
Andrea C. Chomakos  
Stephanie C. Daniel  
Janice L. Davies  
Mark J. Hale Jr.  
Caitlin N. Horne  
Carl L. King  
Mitchell K. Mosley  
Lawrence A. Moyer  
Holly B. Norvell  
Adam L. Shealy  
N. Lucille Siler  
Todd A. Stewart  
Carter B. Webb  
Anna H. Winger

© 2020 North Carolina Bar Association. Views and opinions expressed in articles published herein are the authors' only and are not to be attributed to The Will & the Way, the Estate Planning & Fiduciary Law Section or the NCBA unless expressly stated. Authors are responsible for the accuracy of all citations and quotations. No portion of the publication may be reprinted without permission.

worked through ever changing logistics to share excellent presentations with attendees. Thank you also to the many speakers scheduled to appear in Kiawah who agreed to defer their presentations until next summer in order to accommodate this year's condensed format.

Finally, Linda Johnson, Tanya Oesterreich and Holly Norvell tirelessly raised funds for our Kiawah meeting, only to be left without a Kiawah meeting. They spent June and July communicating our deep gratitude to existing sponsors and discussing future opportunities. We are very grateful for the many 2020 annual meeting sponsors who agreed to roll their sponsorship commitments to the 2021 meeting.

While 2020 has already been a wild ride, we have more adventure ahead as we face continued pandemic-related uncertainty and look toward an election that may usher in significant tax law changes. During these very strange times, I encourage all of us to find support in the many resources of our section and the NCBA.

Remember that section members enjoy access to the members-only listserv, on which members across the state pose questions and share expertise. The Will and the Way provides timely analysis of new statutes, cases and issues relevant to our practice area. The NCBA's Center for Practice Management offers extensive content about managing a law practice under our current circumstances and also provides free consultations to assist members with personalized solutions.

Finally, I hope we continue to rely on our most valuable resources – each other. The true collegiality among our members is a benefit all the time, but it is particularly valuable now. Let's all commit to making special efforts to connect with fellow members during these months of uncertainty and isolation and to offer assistance where possible. Please also remember that the North Carolina State Bar's Lawyer Assistance Program (NCLAP) stands ready to offer free and confidential support to lawyers who face anxiety, addiction, stress, depression and other challenges that current circumstances may exacerbate.

While the coming months may look different from what we are used to, I know our section will find new ways to serve our members and our community. Please join me in these efforts – all of our committees would welcome new members, and you can sign up on the NCBA website (choose Communities/Sections/Estate Planning & Fiduciary Law/Community Login). If you're not sure quite where to plug in – or if you have some suggestions or ideas – please send me an email or give me a call. It is going to be a great year, and I look forward to sharing it with you.

# Interested in writing for The Will and The Way?

Email article suggestions to  
[hroyal@hroyallaw.com](mailto:hroyal@hroyallaw.com) and  
[sarapagewaugh@mvalaw.com](mailto:sarapagewaugh@mvalaw.com)

*nonoperating* foundation or DAF. Therefore, for the purposes of this article, we will focus on private nonoperating foundations.

Private foundations are organized as either corporations or charitable trusts under state law but receive their tax-exempt status from the IRS. The task of establishing a private foundation generally requires the assistance of a lawyer, CPA or other advisors. These advisors oversee the formation process, including establishing the entity (typically through articles of incorporation or a trust instrument). Many states also require (and best practices suggest establishing) bylaws that serve as the private foundation's internal operating rules. In addition, a Form 1023 must be filed with the IRS to apply for exemption under Section 501(c)(3) of the Code. While Form 1023 is usually filed contemporaneously with the creation of the entity, a private foundation may apply for exemption up to 27 months after its creation. Assuming the private foundation receives a determination letter from the IRS approving its exemption, it will be presumed to be tax-exempt retroactive to its date of creation. The entire process, including IRS approval, can take 6 months or longer and cost several thousand dollars or more.

As noted above, as long as the Form 1023 is filed within the first 27 months following creation, a private foundation's tax exemption, upon approval, should be retroactive to its formation, and contributions made to the foundation prior to receipt of the IRS determination letter will be deductible. In this regard, after the legal framework is in place, a donor can begin to make charitable contributions to the private foundation; however, donors should exercise caution. If the application is ultimately denied, any contributions made by the donor to the private foundation will not be deductible.

### What is a Donor Advised Fund? How is it Created?

DAFs were created in the 1930s and proliferated in recent years as a result of their flexibility and preferential tax treatment. A DAF is a separately identified fund or account maintained and operated by a public charity which serves as a sponsoring organization. A sponsoring organization can take many forms, including the 700+ community foundations located throughout the United States.

Unlike a private foundation, there is no separate entity to create. Establishing a DAF is a straightforward process requiring only a single fund agreement and an initial charitable contribution. In general, a donor can choose any name they want for a DAF (e.g., The John and Michelle Client Donor Advised Fund).

Prior to enactment of the Pension Protection Act of 2006 (the PPA), the term "donor advised fund" was not defined in the Code or its regulations. The PPA added Section 4966(d)(2) of the Code which defines a "donor advised fund" as "a fund or account – (i) which is separately identified by reference to contributions of a donor or donors, (ii) which is owned and controlled by a sponsoring organization, and (iii) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reasons of the donor's status as a donor." It is important to note that all three prongs of the definition must be met in order for a fund to be treated as a DAF. Section 4966(d)(2)(B) also includes several exceptions to the definition of a DAF.

DAFs are one of the fastest growing forms of philanthropy. According to the National Philanthropic Trust's "2019 Donor-Advised Fund Report," there were 728,563 DAFs in 2018, which represents a 200%+ increase as compared to the 241,507 DAFs in 2014. The Report also notes that there are approximately nine times as many DAFs as private foundations; however, private foundations collectively own more than seven times as many assets as DAFs. Both the increased number and smaller average size of DAFs have led some to refer to the growth of DAFs as the democratization of philanthropy.

Because of the DAF's relationship to the sponsoring organization, charitable contributions may be made immediately to the DAF and with great confidence that they will qualify for the public charity deduction.

Both private foundations and DAFs can receive a variety of assets including cash, publicly traded stock, real estate and closely held business interests; however, as discussed below, the tax consequences of these contributions often vary between these two vehicles.

### What are the Donor Involvement Considerations for Each Vehicle?

Philanthropy can be a powerful way for families to pass along their shared beliefs and values to children and other descendants and is often a primary reason to create a private foundation or open a DAF.

With a private foundation, a governing board oversees the on-going administration and grantmaking of the foundation. This board is comprised of donors, family members and/or other individuals selected by the founder or as otherwise set forth in the bylaws. The board has fiduciary responsibilities with respect to the foundation, and consideration should be given to obtaining directors and officers liability insurance. In creating a private foundation, the donor should also contemplate board capacity and technical expertise to determine whether the foundation will need to hire foundation staff (including an executive director for larger foundations).

Under Section 4941 of the Code, the payment of compensation or reimbursement of expenses by a private foundation to a disqualified person (as defined under Section 4946(a) of the Code) is generally considered an act of self-dealing. Notwithstanding the general rule, a private foundation may pay compensation, which is not excessive, for personal services that are reasonable and necessary to carry out the foundation's exempt purposes, including serving on the foundation's board.

For DAFs, the opening donor is able to appoint one or more individuals to serve as advisors and successor advisors to the DAF. The fund advisors can be the donor, a family member or any other individual. Such advisors generally have the power to make recommendations regarding grants and investments. A DAF cannot pay compensation to its fund advisors, and the sponsoring organization generally fulfills the fiduciary responsibilities associated with the DAF.

A DAF does not require board meetings or have staff to manage; however, the advisors can be a group of individuals serving in a board-like capacity. Many sponsoring organizations have enhanced service offerings for large DAFs, including convening board meetings, engaging fund advisors and administering robust grant programs. Although formal grant programs are not commonly associated with DAFs, donors have flexibility to administer their giving from their fund in any manner that complies with the sponsoring organization's policies. For example, the donor may be able to engage the sponsoring organization to vet giving opportunities through a

written grant application, conducting site visits or establishing a formal interview process. Additionally, many sponsoring organizations allow donors to leverage their grantmaking software, which can reduce the administrative burden on the donor. This permits donors to focus on other aspects of their grantmaking, including geographic scope, philanthropic focus areas and whether they wish to run an open or closed grant cycle. When layering these types of services on top of a DAF, it is often difficult for grant recipients to distinguish between a grant program run by a DAF or a private foundation.

### **What is the Recommended Minimum Size for Each Vehicle?**

While experts differ on the minimum suggested amount to establish a private foundation, most recommend that a private foundation not be created unless a donor plans to fund it with at least \$5,000,000, whether immediately or over time (e.g., through testamentary gifts). For donors planning to give less than this amount, a DAF is generally a more efficient way to give.

Most sponsoring organizations have established opening minimums for DAFs, typically in the range of \$10,000. Any amount equal to or exceeding the opening minimum is an appropriate amount for creating a DAF. Historically, DAFs were viewed as a good alternative for those giving away more modest sums of money; however, because of the flexibility DAFs offer, many donors consider them attractive giving vehicles for larger charitable gifts as well. Several recent public examples involve donors contributing in excess of \$100,000,000 to DAFs.

### **What are the Ongoing Administrative Requirements for Each Vehicle?**

After a private foundation is established, there are ongoing administrative requirements that must be met. Private foundations must adhere to applicable state laws governing nonprofit corporations or charitable trusts, including registration requirements and corporate formalities. Private foundations are also required to submit a Form 990-PF by day 15 of the fifth month following the close of each tax year, subject to any extensions, as well as to make any required state filings. Form 990-PF is a public document that must be made available by the foundation for public inspection. Under Section 4940 of the Code, a private foundation's investments are subject to a 1.39% net investment income tax (which is calculated and paid along with the filing of Form 990-PF). Private foundations must also follow the regulatory requirements imposed by the IRS, including compliance with various grantmaking, investment, self-dealing and lobbying restrictions. These requirements can be onerous and often require professional assistance to meet fiduciary and regulatory guidelines.

In comparison, donors have no ongoing administrative or governance requirements with respect to a DAF. There are no annual tax returns, and investments grow tax free. In addition, an annual administrative fee typically covers monthly fund reports, unlimited grant distributions and online fund access.

### **What are the Tax Considerations in Making Contributions to Each Vehicle?**

For cash gifts to charity, a donor's income tax deduction is generally limited to a percent of the donor's "contribution base," which

is essentially his or her adjusted gross income (AGI). For gifts of cash to a DAF, this deduction limit is 60% of AGI as opposed to 30% of AGI for cash gifts to a private foundation. Under the Coronavirus Aid, Relief and Economic Security Act (the CARES Act), the 60% AGI limit was increased to 100% for cash gifts made by individuals to certain public charities in 2020; however, this increased AGI limit does not apply to cash gifts made to private nonoperating foundations or DAFs (or supporting organizations or split-interest giving vehicles).

Gifts of appreciated publicly traded stock that a donor has held for more than one year are generally entitled to a deduction equal to the fair market value of the stock donated, but limited to 30% of AGI if made to a DAF and 20% of AGI if made to a private foundation.

The difference in the tax treatment of other gifts of appreciated long term capital assets (such as real estate and closely held business interests) vary greatly depending upon the charitable recipient. If the recipient is a DAF, the deduction will generally equal the fair-market value of the asset donated (as determined by a qualified appraisal), limited to 30% of AGI; however, if the recipient is a private foundation, the deduction is equal to the donor's cost basis up to 20% of AGI. A donor can also elect to deduct the cost basis of a gift of appreciated long-term capital gain property contributed to a DAF, rather than the (higher) fair market value, and utilize a 50% AGI limit rather than the 30% AGI limit. This can be useful if the property has minimal appreciation, or if a current deduction may be more valuable to a donor than in future years.

