Recent Developments Affecting Estate Planning

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I. 2015 Texas Legislative Changes

A. **New rules governing disclaimers.** The Estate Code provisions governing disclaimers were replaced by a new Chapter 240 of the Texas Property Code, adapted from the Uniform Disclaimer of Property Interests Act.

1. **Statute "unbundled" from federal tax law; no longer a nine-month time limit on making a disclaimer**. For many years, a primary motivation for considering a disclaimer was to avoid transfer taxes—that is, avoid stacking assets in the beneficiary's estate. If, for example, already-wealthy daughter Donna received a substantial inheritance (aggravating her estate tax and income tax picture) and then made gifts to her children, there would be federal gift tax consequences. By making a disclaimer, the disclaimed interest would (in most cases) pass to Donna's children (i) with no gift tax consequences, and (ii) with the benefit of utilizing her parent's otherwise-unused GST exemption.

   a. With a $5.45 million estate and gift tax exemption, any tax motivation for making a disclaimer has virtually disappeared (except for estate plans based on a disclaimer-funded spousal bypass trust). Instead, the likely motivation for making a disclaimer would be to avoid creditors' claims.

      Example: Mom leaves a will that bequeaths her $3 million estate "to my son Bubba if he survives me, otherwise to his descendants." Bubba, a failed real estate developer, is up to his eyeballs in creditors' claims. What should Bubba do?

   b. Under the statute as amended, the disclaimer can be made at any time before the heir or beneficiary has accepted the interest. However, t**o be valid for federal tax purposes**, a disclaimer must be made **within nine months** after the transfer is made.

2. **Time limit on making a disclaimer**. Because there is no explicit time limit on making a disclaimer, does this mean that a beneficiary or heir could disclaim four or five years after the decedent's death, and thereby avoid creditors' claims? To say that this is hardly unlikely would be an understatement. Under Property Code §240.151(b), a disclaimer is barred if:

   (1) the disclaimant accepts the interest sought to be disclaimed by:
   (A) taking possession of the interest; or
   (B) exercising dominion and control over the interest.

   It is inconceivable that the heir or beneficiary would not have exercised dominion or control (if not full acceptance) of the interest over such an extended period. Even unoccupied land in far West Texas—who would be paying taxes on the property?

   a. **Future interests**. There is one situation, however, where a years-later disclaimer could be used to defeat creditors' claims. Suppose that Dad's will creates a trust: "Income to my son John for life, and on John's death principal to my grandson Gary." John dies fifteen years later; Gary (a failed real estate developer) is heavily in debt. During John's lifetime, Gary held a future interest, meaning that he never had occasion to accept the interest, and he never exercised dominion and control over the interest.

3. **Simplified delivery and filing requirements**. Under the former law, a disclaimer instrument had to be delivered to the personal representative and filed with the probate court, with distinctive delivery rules applicable to nonprobate transfers. The new rules, applicable to probate and nonprobate transfers alike, greatly simplify the rule governing delivery, which can be in person, by mail, by fax, by email, or by any other method likely to result in receipt.

4. **Fiduciary's power to disclaim**. Fiduciaries may disclaim (1) powers granted to the fiduciary, (2) interests in property, or (3) powers over property otherwise passing to a trust for the benefit of a ward, estate or beneficiary. Court approval is required for disclaimers by a dependent administrator, guardian, or trustee of a court-created trust that benefits a minor or disabled person, or if the disclaimed interest would pass to the disclaiming fiduciary.

B. **Wills may be reformed for mistake.** It has long been held that, under the equitable rules of trust law, a trust can be reformed to correct a mistake. The courts consistently held, however, that a will could not be reformed after the testator's death. "While courts have jurisdiction to construe wills, they have none to reform or correct them." Jackson v. Templin, 66 S.W.2d 666 (Tex. Comm. App. 1933). That rule has been changed by Estates Code §§ 255.451-255.456, authorizing judicial modification or reformation of wills to address administrative issues, achieve the testator's tax objectives, qualify a beneficiary for governmental benefits, or (if supported by clear and convincing evidence) correct a scrivener's error.

a. **It is not clear what might constitute "a scrivener's error."** Wikipedia defines scriveners as "people who made their living by writing or copying written material." This may have had some meaning at the time of Blackstone's Commentaries on the Laws of England (1753), but it is not at all clear what "scrivener" means in the context of typewriters and word processors—and in the context of the Texas statute. As far as Wills law is concerned, the only persons who are scriveners in Blackstone's sense are lay persons who write their own holographic wills, where the issue of testamentary intent would not likely be an issue. It is probable that the Texas courts will give the term a broad construction, and include the person who supervised the will's preparation after the client conference.

C. **Transfer on Death deed as a means of avoiding probate**. New Estates Code Chapter 114 enacts the Texas Real Property Transfer on Death Act, adapted from the Uniform Real Property Transfer on Death Act. The TOD Act enables the owner of real property to designate a beneficiary to receive title to the property on the owner's death without the necessity of probate. For older persons who own only one piece of real estate that they are unlikely to sell—the family home—this affords an attractive means of transferring title without the attendant costs of (*e.g.*,) a muniment of title probate.

