Estate & Gift Tax Update

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I. Legislation Relating to Estate and Gift Tax

A. **Repeal of the Estate Tax?** Proposed repeal of the federal estate and gift tax and the generation-skipping transfer tax is back in the news. On January 5, 2015, Representative Mac Thornberry (R. Texas) introduced the Death Tax Repeal Act of 2015 (H.R. 1105). The bill is rather short and to the point:

> SECTION 1. **Short title**.
> This Act may be cited as the "Death Tax Repeal Act".
>
> SEC. 2. **Repeal of estate and gift taxes**.
>
> (a) **In general**.—Subtitle B of the Internal Revenue Code of 1986 (relating to estate, gift, and generation-skipping taxes) is hereby repealed.
>
> (b) **Effective date**.—The repeal made by subsection (a) shall apply to estates of decedents dying, gifts made, and generation-skipping transfers made after the date of the enactment of this Act.

1. While we have heard this song before, the bill is being taken seriously—at least by Congress. The Death Tax Repeal Act was passed by the House of Representatives on a 240-179 vote, and is headed for the Senate. Well… as noted below, President Obama's Fiscal Year 2016 Budget Proposal proposed *expansion* of the estate tax and disallowance of stepped-up basis. It is fair to say that the administration is not enthused about repeal of the estate tax.

B. **Obama administration's Fiscal Year 2016 Budget Proposal.** In On February 2, 2015, the Treasury Department published its Fiscal Year 2016 Budget Proposal ("the Greenbook"), explaining the president's budget proposals for 2015. Several of the proposals relating to transfer taxes were golden oldies, carried over from earlier Budget Proposals, but one of them—repeal of the §1014stepped-up basis rule—is a stunner … or a joke. (Take your pick.)

1. **Lower the exemption to $3.5 million and increase tax rate to 45 percent—in 2016.** This proposal, which would restore the estate, gift and GST tax parameters to their 2009 levels, first appeared in last year's Greenbook—except that last year's edition would have applied to decedents dying on or after January 1, 2018. This year's proposal would apply to estates of decedents dying on or after January1, 2016. It would raise the transfer tax rate to 45 percent, and would lower the estate tax exemption and the GST exemption to $3,500,000, and the gift tax exemption to $1,000,000, with no indexing for inflation. If it means anything—and it doesn't—last fall Sen. Bernie Sanders (Vt.) introduced a bill that would have enacted these changes.

    a. With more than a few Congressmen working on repeal of the estate tax—as if it hasn't already been repealed for 99.9 percent of the population as a practical matter—this provision is dead ***before*** arrival.

2. **GRATS and installment sales to defective grantor trusts would be killed off**. Two proposals in the 2015 Greenbook were combined into one.

a. **Grantor Retained Annuity Trusts—remainder must be valued at greater of 25 percent of the value of the transferred assets or $500,000.** For the third year, the Budget Proposal includes a provision that would kill off short-term grantor retained annuity trusts by requiring a 10-year minimum GRAT term [*cf.* Walton v. Commissioner, 115 T.C. 589 (2000)], providing that the amount of the annuity payout could not be decreased during the GRAT term, and imposing a maximum term on GRATs—the grantor's life expectancy plus ten years. However, the 2016 edition goes further, by requiring that the GRAT interest must have a value equal to the greater of 25 percent of the transferred assets or $500,000, "but not more than the value of the assets contributed."

b. **DIGITS**. Installment sales to "defective" grantor trusts also would no longer be tax-effective. If a deemed owner under a grantor trust "engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes … the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction) would be includible in the deemed owner's gross estate, would be subject to gift tax if during the deemed owner's life the grantor trust treatment is terminated, and would be treated as a gift by the deemed owner as to any distribution to another person during the deemed owner's lifetime. "The transfer tax imposed by this proposal would be payable from the trust."

3. **Limit GST-exempt trusts to 90 years**. Carried over from earlier proposals is a provision under which the GST exemption would expire after 90 years. The 90-year period is inspired by the Uniform Statutory Rule Against Perpetuities (USTRAP), which has been enacted in about a dozen states.

4. **Extend duration of lien in Section 6166 deferral**. Under current law, if a §6166 election is made to defer taxes relating to a closely held business, the §6324(a)(1) lien continues for ten years. However, the deferral of payment of the tax can continue for up to fifteen years and three months after the decedent's death. The proposal would extend the lien throughout the §6166 deferral period.

5. **Health and Education Exclusion Trusts (HEETS) would be subject to GST**. Section 2503(e) provides for an unlimited gift tax exclusion for tuition and medical payments made directly to the service-provider. For purposes of the GST, §2611(b)(1) excludes "any transfer which, if made during the donors life would not be treated as a taxable gift by reason of section 2503(e)." This has invited the use of HEETs, which provide for payment from the trust of medical expenses and tuition to multiple generations of descendants. (The trust must include a non-skip person—a charity—that has a substantial interest in the trust.) As with last year's edition, the Budget Proposal would kill off HEETs by providing that §2611(b)(1) applies only to a payment by a donor directly to the service-provider, and not to trust distributions.

6. **Restriction on use of *Crummey* withdrawal powers**. It would be an understatement to say that the Commissioner does not like the use of *Crummey* withdrawal powers. Again this year, the Budget Proposal would (i) eliminate the present interest requirement for gifts that qualify for the annual exclusion, and (ii) impose an annual limit of $50,000 per-donor with respect to a "new category" of transfers of property that give the donee a *Crummey* withdrawal power,

as well as transfers to passthrough entities, transfers of interests subject to a restriction on sale, and transfers that cannot be immediately liquidated by the donee.

a. I don't know how this "new category" of gift transfers would work in terms of eliminating the requirement that a gift be of a present interest—but I'm not going to worry about it because it ain't going to happen.

7. **Expand definition of "executor" to encompass all tax issues**. Here is a proposal that isn't controversial, and is not D.O.A. The Code currently defines "executor" for purposes of the estate tax, but not for purposes of tax matters that arose prior to the decedent's death. The proposal would expand the definition, making the Code's definition of executor applicable for all tax purposes, enabling the executor (for example) to agree to a compromise or assessment, claim a refund, and file an action regarding tax liability.

8. **Inherited retirement benefits: Five-year payout limit for beneficiaries other than spouses, minor children**. Under the proposal (also included in the 2014 and 2015 Budget Proposals), except for spouses (who could continue to make spousal rollovers) and minor children, disabled or chronically ill beneficiaries, and beneficiaries not more than ten years younger than the participant, beneficiaries could no longer stretch out required minimum distributions over their life expectancy. Instead, payouts would be limited to five years after the decedent's death. Roth IRAs would be subject to the same five-year rule.

C. Repeal of the "new basis at death" rule? In his State of the Union address, President Obama announced that the Budget Proposal would repeal §1014, the "new basis at death" rule. Prior to his speech, a White House Fact Sheet referred to the stepped-up basis rule as "perhaps the largest single loophole in the entire individual income tax code." The proposal also would raise the capital gain tax rate to 28 percent—"the rate at which capital gains were taxed under President Reagan." All of this would be effective after December 31, 2015.

1. From the Greenbook: "The proposal "would end stepped-up basis by treating bequests ***and gifts*** [emphasis added] as realization events that would trigger tax liability for capital gains. To ensure the proposal creates neither tax nor compliance burdens for middle class families, decedents would be allowed a $200,000 per couple ($100,000 per individual) exclusion for capital gains income, along with a $500,000 per couple ($250,000 per individual) exclusion for personal residences. Tangible personal property other than art and similar collectibles (e.g., bequests or gifts of furniture or other household items) would also be excluded. In addition, family members that inherited small, family-owned and operated businesses would not owe tax on the gains unless and until the asset were sold, and closely-held businesses would have the option to pay tax on gains over 15 years." A deduction would be allowed for the cost of appraisals of appreciated assets, and an estate tax deduction would be allowed for the tax on gains deemed realized at death. The tax could be avoided by donating appreciated assets to charity.

2. **Déjà vu all over again?** Haven't we heard something like this before? The Tax Reform Act of 1976 adopted a carryover basis rule, which (after attempted fixes and technical corrections) was deemed so unworkable that even the Treasury Department was behind repeal of carryover basis in 1979. The TRA '76 model provided for various adjustments to basis, prorating such death costs as administration expenses, state and federal estate taxes, etc., etc. with respect to each appreciated asset. No mention of such adjustments is made in the Budget Proposal.

3. **Provide reporting on a consistent basis between estate tax valuation and income tax basis in the heir's hands.** Curiously, the Greenbook included a proposal from earlier editions, based on the premise that §1014 would still be with us. As noted in the Greenbook, the value of property as reported on an estate tax return raises a rebuttable presumption of the property's basis in the hands of the heir—but in more than a few cases in the past, the heirs have successfully rebutted that presumption. Treasury's concern is that the executor may report a low valuation to reduce estate taxes, yet the heirs would argue that the reported value was low-balled to save transfer taxes. The proposal would provide that the basis for income tax would be the same as values "as determined for gift or estate tax purposes."

    a. Is this just bad editing of the 2016 Budget Proposal, or is it rather a tacit realization that a statute repealing the stepped-up basis rule won't even come before Congress?

D. A history lesson that lays an important predicate. From 1948 to 1976, the exemption under the federal estate tax and gift tax was $60,000. As a result, in the late 1960s and early 1970s, the federal estate tax was a concern for middle America. A client with a house, a life insurance policy and a couple of bank accounts had to be concerned about the estate tax.

1. **The marital deduction**. The Revenue Act of 1948 introduced the marital deduction. Property left outright to a surviving spouse or to a "marital deduction trust" qualified for a deduction. Because the purpose of the marital deduction was to provide parity of treatment for residents of common law jurisdictions and community property states (only one-half of community property is subject to tax on the death of a spouse), the marital deduction was limited to one-half of a decedent's "adjusted gross estate" (essentially, the gross estate minus debts and expenses). Community property was not eligible for a marital deduction, because under state law the community estate was "split" for transfer tax purposes, and only one-half the value of community property is includible in the deceased spouse's gross estate.

    a. This led to the use of **marital deduction formula clauses**, which made a bequest to the spouse or to a marital deduction trust of "the ***maximum*** **allowable marital deduction** available to my estate." The remainder of the estate was (typically) left to the trustee of a "**bypass trust**" for the benefit of the surviving spouse and descendants that gave the spouse, at most, a life income interest. When the spouse died, the value of her life estate terminated and had no value, and thus the trust "bypassed" the spouse's estate for purposes of the estate tax.

        (i) If the trust continued for the benefit of descendants, the trust estate also bypassed the children's estate—a circumstance that ultimately led to enactment of the generation-skipping transfer tax.

    b. With the increased use of bypass trusts, initially spurred by the desire to avoid estate taxes in the surviving spouse's estate, clients and professionals came to appreciate the mon-tax benefits of trusts, including creditor protection via spendthrift provisions, avoidance of guardianships in the incapacity situation, and control of devolution of the assets on the spouse's death.

        (i) Outside the East Coast, trusts were not widely used in estate planning before the 1940s and 1950s, which explains why much of our early trust was based on case law decisions from courts in Massachusetts, New York and similar eastern states.

c. The purpose of the marital deduction was ***not*** to eliminate tax on interspousal transfers. Rather, the purpose was to ***defer*** the tax until the death of the surviving spouse. The price for qualification for a marital deduction was that the interest passing to the spouse had to be includible in the spouse's gross estate, to the extent not consumed or disposed of by the spouse during his or her lifetime.