Charitable income tax deductions for gifts made to private foundations and DAFs may be used in the year the gift is made with any excess deduction carried over for up to five additional years.

### **What are the Investment Considerations for Each Vehicle?**

Private foundations must establish, research and manage their own investment vehicles, or hire an outside manager to do so. In contrast, DAFs generally can access the investment pools offered by the sponsoring organization. Such pools are typically managed by investment advisors hired and overseen by the sponsoring organization, and the individual DAF is able to benefit from economies of scale by having its investments managed in such pools. For larger DAFs, many sponsoring organizations also offer an investment program, which allows fund advisors to recommend an approved outside investment manager for their DAF.

### **What Charities Can Each Vehicle Make Grants To?**

In general, both private foundations and DAFs can make grants to any public charity in the United States. Many advisors incorrectly assume that grants from DAFs are limited by the geographic region served by the community foundation or other sponsoring organization. It is important to note that sponsoring organizations generally require grants from DAFs to align with their mission. Because most sponsoring organizations (e.g., community foundations) have broad charitable missions, as a practical matter, donors can typically recommend grants to any public charity in the United States; however, some sponsoring organizations (e.g., faith-based organizations) may impose additional limits on permissible grantees consistent with their mission.

Most sponsoring organizations do not make grants to international charities because they are generally required to either make an equivalency determination (essentially a good faith determina-

tion that the foreign charity is equivalent to a 501(c)(3) charity) or exercise expenditure responsibility (essentially requiring a grant agreement, reporting and ensuring the grant funds are used for the intended purpose). These obligations also apply to private foundations, which should exercise care in making international grants. For donors interested in supporting international grantmaking, other options may be available, including grantmaking to: (i) U.S. based charities doing international work or (ii) U.S. intermediaries that facilitate gifts to international charities.

### **Are Annual Distributions Required From Each Vehicle?**

Section 4942 of the Code requires private nonoperating foundations to make annual “qualifying distributions” equal to five percent (5%) of the fair market value of assets other than those used or held to be used directly for charitable purposes. Qualifying distributions include grants to independent public charities as well as reasonable administrative expenses allocable to making these grants. Should the private foundation fail to make the required distributions, the foundation will generally be subject to (i) an initial excise tax equal to 30% of the undistributed amount and (ii) an additional excise tax equal to 100% of such amount if the private foundation fails to make such distributions within the permitted timeframe following imposition of the initial tax.

In contrast, there are no requirements that DAFs make annual distributions. This allows donors greater flexibility to determine when and how they want to make gifts to nonprofits. The lack of a payout requirement has led to criticism from some commentators; however, despite the absence of a payout requirement, in 2019, the average payout rate from DAFs across the United States was 20.9%. In addition, in response to the increased charitable needs in 2020, many sponsoring organizations have reported substantial increases in grantmaking from DAFs, with one large sponsoring organization reporting a 46% increase in grantmaking over the first six months of 2020 (as compared with the same period in 2019).

### **Can Grants Be Made Anonymously from Each Vehicle?**

As discussed above, private foundations are required to file Form 990-PF with the IRS each year and to make this form available to the public. A private foundation’s Form 990-PF is also readily available from sites such as [www.guidestar.org](http://www.guidestar.org). The Form 990-PF details all grants made from the foundation and also includes information about the foundation’s assets, finances and trustees. This public information can lead to unsolicited inquiries and funding requests from charities, including charities requesting grants outside the foundation’s mission.

Although grants from DAFs typically include the name of the donor and/or fund advisor, most sponsoring organizations allow grants from DAFs to be made anonymously. In addition, because the grantmaking of the sponsoring organization is collectively reported on its Form 990, the grantmaking and assets associated with individual DAFs are not available to the public.

### **Can My Client Change from One Vehicle to the Other?**

Private foundations can be dissolved with the proceeds distributed to a DAF or other public charity (effectively allowing a “conversion” to a DAF). The dissolution process is fairly straightforward

and includes the board passing a resolution to terminate the private foundation, adopting a plan of dissolution and filing a final Form 990-PF. In a number of states, including North Carolina and South Carolina, notice to the Attorney General’s office is also generally required as part of the dissolution process.

While a DAF can be terminated and distribute its remaining assets to one or more public charities, such assets cannot be distributed to a private nonoperating foundation.

### **How Do Recent Changes in Charitable Giving Laws Impact Vehicle Selection?**

Many of the recent enhanced charitable giving incentives exclude private foundations and DAFs. For example, the CARES Act included an increased 100% AGI limit for cash gifts made during 2020 (discussed above) as well as a \$300 above-the-line deduction for cash gifts made by non-itemizing taxpayers beginning in 2020. Neither of these provisions applies to cash gifts made to private foundations or DAFs. Similarly, the special rules related to “qualified charitable distributions” from individual retirement accounts (IRAs) exclude distributions to private foundation and DAFs.

Several changes related to the Tax Cuts and Jobs Act of 2017 (the 2017 Act) have created an opportunity for some taxpayers to utilize DAFs to make their charitable giving more tax efficient. The 2017 Act nearly doubled the standard deduction from \$12,700 in 2017 to \$24,800 in 2020 and capped the deduction for state and local income sales and property taxes. As a result, many taxpayers who previously itemized deductions now claim the standard deduction. In doing so, these individuals no longer realize any income tax benefits from making charitable contributions (other than the \$300 above-the-line deduction provided by the CARES Act). To address the increased standard deduction, taxpayers might consider “bunching” charitable contributions that they would have ordinarily made over multiple tax years into a single tax year. One easy way to do this is by creating a DAF and making contributions directly to the DAF. Contributions to a DAF qualify for the charitable deduction and also allow the taxpayer to recommend grants from the DAF to other public charities in subsequent years – allowing donors to fulfill their original charitable goals in a tax-efficient manner.

The following example illustrates the potential benefits of bunching. John and Michelle Client anticipate being able to take the following deductions over the next three years: \$7,000 per year for home mortgage interest paid and \$10,000 per year for state and local taxes paid (the limit under the 2017 Tax). John and Michelle also plan to make charitable donations of \$20,000 each year. By itemizing, they would be able to deduct \$37,000 per year which is greater than the standard deduction of \$24,800. But what if they instead decided to “bunch” three years of charitable donations into year 1 and donate that amount to a DAF?

By giving \$60,000 to their DAF in year 1, the Clients’ total deductions for year 1 would be \$77,000. For years two and three, they would claim the standard deduction of \$24,800 (indexed for inflation) which is greater the \$17,000 in remaining deductions. By “bunching” their charitable giving, the Clients will be able to deduct an additional \$15,600 over the three years. Assuming a federal marginal tax rate of 37%, this would amount to approximately \$5,770 in federal income tax savings. Moreover, the Clients can recommend grants from their DAF each year to the same charities to which they would have otherwise made outright gifts, thereby putting such

charities in the same position as if the Clients had not “bunched” their giving. The Clients would also be able to utilize the \$300 tax deduction referenced above for additional charitable gifts in the years that they claim the standard deduction.

“Bunching” also highlights another important feature of DAFs – the ability of a donor to make charitable contributions directly to a single charity (i.e., the DAF) while carrying out the donor’s charitable broader goals. This means one tax receipt at the end of the year for an itemizing taxpayer despite the ability to support an unlimited number of ultimate charitable recipients.

While the concept of “bunching” could be applied to a private foundation, the time involved and cost of creating and operating a private foundation would generally prevent this from being a good tax planning strategy.

### **What Additional Considerations Might Impact Vehicle Selection?**

The following is a summary of the excise taxes and rules which apply to private foundations under Sections 4941 through 4945 of the Code. It is also important to note that the penalties for violating these rules can be significant and even draconian:

- Prohibition against self-dealing under Section 4941 of the Code (prohibiting financial transactions with disqualified person);
- Prohibition against failure to distribute income under Section 4942 of the Code (related to the 5% payout described above);
- Prohibition against excess business holdings under Section 4943 of the Code (limiting collective ownership of interests in a business enterprise by a private foundation and disqualified persons);
- Prohibition against jeopardy investments under Section 4944 of the Code (prohibiting investments that would jeopardize the foundation’s ability to carry out its exempt purposes); and
- Prohibition regarding taxable expenditures under Section 4945 of the Code (prohibiting certain taxable expenditures such as those attempting to influence legislation or grants to organizations not recognized as public charities).

It is important to note that Section 4943(e) of the Code, enacted as part of the PPA, applied the prohibition against excess business holdings to DAFs. In addition, Section 4958(c) of the Code imposes special rules for “excess benefit transactions” between DAFs and disqualified persons. Although this rule is similar to the Section 4941 prohibition on self-dealing which applies to private foundations, Section 4958(c) is generally not an issue for DAFs because most sponsoring organizations will not allow any grants, loans, compensation or similar payments from DAFs to disqualified persons (or non-disqualified person).

The anonymity provided by DAFs and discussed above has led some commentators to criticize DAFs for lack of transparency. This criticism has resulted in proposed legislation – most notably California Assembly Bill 2936, the stated intention of which is to improve transparency and accountability. A similar bill introduced in California last year was ultimately pulled from consideration. It is unclear whether the current bill will be enacted as well as whether it will gain traction outside of California.

Practitioners should also be aware of IRS Notice 2017-73. This Notice sets forth positions that the Treasury and IRS are considering regarding three major DAF issues: (i) bifurcated payments related to charity-sponsored events (e.g., galas), (ii) distributions that fulfill donor/advisor pledges and (iii) the use of DAFs to avoid public support limitations. Additional guidance has been anticipated for more than two years. While some commentators believe this may ultimately lead to additional restrictions on DAFs, the issues raised in the Notice do not impact the vast majority of DAF fundholders.

### **How Can Each Vehicle Be Used to Assist with Estate Planning?**

Each vehicle can be designated as the beneficiary of testamentary assets in a will, trust or beneficiary designation, and such assets should qualify for the unlimited estate tax charitable deduction.

For a private foundation, the foundation’s board would generally determine how any such assets are distributed upon receipt. Given the complexity of establishing a private foundation discussed above, an individual would be unlikely to create a private foundation primarily to carry out prescribed testamentary charitable giving (i.e., charitable giving not left to the discretion of a board).

With respect to DAFs, many sponsoring organizations work with donors to create individualized succession plans for their DAFs. These plans address how assets remaining in the DAF at the donor’s death, as well as any testamentary assets received by the DAF, should be distributed. Such succession plans can provide flexibility and allow donors to incorporate a variety of planning options, including: (1) outright distributions, at death or a later date, to one or more public charities, (2) creating endowed funds for the benefit of one or more public charities and (3) establishing or continuing a DAF and naming their children, other family members or friends to serve as successor fund advisors and carry out the donor’s philanthropic legacy. A testamentary gift can either be added to an existing DAF or to a new DAF established following the donor’s death based on the donor’s instructions.

### **When Might the Use of One Vehicle Complement the Other?**

In some situations, a private foundation and DAF can complement one another. While not an exhaustive list, the following are examples of when a donor with a private foundation might want to open a DAF while continuing to operate the private foundation:

- To contribute assets which provide greater tax benefits when donated to a public charity (e.g., real estate or closely held business interests);
- To make grants from the DAF anonymously. This may be particularly useful if grants fall outside the private foundation’s stated grantmaking focus and/or if the private foundation does not want to be solicited for grants from similar charities;
- To support individual grantmaking by family members and/or foundation board members. This could involve setting up separate DAFs for children, perhaps in a different geographic area from the region served by the private foundation;
- To provide a training opportunity for children or other family members to learn the fundamentals of charitable giving and

gain experience in grantmaking through a DAF before joining the private foundation's board; and

- To test drive a DAF in contemplation of terminating the private foundation (either in the short term or at a later date) and distributing the remaining assets to a DAF.