1. Question for the audience: Have any clients asked you about TOD deeds? If so, what have you told them as to the advisability of utilizing this procedure? (Or if they haven't asked yet, what *would* you tell them?)

2. **Requirements**. The TOD deed of course must be signed by the owner and notarized, but also **must be recorded**. As you learned in first-year Property, a warranty deed or quitclaim deed is valid to transfer title even if not recorded; recordation is intended to give notice. But the TOD deed must be recorded; otherwise it does not transfer title at death. Section 114.051 sets out an optional TOD deed form and gives instructions for executing the deed. No notice to, delivery to, or acceptance by the beneficiary during the transferor's life is required.

   a. A TOD deed may not be created by the exercise of a power of attorney.

3. **Rights retained by owner**. After filing a TOD deed, the transferor retains all ownership rights in the property. A TOD deed does not create any legal or equitable interest in the designated beneficiary, and the owner retains the power to transfer or encumber the property. The owner may revoke the deed, and a subsequent transfer of the property through a recorded conveyance automatically revokes the TOD deed.

   a. **TOD deed cannot be revoked by will**. "A will may not revoke or supersede a transfer on death deed." §114.057(b). In interviewing the client at will preparation time, here's another question to add to your list: "Have either of you executed a Transfer on Death deed?" In *Blausey v. Vanness,* 2015 Ohio Misc. LEXIS 4365 at 4 (Ohio C.P. 2015), a lawyer was told by his client to revise his estate plan in favor of new beneficiaries. The client's will was revised but a TOD deed was overlooked. "Even construing the evidence of intent to replace the TOD instrument strongly in favor of the Plaintiffs, reasonable minds can only conclude that [the decedent's] unfulfilled intent does not affect the TOD instrument and its effective transfer of the real estate to the beneficiaries—in this case, the Defendants."

   b. **Effect of divorce—tricky**. Unlike will and revocable trust provisions in favor of a former spouse, which are automatically revoked by a final decree of divorce, "a final judgment of the court dissolving the marriage operates to revoke the transfer on death deed as to that designated beneficiary ***if*** notice of the judgment is recorded before the transferor's death in the deed records in the county clerk's office of the county where the deed is recorded." §114.057(c) [emphasis added].

4. **Owner should also have a will**. Even if an owner is satisfied that a TOD deed will "do the job," it is advisable for the owner to also have a back-up will, in part to cover the possibility that he may acquire other real property or that the TOD deed may be revoked, but also to make clear the testator's intent as to how other property is to be disposed of. Even if the will is not probated, the testator's expressions of intent in his will would tend to resolve disputes among family members—and if disputes are not resolved, the will can be probated.

5. **Avoiding an ancillary administration**. If the client owns real property in another state and the state has enacted this Uniform Act, a TOD deed would be a useful way to avoid ancillary administration problems. In addition to Texas, as of December 13, 2014, the Uniform RPTOD Act has been enacted in 24 states and the District of Columbia: Alaska, Arizona, Arkansas, Colorado, Hawaii, Illinois, Indiana, Kansas, Minnesota, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, South Dakota, Virginia, Washington, West Virginia, Wisconsin and Wyoming, and bills seeking enactment are pending in Maryland and Tennessee. Most of the statutes include an optional form for a TOD deed for use in that state.

D. Directed Trusts—trust protectors and trust advisors. A new Property Code §114.0031, which was proposed by Texas Bankers Association and applies only to noncharitable trusts, provides that a person who is given authority to direct, consent to, or disapprove a trustee's investment, distribution or other decisions is considered a fiduciary in exercising that authority except to the extent the trust provides otherwise. A trustee who acts in accordance with those directions is not liable for doing so, except in cases of willful misconduct or gross negligence. The trustee has no duty to monitor the advisor's conduct, provide advice to or consult with the advisor, or communicate with or warn any beneficiary or third party just because the trustee might have exercised its discretion differently.

II. Legislation Relating to Estate and Gift Tax

A. FY 2017 Budget Proposal—basis consistency rules would be extended to marital deduction property and taxable gifts. The Obama administration's Fiscal Year 2017 Budget Proposal, published on February 9, 2016, made only one new proposal relating to the estate and gift tax. From the FY 2017 Greenbook: "The proposal would expand the property subject to the consistency requirement imposed under section 1014(f) to also include (1) property qualifying for the estate tax marital deduction, provided a return is required to be filed under section 6018, even though that property does not increase the estate's federal estate tax liability, and (2) property transferred by gift, provided that the gift is required to be reported on a federal gift tax return…. [T]he exclusion from the application of the consistency requirement of property qualifying for the estate tax marital deduction is significant because an unlimited amount of property may qualify for the estate tax marital deduction in a decedent's estate tax proceeding. Although it is true that the value of such property passing to the decedent's surviving spouse may be increased without incurring any federal estate tax, and a high estate tax value provides a high cap on the recipient's permissible basis, current law contains provisions to prevent an inaccurately high estate tax valuation. Specifically, the executor certifies to the accuracy of the information on the estate tax return under penalties of perjury, and significant underpayment penalties are imposed on the understatement of capital gains and thus income tax that would result from an overstatement of basis. "

B. Account transcript in lieu of estate tax closing letters. In a June 16, 2015 update to its frequently asked questions and answers on the IRS website, the Service announced that for estate tax returns filed after June 1, 2015, closing letters will be issued only on request of the taxpayer. The reason given for the change was that "[t]he volume of estate tax returns filed solely to make the portability election continues to increase tying up limited resources." The announcement advised that practitioners should wait at least four months after filing the return to request a closing letter. The premise of the change of procedure is that the IRS believes that it will issue fewer closing letters if taxpayers have to ask for one. This is questionable, as nearly all executors will want to have a closing letter before terminating the administration and distributing the estate.