2. **Increase in the exemption**. In 1976, the estate tax (and gift tax) exemptions were increased to $175,625, and in 1981 the exemption was increased to $600,000 (phased in gradually).

a. The 1981 tax act also introduced the **unlimited marital deduction,** with no quantitative limit on the amount of the deduction**.** Whereas the earlier purpose of the marital deduction was to provide parity of treatment for spouses residing in community property and common law states, the policy underlying the unlimited marital deduction was to give the opportunity to eliminate any tax on the spouse's death—regardless of the size of the decedent's estate, as long as property was left to the spouse in a qualifying way. Instead, tax on the property was deferred until the death of the spouse.

b. This resulted in a change in marital deduction formula clauses, which now provided for a bequest of "the ***smallest*** **marital deduction** needed to eliminate an estate tax in my estate." The remainder of the estate—the largest amount that could pass tax-free by utilizing the decedent's exemption—was (typically) left to the trustee of a bypass trust.

c. Because many existing wills had been drafted containing a formula clause that provided for the maximum allowable marital deduction—which under the unlimited marital deduction could be the entire estate, Congress enacted a "**transition rule**": For wills executed before 1982, marital deduction formula clauses making a "maximum allowable" bequest would be construed under the former law that placed a quantitative limit on the marital deduction.

3. F**urther increases in the exemption**. In 1986, the generation-skipping transfer tax was enacted. In 2001, the exemption was raised to $1 million. The 2001 tax act (the "Bush Tax Act") further increased the exemption in steps, until it reached $3,500,000 in 2009. Because of some convoluted Senate rules involving something called the "Budget Reconciliation Act," all provisions of the Bush Tax Act expired on December 31, 2009. As Congress did not take immediate steps to extend the estate and gift tax rules, there was no federal estate tax in 2010. Congress finally took action in October 2009, and in 2011 and 2012 the exemption was $5,000,000.

4. **Estate planning concern in those early years: Eliminate (or at least reduce) the estate tax**. Throughout all of these years (until 2011), with estate tax rates as high as 50 or 55 percent, for many clients a planning objective was to eliminate (or at least reduce) federal estate tax on the death of the client and his or her death. This could be accomplished through the use of not just marital deduction formula clauses and bypass trusts, but by way of some rather sophisticated planning arrangements designed to reduce the value of the client's gross estate fore estate tax purposes.

a. But now, with an estate and gift tax exemption of $5.43 million in 2014 (and $10. 68 million in the case of spouses), for many of our clients, including "mere millionaires" with an estate of less than $5 million ($8 to $10 million spouses), the greater tax benefit to the heirs may be to hold the assets until death, in order to obtain a basis step-up under §1014.

5. **The purpose of the "new basis at death" rule** was to eliminate what might be seen as a form of double taxation. Suppose that Dad died leaving his estate to Daughter, and Dad's estate paid estate tax. Shortly thereafter, Daughter sells some of the assets (which had a very low income tax basis). If there were no step-up in basis on Dad's death, the same assets would generate (i) estate tax on Dad's death, and (ii) capital gains tax when Daughter sold the assets—deemed to too heavy a hit. The "new basis at death" rule eliminated this concern.

   a. That may have been a justification when the estate tax exemption was $60,000, or $600,000. In today's world, however, with a $5 million-plus exemption very few estates are subject to estate tax, and yet the "new basis at death" rule lives on.

      (i) As noted earlier, in the Tax Reform Act of 1976 Congress attempted to replace the "new basis at death" rule with a carryover basis rule applicable to decedents' estates. The result was a disaster—or fiasco; take your pick—to the point that Treasury supported its repeal.

   b. **Community property**. All community property receives a new basis on the death of a spouse, even though only one-half of the community property is includible in the spouse's gross estate for estate tax purposes.

      (i) This is not a gift to residents of community property states. In the old "maximum allowable marital deduction" days, all of a decedent's property would be includible in the decedent's gross estate (thus receiving a new basis under §1014), but through utilization of the marital deduction only one-half thereof would be subject to tax. In a community property state, only one-half of the deceased spouse's community interest is includible in her gross estate. To provide parity in treatment, all community property (and not just the deceased spouse's one-half interest receives a new basis at death.

      (ii) This is one of the reasons behind statutes recently enacted in Alaska and Tennessee that give their residents the option to elect into the community property regime.

E. **Review of existing estate plans**. Should you consider contacting clients for whom you have prepared estate plans in the past—and, of course, are still with us? Well that is something you should be doing already: a tickler letter along the following lines:

> Several years ago we prepared wills for you. As we discussed at that time, it is desirable for you to review your wills on a regular basis. Our records indicate that it is time for you to make this review.
>
> Changes may be required by the birth of a new family member, by the death of a family member, by changes in financial circumstances, and by other factors such as changes in your goals and desires. Also, recent changes in the federal estate tax and gift tax laws—in particular, a substantial increase in the estate tax and gift tax exemptions—may have impacted your wills in a very substantial way.
>
> At the time you signed your wills, you also executed a power of attorney giving [--] the authority to act on our behalf in the event of your disability. Some financial institutions are

reluctant to transact in reliance on a power of attorney that is more than a couple of years old. To avoid this problem, we recommend that you re-execute your power of attorney.

Please review your wills in light of your current circumstances to be sure that they still reflect your wishes and desires. If you would like to make any changes or discuss any questions regarding changes in the federal estate and gift tax laws, please give me a call.

Here are some of the issues to be considered in the review:

1. **Marital deduction/bypass trust estate plans.** Under the prototypical formula QTIP/bypass trust plan, with a formula clause gifting "the smallest marital deduction needed to eliminate estate taxes in my estate," under many clients' wills all of the estate will pass to a credit shelter trust that (i) will no longer save estate taxes on the death of the surviving spouse because there are no estate taxes to save, (ii) will eliminate any step-up in basis on the spouse's death, and (iii) may alter the dispositive plan if the marital trust and the bypass trust had different remainder beneficiaries.

    (i) By increasing the exemption equivalent to $5 million, just as in 1981 (when the unlimited marital deduction was introduced) Congress has functionally changed the estate plan of any client whose will contains a marital deduction formula clause. Unlike in 1981, however, **there is no transitional rule**.

2. **FLPs and LLCs**. If FLPs or LLCs were established primarily for valuation discount purposes (but of course they were not; there were substantial nontax reasons for the entities' creation!), consider ways in which low-basis assets could be extracted from the entity. How to accomplish this is beyond my pay grade. However, one approach might be to taint the trust, by amending and restating the partnership agreement so as to intentionally "flunk" §2036, resulting the assets' inclusion (and not the decedent's partnership interest) in the decedent's gross estate—an "intentionally defective" FLP!

3. **Loosey-goosey administration of FLPs and LLCs?** In at least a dozen cases involving FLPs and LLCs, a gross estate inclusion has resulted because the creator-donor has failed to respect the entity, and has continued to deal with the assets as though no FLP or LLC has been established. See, *e.g.*, <u>Estate of Schauerhamer v. Commissioner</u>, T.C. Memo. 1997-242; <u>Estate of Harper v. Commissioner</u>, T.C. Memo. 2002-121. In past CLE programs, these cases have been used to illustrate traps that should be avoided. But now, if a gross estate inclusion is to be desired rather than avoided, perhaps these cases illustrate traps that the client may want to fall into!

    (i) Also see <u>Estate of Trombetta v. Commissioner</u>, T.C. Memo. 2013-234, discussed *infra*, where the loosey-goosey creation and administration of an annuity trust resulted in a gross estate inclusion.

4. **Un-fractionalize fractional interests**? If ownership has been fractionalized in the past (perhaps with valuation discounts in mind), consider ways by which those interests could be consolidated.

5. **Move from minority discount to control premium?** In <u>Estate of Frank v. Commissioner</u>, T.C. Memo 1995-132, F's revocable trust owned 252 shares out of 501 shares of stock in a closely held corporation. F's wife owned 68 shares, and their three children owned the remaining 181 shares. F's son, acting under a durable power of attorney that expressly

authorized the transaction, withdrew 91 shares from the revocable trust and gifted them to F's wife. (The gift qualified for the gift tax marital deduction.) F died two days later, and his wife died two weeks after that. F's estate took a minority discount for the 161 shares that Frank owned at his death. The government argued that the transaction, occurring only two days before Frank's death, should be disregarded under the substance over form doctrine, as the transfer was made solely to obtain a minority discount. The Tax Court held otherwise, and recognized a 20 percent minority discount.

(i) Suppose, when the story began, F, terminally ill and incapacitated, owned 161 out of the 501 shares. F's wife could give him her 91 shares, putting F (and shortly thereafter, his estate) in control premium posture.

6. **Grantor trusts**. The grantor could remove non-liquid low-basis assets from the trust by purchase or in exchange for high-basis assets.

II. Section 401—Qualified Plans and IRAs

A. Inherited IRAs are not exempt from bankruptcy estate. In Clark v. Rameker, 134 S.Ct. 2242 (2014), the Supreme Court, resolving a conflict between the Fifth Circuit and the Seventh Circuit, ruled that funds held in an "inherited" individual retirement account—acquired by the designated beneficiary on the death of the owner—are not "retirement funds" as defined by the Bankruptcy Code, and are not exempt from the designated beneficiary's bankruptcy estate.

B. Time period in which designated beneficiary must commence distributions cannot be extended. In Ltr. Rul. 201417027, P (participant in a qualified retirement plan) died before age 70½, naming Daughters as designated beneficiaries. Under the plan, distributions were to begin in the year following P's death. The beginning date could be delayed, but the entire amount was required to be distributed by the end of the year containing the fifth anniversary of P's death. Under the plan, the 5-year rule was an option that had to be elected by September 30 of the year following the year of P's death. Daughters requested an extension to make the 5-year election, contending that they did not learn that they had been named beneficiaries until the time for making the election had passed.

1. The extension cannot be granted, said the Service, because the time period for commencing distributions is fixed by statute. The Service has the authority to extend time periods set out in regulations, revenue rulings, revenue procedures and notices, but not where the time period is statutory.

C. This IRA did not authorize investment in real property. In Dabney v. Commissioner, T.C. Memo. 2014-108, D withdrew $114,000 from his Charles Schwab IRA and transferred the funds to Chicago Title Insurance Co., as part of an effort to invest the funds in real property. Problem: The Charles Schwab IRA prohibited the purchase of or investment in real estate. Thus, the withdrawal was a taxable distribution—and, because D was under age 59½, a withdrawal that was subject to a 10 percent tax under §72. Bottom line: a $42,400 deficiency.

1. The court noted that while there are no laws preventing IRAs from holding real property, there is no requirement that an IRA trustee or custodian must give participants the option of investing in real property.

2. **No accuracy-related penalty, though**. "Although [Mr. Dabney] was mistaken in his understanding of the law, it was reasonable under the circumstances for Mr. Dabney to believe that he had not received an early distribution from his IRA. We find that he had reasonable cause for failing to report the distribution on his return and acted in good faith."

D. **What to do when participant's "estate" (or a trust) is named as beneficiary.** As a general rule, a surviving spouse can make a rollover to his own IRA only if the decedent's qualified plan or IRA designated the spouse as beneficiary. When assets in a decedent's plan or IRA pass to a trust or the decedent's estate, which then distributes the assets to the surviving spouse, the spouse is treated as having received the IRA assets from a third party and not the decedent, precluding a spousal rollover.