#### **Conclusion: When Might a Donor Select Each Vehicle?**

This article examined a number of important considerations for your clients in determining whether a private foundation or DAF is the appropriate vehicle for their charitable planning. In some cases, the answer may be clear, while in other cases, it will be important to consider a variety of issues, including cost and ease of creation, the importance of donor control, size, assets to be contributed and the desire for anonymity.

For donors who plan to contribute assets greater than \$5,000,000 and who also wish to maintain greater control, a private foundation may be a better choice than a DAF. A private foundation may also be the right choice for donors who wish to (reasonably) compensate family members or others for managing charitable activities.

DAFs may be a better choice for many, if not most, other donors. As evidenced by the 200%+ growth in new DAFs from 2014 to 2018 discussed above, DAFs appear to be the preferred choice for many donors for whom control is not a primary factor. They provide a convenient and lower-cost option for donors interested in strategic lifetime tax planning through “bunching” or gifts of assets such as real estate or closely held business interests. As discussed above,

because of flexibility and the enhanced services many sponsoring organizations offer, many donors also consider them attractive giving vehicles for larger charitable gifts.

For a donor struggling with the decision whether to create a private foundation or DAF, consideration should be given to “test driving” a DAF. This can be accomplished by creating a DAF and funding it with a smaller initial contribution to see if the DAF meets the donor's charitable goals. This can be done quickly and inexpensively, and it is likely that the DAF will meet the donor's long-term philanthropic objectives. In the event the DAF does not meet the donor's objectives, it is easy for the donor to recommend grants of the remaining DAF assets to public charities and explore the creation of a private foundation.

Doug Benson is Senior Vice President & In-House Counsel at Foundation For The Carolinas. He previously practiced law at Moore & Van Allen PLLC in Charlotte, N.C. and Sutherland Asbill & Brennan LLP (now Eversheds Sutherland) in Washington, D.C. He received his B.A. in Economics from the University of Rochester and his J.D. from the Duke University School of Law.

Whitney Feld is Vice President, Family Office Partners at Foundation For The Carolinas. She received her B.F.A. from Miami University, her M.S.T. from Pace University and her J.D. from the Charleston School of Law. While in law school, she worked at the Coastal Community Foundation, South Carolina's largest community foundation.

For more news you  
can use, follow the  
NCBA on Twitter  
@NCBAorg.

# Microcaptive Insurance Remains Under Scrutiny

By Kerri L. S. Mast

Microcaptive insurance – a concept that combines captive insurance companies with the tax advantages for small insurance companies under IRC Section 831(b) - has been under scrutiny for several years. The IRS has won several recent victories and continues to devote substantial resources to investigating these strategies.

## Overview

Generally, a business is permitted to create its own insurance company – a captive, which is owned by or related to the business – to insure against risk. The insurance company must be a bona fide insurance company within the meaning of IRC Section 831(c) and IRC Section 816(a). To be considered insurance, the arrangement must: (1) involve risk-shifting; (2) involve risk-distribution; (3) involve insurance risk; and (4) meet commonly accepted notions of insurance. See **Rent-A-Center, Inc. v. Commissioner**, 142 T.C. 1 (2014).

In terms of logistics, the insured business pays insurance premiums to the captive, which are used to fund covered losses incurred by the business. The business can take a deduction as an ordinary and necessary business expense under IRC Section 162 for the insurance premiums paid. Generally, insurance companies are taxed on their income in the same manner as other corporations. However, IRC Section 831(b) provides an alternative taxing structure for certain small insurance companies. If the annual premium payments received do not exceed \$2.3 million, the insurance company can elect under IRC Section 831(b) to be taxed on its investment income only. This has the effect of creating a business deduction up to \$2.3 million, and the insurance company recognizing no income other than investment income.

The IRS is concerned that microcaptive promoters encourage business owners to participate in strategies that lack attributes of genuine insurance. Examples include insuring implausible risk, failing to match business needs, duplicating commercial coverage, and charging premium amounts that are unreasonable and unsupported by actuarial analysis. Policies may contain terms that are inconsistent with industry or regulatory standards, and claims' processes may be insufficient. IR-2018-62, March 19, 2018.

## Recent Cases

In **Avrahami v. Commissioner**, 149 T.C. 144 (2017), the petitioners created a microcaptive insurance company and, after it accumulated a large surplus, took loans from it. The Tax Court found that the Avrahamis' captive failed to distribute risk and was not selling insurance in the commonly accepted sense. The captive issued policies with unclear and contradictory terms and charged premiums the Tax Court described as “wholly unreasonable.” In addition, covered claims were incurred but never filed. As a result, a portion of the loans were considered distributions, and the IRC Section 831(b) election of the captive was invalidated, resulting in the disallowance of deductions.

In **Reserve Mechanical Corp.**, T.C. Memo. 2018-86, a captive was formed to provide coverage that the petitioner's commercial insurers would not cover. The Tax Court found there was no risk distribution because the policies were “cookie-cutter” and not necessarily appropriate for the petitioner's business. All covered entities – regardless of size or risk - had the same policy with the same premium. The Tax Court also found that the arrangement did not meet commonly accepted notions of insurance. Little or no diligence was performed with respect to issued policies and only one claim was ever filed. The Tax Court also found that premiums the insureds were required to pay were not reasonable in relation to the risk of loss and were not the result of arm's-length negotiation.

In **Syzygy Insurance Co.**, T.C. Memo. 2019-34, the Tax Court held that the captive at issue charged unreasonable premiums and issued policies with conflicting and ambiguous terms. Claims were filed and paid, but no due diligence was done to determine whether they were covered claims. As a result of these findings, the Tax Court held that the IRC Section 831(b) election was invalid, resulting in disallowance of premium deductions.

## Continued Scrutiny

In Notice 2016-66 (Nov. 1, 2016), the IRS advised that microcaptive insurance transactions have the potential for tax avoidance or evasion and established reporting and disclosure requirements. Taxpayers who fail to report these arrangements may be subjected to significant penalties.

As noted above, the IRS has been successful in litigating these transactions and continues to devote substantial resources to its review of these strategies. According to an IRS news release, there are currently more than 500 docketed cases in Tax Court, and the IRS is focusing on captives and those who promote them. In March 2020, the IRS issued a letter to taxpayers involved with microcaptives, warning of its increased examination of activity in this area. Subsequently, in July 2020, the IRS issued another wave of letters to taxpayers involved with microcaptives. The letters encourage recipients to seek review by independent counsel.

Clients who are involved with microcaptives should engage independent counsel for review. Attorneys reviewing microcaptives should consider whether the arrangement (1) involves risk-shifting; (2) involves risk-distribution; (3) involves insurance risk; and (4) meets commonly accepted notions of insurance. If the arrangement meets these criteria, additional action may not be needed. If the arrangement does not meet these criteria, the client might consider exiting the strategy.

Kerri L.S. Mast, J.D., is a wealth planner at Brown Brothers Harriman, and she currently serves on the Board of Directors for Brown Brothers Harriman Trust Company of Delaware. She previously practiced at Moore & Van Allen PLLC and worked at Foundation For The Carolinas. She received her BA from Wake Forest University and her J.D. from Emory University.



# Legislative Update to Joint Ownership of Property

By Rebecca Smitherman

The North Carolina General Assembly passed a bill presented by the North Carolina Bar Association that updates the law of joint tenancy and codifies the law of tenancy by the entirety.

## Joint Tenancy

The joint tenancy revisions were in response to an article in the North Carolina Law Review by Daniel R. Tilly and Patrick K. Hetrick, entitled *North Carolina's Joint Tenancy: Oh Intent, Where Art Thou*. 93 N.C.L. Rev. 1649 (2015). The new joint tenancy provisions are contained in Article 6 of Chapter 40 of the North Carolina General Statutes (N.C.G.S. § 41-70 et seq.). The North Carolina session law has a handy chart, which shows where existing statutes were recodified within the new Article 6.

The joint tenancy revisions set out the means by which a joint tenancy is established, the effect of ownership in a joint tenancy, how a joint tenancy is terminated and the effect of termination. It replaces prior N.C.G.S. Section 41-2, while adding clarity that the intent of the parties is the guiding principal in determining whether a joint tenancy exists.

## Tenancy by the Entirety

The committee that worked on the joint tenancy issue thought there would be value in giving similar treatment to the law of tenancy by the entirety – that is, setting out how a tenancy by the entirety is created, codifying the effect of a tenancy by the entirety and addressing termination of a tenancy by the entirety. The statutes that previously addressed tenancy by the entirety were recodified in Article 5 of Chapter 41 of the North Carolina General Statutes, although there is language in the legislation that provides that references to the prior statutes are deemed to be references to the recodified statutes. This language preserves the intent of parties or practitioners who may have relied on previously used forms and references. Again, the session law has a chart setting out the recodification. In addition to the recodification of existing statutes, tenets of common law were also codified, putting the law of tenants by the entirety in a single place in the North Carolina General Statutes.

These statutory revisions were not intended to make substantive changes in North Carolina law, but rather to codify and clarify North Carolina's rules related to ownership of property in a joint tenancy or tenancy by the entireties.

Rebecca Smitherman is a partner with Craige Jenkins Liipfert & Walker LLP in Greensboro.

We recently upgraded  
our technology platforms  
to better serve you.

See what's new at [ncbar.org](http://ncbar.org)!

# Recent Developments

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

## Federal Administrative Developments

### *Service Grants Extensions to Time-Sensitive Filings for Certain Exempt Organizations and IRAs.*

In **Notice 2020-35**, the Service provided for additional relief for taxpayers affected by the COVID-19 pandemic. In addition to providing relief for certain benefit plans and employment tax-related matters, the Service added the filing of Form 990-N required for certain small exempt organizations and the filing of the Form 5498 reporting certain IRA contributions to the list of “Time-Sensitive Actions” set forth in Notice 2020-23. As a result, affected taxpayers had until July 15, 2020, to file the applicable forms.

### *Service Grants Relief for Qualified Opportunity Fund.*

In **PLR 202019017** (May 8, 2020), the Service granted relief pursuant to Regs. 301.9100-01 and 301.9100-03 for a taxpayer to file a late Form 8996 to self-certify status as a Qualified Opportunity Fund. The taxpayer, a limited liability company, was formed for the purpose of investing in a qualified opportunity zone. The taxpayer hired an advisor who agreed to prepare the taxpayer’s federal income tax return and Form 8996. The advisor, however, failed to file for an extension of time to file the taxpayer’s return due to an administrative error. The Service determined that the filing of Form 8996 was an administrative matter and that 301.9100-01 was applicable.

### *SBA Issues PPP Loan Forgiveness and Audit Regulations.*

The Small Business Administration issued an Interim Final Rule (SBA 2020-0032) on June 1, 2020, providing rules applicable to the forgiveness and audit of Paycheck Protection Program loans authorized and issued pursuant to the CARES Act. The regulations provide detailed guidance on forgiveness eligibility and reporting, including proper calculations for reductions in eligible forgiveness based on reduced employee head count and/or a reduction in employee wages. The regulations also provide guidance regarding the application process, including applicable time periods to process applications.