1. **New procedure**. In response to concerns raised by the AICPA and others, on December 4, 2015, the IRS announced on its Office of Information and Regulatory Affairs website that a new procedure can be used by tax professionals to determine that the Service's review of an estate tax return is closed. "Account transcripts, which reflect transactions including the acceptance of Form 706 and the completion of an examination, may be an acceptable substitute for the estate tax closing letter. Account transcripts are available online to registered tax professionals using the Transcript Delivery System (TDS) or to authorized representatives making requests using Form 4506-T." Under this new procedure, the Service will mark account transcripts for estate tax returns with Transaction Code 421 that says "closed examination of tax return."

2. **But please wait four to six months before requesting an account transcript**. The IRS advised that the decision to audit a Form 706 is typically made four to six months after the return's filing date, and requested a wait of four to six months before submitting a request for an account transcript.

III. Section 401—Qualified Plans and IRAs

A. Inherited retirement benefits: Five-year payout limit for beneficiaries other than spouses, minor children? Under the Obama administration's Fiscal Year 2017 Budget Proposal (also included in the 2014, 2015 and 2016 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.

1. No new developments on this issue; Congress hasn't acted on it.

B. **"No tax due" must have meant "no estate tax due."** In Morris v. Commissioner, T.C. Memo 2015-82, Morris received a $95,484 distribution from an IRA owned by his father. Morris told the Tax Court that he checked the box to not have federal income tax withheld from the distribution because the paralegal who settled his father's estate advised him that there would be no tax due on the distribution. After receiving the distribution, Morris distributed $37,000 to his two siblings, based on what he believed were his father's wishes. Judge Lauber noted that the paralegal "evidently meant that there would be no Federal estate tax or Michigan inheritance tax due. But petitioner understood her to mean that no tax of any kind would be due." Needless to say, that's not how it works, and the court affirmed a $27,000 deficiency. Although Morris "acted honorably in executing what he believed to be his father's wishes, his good conduct has no bearing on whether the IRA distributions were includible in his gross income." The judge added that the advice Morris thought he received from the law firm "might have affected his liability for the accuracy-related penalty."

IV. Section 671—Grantor Trust Rules

A. **No rulings on whether assets in a grantor trust receive a step-up in basis**. On June 15, 2015, the Service issued Rev. Proc. 2015-37, 2015-26 IRB 1196, advising that the Service will not issue private letter rulings on whether the assets in a grantor trust receive a §014 basis adjustment at the grantor's death when the trust assets are not includible in the grantor's gross estate. A project to provide guidance on whether such assets receive a basis step-up under is on the Treasury 2015-2016 priority guidance plan.

B. ***Estate of Woelbing v. Commissioner*** **settled**. A case that would have addressed a number of important issues regarding installment sales to a defective grantor trust, *Estate of Woelbing v. Commissioner*, Docket Nos. 30260-13 and 30261-13 (Dec. 26, 2013), was recently settled. The case involved a sale of Woelbing's 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. Among the issues: Use of personal guarantees to partially seed the purchasing trust, the basic validity of a DIGIT transaction, and whether the §2702 special valuation rule should apply, and whether the AFR interest rate rather than the much higher §7520 interest rate could be employed in valuing the transaction. There was also an enormous variation in the parties' valuation of the Carma Laboratories stock ($117 million versus $59 million).

1. The outline of the parties settlement is set out in stipulated decisions (*Estate of Woelbing v. Commissioner*, T.C. Nos. 30260-13 and T.C. No. 30261-13 (March 25 and 28, 2016)). Under the settlement, Woelbing's successors owe no estate or gift tax deficiencies, no penalties are due, and the IRS does not have to make overpayments back to the estate.

V. Section 1014—Basis of Property Acquired From a Decedent

A. Proposed regulations answer some questions and raise others. Proposed regulations under §§ 1014 and 6035 relating to basis reporting were published in T.D. 9757 on March 3, 2016. The proposed regulations give workable answers to some issues, but raise vexing problems on other issues.

1. **Return filed to make portability election—no requirement for basis reporting**. The proposed regulations make it clear that the valuation statement requirement does not apply to an estate tax return filed only for the purposes of making a portability election. The basis consistency reporting rules apply only to property that increases the federal estate tax liability, and property that qualifies for the charitable or marital deduction isn't subject to these rules.