1. **If will or trust benefits spouse and gives broad distribution powers, there's an escape hatch**. A number of rulings have approved rollovers where the surviving spouse had the unrestricted power to distribute P's IRA or plan benefits to herself. Recent entries: Ltr. Rul. 201445031 (spouse was personal representative and sole beneficiary of the estate) and Ltr. Rul.201423043 (spouse was sole trustee of the marital trust, which allowed distributions as trustee deemed desirable for her "support, comfort and welfare in her accustomed manner of living" or "for any other purpose the trustee believes to be for the taxpayer's best interest").

III. Section 671—Grantor Trust Rules

A. **Service challenges installment sale to defective grantor trust**. For several decades, planners have implemented a sophisticated estate "freeze" transaction that results in converting appreciated assets with further appreciation potential into a fixed-yield non-appreciating asset (a promissory note) by way of an installment sale to an intentionally "defective" grantor trust. There are no income tax consequences resulting from the sale (no immediate gain recognition; no recognition of interest and principal payments) because the grantor is in effect selling the assets to himself. Rev. Rul. 85-13, 1985-1 C.B. 184. (*Cf.* Lord Keynes: "We owe it to ourselves.") As is demonstrated by Treasury's Fiscal Year 2016 Budget Proposal (as well as earlier Budget Proposals), Treasury does not like the "DIGIT" transaction.

1. **Estate of Woelbing v. Commissioner**. On December 26, 2013, two companion cases (involving a husband and wife) were filed in the Tax Court. Docket Nos. 30260-13 and 30261-13. In 2006, H sold all of his non-voting stock in Carma Laboratories (Carmex Lip Balm and other skin care products) to an irrevocable grantor trust in return for a $59 million promissory note bearing interest at the AFR rate (applicable federal rate). The sale was to an "Insurance Trust" that owned three life insurance policies on H's life under a split dollar regime. The policies had an aggregate cash surrender value of $12.6 million. Two sons (who were beneficiaries of the trust) executed personal guarantees for 10 percent of the purchase value of the stock. The sales agreement included a defined value feature along the lines of Wandry v. Commissioner, T.C. Memo. 2012-88, under which the number of shares transferred (the transfers were made long before Wandry v. Commissioner, 2012 T.C. Memo. had been decided) would be adjusted to the value of the note. Gift tax returns based on split treatment were filed for 2006, 2008 and 2009. H died in 2009; W died in September 2013. Steve Akers (on whose Bessemer Trust commentary this summary is based) notes that "interestingly, [W died] only two days after receiving the IRS's Notice of Deficiency of almost $32 million against Mrs. Woelbing for her gift tax." The deficiency notices for both estates aggregate $125 million, plus $25 million in undervaluation penalties.

a. **The Service's position as to gift tax**. In Estate of Woelbing v. Commissioner, The Service has taken the position, first, that the note should be treated as having zero value and that, under §2702, the entire value of the non-voting shares transfers should be treated as a gift because the note payments were not structured as guaranteed annuity payments. Second, the value of the transferred stock was $116.8 million, not $59 million.

b. **The Service's position as to estate tax**. The Service has contended that, while the value of the note should not be included in H's gross estate, the value of the stock should be includible under §§ 2036 and 2038. Furthermore, the value of the stock had increased to $162.2 million at the time of H's death.

2. **The case raises some rather interesting issues**. That is something of an understatement.

a. **Use of personal guarantees to partially seed the purchasing trust?**

b. **Basic validity of DIGIT transaction, and whether §2702 should apply?**

c. **AFR interest rate rather than the much higher §7520 interest rate?** Steve Akers points out that in several cases, the Tax Court itself has approved use of the AFR interest rate in intra-family sale transactions (Frezee v. Commissioner, 98 T.C. 554 (1992); True v. Commissioner, T.C. Memo. 2001-167), and several private letter rulings have also so ruled.

d. **Steve Akers commentary: '**There seems to be a trend of IRS attacks on installment sales to grantor trusts, but is this primarily just a valuation case? (The IRS contends that the value of the transferred units was $116.8 million compared to the $59 million purchase price). Time will tell whether the IRS settles (as it did in *Karmazin*, T.C. Docket No. 2127-03, filed Feb. 10, 2003) or drops the §§2702, 2036 and 2038 arguments (as it did in *Dallas v. Commissioner*, T.C. Memo. 2006-212). If the case proceeds as an attack on whether the note is disregarded for gift tax purposes under §2702 and whether the sold assets are included in the seller's estate under §§2036 and 2038, this case will break new ground and provide court guidance on the requirements for a valid sale-to-grantor-trust transaction."

e. A trial at the Tax Court was set for March 16, 2015, but a motion for continuance was filed, suggesting that the parties may be working on a settlement. No new court date has been announced.

B. Assets of wife's revocable trust were not assets of husband's bankruptcy estate. In In re Reuter, 499 B.R. 655 (W.D. Mo. 2013), H and W established revocable trusts in 2005. H was a trustee and beneficiary, along with W, of both trusts. The bankruptcy trustee sought a declaratory judgment that H's powers over and interests in W's revocable trust caused the property to be included in his bankruptcy estate. Not so, said the court. First, H was a discretionary beneficiary of the trust, and discretionary interests are not subject to the claims of the bankruptcy trustee. Second, H did not hold the power to revoke the trust; only W could revoke her trust. Third, the trust contained a valid spendthrift clause.

C. GRAT reformed to make trust remainder interest irrevocable. Under the facts of Ltr. Rul. 201442042, T retained an attorney to prepare two GRATs, under which the remainder interests would pass to a trust for the benefit of T's children. The attorney drafted the children's trust as a revocable trust, over which T retained a right to amend, modify or revoke. In addition, T was the trustee. (Ouch!) An accountant preparing the gift tax return noted that the trust receiving the remainder interests would be includible in T's estate, but was assured by the attorney that there was no tax problem (!). Gift tax returns were filed showing the transfers as completed gifts. Some years later, another attorney reviewed T's estate plan and the GRATs, and advised T as to the problem.

1. The Service approved reformation of the trusts. Affidavits made by the taxpayer, attorneys, accountant and financial advisors established by clear and convincing evidence that T intended the transfers to the GRATs to be completed gifts.

IV. Section 2010—Unified Credit Against the Estate Tax

A. Portability is now permanent. "Portability," introduced by the 2010 Tax Act and made permanent by ATRA 2012, allows a surviving spouse to in effect inherit the unused exemption of his or her last deceased spouse. Portability allows the spouse to use the "deceased spouse unused exclusion amount" [DSUE amount] for estate and gift tax purposes, but only if a portability election is made on a timely filed estate tax return at the deceased spouse's death. There is no portability for any unused GST exemption of the last deceased spouse.

1. **Surviving spouse can use DSUE amount for gift tax and estate tax purposes**. Once the spouse inherits the DSUE amount, the spouse can use the DSUE amount either for lifetime gifts or for estate tax purposes on his or her subsequent death.

Example: H dies in 2013* leaving a $4 million estate; his will devises one-half of his estate to his wife W and the remaining one-half to a trust for the benefit of his children. H's executor could file an estate tax return that uses $2 million of his $5.25 million* exemption to shelter the gift to the children, and pass the remaining $3.25 million of his exemption to W. W would then have an estate and gift tax exemption of [$3.25 + her own $5.25* =] $8.5 million.

*I have used the 2013 exemption of $5.25 million, to make the computations (hopefully) simpler to digest—even though, obviously, the number will be higher on W's subsequent death due to annual inflation adjustments of the exemption.

B. Which planning decision should be made: reliance on portability election or bypass trust? There is no one answer. The portability option raises new questions and new decisions that must be made (i) at estate planning time and (ii) on the first spouse's death. Looking first at the planning issues, a variety of factors must be considered in the clients' determination of whether to rely on traditional bypass trust planning or, instead, anticipate that a portability election is likely to be the best option on the first spouse's death. There is no "one size fits all" solution. The following factors (and probably some that I have not listed) will affect the clients' decision—and in many cases several of these factors will be in play at the same time, pushing in opposite directions. (In this initial discussion, I will contrast outright dispositions versus bypass trusts, leaving for later herein a discussion a "best of both worlds" option involving a QTIPable trust.)

1. **Size of the marital estate and likelihood of estate taxes on surviving spouse's death**. The estate tax exemption is destined to increase every year due to annual inflation adjustments. For "mere millionaires"—a couple in their 70s with a $5 to $6 million community property estate and a mix of assets that have little or no significant appreciation potential—it is highly unlikely that the surviving spouse will "need" any additional exclusion amount to eliminate

estate tax on his or her death. Instead, the availability of a second basis step-up may be of greater potential value to the surviving family members.

a. But remember that Murphy's Law operates with a vengeance in this area of the practice! Do the clients play the lottery on a regular basis? Is there the possibility of a substantial inheritance from that uncle in East Texas? (This latter issue, of a potential inheritance, should of course be explored at that first client consultation in all cases.)

b. On the other hand, projecting estate values for a couple in their 40s or early 50s is problematic at best.

2. **Are all of his kids also her kids, or do we have a blended family?** If we have a second marriage situation and either or both spouses have children by an earlier marriage, a bypass trust that gives the spouse a special testamentary power of appointment, will insure that the client's assets will stay on his or her side of the house.

C. Reasons favoring the use of bypass trusts.

1. **Portability election requires that an estate tax return must be filed**. In medium-sized estates of "mere millionaires," the cost and complexity of filing an estate return will be seen as too high a price to pay for the *potential* benefit of a portability election.

a. But even here it is important to discuss the topic with the clients, ***and to document that conversation***.

2. **Traditional benefits of trust settlements rather than outright dispositions**

a. **Creditor protection via spendthrift provision**. Is spendthrift protection really a concern if the clients' investment strategy is conservative and neither spouse is a risk-taker? Yes it is—if either spouse occasionally drives on I-10 or I-35. All it takes is for the client to be the *alleged* negligent driver in a car collision where the damage claim exceeds the GEICO or USAA policy limits.

b. **Avoiding guardianship**. A major concern is that the surviving spouse may later become incapacitated. The consequence of an outright disposition would likely be a cumbersome and costly guardianship administration. If the client's estate is left in trust, perhaps with the spouse serving as trustee for as long as he or she is able and so inclined, a guardianship administration will be avoided.

(1) Attorneys and other professionals invariably recognize this as a topic of discussion if the clients are in their 70s—but the topic also merits discussion if the clients are in their 40s. After all, the trust would continue for the spouse's lifetime, meaning (if all goes well) into his or her old age.

c. **Management by a qualified manager**. The surviving spouse (whichever it may turn out to be) may be seen as not having sufficient management and investment skills, making it more appropriate to name a professional as trustee.

d. **Keeping it in the family**. While this concern is apparent in the second marriage-divided family situation, it can be a concern even in the one-marriage situation where all of his kids are also her kids. A trust settlement assures that on the spouse's death, the remainder interest will pass to the client's descendants, rather than to that dreaded second husband, that trophy second wife, or a too-solicitous caretaker.

e. **Special testamentary power of appointment tends to insure filial devotion**. Even in the one-marriage situation, a trust that gives the surviving spouse a special testamentary power of appointment can be beneficial. If the spouse has a power of appointment over a $900,000 trust, it is highly unlikely that she will be alone at Thanksgiving! "It doubtless occurred to the testator that by restraining a disposition of his property except by will, which is in its nature revocable, [his widow] would, to the end of her life, retain the influence over, and secure the respect of, the several objects of his bounty." Hood v. Haden, 82 Va. 588 (1886).

f. **Appreciation in assets' value excluded from surviving spouse's gross estate.** If, through appreciation or otherwise, there is a likelihood that the surviving spouse's estate may push toward his or her estate tax exemption, assets in the bypass trust will pass to the next generation free of estate tax—that's why we call them bypass trusts! (On the other hand, appreciated assets in the bypass trust will not get a step-up in basis.)