### *Service Grants Extension of Time to Elect Alternate Valuation Date.*

In **PLR 202019015** (May 8, 2020), the Service granted Reg. 301.9100-3 relief and permitted an extension of time to use an alternate valuation date for federal estate tax purposes. The Estate hired an attorney to prepare its estate tax return and, in consultation with the attorney, planned to make an election to use the alternate valuation date. However, the appraisals were not completed by the due date for the return and the return was filed using date of death values. A supplemental Form 706 was filed using the alternate valuation date and had the required appraisals attached. The Service determined that relief to make the extension was appropriate under 301.9100-3.

### *Service Rules on Effect of Trust Provisions for Income, Gift, and Estate Tax Purposes.*

In **PLR 202014001** (April 3, 2020), the Service ruled on the effect of certain powers retained by the grantor and certain powers held by a power of appointment committee for income, gift, and estate tax purposes. The grantor created a trust with third-party beneficiaries. The Trust provided for a power of appointment committee (the “Committee”) that possessed the power to direct distributions to the grantor and the beneficiaries. The grantor retained the right to consent to distributions and also the power to appoint property to the beneficiaries in a non-fiduciary capacity. The Service ruled that (i) the trust was not a grantor trust for income tax purposes, (ii) the contribution to the trust was an incomplete gift, (iii) distributions from the trust to the grantor were not completed gifts, (iv) the Committee members did not make a gift by appointing property to beneficiaries, and (v) no member of the Committee had a power over the trust property that would cause estate tax inclusion for the member.

### *Service Rules that Stock-Split and Recapitalization Does not Constitute Substantial Modification to Buy-Sell Agreement.*

In **PLR 202015005** (April 10, 2020), the Service ruled that the recapitalization of shares into voting and nonvoting common stock did not constitute a substantial modification for purposes of Reg. 25.7203-1(c). The parties’ predecessors-in-interest entered into a pre-October 8, 1990 buy-sell agreement that provided for a fixed purchase price and payment terms upon a buy-sell event. The taxpayers requested a ruling as to whether certain transfers and a recapitalization of the company constituted a substantial modification that would cause the loss of the buy-sell agreement’s grandfathered status. The Service ruled that (i) the changes of ownership did not result in the transfer of the shares to a lower generational assignment and (ii) a company name change and the recapitalization of common shares to voting and nonvoting did not constitute a substantial modification that would cause the loss of grandfathered status.

### *Service Closes Possibility of Double Tax Benefit for PPP Loan Forgiveness.*

In **Notice 2020-32**, the Service announced that payments made for normally deductible expenses such as payroll costs, rent, and utilities, but that are paid with proceeds from a loan under the Paycheck Protection Program (“PPP”) and forgiven under Section 1106(i) of the CARES Act are non-deductible pursuant to I.R.C. Section 265. PPP loans are eligible for forgiveness if used for eligible purposes and the amount forgiven is excluded from gross income. The Service reasons that I.R.C. Section 265 prevents a double tax benefit.

### *Service Issues Notice Regarding Coronavirus-Related Distributions and Loans from Retirement Plans under CARES Act.*

In **Notice 2020-50**, the Service provided guidance regarding the application of the CARES Act on retirement plan distributions and loans.

*Expansion of Qualified Individuals.* The guidance expands the scope of eligible distributions and loans. The Notice expands the scope of qualified individuals to an individual who experiences adverse financial consequences as a result of: (1) the individual having a reduction in pay (or self-employment income) due to COVID-19 or having a job offer rescinded or start date for a job delayed due to COVID-19; (2) the individual's spouse or a member of the individual's household (as defined below) being quarantined, being furloughed or laid off, or having work hours reduced due to COVID-19, being unable to work due to lack of childcare due to COVID-19, having a reduction in pay (or self-employment income) due to COVID-19, or having a job offer rescinded or start date for a job delayed due to COVID-19; or (3) closing or reducing hours of a business owned or operated by the individual's spouse or a member of the individual's household due to COVID-19. For purposes of applying these additional factors, a member of the individual's household is someone who shares the individual's principal residence.

*Clarification of Definition of Coronavirus-Related Distributions.* The Service further provides that a coronavirus-related distribution includes periodic payments and distributions that would have been required minimum distributions but for Section 2203 of the CARES Act, received by a qualified individual from an eligible retirement plan on or after January 1, 2020, and before December 31, 2020. Similarly, any distribution received by a qualified individual as a beneficiary can be treated as a coronavirus-related distribution. In addition, a reduction or offset of a qualified individual's account balance in order to repay a plan loan, as described in Q&A-9(b) of Reg. 1.402(c)-2, including a qualified plan loan offset, is permitted to be treated as a coronavirus-related distribution. However, any amount described in Q&A-4 of Reg. 1.402(c)-2 is not permitted to be treated as a coronavirus-related distribution. Thus, the following amounts are not coronavirus-related distributions: corrective distributions of elective deferrals and employee contributions that are returned to the employee (together with the income allocable thereto) in order to comply with the I.R.C. Section 415 limitations, excess elective deferrals under I.R.C. Section 402(g), excess contributions under I.R.C. Section 401(k) and excess aggregate contributions under I.R.C. Section 401(m); loans that are treated as deemed distributions pursuant to I.R.C. Section 72(p); dividends paid on applicable employer securities under I.R.C. Section 404(k); the costs of current life insurance protection; prohibited allocations that are treated as deemed distributions pursuant to I.R.C. Section 409(p); distributions that are permissible withdrawals from an eligible automatic contribution arrangement within the meaning of I.R.C. Section 414(w); and distributions of premiums for accident or health insurance under Reg. 1.402(a)-1(e)(1)(i).

*Most Inherited IRAs Excepted from Recontribution.* Distributions from inherited IRAs are generally ineligible to be recontributed within the three-year period for contribution provided by the CARES Act. The notice provides that any coronavirus-related distribution (whether from an employer retirement plan or an IRA) paid to a qualified individual as a beneficiary of an employee or IRA owner (other than the surviving spouse of the employee or IRA owner) cannot be recontributed.

*Flexible Reporting.* The Service indicates that Form 8915-E is expected to be available before the end of 2020 and will be the method for a

qualified individual to elect to treat a distribution as a coronavirus-related distribution from his or her plan or IRA. The Service explains that if an individual includes all or a portion of a coronavirus-related distribution in income during the 3-year period but recontributes all or a portion of the distribution during the period, the individual has flexible reporting options but may have to file an amended return for an earlier year.

*Special Rule for Deceased Qualified Individuals.* If a qualified individual dies before the full taxable amount of the coronavirus-related distribution has been included in gross income, then the remainder must be included in gross income for the taxable year that includes the individual's death.

### ***Proposed Regulations Issued on Effect of I.R.C. Section 67(g) on Estates and Trusts.***

In REG-113295-18, the Service issued proposed regulations on the effect of I.R.C. Section 67(g) on estates and trusts.

*Background.* I.R.C. Section 67(g) was added to the Code by the Tax Cut and Jobs Act on December 22, 2017, and prohibits individual taxpayers from claiming miscellaneous itemized deductions for taxable years beginning after December 31, 2017, and before January 1, 2026. I.R.C. Section 67(e) provides that an estate or trust computes its adjusted gross income in the same manner as an individual except that the following additional deductions are allowable: (1) the deduction for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in the estate or trust, and (2) deductions allowed under I.R.C. Sections 642(b), 651, and 661. Thus, I.R.C. Section 67(e) removes the deductions permitted under I.R.C. Section 67(e)(1) and (2) from the definition of miscellaneous itemized deductions.

*Issues Addressed.* The proposed regulations address (1) the deductibility of excess deductions under I.R.C. Section 642(h) for a beneficiary, including when a portion of the excess deduction is attributable to deductions under I.R.C. Sections 62 and 67(e), and (2) the allocation of excess deductions among beneficiaries under I.R.C. Section 642(h).

*Proposed Reg. 1.67-4.* The proposed regulations expressly provide that the deductions permitted by I.R.C. Section 67(e)(1) and (2) are not miscellaneous itemized deductions. Further, Prop. Reg. 1.67-4(a)(2) provides that a cost is not a 67(e) deduction and is therefore subject to the 2% floor under I.R.C. Sections 67(a) and 67(g) to the extent it is included in the definition of miscellaneous itemized deductions under I.R.C. Section 67(b) and "commonly or customarily would be incurred by a hypothetical individual holding the same property."

*Proposed Reg. 1.642(h)-2.* The proposed regulations provide that excess deductions permitted under I.R.C. Section 642(h) "retain, in the hands of the beneficiary (specifically, as allowable in arriving at adjusted gross income, as a non-miscellaneous itemized deduction, or as a miscellaneous itemized deduction) while in the estate or trust." Each item of deduction remains subject to additional applicable limitations under the Code and must be separately stated if it could be so limited, as provided in the instructions to Form 1041 and Schedule K-1, or any successor forms.

The character and amount of the excess deduction is determined under Reg. 1.642(h)-2(b) which provides that (i) each deduction directly attributable to a class of income is allocated in accordance with Reg. 1.652(b)-3(a); (ii) to the extent of any remaining income after application of (i), deductions are allocated in accordance with Reg. 1.652(b)-3(b) and (d); and (iii) deductions remaining after application of (i) and (ii) comprise the excess deductions on termination of the estate or trust. The excess deductions are then allocated to the beneficiaries in accordance with Reg. 1.642(h)-4. The excess deduction may only be used in the taxable year of the beneficiary in which the estate or trust terminates and may not be carried forward. Proposed Regulation 1.642(h)(5) contains an Example illustrating the new regulations including a specific conclusion that I.R.C. Section 67(e) deductions may be itemized when reporting excess deductions to the beneficiaries.

#### ***Service Addresses Effect of State Law Change on GST Exempt Trust.***

In **PLR 202020010** (May 15, 2020), the Service addressed the estate and generation-skipping transfer tax consequences of certain state law changes affecting two grandfathered GST exempt trusts. The settlors created two grandfathered GST exempt trusts for the benefit of their child and issue. The terms of the trusts provided that the child, as trustee, may make principal distributions to himself that were not subject to an ascertainable standard. Accordingly, the child possessed a general power of appointment. However, in a later year, state law was enacted that applied to the trusts and provided that a trustee possessing a discretionary power that could be exercised in favor of the trustee-beneficiary could only exercise the discretionary power pursuant to an ascertainable standard. The Service, citing Rev. Proc. 99-44, held that the change in state law did not cause a lapse or release of a general power of appointment, that the decedent-beneficiary did not possess a general power of appointment on his date of death, and that the trusts did not lose their grandfathered GST exempt status.

#### ***Service Holds a Subtrust's Transfer of Interests in an LLC to a Grantor Trust is Not a Sale for Federal Income Tax Purposes.***

In **PLR 202022002** (May 29, 2020), the Service ruled that the transfer of LLC interests from a subtrust to a trust was not a sale for federal income tax purposes. Trust 1 was an irrevocable trust created for the benefit of the grantors' children and grandchildren, and Trust 1 was divided into separate trusts for each of the children and grandchildren. Trust 1 exchanged all of its shares for membership interests in an LLC. Under the terms of Trust 1, the shares may not be distributed, but the proceeds from the sale of the shares may be distributed. The LLC interests also may not be distributed under the terms of Trust 1. Trust 1 then transferred a portion of the LLC interests to a Subtrust that has one beneficiary, Beneficiary A, who has the authority to withdraw all of the Subtrust's assets except for the LLC interests after she reaches age 40. Beneficiary A withdrew all of the Subtrust's assets except for the LLC interests and agreed to sell a portion of the LLC interests to Trust 2, a grantor trust with respect to Beneficiary A, in exchange for cash and a promissory note. Beneficiary A has the authority to withdraw the cash and promissory note from the Subtrust after the sale. The Service held that the beneficiary would be treated as the owner of the Subtrust under I.R.C. Section 678 because she has the sole power to vest in

herself the proceeds from the sale of the Subtrust's LLC interests, and those proceeds are the Subtrust's only asset. Because the beneficiary is the sole owner of Trust 2 and the Subtrust, the Service held that the transfer of the LLC interests to Trust 2 would not be a sale for federal income tax purposes.