2. **Reporting requirement on beneficiary who transfers inherited property**. The proposed regulations impose a new reporting requirement imposed on a beneficiary who transfers the inherited property a related recipient—a member of the beneficiary's family, an entity controlled by the beneficiary, or a grantor trust. The transferee takes the basis of the original beneficiary, of course—but beneficiary has a duty to file an information statement with the Service and the related recipient within 30 days of the transfer. There is no explicit (or even implicit) language in §6035 to support this requirement, which considerably expands the reporting requirements to include not just executors but also beneficiaries. Of course, §6035(b) provides that "The Secretary shall prescribe such regulations as necessary to carry out this section.…"

    a. If a beneficiary disposes of property before its value is finally determined, the beneficiary must provide the executor with the information, and the executor will send the related recipient the supplemental statement once the value is finally determined.

3. **Zero basis for unreported assets?** Suppose that property is discovered after the federal estate tax return was filed, or was omitted from the return for any other reason? If the executor reports that property before expiration of the assessment period, the basis of the property will be the estate tax value as finally determined. If, however, the property is not reported before the limitations period on assessment expires, property's basis is ***zero***.

    a. To say that this is an interesting "interpretation" of §1014(f) is—a stretch. Put simply, there is nothing in the statute to support what amounts to a rewriting of the statute. The statutory language does not impose a "zero basis" rule in any circumstance.

    b. If valid, this rule would have extraordinarily negative tax consequences to the property's beneficiaries, which in some cases could be recouped by suing the executor if the situation arguably was of the executor's doing.

4. **These items need not be reported**. Under the proposed regulations, the following items need not be included on an information statement: cash, income in respect of a decedent, tangible property (unless an appraisal is required because an item's value exceeds $3,000), and property sold or otherwise disposed of by the estate. If, however, an executor is not sure what property will be used to satisfy a beneficiary's interest, the executor must list all of the properties that could possibly be used.

5. **Supplemental statements.** Supplemental statements are required for discovery of property not reported on a return, a change in value due to an audit or litigation, or a change in the identity of the beneficiary due to death or disclaimer.

6. **You’ve got until June 30 to file basis information statements**. Because of delays in releasing the temporary regulations, Notice 2016-27, IRB 2016-15 (April 11, 2016), extended the time for filing valuation statements, for executors required to file a return after July 31, 2015, to June 30. This is the second time the Service has extended the deadline. Because temporary regulations have now been published, a third extension of the due date is highly unlikely.

VI. Section 2031—Definition of Gross Estate—Valuation Issues

A. Auction sale of Picasso two months after return filed established its value for estate tax purposes. In Estate of Newberger v. Commissioner, T.C. Memo. 2015-246, the estate of the decedent, who died on October 28, 2010, included a painting by Pablo Picasso titled “Tete de Femme,” which she had acquired in 1981 for $195,000. In November 2009, the estate sought appraisals of the Picasso and other paintings. In December 2009, Sotheby's offered to sell the Picasso, and guaranteed that it would pay the estate $3.5 million if the Picasso did not sell at auction. The estate rejected the offer, and on December 18, 2009, agreed to sell the Picasso at Christie's London auction scheduled for February 2, 2010. Their agreement provided the estate with a guarantee of $4.8 million plus 60 percent of the hammer price (the amount of the winning bid) that exceeding that amount. Christie's listed the Picasso in its catalog with an expected sale price of between $4.8 million and $6.4 million, and provided the estate with an appraisal reporting the Picasso’s date-of-death value at $5 million.

Judge Foley in his opinion noted that “[t]he market for fine artwork declined precipitously during the autumn of 2008” but “ rebounded in 2010, with auction revenue from that year nearly doubling the 2009 total and almost matching the 2007 high point.”

1. The estate tax return filed on October 28, 2010, reported the Picasso’s value at $5 million. On February 2, 2010—two months after the estate tax return was filed—the Picasso sold at auction for nearly $13 million. The Service issued a deficiency, determining that the Picasso had a date-of-death value of $13 million.

2. “The estate's experts ask us to disregard this sale because ‘[i]t was a fluke’, and the estate unconvincingly contends that this sale is not relevant because it could not have been reasonably anticipated on the date of death. To the contrary, the sale of the Picasso may ‘be taken into account as evidence of fair market value as of the valuation date.’ See Estate of Jung v. Commissioner, 101 T.C. 412, 431–432 (1993)…. Indeed, no evidence is more probative of the Picasso's fair market value than its direct sale price…. “ The estate's experts' failure to consider the sale of the Picasso renders their valuation wholly unreliable. Respondent's expert, after adjusting the $12,927,874 sale price downward to reflect July 28, 2009, market conditions, valued the Picasso at $10 million. We agree with respondent's expert.”

B. Three parcels of land were valued individually, not as part of a package that included two larger contiguous parcels. Estate of Pulling v. Commissioner, T.C. Memo. 2015-134, involved five contiguous parcels of land totaling 131 acres, zoned agricultural, near Naples, Florida. Pulling owned three parcels totaling 20.5 acres, and a land trust in which Pulling had a 28 percent interest owned two contiguous parcels totaling 110.5 acres. Members of Pulling’s family owned over 50 percent of the ownership interests in the land trust. After concessions, the only issue before the Tax Court was valuation of the three parcels owned by Pulling. The expert witnesses for both parties agreed that if the estate's property could be assembled with the land trust's property, residential development of the whole would be the highest and best use. They also agreed that if assemblage is not possible, residential development of the estate's property would not be economically feasible due to the parcels’ size, shape and limited access.