3. **Avoids hostility, in the blended family situation, as to whether the portability election should be made**. If client's will names a child by his first marriage as executor and a portability election will benefit the spouse's family, "why should I go to the trouble and expense of filing an estate tax return which benefits that ****?"

4. **Utilization of both spouses' GST exemption**. There is no portability election with respect to the generation-skipping transfer tax. Thus, an "all my property" estate plan utilizes only one GST exemption in passing property to the descendants. By allocating GST exemption to a bypass trust, both spouses' GST exemptions can be utilized. (It should be noted, however, that this benefit also can be secured through the use of a QTIP trust and a reverse QTIP election.)

5. **Bypass trust can be funded with discounted and/or hard-to-value assets**. The bypass trust can be funded with, *e.g.*, FLP interests utilizing discounted values, with a low audit risk at the first spouse's death. The statute of limitations runs on values if a bypass trust is funded at the first spouse's death. If a portability election is made, both estates can be audited (*i.e.*, to see that the DSUE amount was properly determined).

6. **Client owns real property in a jurisdiction that has state estate tax**. This would suggest that a bypass trust should be employed to utilize the state's estate tax exemption.

7. **Possible loss of DSUE amount upon remarriage**. Portability applies only to the DSUE of the last deceased spouse. If the surviving spouse remarries and the new husband or wife then dies, that new spouse becomes the last deceased spouse, meaning that the portability election that was made when the first spouse died will turn out to have been useless.

a. Lawyers, accountants and trust officers need to know this, of course—but I doubt that this would be a selling point, one way or the other, in counseling clients as to their estate plans!

D. Reasons favoring the use of portable election. This could be achieved either by leaving the bulk of the client's assets outright to the spouse or by way of a QTIP trust, securing a marital deduction, and relying on portability to reduce if not wholly eliminate taxes in the spouse's estate.

1. **More than a few clients favor the simplicity of outright bequests**. "Ah! Now I can have a two-page will that I can read and understand!" If (i) all of his kids are also her kids, (ii) the clients are not bothered by the possibility of remarriage, and (iii) the clients are satisfied that the surviving spouse will have sufficient management capabilities (although those capabilities could be utilized by the spouse serving as a trustee), an outright disposition may be attractive to clients who don't like (or don't understand, or are suspicious of) trusts.

2. **Where major assets do not "belong" in a trust.**

   a. **Residence or vacation property**. This is not to say that assets such as the family residence or a vacation property shouldn't ever be placed in a trust. (The trustee could authorize the spouse's possession or user rent-free, for example; and as for the residence, creditor protection is given under the Texas homestead laws.) However, assets such as this do not call for management by a trustee.

   b. **Qualified plan benefits and IRAs**. In some cases, qualified plan benefits and IRAs comprise a major portion of the estate, and there are not sufficient "other" assets to fully fund the bypass trust. In most cases, it is advisable to name the spouse as designated beneficiary, securing the benefits of a spousal rollover and deferring required minimum distributions.

      (1) These assets are called in the Texas Uniform Principal & Income Act, "liquidating assets." Required minimum distributions plus the payment of income taxes thereon will cause these assets to "depreciate" over the spouse's lifetime, resulting in a progressively lower value for gross estate inclusion purposes in the spouse's estate.

3. **Basis step-up seen as more beneficial than a bypass**. Because of the nature of some principal assets in the estate, a step-in in basis may be seen as potentially more significant that removing future appreciation from the spouse's gross estate.

E. It's not an "either/or" situation. Keep in mind that an estate plan may (and often will) include a bypass trust and also dispositions that can be the basis for a portability election.

Example: W dies in 2013 leaving a $4 million probate estate, consisting of her one-half community interest in their $2 million residence and $3 million in other assets (her one-half of the couple's community estate). W's will devises her interest in the residence to H, and bequeaths her $3 million residuary estate to a bypass trust that benefits H and their descendants. W named H as designated beneficiary of her $1 million IRA. Thus, $2 million in assets (the residence and the IRA) qualify for the marital deduction. W's executor could file an estate tax return that uses $3 million of her $5.25 million exemption to shelter the gift to the bypass trust, and pass the remaining $2.25 million of her exemption to H.

F. The best of both words: a QTIPable trust? In the pre-portability world in which the exemptions were much lower (*e.g.*, $60,000 until 1977, $600,000 in 1997, $1,000,000 in 2002, $3,500,000 in 2009), the paradigm estate plan for spouses involved a formula gift to a QTIPable trust and a residuary gift to a bypass trust. But once the exemption reached $5,000,000, the effect of such a plan for a “mere millionaire” was a formula gift of $0 to the marital trust and everything else (except, typically, the house and tangibles) to the bypass trust. But now we live in a world in which (i) the bypass trust does not save estate taxes because (in the particular case) there are no estate taxes to save, and (ii) a step-up in basis may be a more useful objective than … avoiding estate taxes when there are no estate taxes to avoid. While it is true that (as summarized above) there are a myriad of non-tax reasons for using a bypass trust, these non-tax benefits of a trust settlement also can be obtained through the use of a QTIPable trust for which (for example) a partial QTIP election is made.

Example: At the time their estate plans are prepared, H and W (in their 50s) have an $8 million community estate that includes a residence ($2 million). Under their estate plan, each has a will that devises his or her interest in the residence to the survivor, and devises his or her residuary estate to a QTIPable trust. When one of them (let’s say H) dies, the surviving spouse (W) and H’s executor can take a “second look” at the financial and tax situation—how much marital deduction does H’s estate need (over and above H’s one-half interest in the residence) in order to eliminate tax? If the answer is that no additional marital deduction is needed, then no QTIP election is made, the trust remains a bypass trust, and any DSUE passes to W. If more marital deduction is needed in order to eliminate estate tax—or if it is decided that a step-in basis will be more useful to the heirs than an estate tax bypass—then a partial QTIP election plus a reverse QTIP election is made. As a result, the trust qualifies for the marital deduction as to the elected portion and is a bypass trust as to the unelected portion.

1. **Getting around the “negatives” of a QTIP trust by building in flexibility**. A QTIP trust doesn’t allow for much flexibility. All trust income must be paid to the spouse at least annually (the trust cannot have a spray or accumulation provision with respect to income) and no one other than the spouse can be a beneficiary during the spouse’s lifetime (no discretionary power to distribute principal to descendants or others). How can we build flexibility into the plan?

2. **Disclaimer-funded bypass trust**. Properly structured, this is a “second look” plan. H’s will is drafted (and, vice versa, W’s is drafted) to provide that the residuary estate shall pass to a QTIPable trust. The will further provides that if or to the extent W disclaims, the disclaimed interest shall pass to a bypass trust that contains more flexible terms—and which can name W as a beneficiary. On H’s death, W can (i) assess the financial and tax picture in H’s estate—how much marital deduction (if any) is needed to eliminate estate tax, and (ii) make an educated projection—with more information than was available when the estate plan was prepared—as to whether (or to the extent) portability is preferable to a bypass trust arrangement.

   a. **Caveat**. In addition to meeting the nine-month deadline for making a disclaimer, W must not have accidentally “accepted the interest or any of its benefits.”

   a. **Caveat**. The disclaimed interest must pass “without any direction on the part of the person making the disclaimer.” Thus, W cannot be a trustee or co-trustee if the trust gives her a discretionary distribution power (but an independent co-trustee could be given a discretionary distribution power). Also, W cannot be given a special testamentary power of appointment over the bypass trust.

3. **Clayton trust approach: Interest passing to spouse can be made contingent on QTIP election**. Suppose that property is devised to a QTIPable trust, but the will provides that, if or

to the extent that the executor does not make a QTIP election, the property shall be added to a residuary trust that permits discretionary distributions. In the early 1980s, when the QTIP election first hit the scene, a number of wills were drafted along these lines. The QTIP regulations initially took the position that if the income interest given to the spouse was contingent on the executor's making a QTIP election, the interest was not QTIPable. The Tax Court initially agreed with this reading of the statute, but three Courts of Appeal rejected it. Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992); Estate of Robertson v. Commissioner, 94-1 U.S.T.C. ¶60,153 (8th Cir. 1994); Estate of Spencer v. Commissioner, 43 F.3d 226 (6th Cir. 1995). In 1997 the government threw in the towel, and new regulations were issued: An income interest that is contingent upon the executor's making a QTIP election is not precluded, on that basis, from qualifying for the marital deduction. Reg. §§20.2044-1, 20.2056(b)-7 and 20.2056(b)-10. The regulations make it clear that interests for which the QTIP election is not made may pass to another beneficiary.

a. Including this language in the client’s will would enable the client’s executor (in many cases, the surviving spouse) to determine, based on the tax and financial picture as of the first spouse’s death, whether (or to what extent) a QTIP election should be made.

b. Unlike a disclaimer-funded bypass trust, in this situation the spouse can be given a special testamentary power of appointment over the bypass trust.

G. **Document, document, document!** At some point on the economic scale—and also depending upon the age of the clients, whether there are children from an earlier marriage, the clients’ attitudes and inclination as to the types of investments they pursue, the possibility of volatility (or not) as to the size of the marital estate, the likelihood of an inheritance by either client, etc. etc.—it is important—no, *imperative*—that the “credit shelter versus portability” topic be discussed with the clients at estate planning time … and to document that that discussion took place. True, the issue of whether an election should be made does not arise until the death of the first spouse. However, the estate plan prepared for the clients may preclude a portability election (*e.g.*, a bypass trust plan).

1. **Hindsight, anyone?** Perhaps you have noticed (he said with a modicum of understatement) that heirs and other disgruntled family members are blessed with perfect hindsight, and in this context would have no difficulty concluding the “obvious”: If it turns out that, in retrospect, the decision to elect portability [should] [should not] have been made, making the wrong decision (or making no decision at all because, it is alleged, the topic was not even discussed) was obviously the result of the attorney’s negligence—so grossly negligent, in fact, to warrant the imposition of punitive damages.

2. **Make it clear that you gave the clients the opportunity to understand the topic**. This raises another question: Will your typical clients really understand the issue, and the implications of the decision? Clients never have a problem understanding what an exemption is—especially a $5.34 million exemption, and can grasp the concept of an unlimited marital deduction. But new basis at death??? What’s that all about? In teaching law students (a pretty sophisticated audience) over a number of years, I have seen that, especially for students who haven’t (yet) taken the Federal Income Tax course, the new-basis-at-death concept is, for some, hard to grasp for some reason.

a. **Recommendation**. In addition to discussing the issue with the clients at estate planning time (in the appropriate case), consider preparing a two-or-so page handout for clients that explains (in lay language) how “new basis at death” works, the election that will be faced by the surviving spouse (and give a few examples), and how the election would not be available as a practical matter (absent disclaimer) under a bypass trust plan. Then have the clients sign underneath a paragraph which says (along the following lines) We have considered the possibility of relying upon an estate plan that makes the portability election available, but given the benefits provided by a bypass trust, the cost filing an estate tax return to make the election, and the fact that it is highly unlikely that the survivor of us would have need for additional exemption, we have decided.

b. Alternatively, the two-page handout would close with a paragraph along the following lines: We have considered the possibility of relying upon an estate plan that utilizes a bypass trust for the survivor of us makes the portability election available, but given the benefits provided by a bypass trust, the cost filing an estate tax return to make the election, and the fact that it is highly unlikely that the survivor of us would have need for additional exemption, we have decided.