#### ***Service Issues Proposed Regulations on Statutory Limitations on Like-Kind Exchanges.***

In **REG-117589-18** (June 11, 2020), the Service issued proposed regulations which would provide guidance regarding changes to I.R.C. Section 1031 under the Tax Cuts and Jobs Act by adding a definition of real property and addressing a taxpayer's receipt of personal property incidental to receipt of real property. The proposed definition of real property is "land and improvements to land, unsevered natural products of land, and water and air space superjacent to land." In addition, the proposed regulations provide that incidental personal property is disregarded in determining whether a taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by a qualified intermediary are expressly limited under Reg. 1.1031(k)-1(g)(6). The proposed regulations consider personal property received to be incidental if (1) it is typically transferred with the real property in standard commercial transactions and (2) the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15% of the aggregate fair market value of the replacement real property.

#### ***Service Permits Spousal Rollover of Retirement Plan Distribution Payable to Estate.***

In **PLR 202019003** (May 8, 2020), the Service permitted the rollover of a decedent's retirement plan distribution to the surviving spouse. The decedent was the participant in an employer sponsored retirement plan. The decedent's ex-spouse received a qualified domestic relations order directing that a portion of his account be distributed to her. The plan administrator divided the participant's account into two accounts. The decedent did not update the designated beneficiary on his accounts, and the assets were therefore payable to his estate. The terms of his will and revocable trust provided that all assets were to be distributed to his then-spouse. The Service ruled that the retirement benefits may be rolled over into the surviving spouse's IRA.

#### ***Service Issues Guidance on Waiver of 2020 Required Minimum Distribution.***

In **Notice 2020-51**, the Service issued guidance on the waiver of 2020 required minimum distributions from qualified retirement plans under the CARES Act. The Service provides that the following distributions from a plan (other than a defined benefit plan) may be rolled over, provided the other rules of I.R.C. Section 402(c) are satisfied (and regardless of whether the distributions would otherwise be made as part of a series of substantially equal periodic payments): (1) distributions to a plan participant paid in 2020 (or paid in 2021 for the 2020 calendar year in the case of an employee who has a required beginning date of April 1, 2021), if the payments equal the amounts that would have been RMDs in 2020 (or for 2020) but for I.R.C. Section 2203 of the CARES Act (2020 RMDs), or are

one or more payments (that include the 2020 RMDs) in a series of substantially equal periodic payments made at least annually and expected to last for the life (or life expectancy) of the participant, the joint lives (or joint life expectancies) of the participant and the participant's designated beneficiary, or for a period of at least 10 years; and (2) for a plan participant with a required beginning date of April 1, 2021, distributions that are paid in 2021 that would have been an RMD for 2021 but for I.R.C. Section 2203 of the CARES Act (as described in Q&A-5 of section V of this Notice). In addition, participants that have already been distributed an RMD from their plan have an extended 60-day deadline to roll over the RMD, which will not end earlier than August 31, 2020. Individuals who have already withdrawn their 2020 RMD from an IRA may repay the RMD to the IRA no later than August 31, 2020.

### ***Treasury Issues Final Regulations including Special Rules for Trusts and Estates regarding I.R.C. Section 199A Deductions.***

In T.D. 9899 (June 24, 2020), the Treasury Department issued final regulations under I.R.C. Section 199A addressing a number of matters including the special treatment of certain trusts and estates. Reg. 1.199A-6(d)(3)(iii) clarifies the treatment of a trust or estate if the trust or estate consists of separate shares as defined in I.R.C. Section 663(c) under Subchapter J. The final regulations provide that in the case of a trust or estate with substantially separate and independent shares for multiple beneficiaries, such trust or estate will be treated as a single trust for purposes of (i) determining whether the taxable income of the trust or estate exceeds the threshold amount for the purposes of determining any reductions to the deductible amount of qualified business income, (ii) determining taxable income, net capital gain, net QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends and qualified PTP income for each trade or business of the trust or estate and (iii) computing the W-2 wage and UBIA of qualified property limitations. The allocation of such items to the separate shares of the trust or estate will be governed by Regs. 1.663(c)-1 through 1.663(c)-5.

In addition, the final regulations adopted, without change, proposed regulations issued in February 2019 which provide rules under which the taxable recipient of a unitrust or annuity amount from a charitable remainder trust described in I.R.C. Section 664 can take into account QBI, qualified REIT dividends or qualified PTP income for purposes of determining the recipient's I.R.C. Section 199A deduction. Reg. 1.199A-6(d)(3)(v) provides that charitable remainder trusts are not entitled to and do not calculate an I.R.C. Section 199A deduction, and that the threshold amounts for determining the I.R.C. Section 199A deduction does not apply to charitable remainder trusts. However, the recipient of a unitrust or annuity amount from a charitable remainder trust must determine and apply the recipient's own threshold amount for purposes of I.R.C. Section 199A taking into account any annuity or unitrust amounts received. A recipient of a unitrust or annuity amount from a charitable remainder trust must take into account QBI, qualified REIT dividends or qualified PTP income for purposes of determining the recipient's I.R.C. Section 199A deduction to the extent the unitrust or annuity amount distributed for the applicable tax year consists of such I.R.C. Section 199A items under Reg. 1.664-1(d).

### ***American Bankers Association Comments on the Service's Proposed Rule and Effect of I.R.C. Section 67(g) on Trusts and Estates.***

In response to REG-113295-18, the American Bankers Association encouraged the Service to provide additional guidance regarding the treatment of deductions in excess of gross income succeeded to by a beneficiary on the termination of an estate or non-grantor trust. The American Bankers Association suggested that Schedule K-1 of Form 1041 should include specific codes for the three categories of excess deductions, which include (1) deductions allowed in arriving at adjusted gross income, (2) non-miscellaneous itemized deductions and (3) miscellaneous itemized deductions. It also suggested that the instructions should include an explanation of where the three categories should be reported by beneficiaries who file Form 1040.

### **Federal Cases**

#### ***Tax Court Finds Interest in FLP Included in Gross Estate under I.R.C. Section 2036.***

In *Estate of Moore v. Commissioner*, T.C. Memo. 2020-40, 119 T.C.M. (CCH) 1251 (April 7, 2020), the Tax Court found that a farm transferred to a family limited partnership was included in the decedent's estate under I.R.C. Section 2036. The decedent owned a large farm in Arizona and was engaged in discussions to sell the farm and intended to do so prior to experiencing a sudden health crisis. After being placed in hospice care, the decedent contacted an estate planning attorney who established a series of trusts and a family limited partnership. Thereafter, in a matter of days, the farm was transferred to the FLP and was sold to a third-party. The proceeds of the sale were transferred to the FLP. As part of the sale, the decedent retained the right to live on the property and directed its operations until the time of his death.

The decedent transferred the interests in the FLP held by his revocable trust to an irrevocable trust for his children in exchange for \$500,000 in cash and a promissory note. He also received \$2,000,000 from the FLP, allegedly in the form of a loan. The purpose of the FLP was stated to promote family function in the administration of the business and to protect against creditors. The decedent died within one year from establishing the FLP.

The Estate filed Form 706 reporting the value of the note receivable from the irrevocable trust. The Form 706 also reported certain charitable contributions and \$475,000 in attorney's fees paid to administer the Estate. The Service issued a notice of deficiency claiming the value of the FLP was included in the Estate, reducing the amount of the charitable deduction, and indicating certain lifetime loans to the children were actually taxable gifts.

The Court held that the value of the farm (not the value of the transferred FLP interest) was included in the Estate under I.R.C. Section 2036. No legitimate non-tax reason existed for the creation of the FLP. The FLP held only liquid investments and required no active management. In addition, there was no showing that the family was engaged in any active management. There was no showing of any legitimate creditor threat nor a showing that the FLP actually helped promote family togetherness. Further, the decedent at least

impliedly retained the right to occupy the property conveyed and went further by actually retaining the right to operate the property.

The Court then engaged in a detailed discussion of the calculation necessary to determine the value of the assets to include in the Estate under I.R.C. Section 2043. In doing so, the court found that the loans to the children, though evidenced by promissory notes, were not legitimate debt and were taxable gifts. In addition, the court found that \$475,000 in claimed administrative expenses for attorney's fees was not reasonable as counsel provided no evidence as to what work was actually performed to justify the fee.

#### ***Sixth Circuit Affirms Denial of Deduction for Conservation Easement Due to Involuntary Extinguishment Clause.***

In **Hoffman Properties II, LP v. Commissioner**, 956 F.3d 832 (6th Cir. 2020), the Sixth Circuit affirmed the denial of a charitable deduction for a conservation easement. Hoffman Properties, the owner of a historic building, donated an easement in the façade of the building and certain airspace restrictions to a historic preservation society and claimed a \$15 million deduction. The donation agreement contained a clause providing that the society had a period of 45 days to accept or reject certain changes to the building that might violate the historic standards. If the society did not reject the change in the 45-day period, the change was deemed accepted. The Service claimed that the clause failed to protect the conservation purposes in perpetuity within the meaning of I.R.C. Section 170(h)(5)(A). In ruling for the Service, the Court found that the reserved conditional rights, on their face, did not protect the conservation purposes in perpetuity but were contrary to those purposes. The Court rejected claims that this provision was similar to other provisions in other cases that had been upheld where the donee organization had a period of time to accept or reject a proposed change. In those cases, the provision deemed the requested change rejected where, here, the change was considered accepted. In addition, the changes that could occur in this case were directly contrary and would destroy the charitable purposes. The Court further noted that the agreement had not been amended by its terms and that the Tax Court had refused to reform the agreement.

#### ***Ninth Circuit Finds Value of GRAT Includable in Decedent's Gross Estate.***

In **Badgley v. United States**, 957 F.3d 969 (9th Cir. 2020), the Ninth Circuit Court of Appeals affirmed the earlier decision of the district court holding that the value of a grantor retained annuity trust ("GRAT") was includable in the gross estate of the decedent under I.R.C. Section 2036(a)(1). The decedent transferred a 50% partnership interest in a family-run company to a GRAT. Pursuant to the terms of the GRAT, the decedent retained a right to an annuity paid for 15 years. The decedent died before the end of the 15-year annuity period. The Estate reported the value of the assets in the GRAT on Form 706 and commenced a refund action. The Estate argued that only the net present value of the unpaid annuity payments should have been included. The Court held that the grantor's right to income and the continued enjoyment of the trust property was a sufficient "string" under I.R.C. Section 2036(a)(1) and that the total value of the assets in the trust were includable in the gross estate. The Court rejected the taxpayer's argument that I.R.C. Section 2036(a)

(1) was not applicable to annuities and that the right to the annuity payment was not a substantial present economic benefit from the trust property.