1. The court noted that if a higher use of land is possible if it land is combined with other parcels, the court could consider that higher use, but only if there is a reasonable probability that the lands will be combined with the other tracts in the near future. The court concluded that on the facts presented, assemblage of the parcels was unlikely. While assemblage would yield the greatest economic benefits, there was nothing to suggest that the land trust stakeholders were interested in selling. Also, the land ownership of Pulling’s family members was to be disregarded because the courts have rejected family attribution for purposes of valuing property.

2. The estate’s expert offered an opinion as to the value of the three parcels if assemblage was not reasonably likely, but the government’s expert did not. “[R]espondent argues that even if the estate's property's value should not be based on assemblage, we should recognize a ‘premium to fair market value’ that a buyer of TCLT's property would place on the adjacent property owned by the estate. We find that respondent's theory is too speculative and is not supported by the record.” The court accepted the valuations presented by the estate’s expert.

C. Ninth Circuit says—again—that Tax Court does not know how to handle valuation cases. In recent years, in estate tax valuation cases the Court of Appeals for the Ninth Circuit has been decidedly hostile territory as far as the Tax Court is concerned. In several high-profile cases, Tax Court decisions have been reversed and remanded (or reversed and rendered judgment) with dismissive and sometimes sarcastic language strongly intimating that, in the Ninth Circuit’s view, certain judges on the Tax Court couldn’t tell their … er, don’t know what they are doing when it comes to valuation issues. See <u>Morrissey v. Commissioner</u>, 243 F.3d 1145 (9th Cir. 2001); <u>Estate of Simplot v. Commissioner</u>, 249 F.3d 1191 (9th Cir. 2001); <u>Estate of Mitchell v. Commissioner</u>, 250 F.3d 696 (9th Cir. 2001). The most recent entry in this interesting saga is <u>Estate of Giustina v. Commissioner</u>, 2014-2 USTC ¶60,684 (9th Cir. 2014), involving valuation of a decedent’s interest in a limited partnership.

1. Guistina held a 41.1 percent limited partnership interest in a timberland company. The Tax Court had concluded that although the owner of an LP interest could not unilaterally force liquidation, the owner of that interest could form a two-thirds voting bloc with other limited partners to do so, and assigned a 25 percent probability to this occurrence. As there was a 25 percent likelihood that the partnership would be liquidated, the Tax Court assigned a 25 percent weight to an asset-based valuation and a 75 percent weight to valuation of the partnership as a going concern.

2. **You are dead wrong again**, said the Ninth Circuit. “This conclusion is contrary to the evidence in the record. In order for liquidation to occur, we must assume that (1) a hypothetical buyer would somehow obtain admission as a limited partner from the general partners; (2) the buyer would then turn around and seek dissolution of the partnership or removal of the general partners who just approved his admission to the partnership; and (3) the buyer would manage to convince at least two (or possibly more) other limited partners to go along, despite the fact that no limited partner ever asked or ever discussed the sale of an interest. Alternatively, we must assume that the existing limited partners, or their heirs or assigns, owning two-thirds of the partnership, would seek dissolution. We conclude that it was clear error to assign a 25% likelihood to these hypothetical events. As in <u>Estate of</u>

Simplot v. Commissioner, 249 F.3d 1191, 1195 (9th Cir. 2001), the Tax Court engaged in 'imaginary scenarios as to who a purchaser might be, how long the purchaser would be willing to wait without any return on his investment, and what combinations the purchaser might be able to effect' with the existing partners." The case was remanded to the Tax Court for recalculation of the value of Guistina's interest in the partnership.

a. However, the court concluded, "the Tax Court did not clearly err by using the Commissioner's proposed 25% marketability discount rather than the Estate's proffered 35% discount, especially considering that the Estate's expert acknowledged that such discounts typically range between 25% and 35%."

VII. Section 2033—Property In Which the Decedent Had an Interest

A. **Income tax refunds includible in gross estate**. In Estate of Badgett v. Commissioner, T.C. Memo. 2015-226, the court ruled that income tax refunds that were due prior to death were includible in the decedent's gross estate because the estate had the right to compel the Service to issue a refund. Involved were a $404,315 refund from the 2011 tax year and a $14,126 refund from the 2012 tax year, both distributed to Badgett's estate after his death. The court distinguished cases in which taxpayers had offsetting liabilities. When no offsetting liability exists, §6402(a) "mandates that the IRS 'shall' refund any balance to the taxpayer. There is no indication that decedent was subject to any liability or obligation against which the IRS could offset his overpayments."

VIII. Sections 2036 and 2038—Retained Interests or Powers

A. **Tax court rules in favor of estate on three issues relating to transfers to a limited liability company.** In Estate of Purdue v. Commissioner, T.C. Memo. 2015-249, the Tax Court ruled that (1) assets transferred to a limited liability company ("LLC") were not includible in the decedent's gross estate, (2) the gift transfers qualified for annual exclusions, and (3) the estate could deduct the interest on loans from beneficiaries to pay the estate tax. D's husband H (who predeceased her) was a founding partner of a Seattle law firm. Beginning in 2000, D and H entered into several planning arrangements recommended by one of H's partners, an estate planning attorney. Among them, D and H transferred assets to an LLC. The LLC agreement listed seven ("round up the usual suspects") non-tax purposes for establishing the LLC. H died in 2001; D died in 2007 at age 95.