H. The DSUE Amount as an Estate Asset With Value. This caption is the title of Howard Zaritsky's article in the May 2014 edition of Estate Planning. Zaratsky has brought to our attention an Indiana case that has some important lessons regarding the portability election. Walton v. Estate of Swisher, 2014 WL 325666 (Ind. App. 2014), involved a blended family. Mary died in May 2011, leaving a $100,000 estate and a will that named her daughter Kathleen as personal representative. Four months later, Kathleen (represented by counsel) entered into an agreement with Mary's surviving husband Glenn under which Glenn waived his survivor's allowance and paid Mary's estate $5,000, and the estate "agrees to relinquish any and all claims to any tax benefit or refunds" on any tax returns filed by Glen, Mary, or Mary's estate. The agreement was to be binding on the parties, their heirs and assigns. Glenn's advisors then prepared a federal estate tax return for Mary's estate that made a portability election. In March 2012, Mary filed a Closing Statement upon completion of the estate administration.

1. **Unjust enrichment claim made by daughter.** Shortly thereafter, Kathleen, as personal representative of Mary's estate, filed a claim for $500,000 against Glenn's estate, contending that without additional compensation over the agreed-to $5,000, Glenn' estate would be unjustly enriched by reducing its tax obligation.

a. **The daughter had standing as heir**. Glenn's estate contended that Kathleen had no standing to bring the action as personal representative because her mother's estate had been closed. That is true, said the court, but Kathleen had standing as her mother's heir.

b. **Unjust enrichment claim rejected**. Affirming the lower court's ruling, the court held that the DSUE was a bargained-for tax benefit under the parties' agreement for which Kathleen received consideration, and "she cannot now complain that she should have bargained for more."

c. **Breach of ethics claim rejected**. Kathleen also contended that Glenn's representative violated the Indiana Rules of Professional Conduct when they failed to explain the tax consequences of her signing the Form 706 (!). The court pointed out that Glenn's representative did not have such a duty, as Kathleen was represented by her own counsel and Glenn's counsel represented Glenn alone.

2. **Lesson: Address the portability issue at estate planning time.** This wasn't on the table in the Indiana case, where the wife died in May 2011 and the husband died in July 2012. For

your clients, though, the issue should be addressed at the time estate plans are being prepared or reviewed. There are several advantages to this.

a. **Avoids need to negotiate on first spouse's death**. Such negotiations can be awkward, especially where (as in Walton v. Estate of Swisher) the executor is a child by the deceased spouse's earlier marriage. "What's in it for me, or for Mom's estate? Mom's estate doesn't get any benefit at all, while your estate and beneficiaries will save big taxes. I'll agree, but it will cost you a bundle."

b. **At estate planning time, the spouses are lovey-dovey**. Well, perhaps not love-dovey, but they are inclined to be cooperative because each spouse's will invariably makes some provision (if not substantial provision, or at least a trust income interest) for whoever turns out to be the surviving spouse. This isn't the time or place for either spouse to be argumentative.

c. **In many cases, each spouse will have skin in the game**. This was not the situation in Walton v. Estate of Swisher, where the wife's gross estate was $100,000; and while the value of the husband's estate was not mentioned in the opinion, it was sizeable enough to warrant bargaining for the DSUE. Also, in some situations because of age disparities or health issue, the predictability of who will be the first deceased spouse is high. In many situations, though, (i) which of them will be the surviving spouse is not predictable with certitude, and (ii) because of the projected value of their respective estates, the portability election will be attractive to whichever of them turns out to be the surviving spouse.

d. **Draft of will provision**. Here is my first cut of a clause that might be inserted in each spouse's will. Critiques or suggested improvements would be appreciated.

If my husband survives me and (within six months after my death) my husband or his representative requests that my executor make a portability election with respect to all or a portion of my "deceased spouse unused exclusion amount," I direct that my executor make the election in the amount and under the terms provided to my executor by my husband or his representative. The cost of preparing and filing a Form 706 estate tax return making the portability election shall be [charged against my estate as an administration expense] [borne and paid for by my husband].

3. **Lesson: Negotiating an agreement after death of first spouse.** Suppose (as in Walton v. Estate of Swisher) the issue was not issued at estate planning time? The estate and surviving spouse should enter into a written agreement regarding the DSUE election, addressing who will prepare the Form 706 and who will pay for it.

a. **Consideration for the agreement: Spousal or family allowance?** Looking at the issue from the surviving spouse's perspective, what should be the response if the decedent's executor takes the position, "What's in it for me and Mom's estate? This is very valuable to you and your heirs, and it's going to cost you a bundle." The answer is that the spouse does have a potent bargaining tool. The court's opinion in Walton v. Estate of Swisher mentions three times the $5,000 the husband agreed to pay, but mentioned only in passing the husband's agreement "to waive his survivor allowance." Every state gives the surviving spouse an entitlement to a family allowance or spousal allowance, and in nearly every state there is no necessity of showing need. (In Indiana, the spousal allowance is $25,000. Ind. Code §29-1-4-1.) Few states are as generous as

Texas, where the family allowance is the amount needed for the spouse's maintenance for the period of one year, without regard to other resources (other than separate property) available for the spouse's support. Tex. Estates Code §353.102. In Estate of Wolfe, 268 S.W.3d 780 (Tex. App. 2008), the court affirmed a family allowance of $126,840, even though the spouse received $291,250 in insurance proceeds, was the beneficiary of IRA accounts totaling $120,000, and had income of $85,000.

b. Because the family or spousal allowance is available for the asking, if the executor is being obstreperous, an offer to waive the allowance (or claim only a portion of it) should be a useful bargaining chip. ("Unless you agree to make a portability election, you are going to take $___ less under your mother's will.")

4. **Lesson: Advising the deceased spouse's executor.** In Walton v. Estate of Swisher, the daughter's contention of a violation of the Indiana Rules of Professional Conduct was silly: The daughter had her own attorney, and "Glenn's counsel represented Glenn alone." Besides, where was the detriment to the mother's estate, when (i) with a $100,000 gross estate the DSUE amount was of no use to the estate, and (ii) the husband prepared and paid for preparation of the Form 706?

a. **Dual representation**. The situation is more sensitive if one attorney represents both the deceased spouse's estate and the surviving spouse. And that attorney could be you! After all, you drafted both wills—after the couple's written consent to dual representation—and the family looks to you as "their" attorney.

b. **Nuclear family; spouse named as executor**. This is the easiest case. If all of his kids are also her kids, absent unusual estate plans the portability election will inure to the benefit of *their* descendants.

c. **Blended family; spouse named as executor**. In this situation, where one or both spouses had children by an earlier marriage, dual representation is dicey, but doable. The spouse's beneficiaries are not adversely affected by the portability election as long as her estate isn't going to pay any estate taxes—with one exception: The cost of preparing the estate tax return. In this situation, it may be advisable for the parties to agree that surviving spouse is to pay the cost of preparation and filing, unless her agreement to give up the family allowance entitlement is seen as an adequate quid pro quo.

(1) In any case, full documentation and full disclosure is not just advisable but necessary.

d. **Blended family; child by first marriage named as executor**. In this situation, if the son or daughter wants to retain you to represent the estate, there is a potential conflict of interest that needs to be recognized and then addressed.

V. Section 2032—Alternate Valuation

A. **Extension to make election granted**. In Ltr. Rul. 201503003, the Service granted a 120-day extension to make an alternate valuation election under §2032, although the executor filed to timely file the estate tax return—and did not consult with an attorney until after the return's due date (including extensions). An attorney advised the executor of the estate's filing requirement and filed a return within one year after the due date (including extensions)—but no alternate valuation was made on the late-filed return. Nonetheless, the Service ruled that the executor had acted reasonably and in good faith, and granted an extension.

1. The election to utilize the alternate valuation date (six months after the date of decedent's death), and even the opportunity to consider the election, is rarely encountered in today's world. The election can be made only if the effect will be to (i) reduce the value of the decedent's gross estate and (ii) reduce the total amount of estate tax and generation-skipping transfer tax that otherwise would be due. Needless to say, a lower valuation of the estate's assets would produce a lower basis under the "new basis at death"rule.

VI. Section 2033—Property In Which Decedent Had Interest

A. Tax Court rejects dollar-for-dollar discount for unrealized capital gain. Estate of Richmond v. Commissioner, T.C. Memo. 2014-26, involved a personal holding company (incorporated in 1928) whose assets consisted primarily of publicly traded stock. The PHC had a "hold" strategy with an investment philosophy of maximizing dividend income. The PHC held common stocks in ten major industries, with 43 percent of its holdings in Exxon Mobil, Merck, General Electric and Pfizer. R, who died in 2005, held 23.5 percent of the PHC shares. The PHC's portfolio value on the date of R's death was $52.2 million. The estate filed a Form 706 that valued R's interest at $3.15 million, based on a capitalization-of-dividends valuation method. The Service assessed a deficiency of $2.85 million based on a $9.2 million valuation and a $1.42 undervaluation penalty.

1. **Net asset valuation method and not dividend capitalization was the better methodology**. The Service's expert reported a value of $7.33 million based on a net asset valuation methodology, which the Tax Court determined as the better approach. Dividend capitalization was an appropriate method where the company's assets are difficult to value, said the court, but was inappropriate for personal holding companies whose assets are marketable securities with ascertainable market values.

2. **Fifteen percent discount for unrealized capital gain tax**. Of the PHC's $52.2 million value, unrealized appreciation on its assets was $45.6 million, which under federal and state tax rates would generate a capital gains tax of $18.1 million. The court noted that several Courts of Appeal had recognized a 100 percent discount for the potential capital gain tax liability. Estate of Jelke v. Commissioner, 507 F.3d 1317 (11th Cir. 2007); Estate of Dunn v. Commissioner, 267 F.3d 339 (5th Cir. 2002); Estate of Jameson v. Commissioner 366 (5th Cir. 2001). The Tax Court chose instead to follow other Courts of Appeal (and its prior decisions) that rejected the dollar-for dollar approach. Estate of Eisenberg v. Commissioner, 155 F.3d 50 (2d Cir. 1998); Estate of Welch v. Commissioner, 208 F.3d 213 (6th Cir. 2000). The dollar-for-dollar method is "plainly wrong in a case like the present one…. [A] prospective [built-in capital gain] is not the same as a debt that really does immediately reduce the value of a company dollar for dollar," because the tax is susceptible of indefinite postponement. Instead, "the most reasonable discount is the present value of the cost of paying off that liability in the future." The court concluded that a discount of $7.8 million was appropriate.

    a. The case is appealable to the Court of Appeals for the Third Circuit, which has not yet weighed in on the issue.