#### ***Tax Court Finds "Involuntary Extinguishment" Clause Violates Perpetuity Requirement.***

In **Oakbrook Land Holdings, LLC, et. al. v. Commissioner**, T.C. Memo. 2020-54, (June 9, 2020), the Tax Court again found that language contained within the deed of conservation easement pertaining to the division of proceeds from a judicial extinguishment violated the "protected in perpetuity" requirement contained in I.R.C. Section 170(h)(5)(A). The taxpayer purchased the subject property for \$1,700,000 in 2007. After making certain limited improvements to the property, the taxpayer granted a conservation easement over 106 acres and claimed a charitable income tax deduction of \$9,545,000. The Service denied the deduction and assessed an accuracy related penalty on the basis that the easement did not protect the conservation purpose in perpetuity as required by Reg. 1.170A-14(g)(6)(i). That regulation requires that the donee organization have a vested property right with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift bears to the value of the property as a whole at the time of the extinguishment. The proportionate value must remain constant. The extinguishment clause did not provide for a constant "proportionate value" as construed by the court.

The taxpayer argued that "proportionate value" meant only that the donee must be required to receive the initial value of the conservation easement at the time of the gift. The Court rejected that argument and found that, while "proportionate value" was ambiguous, the Service's "proportionate share" reading was better and supported by the regulation and other law.

The taxpayer also cited the Service's ruling in PLR 200836014 for the proposition that future improvements are deducted "off-the-top" from a split of the extinguishment proceeds with the donee. Citing **PBBM-Rose Hill v. Commissioner**, 900 F.3d 193 (5th Cir. 2018), the Court found the regulations unambiguously required that the value of future improvements be included in the split of proceeds with the donee under the regulation.

#### ***Tax Court Repeatedly Finds "Involuntary Extinguishment" Clause Violates Perpetuity Requirement.***

In **Woodland Property Holdings, LLC v. Commissioner**, T.C. Memo. 2020-55, (May 13, 2020), the Tax Court found that a judicial extinguishment clause contained in a conservation easement violated the "protected in perpetuity" requirement of I.R.C. Section 170(h)(5)(A). The Court noted that the case was identical "with similar conservation easement language" decided adversely to taxpayers in **R.R. Holdings, LLC v. Commissioner**, T.C. Memo. 2020-22, **Oakbrook Land Holdings, LLC v. Commissioner**, T.C. Memo. 2020-54, as well as **PBBM-Rose Hill, Ltd v. Commissioner**, 900 F.3d (5th Cir. 2018) and **Coal Property Holdings, LLC v. Commissioner**, 153 T.C. 126 (2019). Similar clauses were found to violate the perpetuity requirement in **Hewitt v. Commissioner**, T.C. Memo. 2020-89, (June 17, 2020), **Lumpkin HC, LLC v. Commissioner**, T.C. Memo.

2020-95 (June 23, 2020), **Charles W. Harris et ux. v. Commissioner**, No. 24201-15 (June 30, 2020), and **Habitat Green Investments LLC et al. v. Commissioner**, No. 14433-17; No. 14434-17; No. 14435-17 (June 30, 2020).

***Tax Court Holds Loans from Decedent to her Son Became Advances on Inheritance for Estate Tax Purposes.***

In **Estate of Bolles v. Commissioner**, T.C. Memo. 2020-71, (June 1, 2020), the Tax Court held that loans made by the decedent to her son eventually became advances prior to her death. Upon their divorce, the decedent and her husband established the Bolles Trust, of which the decedent and her five children were beneficiaries. Between 1985 and 2007, the decedent transferred a total of \$1,063,333 to or for the benefit of her son, Peter, who had begun struggling financially and in his career. She also directly transferred money to Peter, deposited money into accounts to which he had access and made payments on some of his loans. On October 27, 1989, the decedent established the Mary Piper Bolles Revocable Trust, under which she specifically excluded Peter from distributions upon her death.

The Court applied the following factors in deciding whether the advances were loans or gifts: (1) there was a promissory note or other evidence of indebtedness; (2) interest was charged; (3) there was security or collateral; (4) there was a fixed maturity date; (5) a demand for repayment was made; (6) actual repayment was made; (7) the transferee had the ability to repay; (8) records maintained by either party reflect the transaction as a loan; and (9) the transaction was reported for federal tax purposes in a manner consistent with a loan. The Court emphasized the importance of “an actual expectation of repayment and an intent to enforce the debt” when determining the tax characterization of a family loan. The decedent recorded the advances as loans and kept track of interest, but there were no loan agreements, attempts to enforce repayment, or security on the loans. The Court held that while the decedent had initially viewed the advances to Peter as loans, she realized by October 27, 1989 that it was very unlikely he would pay her, as demonstrated by her exclusion of Peter under the terms of the Revocable Trust. Thus, the Court held that the “loans” should be characterized as loans through 1989, but they became advances on Peter’s inheritance for tax purposes beginning in 1990.

***Tax Court Holds Petitioner Failed to Present Evidence that Transfers Totaling \$24 Million Were I.R.C. Section 102 Gifts.***

In **Kroner v. Commissioner**, T.C. Memo. 2020-73, (June 1, 2020), the Tax Court affirmed the Commissioner’s determination of deficiency, holding that transfers to the petitioner totaling \$24 million did not constitute excludable gifts under I.R.C. Section 102. The petitioner and the transferor, Mr. Haring, formed a business relationship during the petitioner’s employment with Dunewood Funding, a company in which Mr. Haring was an investor. In 1993, the petitioner and Mr. Haring formed Singer Asset Finance Co. (“Singer”). Mr. Haring provided the financing in exchange for a 75% equity interest, while the petitioner held the remaining 25% interest. In 1995, Mr. Haring asked the petitioner to hold some of his beneficial financial interests as nominee, so the petitioner opened nominee bank account at Credit Suisse. In 1997, when Mr. Haring and the petitioner sold their interests in Singer, the petitioner signed a non-compete agreement

preventing him from conducting similar business for five years. In 2000, the petitioner established the Waromi Trust in Liechtenstein for Mr. Haring and started a credit counseling business called First Mutual Financial. Mr. Haring provided loans to First Mutual through Avenger, which was an entity Mr. Haring controlled. That same year, while the petitioner’s non-compete agreement was still in force, Mr. Haring invested in Peachtree Settlement Funding (“Peachtree”) through Skyline Technologies, Ltd. and acquired a 70% equity interest. Through a series of three transactions, Mr. Haring liquidated his interest in Peachtree by the end of 2006. The Court noted that within a month of each of the three liquidity events, Mr. Haring made a transfer to the petitioner, raising suspicions that Mr. Haring was acting as nominee for the petitioner in an investment in Peachtree.

Because the Commissioner’s determination of a deficiency is presumed correct, the taxpayer bears the burden of presenting credible evidence to the contrary. Thus, in this case, the petitioner was required to present credible evidence that Mr. Haring’s transfers were excludable gifts. The Court applied the Duberstein rule that a transfer is an I.R.C. Section 102 gift only if it was made with “detached and disinterested generosity.” At trial, the petitioner introduced a note that he had allegedly received from Mr. Haring in 2005, which expressed Mr. Haring’s appreciation for their friendship and a desire to make “a monetary gift” to the petitioner. However, the Court voiced “serious doubts” regarding the note’s authenticity and credibility. In addition, the Court held that the testimony of the petitioner’s witnesses was not credible because one of the witnesses was a close associate of Mr. Haring and the petitioner’s friend, and another was an attorney who represented both the petitioner and Mr. Haring. Furthermore, the petitioner’s testimony was self-serving, and Mr. Haring chose not to testify at all. Because the petitioner failed to present credible evidence that Mr. Haring’s transfers were made with detached and disinterested generosity, the Court ruled in favor of the Commissioner.

***Eleventh Circuit Upholds Deduction for Conservation Easement.***

In **Champions Retreat Golf Founders, LLC v. Commissioner**, 959 F.3d 1033 (11th Cir. 2020), the Eleventh Circuit upheld a deduction for a conservation easement over a private golf course and undeveloped land. The Tax Court previously upheld the Service’s denial of the deduction. The issue was whether the deduction was properly made “for the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem,” or was made for “the preservation of open space ... for the scenic enjoyment of the general public” pursuant to I.R.C. Section 170(h)(4)(A)(ii) and (iii)(I). The subject property consisted of 348 acres north of Augusta, Georgia, consisting of the private golf club and undeveloped land, but not the golf course buildings or parking lot. Significantly, a national park was located immediately on the far side of a 700-foot river that ran adjacent to the property.

The Court found that the taxpayer was entitled to a deduction if the easement either included a habitat for rare, endangered or threatened species of animal, fish, or plants, or if the easement contributed to the “ecological viability” of the adjacent national forest. The Court then evaluated the multiple birds, foxes, and rare species of plants. The Service argued that the golf course resulted in a non-natural habitat. The Court rejected that argument and found that the land does not

have to remain natural, but the habitat must be natural, meaning the fish, wildlife or plants continue to exist there in a relatively natural state. In addition, the Court found that the easement contributed to the ecological violability of the national forest, specifically in that it provided scenic enjoyment for the general public.

### ***Tax Court Values Gift of Limited Partnership Interest and Re-characterizes Sale as Gift.***

In **Nelson v. Commissioner**, T.C. Memo. 2020-81 (June 10, 2020), the Tax Court valued a limited partnership interest for federal gift tax purposes. On December 31, 2008, the taxpayer assigned a limited partner interest in Longspar Partners, Ltd. (“Longspar”) to an irrevocable trust. The assignment instrument stated that the gift was of an “interest having a fair market value of [\$2,096,000.00] ... as determined by a qualified appraiser within ninety (90) days of the effective date of [the assignment].” On January 2, 2009, the taxpayer sold a limited partner interest in Longspar to the trust. The memorandum of sale stated that the property transferred consisted of an “interest ... having a fair market value of [\$20,000,000.00] ... as determined by a qualified appraiser.” The taxpayers reported the 2008 transfer on a federal gift tax return. The 2009 sale was not reported on a gift tax return. The Service challenged both transfers claiming the 2008 transfer was undervalued and the 2009 sale resulted in a gift because the sale price was undervalued.

The taxpayer argued that the assignment was really a formula clause and the transfers were of a defined value rather than a limited partner interest. The Court rejected the taxpayer’s argument finding that the value was to be a limited partner interest as determined by an appraiser rather than a value as finally determined for federal estate or gift tax purposes. The Court found that the taxpayers were bound by the instruments transferring the interests. The taxpayer did not transfer a defined value but rather a set percentage of limited partnership interest.

The Court then addressed the valuation of the limited partnership interests. Longspar’s primary asset consisted of common stock in a closely-held corporation (“WEC”) which had to be valued. The valuation for WEC was performed by Expert 1, whose valuation opinion was then used by the taxpayer’s Expert 2 and Service’s Expert 3.

**WEC Valuation.** WEC was a holding company with six subsidiaries. Expert 1 valued WEC by determining the fair market value of each subsidiary, combining those values, subtracting WEC’s interest-bearing debt and preferred stock to determine a value of \$363.7 million on a controlling interest basis before any discounts. Expert 1 then applied a 20% discount for lack of control and a 30% discount for lack of marketability. Expert 3 disputed the application of the lack of control discount for several of the subsidiaries, claiming that it was inappropriate because each WEC subsidiary was valued on a noncontrolling basis. Specifically, Expert 3 argued that Expert 1’s use of the cost approach to value the subsidiaries did not take into account intangible assets and therefore resulted in a noncontrolling value. The Court rejected Expert 3’s argument and further found that Expert 1 did consider intangible assets in the valuation. The restrictive terms of certain dealer agreements may eliminate any intangible value for the companies and therefore the valuation was appropriate.