1. The Service contended that W's interest in the LLC assets was includible in her gross estate: that W's transfers to the LLC were not bona fide sales for an adequate and full consideration, that the LLC was a testamentary substitute, and that transfer tax savings were the primary motivation for the formation and funding of the LLC. After reviewing the facts involved in the LLC's creation (the elderly couple's five children made most of the planning decisions), the court ruled in favor of the estate. While one of the motives for creating the LLC was to simplify the gift-giving process and secure transfer tax savings, this was not the only motive. The court bought into the estate's contention that a significant purpose was to consolidate investments into a family asset managed by a single adviser.

2. The Service also contended that W's gift transfers to the LLC did not qualify for annual exclusions. Because members of the LLC could not transfer their interests without unanimous consent, the donees did not receive unrestricted and noncontingent rights to the LLC interests themselves. However, the donees received rights in the LLC's income, and the facts satisfied the requirement that, for an income interest to be a present interest, (1) the LLC would

generate income, (2) some portion of that income would flow steadily to the donees, and (3) that portion of income could be readily ascertained. Here, the LLC receive interest income from a building that was subject to a 55–year lease, and also held dividend-paying marketable securities. The rent amount for the building was readily ascertainable, and the marketable securities were publicly traded for which expected dividends could be estimated.

3. With a substantial estate tax to be paid, the estate's attorney discussed with D's five children various options that might be pursued. Among the options listed were loans from the LLC and a substantial dividend from the LLC. One child refused to approve a dividend sufficient to pay the estate tax in order to induce her siblings to approve a much larger dividend. When the children were deadlocked, several of them made loans to the estate. Concluding that the loans were bona fide, the Tax Court ruled that the estate could deduct the accrued interest on the loans.

B. This family limited partnership did not pass muster. In *Estate of Holliday v. Commissioner*, T.C. Memo 2016-51, involving a $785,000 deficiency, the Tax Court ruled that the full value of marketable securities transferred to an FLP were includible in H's gross estate under §2036 because H retained rights in the securities, and there was no legitimate and significant non-tax reason for the transfer. The Tax Court concluded that there was an implied agreement that Holliday retained economic benefits in the transferred securities, and that H had an unqualified right to receive distributions from the FLP.

1. H moved into a nursing home in 2003, and her financial affairs were managed by her two sons. In December 2006, H transferred $5.9 million in marketable securities to a family limited partnership and an LLC with a 0.1 percent general partnership interest. H then sold the LLC to her sons and transferred a ten percent limited partnership interest to an irrevocable trust. On her death two years later, the estate timely filed an estate tax return that claimed a combined forty percent discount for H's remaining 89.9 percent LP interest. The Service contended, and the Tax Court agreed, that the 0.1 percent general partnership interest and the ten percent LP interest were includible in H's gross estate, and that the assets in the remaining 89.9 percent LP interest were includible in the gross estate at their undiscounted value.

2. The court concluded that H retained, by implied agreement, the possession or enjoyment of, or the right to income from the transferred property. The FLP agreement required the periodic distribution of "distributable cash," defined in the agreement (as it is in most partnership or operating agreements) as cash in excess of current operating needs, as determined by the general partner. One of the son testified that "this seemed to come from some sort of boilerplate for Tennessee limited partnerships, this sort of gave you broad powers to do anything you needed to do, including make distributions. But that wasn't necessary; no one needed a distribution." Oops! Although only one distribution of $35,000 had been made, this interpretation essentially gave the GP unlimited discretion with regards to setting the level of distributable cash. Also, no books or records other than brokerage statements had been kept, and there was nothing to show there no "distributable cash" was available.

3. The court also ruled that the transfer was not a bona fide sale for adequate and full consideration. Taxpayer cited three non-tax reasons for establishing the FLP, and none was persuasive to the Tax Court.

    a. **Protection from trial attorney extortion?** The court noted H had never been sued and that since she lived in a nursing home, her risk of being sued was minimal. Also, H had retained significant assets that could be reached by someone.

b. **Protection against undue influence of caregivers?** The court noted that while caregivers had taken advantage of or stolen from other family members, H's situation was different because her sons managed her affairs and visited her often. Also, this concern was not discussed when the FLP was formed.

c. **Preservation of assets for the decedent's heirs?** Taxpayer's argument was unpersuasive as the assets of H's deceased husband were being managed in trusts without difficulty. Also, H was not involved in selecting the structure to preserve her own assets.

4. **The transfer was not an arm's-length transaction** because there was no meaningful negotiation or bargaining. H agreed to whatever her sons and attorney decided. The court concluded that the assets were transferred to the FLP solely to take advantage of valuation discounts, and that the transaction was testamentary in character.