3. **Twenty percent undervaluation penalty affirmed; estate did not use a certified appraiser**. The PHC's value reported on the estate tax return, 65 percent of the determined

value of $7.33 million, was based on a report by Mr. Winnington, a CPA who had written 10 to 20 valuation reports and had testified on valuation issue, but who was not a certified appraiser. "[W]e cannot say that the estate acted with reasonable cause and in good faith in using an unsigned draft report prepared by its accountant as its basis for reporting the value of the decedent's interest…. While we do not disagree with the estate's ascertain that the decedent's interest in PHC may be difficult to value, we believe this further supports the importance of hiring a qualified appraiser."

VII. Sections 2036 and 2038—Retained Interests or Powers

A. **Annuity trust includible in gross estate; too much retained control**. In Estate of Trombetta v. Commissioner, T.C. Memo. 2013-234, T transferred two rental properties to an annuity trust with a term of 180 months, but retained the power to reduce the trust's term. The trust was to distribute to T an annuity of $75,000 for the first 12 months, with a 4 percent increase in each successive 12-month period. Upon termination of the trust, the assets were to be distributed to T's children and grandchildren. The rental properties were subject to mortgages, on which the trust paid the interest and principal even though the trust had never assumed the mortgages. When T was diagnosed with cancer and concluded that she would not live until the end of the trust term, she amended the trust by reducing its term to 156 months. T died six weeks after the end of the amended trust term.

1. The Tax Court ruled that the value of the two rental properties was includible in T's gross estate because the transfers were not bona fide sales for adequate and full consideration. T's attorney prepared the trust agreement without any meaningful negotiation or bargaining with the other co-trustees or future beneficiaries. T and her attorney determined how the annuity trust would be structured and operated and which properties would be contributed to the trust.

2. T retained an interest in the properties, as evidenced by her retained control of the properties and the use of income from the properties to satisfy her personal legal obligation—the mortgage payments. As for control, T made all decisions with respect to the properties, and the other co-trustees (Tt's children) generally acted on her recommendation. T alone retained signatory authority with respect to the properties. Because the trustees could distribute additional income to T, she maintained the same enjoyment of the properties and their income as she had before transferring the properties to the trust. The court concluded that there was an implied agreement that T would retain an economic benefit in the properties.

3. The estate cited a number of family limited partnership cases in support of its position. However, T's transfers were not comparable to a transfer to an FLP because no other individual received a present interest in the annuity trust. Consequently, there was no basis for discussing, let alone applying, the "legitimate and significant nontax reason" exception. In any case, the nontax objectives in making transfers to the annuity trust were not significant, said the court.

VIII. Section 2041—General Powers of Appointment

A. **Power to appoint to grantor's descendants did not include beneficiary**. This drafting error has occurred more than a few times, when a trust grantor wants to give the trust beneficiary a special power of appointment. Under the facts of Ltr. Ruls. 201446001 thru 201446011 (trusts for 11 grandchildren!), Grandfather established a trust for the benefit of grandchild G. The trust gave G a testamentary power to appoint the trust property to the grantor's "issue." Oops! Grandchild G was one of the grantor's issue! The Service ruled that this was not a general power of appointment. Because G's power of appointment was a testamentary power, G could not appoint to himself or to any of his creditors. Also, as the permissible appointees were Grandfather's issue, G by his will could not appoint to his estate or the creditors of his estate.

1. Also see Ltr. Rul. 201444002, involving the same issue and the same result.

IX. Section 2042—Life Insurance

A. "Transfer for value" rule did not apply because grantor trusts and spouses were involved. In Ltr. Ruls. 201423009 and 201426005, Trust 1, a grantor trust as to both H and W, owned several joint life policies on H and W, and a single life policy on H. Trust 2, a grantor trust as to W only, was substantially funded. It was proposed that Trust 2 would purchase the life insurance policies from Trust 1, to ensure the funding of premiums on the life insurance contracts. In concluding that the proposed transfers would not trigger the transfer for value rule, the Service analyzed the transaction as having two aspects.

1. As for the joint lives policies, to the extent the transfer was attributable to W, this was a transaction between W as a grantor of Trust 1, transferring the policy to W as grantor of Trust 2. This did not involve a sale or exchange because W was treated as the income tax owner of both the seller trust and the purchaser trust.

2. The second aspect of the transaction involved the joint lives policies attributable to H and the single life policy of which H was the insured. W as grantor of Trust 2 gave consideration to H as grantor of Trust 1 in exchange for the policies. Under §1041(a), there is no gain or loss on transactions between spouses. "This action has the result, under §1041(a), as being treated as a gift to her husband."

X. Section 2053—Administration Expense Deduction

A. No "hazards of litigation" valuation discount. In <u>Estate of Foster v. Commissioner</u>, 2014-1 U.S.T.C. ¶60,675 (9th Cir. 2014), at the time of her death F was the defendant in several lawsuits in her capacity as trustee of three marital trusts established under her husband's estate plan. The estate's appraisal of the marital trusts reflected a 29 percent discount based on the hazards of litigation presented by the lawsuits. When the Service denied the "hazards of litigation" discount, in anticipation of a Tax Court trial the estate obtained a second appraisal, which applied a discount of 12.9 percent to 17.2 percent. The difference in value between the two appraisals was $8.1 million. Pointing to this discrepancy, the Tax Court upheld the Service's denial of the "hazards of litigation" discount and the Court of Appeals for the Ninth Circuit affirmed, because the litigation was not "ascertainable with reasonable certainty" at the time of F's death.

1. **The case arose prior to 2009 changes in the §2053 regulations**. Under the former regulations, in order to deduct the estimated amount of a claim, the estate had to show that the amount of the claim was ascertainable with reasonable certainty, and the estimated amount was deductible only if the amount will be paid. Under current Reg. § 20.2053-4(d)(1), no estate tax deduction can be taken for potential or unmatured claims. If a claim is later paid or matures, it can be deducted under a timely refund claim.

XI. Section 2055—Charitable Deduction

A. **No charitable income tax deduction because amount wasn't "permanently set aside" due to pending litigation**. In Estate of Belmont v. Commissioner, 144 T.C. No. 6 (2015), B died in 2007, owning a primary residence in Ohio, a condominium in Santa Monica, and a pension retirement account. B's will bequeathed $50,000 to her brother David and her residuary estate to the Columbus Jewish Foundation. In 2006, B had permitted David to move into the condominium, and he had been living there for about nine months when B died in April 2007. David, who wanted to continue to reside in the condominium, asked the Foundation if he could exchange his bequest for a life estate in the condo, but the Foundation said no. David filed a creditor's claim, which was denied. He then filed a Petition to Confirm Interest in Real Property on which he ultimately prevailed.

1. The accountant who filed the estate's fiduciary income tax return was not aware of David's claim regarding the condominium. The return claimed a charitable deduction based on the value of the residuary estate passing to the Foundation. The funds thought to be payable to the Foundation were not segregated or otherwise set apart from the general funds used by the estate to pay its expenses.

2. The Tax Court held that the estate was not entitled to a charitable income tax deduction under §642(c). For funds to be considered "permanently set aside" under the Treasury regulations, the possibility that the amount set aside will not ultimately be devoted to such charitable purpose must be "so remote as to be negligible." Here, there was more than a negligible risk that the costs of defending David's claims could dissipate the estate, which contained no other income-producing assets and had other expenses that could deplete its residue.

XII. Section 2056—Marital Deduction

A. **Trustee was supposed to segregate the revocable trust assets into separate trusts**. In Estate of Olsen v. Commissioner, T.C. Memo. 2014-58, H and W created reciprocal revocable trusts, with H serving as trustee of both trusts. W died in 1998, and on the estate tax return H as personal representative reported that the assets in W trust ($2.1 million) were to be segregated into Family Trust ($600,000—the estate tax exemption at that time), Marital Trust A ($1,000,000—the GST Exemption), and Marital Trust B ($500,000). The principal and income of Family Trust was to be used for the benefit of the couple's children and grandchildren, and H was given a lifetime and testamentary power of appointment in favor of the children, grandchildren, and charities. Principal and income of Family Trust could be used for H's benefit only if the principal of the Marital Trusts was exhausted. However, H never segregated the funds into the three separate trusts as called for by the trust. Before H died in 2008, he donated $1.08 million from W's trust to Morningside College. He also withdrew $394,000 from W's trust and deposited it into his own account, from which he made gifts to family members.

1. The Service took the position that the entire value of W's trust should be included in H's estate. The Service's position was that all of the withdrawals should be deemed to have been made from Family Trust or, in the alternative, to have been made pro rata. The estate contended that since it was W's and H's clear intent to reduce estate taxes and use W's unified credit for the benefit of their descendants, and because H as trustee had a duty to minimize estate taxes for the benefit of the remainder beneficiaries, the withdrawals should be treated as having been made from the Marital Trusts.

2. The Tax Court ruled that H's withdrawals that were donated to Morningside College were exercises of the limited power of appointment in favor of charity, and thus were taken from Family Trust. However, the withdrawal that was deposited into H's personal account was determined to be a distribution from Marital Trusts, because W intended that discretionary distributions from Family Trust were not to be made to H until Marital Trusts were exhausted.

3. The opinion notes that the attorney working with H in the estate's administration reminded H (in writing) on at least two occasions that H was to segregate the trust into three separate trusts.

B. **Spouse's right to elect one of two benefits is not a "contingency" that will impair marital deduction**. In Ltr. Rul. 201410011, a prenuptial agreement provided for certain outright distributions to S and a distribution to a QTIPable marital trust for S's benefit. A revocable trust provided for distributions to S and the marital trust pursuant to the prenuptial agreement, but gave S an election to forgo the distributions required under the prenuptial agreement. The election was to be made within 180 days after Taxpayer's death. If the election were made, S and the marital trust would receive different amounts.

1. The Service ruled that the election provision will not impair qualification for the marital deduction. "In each event, Spouse will have an absolute right to any property passing outright to her as well as an absolute right to the income from any property passing to Marital Trust… The requirement that Spouse make a timely election is a mere procedural formality, and is not a contingency within the meaning of § 2056(b)(1)." If such an election is made, the property interest relinquished by the spouse is not considered as having passed from the decedent to the spouse, and so is not considered an impermissible terminable interest.

2. The Service also ruled that preferred units in an LLC to be distributed to Marital Trust would qualify for the marital deduction. The preferred units specified an annual return of 8 percent, the LLC could not redeem the preferred units for less than the greater of face value or market value, and the operating agreement could not be amended without the vote of all preferred members.

C. **No problem in dividing QTIP trust into three trusts and terminating one of them.** In Ltr. Rul. 201426016, D and his wife S had six children. S and two of the children served as trustees of a trust for which a QTIP election had been made. The trustees proposed to (1) divide the trust into three separate trusts, (2) leave one of the new trusts as is, (3) convert a second trust into a total return trust, and (4) petition a state court to terminate the third trust and distribute the assets to the six children, subject to the children paying any resulting gift taxes.

1. You can do that, said the Service. First, dividing the trust into three trusts would not affect the trusts' QTIP status. Second, termination of the third trust would not have any impact on the other two trusts. Under §§2511 and 2519, S would be deemed to make a gift of the entire value of the third trust, reduced by the amount of gift tax paid by the children. However, this would not cause S to be treated as having made a gift or a transfer with respect to the other two trusts, and thus the special valuation rule of §2702 would not be invoked. Third, conversion of the second trust to a unitrust pursuant to state law would not be deemed a gift or other disposition of any interest in the trust to the remainder beneficiaries. Finally, the transactions would not cause the marital trust to recognize gain or loss under §1001. Prior revenue rulings have established that a partition of jointly owned property is not a sale or other disposition because the owners do not acquire any new or additional interests.