For other subsidiaries of WEC, Expert 1 used the income approach and the market approach and applied a discount for lack of control because the subsidiaries operated efficiently like a publicly-traded company, and minority shareholders in a publicly traded company would not have control. Expert 3 argued that the income approach used resulted in values of noncontrolling interests because (i) the assumptions used did not take into account the ability of a shareholder to recognize more for a controlling interest and (ii) the valuation did not take into account increased profits or changes in capital structure that would differentiate controlling and noncontrolling interests. Expert 3 also argued that the market approach was flawed because Expert 1 should have decreased the multiples to reflect the differences with the guideline companies used and then applied control premiums to offset the difference.

The Court accepted Expert 3’s criticism of the income approach but found that elements of control still existed. Accordingly, the lack of control discount may be reduced but would not be eliminated. The Court, however, accepted Expert 3’s criticism of the market approach. Expert 1’s reduction of minority-marketable multiples was vague and unconvincing. Further, Expert 1 used a similar transactions method but relied on management for determining an average price per unit.

The Court then examined the amount of the discount for lack of control and rejected the 20% discount. The Court criticized the valuation because it did not use comparable holding companies. The Court reviewed prior cases and found that a 15% discount was appropriate.

**Longspar.** Expert 2 and Expert 3 disagreed on the amount of discounts for lack of marketability and lack of control. For lack of control, Expert 2 claimed a 15% discount was appropriate while Expert 3 claimed a 5% discount was appropriate. Expert 2 reviewed certain closed-end funds for comparison and Expert 3 reviewed other closed-end funds. The Court found that both experts suffered from a lack of suitable comparables and rejected both experts’ analyses. The Court adopted a 5% discount for the possibility of a lack of control disadvantage.

For lack of marketability, Expert 2 looked at several studies on the sale of restricted stock. Expert 3 also looked at pre-IPO restricted stock sales, but also reviewed quantitative models. The Court noted that Expert 2 relied on studies that have been addressed by the Court in prior cases and valuations based on those studies have been rejected. The Court further found that Expert 3 did not support his conclusion that 25% was the appropriate discount rather than 30%. The Court decided to adopt the median discount of 28% when using Expert 3’s methodology.

### ***Court Values Conservation Easement.***

In **Johnson v. Commissioner**, T.C. Memo. 2020-79 (June 8, 2020), the Tax Court valued a conservation easement. In 2007, the taxpayer granted a conservation easement over 116.14 acres of a ranch in Colorado. The taxpayer then claimed a \$610,000 charitable deduction. The Service challenged the deduction on the basis that the conservation easement was overvalued.



All parties agreed that the proper measure of value was the difference between the value of the land prior to the easement and after the easement. First, the parties disputed the highest and best use of the property. The Court rejected the Service's expert's ("Expert 2") argument that the highest and best use must take into account certain limitations on the use of the property for residential purposes. The Court noted that Expert 2's own report indicated that the property could be used for residential purposes.

The Court then evaluated the "before value." Both the taxpayer's expert ("Expert 1") and Expert 2 used sales and market data, but each applied different methodologies to make adjustments to value based on the data. Expert 1 used a quantitative approach, while Expert 2 used a qualitative approach. The Court rejected the qualitative approach. The Court agreed with the quantitative approach but found that several adjustments were inappropriate.

The Court then evaluated the "after value." Both experts considered other properties. The Court found that none of the properties were sufficiently comparable to support a direct comparable sales approach. The Court, however, found that the comparables were acceptable to determine a proper diminution in value. The Court found that both experts included unreasonably high or low values in their analyses and removed those values. The Court then used the midpoint between the two values to reach its final diminution value.

#### ***U.S. District Court for the Eastern District of California Grants Service's Motion to Submit a Broad Range of Documents for In Camera Review.***

In **Mertes v. Internal Revenue Service**, 126 A.F.T.R.2d 2020-5036 (E.D. Cal. June 25, 2020), the United States District Court for the Eastern District of California granted the Service's motion to submit a broad range of documents for *in camera* inspection. Plaintiff Billie Mertes sought a copy of the United States Gift and Generation-Skipping Transfer Tax Form ("Form 709") used to assess gift taxes against her in 2012 which were later reversed. The Service held that Freedom of Information Act ("FOIA") Exemption 7 applied and that disclosure of Form 709 would be improper. Because the Service's motion for summary judgment was significantly redacted, it filed a motion to submit documents for *in camera* inspection, including Form 709, the unredacted motion for summary judgment, the unredacted supporting affidavit, the unredacted statement of facts and an additional non-publicly filed declaration explaining the basis for the FOIA exemption. Mertes opposed the motion for *in camera* inspection, arguing that while she did not oppose submission of Form 709, there was no legal authority to support submission of the unredacted motion and supporting declarations. Furthermore, Mertes argued such submission would be a violation of due process and "a gross miscarriage of justice," as she would have to guess as to what opposing legal arguments to make, and the Court would not know whether the "undisputed facts" submitted by the Service were undisputed. The Service argued that submission of the other documents in addition to Form 709 were necessary to establish the FOIA exemption and that publicly disclosing those documents would defeat the purport of the exemption. The Service further argued that broader submission of documents *in camera* has been permitted "where a failure to do so would undermine the claimed exemption and other alternatives fail to provide a sufficient basis for decision."

The Court applied the rule from **Lion Raisins, Inc. v. USDA**, 354 F.3d 1072 (9th Cir. 2004), that in exceptional circumstances where as much public information as possible has been provided, a court can order an *in camera* inspection of both a contested document and supporting declarations. Here, the Service had asserted in two different motions that it could not publicly release further information. Thus, the Court granted the Service's motion to submit the requested documents for *in camera* review, allowing it an opportunity to demonstrate this was an "exceptional case." However, the Court noted that after *in camera* review, it may issue additional orders, such as requiring additional information to be publicly disclosed. In addition, the Court would not rule on the summary judgment motion without affording the parties an additional opportunity to be heard.

## North Carolina Cases

### ***North Carolina Court of Appeals Holds the Language of an Alleged Will Ambiguous Enough for Submission to a Jury.***

In **In re Estate of Worley v. Sprouse**, 843 S.E.2d 300 (N.C. Ct. App. April 21, 2020), the North Carolina Court of Appeals vacated the trial court's order which held that a certain document offered for probate did not constitute a will and which revoked the Certificate of Probate and Order Authorizing Issuance of Letters. Mr. Worley died on January 14, 2017, unmarried and without children but survived by three of his four siblings. After Mr. Worley's death, Ms. Sprouse, his partner for the 36 years prior to his death, offered a handwritten document for probate which read as follows:

March 13, 2001

Last Will of Paul Worley:

I want Pat [Sprouse] to have the power of attorney of all that I own. That means land, cars, money, guns, clothing, and anything else!

I don't want Grace Price Worley to have none.

Signed March 13, 2001 9:00 pm

Paul Worley

Mr. Worley's three surviving siblings filed a petition seeking an order to revoke the probate of the document and asserting that it was not Mr. Worley's will. The trial court ordered the clerk to revoke probate, holding that the document was not a will because it did not make a testamentary disposition and only granted Ms. Sprouse a power of appointment which would terminate at Mr. Worley's death. The Court of Appeals disagreed, holding that a jury could reasonably infer from the text of the document that Mr. Worley intended for the document to be his will and that "the language of the [document was] sufficiently ambiguous to allow a construction to effectuate a testamentary transfer of property." The Court further reasoned that there may be multiple possible interpretations of Mr. Worley's intentions based on the language used and other competent evidence, such as whether he intended to grant Ms. Sprouse a power of appointment over his property at his death, whether he intended

for Ms. Sprouse to have absolute control of his property at his death with the exclusion of transfer to Grace Price Worley, or whether he intended to make Ms. Sprouse the executrix of his estate.

***North Carolina Court of Appeals Finds Adverse Possession Where a Trustee Improperly Conveyed Land in her Individual Capacity.***

In **Bauman v. Pasquotank County ABC Board**, 842 S.E.2d 166 (N.C. Ct. App. April 7, 2020), the Court of Appeals of North Carolina affirmed the trial court's judgment in favor of the defendant's adverse possession counterclaim. The plaintiff's grandmother, Margaret Fletcher, placed her real property in testamentary trust for the benefit of her son, Charles Fletcher, providing that the remainder would pass to the plaintiff upon Mr. Fletcher's death. Emma Norris was named trustee and given full discretion to sell the corpus for Mr. Fletcher's benefit or to terminate the Trust. Emma and Mr. Fletcher got married in 1997, and Emma conveyed the majority of the Trust's real property to Mr. Fletcher individually by general warranty deed. She then had Mr. Fletcher convey the property to her by deed in her individual capacity. However, a .66-acre tract of land ("Disputed Tract") was not transferred because it had not been described in the deeds. In March 2000, Emma executed a deed transferring the Disputed Tract to the Pasquotank County ABC Board ("Board") for \$165,000. Emma "and husband, [Mr.] Fletcher" were listed as the grantor, and they each signed the deed, but it did not reference the Trust. The Board built and operated an ABC store on the Disputed Tract.

In 2015, the plaintiff and Mr. Fletcher sued Emma for undue influence, fraud, and breach of fiduciary duty in connection with the transfers from the Trust. Mr. Fletcher and Emma died before the resolution of the litigation, but the plaintiff and Mr. Fletcher's estate were ultimately granted summary judgment on those claims. In 2018, upon learning that the Disputed Tract had not been properly conveyed, the plaintiff brought a quiet title action against the Board. The Board argued adverse possession under color of title, and the trial court entered judgment on the pleadings in favor of the Board. On appeal, the plaintiff argued that adverse possession under color of title could not be applied against the beneficiaries of a trust when the trustee had created the color of title in the adverse possessor. The Court disagreed, applying the general rule that if a trustee may sue to eject an adverse possessor, the time for adverse possession under color of title runs against the trust beneficiaries. Here, because Emma had conveyed the Disputed Tract in her individual capacity, she was not estopped from challenging the conveyance in her capacity as trustee. The plaintiff argued that an exception allowing tolling the term of adverse possession against beneficiaries should apply because Emma and the Board had "united in a breach of the . . . trust." The Court again disagreed because Emma was given the sole discretion as trustee to sell the trust property, and the constructive fraud judgment against her did not invalidate the conveyance of the Disputed Tract.

***North Carolina Court of Appeals Finds Undue Influence Led to Amendment of Revocable Trust.***

In **Cobb v. Day**, 840 S.E.2d 538 (Table) (N.C. Ct. App. April 7, 2020), the North Carolina Court of Appeals affirmed a jury verdict of undue influence against the defendant and the trial court's directed verdict in favor of the defendant on the issues of constructive fraud and lack

of testamentary capacity. In September 2004, John Bruce Day was diagnosed with dementia. On November 22, 2004, Mr. Day executed his will, which established a revocable living trust for the benefit of six beneficiaries. Under the Trust, Mr. Day's son, Arley Andrew Day (the defendant), would take 50%, the defendant's daughter would take 10%, and Mr. Day's other four grandchildren (the plaintiffs) would take 10% each. On June 21, 2012, the defendant assisted Mr. Day at Mr. Day's residence in amending the Trust to make the defendant the sole beneficiary. The plaintiffs sued on several claims, including undue influence, constructive fraud and lack of testamentary capacity.

In reviewing the undue influence claim, the Court applied factors from **In re Andrews**, 299 N.C. 52, 261 S.E.2d 198 (1980) including the testator's old age and physical and mental weakness, the beneficiary's constant association and supervision, the opportunity for others to see the testator, how the will is different from or revokes a prior will and the beneficiary's procurement of its execution. Here, Mr. Day was 95 years old, had dementia and suffered from confusion and occasional fainting. At the time of the amended trust's execution, Mr. Day was unable to get out of his chair and was then hospitalized and moved to an assisted living facility. The defendant was present for the amended trust's execution, had more frequent contact with Mr. Day than the plaintiffs and assisted with Mr. Day's day-to-day affairs. In addition, the Court reasoned that the amendment was a "significant deviation" from the original terms and basically disinherited Mr. Day's grandchildren. For these reasons, the Court affirmed the jury verdict of undue influence.