IX. Section 2042—Life Insurance

A. Exculpatory clause no help to trustee where insurance policies lapsed. In Rafert v. Meyer, 290 Neb. 219 (2015), Rafert established an irrevocable insurance trust to own three insurance policies whose death benefits totaled $8.5 million. The beneficiaries were to be Rafert's daughters. Rafert's attorney (Meyer) drafted the trust and was the trustee. Meyer completed the policy applications and used a false address (in South Dakota!) for his contact information. (Why the false address? No explanation is given in the court's opinion.) The trust instrument provided that "[t]he Trustee shall be under no obligation to pay the premiums which may become due and payable under the provisions of such policy of insurance, or to make certain that such premiums are paid by the Grantor or others, or to notify any persons of the non-payment of such premiums, and the Trustee shall be under no responsibility or liability of any kind in the event such premiums are not paid as required." However, the trustee did have an obligation to furnish annual reports to trust beneficiaries.

1. Rafert made the initial premium payments totaling $262,000. She made a second set of premium payments, which "were paid directly to an insurance agent by issuing checks to a corporation owned by the agent. However, the premiums were never forwarded to the insurers by the agent or his company, and Appellants do not know what happened to the premiums." The notices of nonpayment were sent to the South Dakota address and were never received by Meyer. As a result, Rafert and her daughters were unaware that the policies lapsed. Rafert and her daughters sued for breach of fiduciary duty, but the trial court held that Meyer wasn't liable by reason of the trust's exculpatory provision.

2. The Nebraska Supreme Court reversed, and remanded the case for trial. Under the Nebraska statutes, the terms of a trust do not prevail over a trustee's duty to act in good faith and in the interests of the beneficiaries, and the duty to keep qualified beneficiaries reasonably informed about facts necessary to protect their interests. Further, even if an exculpatory can prevail over the statute, it cannot prevail in this case because Meyer didn't adequately explain the exculpatory clause and its consequences to his client.

3. Moral: If an instrument you draft contains an exculpatory clause, make sure that you explain its implications to the client—and memorialize that you gave that explanation.

X. Section 2053—Administration Expense Deduction

A. **After estate had settled with the IRS, an increase in debt obligation did not warrant an increase in the Section 2053 deduction**. In Billhartz v. Commissioner, No. 14-1216 (7th Cir. 2015), B had entered into a court-approved divorce settlement under which the couple's four children (three daughters and a son) would receive one-half of B's estate at his death. After B died, the four children entered into a settlement agreement with B's second wife under which the children received $20 million. On the estate tax return, the estate claimed a $14 million deduction under §2053(a)(3), which permits a deduction for an indebtedness founded upon a promise or agreement. (The opinion notes that it is unclear why the estate claimed a $14 million rather than a $20 million deduction.) The IRS issued a notice of deficiency that disallowed the deduction in full. In a settlement reached two weeks before the Tax Court trial date, the parties agreed to a deduction of 52.5 percent of the claimed $14 million. Two months later, B's three daughters brought suit against the estate, contending that their settlement with the estate was procured by fraud. The parties reached a court-approved settlement under which each daughter received an additional $1.45 million.

1. Seeking an increase in the amount of the §2053 deduction, the estate filed a motion to have the case restored to the Tax Court's general docket, which the court denied. On appeal, the Court of Appeals for the Seventh Circuit ruled that the Tax Court did not abuse its discretion by refusing to set aside the settlement agreement. The court rejected the estate's argument that there was a mutual mistake of fact. The estate's failure to foresee the daughters' lawsuits did not involve a fact about which the parties were mistaken at the time they reached the settlement. Moreover, the $14 million claim was the basis for the Service's settlement offer, not the amount actually paid to the children. Also, said the court, the fact that the settlement was calculated as a percentage made no difference; "all monetary settlement amounts can be expressed as a percentage of the amount claimed by the plaintiff."

2. Finally, "the Estate's argument is contrary to the very nature of settlements…. Settlements are meant to substitute certainty for risk, but that does not make them risk free. By settling, parties close the door to new information; that's risky because they do not know whether new information will be helpful or harmful."

XI. Section 2055—Charitable Deduction

A. Bequest to "the church that I regularly attend"? No charitable deduction for amount paid in settlement. That's what the will said in Estate of DiMarco v. Commissioner, T.C. Memo. 2015-184, which means that you don't have to know what happened to produce this litigation! Immediately before his death, DiMarco regularly attended ***two*** churches: the Calvary Tabernacle Assembly of God and the New Life Ministries. The will named DiMarco's father as executor, but because the father predeceased the alterante executor was … the pastor of the church that DiMarco regularly attended. The two pastors of the respective churches sought appointment as co-executors. Not surprisingly, the heirs contended that the bequest was invalid for failing to name an identifiable beneficiary. After several pretrial skirmishes and an attempt to locate other heirs, the parties reached a settlement on March 22, 2012 (approved by the Surrogate's Court on April 26). Under the settlement, the estate was split three ways; one share for each church and one share for the heirs.

1. In the meantime, the estate's Form 1041 for the 2010 taxable year was filed (late) on April 19, 2012—a week before the Surrogate approved the settlement, reporting $336,000 of income and a $315,000 charitable deduction as a charitable set-aside. At issue was whether

the estate could prove that the possibility that the amount set aside would go to noncharitable beneficiaries was so remote as to be negligible. The estate could not do so, said Judge Laro. The parties' settlement in March allocated the beneficial interest in the estate, but not legal fees, expenses of administration and the co-executor's commissions, which were not resolved until January 2013. "By virtue of the fact that the settlements pertaining to designation of the beneficiaries and consequential legal and administrative expenses were not finalized until after the year at issue and the estate filed its income tax return, we find that the possibility that the funds would go exclusively to noncharitable beneficiaries was not so remote as to be negligible."