2. Also see Ltr. Rul. 201419001, involving division of a QTIP trust into two separate trusts.

XIII. Section 2503—Taxable Gifts; Annual Exclusions

A. **Crummey provisions qualified for annual exclusions notwithstanding trust's no-contest and arbitration provisions.** Chief Counsel's Advice 201208026, published in 2012, caused a lot of consternation (and heartburn) regarding the use of Crummey withdrawal provisions. The CCA advised that gifts to a trust with Crummey provisions did not qualify for annual exclusions because the trust included an arbitration provision and contained a no-contest ("*in terrorem*") clause which, if triggered by a beneficiary's challenge, would remove the beneficiary from the trust. The CCA apparently was issued in relation to <u>Mikel v. Commissioner</u>, T.C. Memo. 2015-64, in which the Tax Court rejected the Service's position in a case in which there were 60 (!) Crummey beneficiaries.

1. **The trust provisions**. The Mikels jointly transferred their residence, a condominium and other real property, at a reported value of $3.262 million, to an irrevocable trust for the benefit of their family members. The trust gave the trustee discretion to make distributions of income and principal among the grantors' children, descendants, and their spouses for a beneficiary's health, education, maintenance, support, wedding costs, purchase of a primary residence or business, or for entering a trade or profession.

   a. **Crummey withdrawal power**. The trustee was required to give beneficiaries notice of their Crummey withdrawal right within a reasonable time after a contribution was made to the trust. The withdrawal power would lapse if not exercised within 30 days after receipt of the notice. A savings clause provided that the withdrawal provision should be construed so as to qualify for the federal gift tax annual exclusion. The transfer was made on June 15, 2007, and the trustee gave notice to the beneficiaries almost four months later, on October 9, 2007.

   b. **The arbitration provision**. The trust provided that if a dispute were to arise concerning the trust, the dispute "shall be submitted to a panel consisting of three persons of the Orthodox Jewish faith." The Tax Court opinion advises that "[s]uch a panel in Hebrew is called a *beth din*."

   c. ***In terrorem* provision**. Under the trust, if a beneficiary were to "take part in or aid in any proceeding to oppose the distribution of the Trust Estate, … or challenges an distribution set forth in this Trust," any provision in favor of the beneficiary would be revoked and the beneficiary "shall be excluded from any participation in the Trust estate."

   d. **The gift tax return—filed late**. The Mikels did not file timely gift tax returns reporting the gifts. In December 2011, "after being contacted by the IRS, the Mikels each filed gift tax returns." (The opinion does indicate how the Service learned about the 2007 gifts.) Each return reported a transfer of assets worth $1,631 million, and each return took 60 annual exclusions. With an annual exclusion of $12,000 in 2007, exclusions totaled $720,000 and reduced the taxable gift to $911,000, fully covered by the gift tax exemption equivalent—meaning that no gif tax was due.

2. **Partial summary judgment granted to taxpayers**. Before the Tax Court, the government made the arguments set out in the 2012 CCA. The government conceded that each

beneficiary was given an unconditional right of withdrawal, that the notices were timely received, and that the trustee could not properly refuse a demand. However, it was contended, the beneficiaries did not receive a present interest because a right of withdrawal would be legally enforceable only if the beneficiary could go before a state court to enforce that right. That is something a beneficiary would be reluctant to do because of the *in terrorem* provision. Therefore, said the government, the withdrawal rights were "illusory," because any attempt to seek legal enforcement of that right "would result in adverse consequences to its holder."

a. As to the first contention, that the withdrawal right would be legally enforceable only if the beneficiary could go before a state court to enforce that right, the court responded: "[I]t is not obvious why the beneficiary must be able to 'go before a state court to enforce that right.' Here, if the trustees were to breach their fiduciary duties by refusing a timely withdrawal demand, the beneficiary could seek justice from a beth din, which is directed to 'enforce the provisions of this Declaration … and give any party the rights he is entitled to under New York law.' A beneficiary would suffer no adverse consequences from submitting his claim to a beth din, and respondent has not explained why this is not enforcement enough."

b. ***In terrorem* clause not triggered by challenge to withdrawal provision**. Moreover, said the court, the *in terrorem* clause was to be triggered if a beneficiary were to "take part in or aid in any proceeding to oppose the *distribution* of the Trust Estate, … or challenges an *distribution* set forth in this Trust." [Emphasis added.] The purpose, said the court, was to deter challenges to the trustee's discretionary power to make distributions, and did not speak to challenges to the exercise or non-exercise of the withdrawal right.

3. **Other issues—number of Crummey beneficiaries and asset valuations—have yet to be resolved.** The cross-motions for partial summary judgment addressed only the issue of whether the beneficiaries had been given present interests for annual exclusion purposes. A footnote notes that there are factual disputes, yet to be resolved, as to the number of beneficiaries who were give withdrawal rights, and as to the asset values reported on the gift tax returns.

4. **What about the "retained special power of appointment" issue?** Under the facts of CCA 201208026, the grantors had retained special testamentary powers of appointment. The CCA concluded that this made the transfers "incomplete" for gift tax purposes, but only as to the remainder interests. And this, said the CCA triggered the special valuation rule of Int. Rev. Code § 2702: because the grantors had retained interests that were not qualified annuity trust or unitrust interests. Thus, their retained interests were valued at zero, and annual exclusions did not apply to the transfer. The Tax Court decision in <u>Mikel v. Commissioner</u> sets out only the dispositive provisions mentioned above, and does say anything about any retained special power of appointment.

(1) **Wow! Depending on its wording, no-contest provision in a trust may kibosh Crummey withdrawal provision—in particular (but not exclusively) if trust includes an arbitration provision**. To date, courts in California, the District of Columbia, Arizona (overturned by statute)—and Texas (<u>Rachal v. Reitz</u>, 347 S.W.3d 305 (Tex. App.—Dallas 2011, review granted)), have held that arbitration provisions in trusts are unenforceable. Until the dust settles, it would not be prudent to include an

arbitration provision in a trust that has Crummey withdrawal powers designed to secure annual exclusions.

XIV. Section 2512—Valuation of Gifts

A. **No summary judgment on issue of adequate disclosure**. In Estate of Sanders v. Commissioner, T.C. Memo. 2014-100, S had made gifts of stock in JSI (a farm equipment company) in each year from 1999 through 2008, filing timely Form 709s reporting the gifts. S died in April 2008. In 2012, the Service issued deficiency notices for nine of the ten years, and increased the "adjusted taxable gift" values reported on the estate's Form 706 by $3,250,000. The estate filed a motion for summary judgment on the ground that the statute of limitations had run with respect to the adjusted taxable gifts determination, because the gift tax returns had made adequate disclosure of the nature and value of the gifted stock.

1. No go, said the Tax Court. The government had contended that there was no adequate disclosure on the returns. "Respondent contends JSI owned but did not disclose its ownership of another closely held entity—something the regulations require if that information is relevant and material in determining the value of the JSI stock." As the estate failed to show that there was no genuine dispute as to the issue of adequate disclosure, summary judgment was denied.

B. **No summary judgment on issue of gift versus transfer in ordinary course of business.** In Estate of Brown v. Commissioner, T.C. Memo. 2013-50, on January 1, 2004, B transferred 20-percent income interests in a limited liability company to two trusts in exchange for the trusts' 10-year promissory notes, each in the face amount of $1,875,000. The transfers were not reported on a gift tax return, the donor (and now the estate) taking the position that the transfers were for a full and adequate consideration.

1. The Tax Court denied the estate's motion for summary judgment on two counts. On the first count, the estate argued that the statute of limitations had run on any supposed gift made in 2004. Wait a minute, said the Tax Court; the government has disputed the value of the income interests, and thus there is a genuine issue of material fact.

2. The estate further argued that, regardless of the value of the consideration received by B, the transfers were made in the ordinary course of business. No summary judgment here either, said the Tax Court, as that characterization of the transaction was disputed by the Service.

XV. Section 6166—Extension of Time to Pay Tax—Closely Held Business

A. **Letters accompanying extension to file did not satisfy requirements for making Section 6166 election**. In Estate of Woodbury v. Commissioner, T.C. Memo. 2014-66, the estate filed an application for a six-month extension to file the estate tax return, and was granted the six-month extension. Accompanying the Form 4768 was a letter indicating the estate's intention to make a §6166 election when the estate tax return was eventually filed. The letter stated that the amount of tax to be paid in installments would approximate $10 million, but did not give specific information as to the properties that would constitute closely held businesses. Six months later, the estate requested another six-month extension, and included a similar letter regarding a §6166 election. The Service denied the request. After receiving the IRS's letter, the estate proceeded to make payments generally consistent with a §6166 election. The estate filed the Form 706—2½ years late, and with the return made a §6166 election containing all of the information.

1. In granting summary judgment to the government, the court rejected the estate's position that it substantially complied with the requirements of §6166. The estate failed to include in any of its letters the specific property information "that purportedly constituted closely held business interest," and a statement of facts that formed the "basis for the executor's conclusion that the estate qualifies for the payment of the estate tax in installments."

B. **No refund as to non-deferred estate tax if the estate has made a 6166 election.** In Estate of McNeely v. United States, 2014-1 U.S.T.C. ¶60,679 (D. Minn. 2014), the estate filed for an extension of the filing deadline and made an estimated estate tax payment of $2.5 million. A cover letter noted that the estate expected to make a §6166 election. When the estate tax return was filed making a §6166 election, the estate tax due was $9.13 million, of which only $512,000 was not subject to deferral under §6166. The estate sought a refund of $1,988 million (the difference between its estimated payment of $2.5 million and the non-deferred estate tax of $512,000).

1. The Service denied the request for a refund, stating that the "overpayment" would be applied to the installments due under §6166, the first of which wasn't due for five years. The court upheld the denial of a refund. At the time the estate made the tax payment, it had a net tax liability (the amount of the deferred portion of estate tax). Thus, there was no balance to refund. The Service had the discretion to credit the overpayment to the outstanding tax liability, regardless of the taxpayer's instructions.

C. **Pro rata transfer of assets from a partnership to LLCs did not unwind §6166 election**. Ltr. Rul. 201403012 involved the pro rata distribution of business assets of a partnership to D's estate (for which a §6166 election had been made) and another partner, followed by contribution of the assets to separate limited liability companies. After the restructuring, each LLC was owned pro rata by the partner and the estate, and continued the same business activities as before. Because the transaction did not materially alter the business and no withdrawal of money or property occurred, the deferral of tax under §6166 was not affected.

XVI. Section 6511—Limitations on Credits or Refunds

A. **Was it a tax payment or a tax deposit?** A six-month extension to file the Form 706 does not, by itself, give you an extension to pay the estate tax. Well, then: What do you do when the calendar pages are rapidly turning toward that 9-month due date, you are not ready to file the return, and you've made a guesstimate of the tax that will be due? The first thing you should do is read Rev. Proc. 84-58, 1984-2 C.B. 501, where you will discover that the terminology used on the remittance check and in the accompanying correspondence is terribly, terribly important. If it's a tax payment, the statute of limitations is in play. If it's a tax deposit, the statute of limitations does not begin to run if it turns out that the tax was overestimated.