The Court affirmed the trial court's directed verdict for the defendant on the issues of constructive fraud and testamentary capacity. The Court reasoned that there was no constructive fraud because there was no confidential relationship between the plaintiffs and the defendant. While the defendant's status as Mr. Day's attorney-in-fact created a relationship of trust and confidence between the defendant and Mr. Day, it did not create such a relationship between the defendant and the plaintiffs. "The mere family relationship and general allegations of consultations among family members" was not sufficient to establish a relation of trust and confidence. The Court also found that plaintiffs had failed to present evidence that Mr. Day lacked testamentary capacity at the time the amended trust was executed, that he did not understand the kind, nature or extent of his property or that he did not understand the effect his act would have on his estate.

***North Carolina Court of Appeals Upholds Order Approving Settlement with Insurer Where it was the Only Likely Source of Recovery.***

In **In re Estate of Purswani**, 839 S.E.2d 874 (N.C. Ct. App. April 7, 2020), the North Carolina Court of Appeals affirmed the trial court's Order Approving Settlement. In 2002, Krish Purswani and Kiran Purswani obtained a divorce and executed a final parenting plan which gave Kiran primary decision-making authority regarding their minor children, including Vijay Krish Purswani. In 2016, Vijay died in a single-car accident in which he was a passenger, and Kiran was ultimately appointed as administratrix of Vijay's estate. Kiran filed a Petition for Approval of Settlement in superior court on the grounds that her attorney's investigation had revealed that recovery would likely be limited to the \$200,000 insurance policy

limits of the car's owner. The trial court entered an Order Approving Settlement authorizing Kiran to settle the wrongful death claim of the Estate, and Krish appealed. The Court affirmed the order, holding that Kiran was authorized to settle claims on behalf of the Estate in her capacity as administratrix. In addition, the trial court's conclusion was supported by findings of fact that Kiran's attorney had investigated possible sources of recovery and determined that the insurer was the only likely source of recovery.

#### ***North Carolina Court of Appeals Addresses Non-Probate Assets and Breach of Fiduciary Duty by Power of Attorney.***

In **Stitz v. Smith**, --- S.E.2d ---, 2020 WL 3697776 (N.C. Ct. App. July 7, 2020), the North Carolina Court of Appeals reversed the trial court's order dismissing certain claims by plaintiffs for lack of subject matter jurisdiction and for failure to state a claim. Plaintiffs were three siblings who brought suit against their Sister and her husband claiming that they wrongfully converted proceeds from savings bonds and an annuity belonging to their deceased Mother. During her lifetime, Mother co-owned a number of savings bonds, where each bond was owned by Mother and one of her children, such that each of her children co-owned some bonds with her. Mother also owned a life insurance policy which named her children as beneficiaries. In 1989, Sister and her husband moved in with Mother and lived with her for the next 27 years until her death. In 2008, Sister was named power of attorney for Mother. In late 2012 and early 2013, Sister took Mother to the bank to cash in the savings bonds Mother owned with each Plaintiff. The proceeds were deposited into an account jointly owned by Mother and Sister. Mother then directed Sister to give the proceeds from the bond sales to each Plaintiff. Mother then executed a new Will devising her entire estate to Sister and her husband and expressly excluding Plaintiffs "because I have made gifts to them previously, including savings bonds which I have bought in their names." Shortly thereafter, Mother rolled her life insurance policy into an annuity and named Sister and her husband as the sole beneficiaries. Mother died in 2016, and Sister qualified as the Executrix of Mother's estate. When Plaintiffs learned of the savings bond proceeds and annuity, they requested that Defendants turn over the proceeds to them. When Defendants refused, Plaintiffs instituted two civil actions: (1) a caveat to the Will and (2) a Superior Court action claiming conversion and unjust enrichment as to the savings bonds and annuity, interference with inheritance and undue influence as to the annuity, breach of fiduciary duty and constructive fraud. The trial court dismissed the Superior Court action for lack of subject matter jurisdiction and failure to state a claim.

The Court reversed the dismissal based on lack of subject matter jurisdiction as the joint account and annuity were not part of Mother's estate and therefore not part of the caveat proceeding. The Court also held that Plaintiffs stated claims for conversion and unjust enrichment for the proceeds from the savings bonds and for any proceeds that Defendants received from the annuity within three years of the filing of the complaint. The Court also held that Plaintiffs stated claims for undue influence/rescission of the change of beneficiary for the annuity. However, the Court agreed with the trial court's dismissal of Plaintiffs claims for breach of fiduciary duty and constructive fraud as Plaintiffs failed to allege facts establishing that Sister owed a fiduciary duty to Plaintiffs.

#### ***North Carolina Court of Appeals Reinstates Assignment and Deficiency Judgment.***

In **In re Estate of Meetze**, --- S.E.2d ---, 2020 WL 4092156 (N.C. Ct. App. July 21, 2020), the North Carolina Court of Appeals vacated the trial court's order barring the Decedent's surviving spouse, Ms. Peacock, from her spousal year's allowance. Ms. Peacock and the Decedent were married in 1997. Throughout their marriage, Decedent physically abused Ms. Peacock. After one particularly violent assault, Ms. Peacock fled the home and sought a protective order against the Decedent. She filed for divorce later that year, but ultimately dropped the divorce proceeding. However, Ms. Peacock and the Decedent remained separated and both entered into other relationships until the Decedent's death in 2016. In 2001, Decedent purported to marry another woman, Ms. Burgess, who was unaware that he was still married to Ms. Peacock.

Shortly after the Decedent's death, Ms. Burgess filed an application for and was assigned the spousal year's allowance. However, Decedent's son from a previous marriage filed a motion to set aside the assignment of the year's allowance because the Decedent was still married to Ms. Peacock at the time of his death. On February 15, 2016, Ms. Peacock filed her own application for the spousal year's allowance and joined in the motion to set aside Ms. Burgess' assignment. The trial court later set aside the assignment to Ms. Burgess after declaring the marriage void. However, Ms. Peacock's application sat dormant in the Clerk's office for the next 3 years, until February 15, 2019, when an assistant clerk allowed the application, assigned the year's allowance to Ms. Peacock, and entered a deficiency judgment. In so doing, the assistant clerk backdated her signature on the assignment to February 15, 2016 but dated the deficiency judgment February 15, 2019, the date actually signed. When the backdating was brought to the attention of the Clerk, the Clerk entered an Order re-dating the assignment and deficiency judgment to April 4, 2019 pursuant to Rule 60 but did not specify which specific subsection of the Rule applied. All parties appealed and Ms. Burgess and the Decedent's beneficiaries under his Will also filed a motion to set aside the assignment and deficiency judgment. On appeal the trial court (1) granted Ms. Peacock's motion to dismiss Ms. Burgess' appeal based on a lack of standing, (2) affirmed the Clerk's re-dating of the assignment and deficiency judgment and (3) granted the beneficiaries' motion to set aside the assignment and deficiency judgment pursuant to N.C.G.S. Section 31A-1 based on a finding that Ms. Peacock willfully and without cause abandoned the Decedent.

Ms. Peacock appealed on the grounds that Rule 60 did not authorize the Clerk to amend the dates of entry of the assignment and deficiency judgment and that she did not willfully and without cause abandon the Decedent. The Court agreed and held that the Clerk and the trial court abused their discretion in re-dating the assignment and deficiency judgment to April 4, 2019 because the requested relief was outside the scope of Rules 60(a), 60(b)(1), and 60(b)(6). Under Rule 60(a), a judge does not have the power to make a correction affecting the substantive rights of the parties. By re-dating the assignment and deficiency judgment to April 4, 2019, the Clerk renewed the time in which the beneficiaries could appeal those orders, a result which is plainly prohibited under Rule 60(a) and **Food Service Specialists, Inc. v. Atlas Restaurant Mgmt, Inc.**, 111 N.C. App. 257 (1993). Under Rule 60(b)(1), the moving party must prove mutual mistake

or that a unilateral mistake was made because of some misconduct. Here, there was no evidence that the assistant clerk's unilateral mistake in backdating her signature was the result of impropriety. Rather, the trial court found "she thought it was the proper thing to do and there was no ill will on [her] part." Therefore, relief could not be granted under Rule 60(b)(1). Finally, Rule 60(b)(6) requires a showing (1) that extraordinary circumstances exist and (2) that justice demands relief. The beneficiaries argued that by backdating the assignment, the assistant clerk deprived them of their right to appeal. The Court disagreed as the beneficiaries had a right to appeal within 10 days of the actual entry of the order, which was February 15, 2019. Thus, they had until February 25, 2019 to file any appeal, and their failure to do so was the result of inaction on their part. The Court then vacated the trial court's order for lack of jurisdiction as the beneficiaries' appeal after April 4, 2019 was untimely.

While not pertinent to its holding, the Court also expressly found that the evidence and findings of fact by the trial court did not support its conclusion that Ms. Peacock abandoned Decedent without just cause but rather that Decedent abandoned her through his abuse and the total absence of acts of contrition or reform on his part.

***North Carolina Court of Appeals Reverses Summary Judgment on Claims against Attorney-in-Fact.***

In **Smith v. Smith**, --- S.E.2d. ---, 2020 WL 4092178 (N.C. Ct. App. July 21, 2020), the North Carolina Court of Appeals reversed the trial court's order granting summary judgment in favor of the Defendant on claims for (1) constructive fraud while acting as attorney-in-fact, (2) breach of fiduciary duty while acting as attorney-in-fact, (3) constructive trust and (4) conversion while acting as attorney-in-fact with regard to the expenditure of the principal's funds. Plaintiff, one

of Decedent's grandchildren and beneficiary of her estate, brought suit against Decedent's son, who had served as Decedent's attorney-in-fact and former co-executor of her estate. Plaintiff asserted that Defendant had improperly transferred Decedent's assets to himself and others while he was acting as her attorney-in-fact and had misrepresented the value of certain land, specifically the value of the timber on such land, during negotiations to divide such property between Plaintiff and Defendant which they had inherited as tenants in common upon the Decedent's death.

Plaintiff alleged that Defendant improperly gifted assets to himself when he transferred sums from the Decedent's individual accounts to accounts he held jointly with the Decedent and improperly spent funds from the joint accounts on his personal expenses and those of his family. The Court found that while the Defendant did not make any gifts to himself when he transferred funds from the individual accounts into the joint accounts, the transfers and subsequent expenditures could nevertheless constitute a breach of fiduciary duty if they were unauthorized. Likewise, while the transfers to the joint accounts did not satisfy the elements of a claim for conversion because there was no wrongful deprivation of such funds to the owner, the use of such funds for his personal expenses clearly deprived the Decedent of such funds and were wrongful if unauthorized. As Plaintiff presented evidence that raised a genuine issue of material facts as to whether such transfers and expenditures were authorized, the trial court erred in granting summary judgment in favor of the Defendant on these claims.

The Court upheld the trial court's grant of summary judgment with regards to the real property division claims as no fiduciary relationship existed between Plaintiff and Defendant as tenants in common because Plaintiff did not repose a special confidence or trust in Defendant.

Visit [ncbar.org/members/benefits](https://ncbar.org/members/benefits)  
to access valuable NCBA  
Member Discounts available for  
your practice and personal use.