B. **That was a tax payment, and the statute of limitations had run**. In Winford v. United States, 2013-2 U.S.T.C. ¶ 60,672 (W.D. La. 2013), W's executors filed a Form 4768 requesting an extension of time to file because the estate was in litigation with W's son. With the request, the executors submitted a check for $230,884, but did not indicate whether the remittance was a tax payment or a deposit. The litigation ended five years later, and the executors determined that the estate was due a credit of $136,268. The court declined to follow Huskins v. United States, 2007-1 USTC ¶ 60,538, (Fed. Cl. 2007), which had ruled that an undesignated remittance was a deposit.

Instead, the court used a six-factor "facts and circumstances" test to determine whether the remittance was a payment or a deposit. After taking all of the factors into account, it was determined that the factors weighed in favor of the Service—and the statute of limitations had run.

C. **Second verse, same as the first.** No, that's not Herman's Hermits singing "I'm Henery the 8th I Am"; it was the result in Syring v. United States, 2013-2 U.S.T.C. ¶ 60,671 (W.D. La. 2013). (This is the fourth case on this issue in Louisiana in the past two years!) The estate's accountant advised the executor to make a payment of $170,000 to the IRS along with a request for an extension to file. In sending in the check, the executor failed to provide a written statement designating the remittance as a deposit. Further, she neglected to submit an affidavit, declaration, or other testimony describing her intent to make a deposit when the payment was made. Besides, the estate only requested an extension of time to file, not pay the estate tax. In addition, the accountant's recommendation that the executor make a partial payment of the estate tax due suggested that the remittance was not meant to be a deposit but rather payment of tax. Thus, the estate's claim for a refund fell outside the three-year recovery period.

D. **If time is running out, don't use the Post Office!** In Langan v. United States, 2013-2 U.S.T.C. ¶60,668 (Fed. Claims 2013), a refund suit was untimely because it was filed more than two years after the date on which the Service's disallowance of an executor's refund claim was mailed. The complaint was mailed on the day before the deadline, but was not delivered until three days after the deadline. The executor's attorney dropped the complaint off after the cut-off time at the post office's 24-hour window. Despite the late drop-off, the executor sought to correct the filing date, based on a postal employee's statement that the complaint was expected to reach government offices the next day. The executor did not "do everything that could be expected of him to ensure timely delivery."

1. No go, said the court. Mailing the complaint at 11:00 p.m. on the last day of filing was not reasonable. Even if the executor was entitled to a presumption of timely filing, shifting the burden of proof to the government, the complaint arrived late.

XVII. Section 6651—Failure To File Return or To Pay Tax

A. **Reliance on over-the-hill attorney results in $1.2 million in late-filing penalties.** While "the factual circumstances are complex and sad," and "this Court finds it difficult to hold that Plaintiffs are ultimately responsible for Ms. Backsman's malpractice, that is what binding precedent requires." So said the court in Specht v. United States, No. 1-13-cv-00705 (S.D. Ohio 2015). The result was a $1.2 million failure-to-file penalty and $210,600 in interest, along with an estate tax of $3.9 million.

1. T died at age 92 on December 30, 2009, leaving a $12.5 million estate and a will that named T's cousin, Specht, as executor. Specht, then 73, was a homemaker with a high school education who had never served as an executor, did not own any stock, and had never been in an attorney's office. Specht retained attorney Backsman, who had drafted T's will, to represent her in administering the estate. Backsman "had over 50 years of experience in estate planning, but unbeknownst to Mrs. Specht, was privately battling brain cancer. Ms. Backsman deceived Mrs. Specht (whether intentionally or unintentionally), as to the status of an extension regarding the filing of the estate's tax returns. That deception eventually led to malpractice claims and the voluntary relinquishment of Ms. Backsman's law license." A footnote in the opinion notes that Ms. Backsman had since been declared incapacitated and was subject to a guardianship over her person and estate.

a. Backsman discussed with Specht the deadline for filing an estate tax return, and advised Specht that UPS stock would have to be sold to pay estate taxes. Backsman had Specht sign a blank paper that would authorize the sale, but the stock was not sold. Prior to the return deadline, Sprecht received four notices from the Ohio probate court warning her that the estate had missed probate deadlines. When Specht asked Backsman about this, Backsman advised that she would take care of the matter. Notices were received from the Ohio Department of Taxation warning that a state estate tax return had not been filed. Another family that had retained Backsman as attorney for their estate called Specht, warning her that Backsman was incompetent. After receiving these calls, Specht contacted Backsman, who assured her that things were going fine. Bottom line: Specht received several warnings but took no action until November 1, 2010, when she terminated Backsman and hired another attorney. The estate tax return was filed on January 26, 2011—15 months and 26 days after T's death. The estate brought a malpractice action against Backsman, which was settled.

2. Assessment of the late-filing penalty was affirmed. Specht argued that she lacked the sophistication to single-handedly complete and file the estate tax return, but the court responded that "there is no evidence to suggest that she lacks the sophistication to understand the importance of the estate tax deadline or to ensure that deadline was met." Under <u>United States v. Boyle</u>, 469 U.S. 241 (1985), "[t]he failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for a late filing under Section 6651(a)(1)…. One does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due."

   a. The court noted that "in light of Ms. Backman's malpractice, the State of Ohio refunded the late filing and payment penalties for Ohio estate taxes without the Estate filing a refund suit. It is truly unfortunate that the United States did not follow the State of Ohio's lead."

XVIII. Section 6901—Transferee Liability

A. **Estate of J. Howard Marshall still fomenting litigation, but this time not involving Anna Nicole Smith.** Topless dancer Anna Nicole Smith's dalliance with and marriage to wheelchair-bound octogenarian J. Howard Marshall, a Texas billionaire, engendered much litigation and problems for J. Howard's family members in the 1990s. And the litigation isn't over, as a result of some of J. Howard's transactions. <u>United States v. Marshall</u>, 771 F.3d 854 (2014), involved three issues: (1) whether donees of gifts had to pay interest on their transferee liability, (2) whether the donee of a gift to a GRIT was the income beneficiary or the remainderman, and (3) whether a trustee and an executor were personally liable for distributions made prior to the government's assessment of transferee liability.

Shortly before his death in 1995, J. Howard sold all of his stock in Marshall Petroleum Inc. ("MPI") back to MPI at below-market value. Extended litigation between J. Howard's estate and the IRS resulted in three unreported Tax Court decisions that (among other issues) concluded that the bargain sale to MPI resulted in indirect gifts to the other MPI shareholders—J. Howard's ex-wife Stevens, his son Pierce, Pierce's wife, and trusts for two grandchildren. (It must *really* have been a bargain sale, because the gifts totaled $83 million!) When J. Howard's estate refused to pay the resulting gift tax, the government assessed transferee liability against the donees.

1. **Donees must pay interest on amount of unpaid transferee liability**. The parties agreed that the donees were liable for interest attributable to the donor "at least up to the amount of each individual gift." They disagreed as to whether the government was entitled to interest on the unpaid donee liability. Ruling for the government and affirming the district court, the court, after an extended analysis of the relevant statutes and their legislative history, concluded that because §6901 imposed personal liability upon transferees, it was appropriate for the government to impose interest with respect to that personal liability. The court chose to follow Baptiste v. Commissioner, 29 F.3d 1533 (11th Cir. 1994), and not Poinier v. Commissioner, 858 F.2d 917 (3rd Cir. 1988).

2. **Transferee liability imposed on GRIT income beneficiary.** J. Howard's ex-wife Stevens had received 47,623 shares of MPI stock as part of a divorce settlement. In 1989, Stevens transferred 22,798 shares of those shares to a ten-year grantor retained income trust, with the remainder to pass to her son Pierce. When the government imposed transferee liability against Stevens' estate (Stevens died in 2007), her estate contended that the tax attributable to the GRIT should be charged against the Pierce's estate, because Pierce had received the trust corpus when the GRIT terminated in 1999. After an extended analysis, the court concluded that the income beneficiary was the donee for gift tax purposes, and that the remainderman did not share responsibility for the unpaid gift tax.

3. **Executor and trustee personally liable for distributions from the estate and for charitable set-aside after receiving notice of government claim**. Finally, the court held that Pierce as executor of Stevens' estate and Finley Hilliard as trustee of the Stevens Living Trust were personally liable for distributions that had been made after the Service had given notice that it intended to impose transferee liability on the estate and the trust. The action was based on 31 U.S.C. § 3713, known as the Federal Priority Statute, for distributions by a fiduciary to lower priority creditors and failure to preserve sufficient funds to pay taxes. The court affirmed the district court's finding that Pierce and Hilliard should have been aware of the potential liability to the government when the various distributions were made. The court held, however, that Pierce did not breach any fiduciary duty because under Texas law an executor does not owe a fiduciary duty to the estate's creditors.

B. **Transferee cannot collaterally attack tax assessment against estate**. In United States v. Cowles-Reed, 2014-2 U.S.T.C. ¶60,682 (9th Cir. 2014), D's gross estate included the entire value of Proctor & Gamble stock held in joint tenancy with each of his children. When the estate tax was not paid when due, the Service asserted transferee liability. The children collaterally attacked the assessment made against D's estate, contending that the estate tax should be reduced because of unclaimed administration expense deductions, and that the estate should be excused from late-payment penalties because the failure to pay was due to reasonable cause. No go, said the court. The estate was not a party to this action, and the children were suing in their individual capacities and not in any representative capacity. Third parties may not contest the merits of a tax assessment.

1. One of the children contended that she is not personally liable for the unpaid estate tax because the Service had not made an assessment against her as a transferee under §6901. A losing argument, said the court. In an action to impose transferee liability under §6324(a)(2), the Service may rely on the assessment of tax against the estate, and is not required to make an individual assessment under §6901.

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C. **Summary judgment: Transferee personally liable without regard to his third-party claim for contribution from estate's co-beneficiaries**. In United States v. Whisenhunt, 2014 WL 3610792, (N.D. Tex. 2014), the court ruled that there was no reason to delay entry of judgment against an estate beneficiary who was personally liable for the estate's unpaid penalties and interest. The transferee had filed an action against co-beneficiaries to contribute their pro rata share of the assessed penalties. However, said the court, this was a separate issue from and did not affect the transferee's personal liability to the extent of distributions he had received from the estate. The facts necessary to determine the co-beneficiaries' duty to share in the unpaid penalties were separate from the facts necessary to conclude that the transferee was personally liable. Also, the transferee failed to timely raise the issue of whether the executor's alleged disability may have raised a reasonable cause defense.

XIX. Section 7502—Timely Mailing Treated as Timely Filing and Paying

A. **Always use registered or certified mail; OK?** Ltr. Rul. 201442015 involved a request for an extension of time to file Form 8939, making a §1022 election to allocate basis with respect to carryover basis property. (The decedent died in 2010.) The executor contended (with supporting affidavits) that the Form 8939, which had been mailed by regular mail by the estate's accountant, was lost by the U.S. Postal Service. Sorry, said the Service; no extension. If the accountant had mailed the Form 8939 by registered or certified mail or other designated delivery service, under §7502 the mailing would have constituted prima facie evidence of the filing. Not so with regular mail, however. Because the executor could have easily avoided the problem, failure to make the election was not the result of intervening events beyond the executor's control.