2. Did someone purporting to be a competent attorney prepare draft this rather embarrassing will? Apparently not. ("[D]ecedent executed a will while living in Hartford, Connecticut. Decedent had three witnesses sign the will."

B. No deduction for conservation easement where mortgage on property not subordinated to easement at time of donation. So held in Minnick v. Commissioner, 796 F.3d 156 (9th Cir. 2015). Minnick took out a mortgage loan on property in Idaho. Two days after receiving approval of development plans, Minnick donated a conservation easement on parts of the land that were not to be developed, and took charitable deductions on income tax returns. The Service assessed a deficiency, which Minnick challenged. As the case was approaching trial in Tax Court, Minnick entered into an agreement with the bank subordinating the mortgage to the easement. Following trial in the Tax Court but before the court had issued a ruling, the Tax Court decided Mitchell v. Commissioner, 138 T.C. 324 (2012), which held that a mortgage must be subordinated at the time of the donation in order to be deductible. On the basis of Mitchell v. Commissioner, the Tax Court ruled for the IRS. Minnick filed an appeal, but while the appeal was pending the Court of Appeals for the Tenth Circuit affirmed the Tax Court in Mitchell v. Commissioner, 775 F.3d 1243 (10th Cir. 2015).

1. To all of this, the Ninth Circuit Court of Appeals said: "We reject Taxpayers' argument and hold, like the Tenth Circuit in Mitchell II, that Treasury Regulation §1.170A–14(g)(2) requires that the mortgage be subordinated at the time of the gift for the gift to be deductible."

2. **On top of that, an accuracy-related penalty because of that law degree**. The court affirmed the Tax Court's imposition of a 20 percent accuracy-related negligence penalty under §6662(a). "The record supports the Tax Court's finding of fact that Taxpayers were negligent, so this finding was not clearly erroneous. Even if Taxpayers' ignorance of the subordination requirement was in good faith, it was not clear error for the Tax Court to find that Taxpayers 'did not have reasonable cause for claiming a charitable-contribution deduction' because Minnick has a law degree and reading the Treasury Regulation would have given him notice that subordination may have been required."

C. No deduction for conservation easement where grantor reserved right to change boundary. In Balsam Mountain Investments LLC v. Commissioner, T.C. Memo. 2015-43, BMI conveyed 22 acres of land in southwestern North Carolina (near the Nantahala National Forest) to the North American Land Trust. Under the conveyance, BMI retained for five years the right to change the boundaries of the tract, subject to the condition that the area restricted by the conservation easement had to remain 22 acres and that at least 95 percent of the original 22 acres had to remain within the restricted area's boundaries. Following its decision in Belk v. Commissioner, T.C. Memo.2013-154, *affd*, 774 F.3d 221 (4th Cir. 2014), the court ruled that this was not a "qualified real property interest" under §170(h), which must be an identifiable, specific piece of real property.

D. Taxpayer is arguing for higher valuation of property and Service is arguing for a lower valuation? It must be a conservation easement case. And it was, in Palmer Ranch Holdings Ltd. v. Commissioner, 812 F.3d 982 (11th Cir. 2016). The land's history is fascinating. Bertra Palmer, the widow of Chicago department store magnate Potter Palmer (he built the Palmer House hotel on State Street in Chicago), purchased 80,000 acres of land in Sarasota, Florida. The land, initially developed for orange groves and livestock pastures, now consists of upscale housing (including more than a few mansions), malls, and the PGA'S Tournament Players Club at Prestancia. Coming down to the present, the case involved 82 acres of Palmer Ranch, for which the bad news—or the good news, depending on your perspective—was that one bald eagle nest was located on the eastern side of the tract. Palmer Ranch, managed by Hugh Culverhouse, Jr., son of the former owner of the Tampa Bay Buccaneers donated 82 acres as a conservation easement, and took a $25.2 million deduction no that year's tax returns. And where are those 82 acres? As Judge Goldberg puts it in his opinion:

> "To the west of B–10 lies Sarasota Bay, where the eagles would fly to feed. To allow the eagles to reach their feeding grounds safely, B–10 sported a nest-to-coast flyway in the form of a 'wildlife corridor.' The wildlife corridor also provided a habitat to small urban animals of considerably less patriotic interest. Freedom isn't free. Concern over the eagle nest, wildlife corridor, and wetlands on B–10 thwarted plans by the parcel's owner, Palmer Ranch, Inc. ("Palmer Ranch") to sell B–10 and the adjacent B–9 for residential development. Ever resourceful, Palmer Ranch turned around and donated a conservation easement on B–10 to Sarasota County in 2006, a strategy that allowed the corporation to deduct the easement's value from that year's tax returns. But Palmer Ranch's backup plan fell prey to a sharp-eyed IRS, who disallowed the deduction on grounds that Palmer Ranch had overvalued B–10 in calculating the associated easement's worth. Palmer Ranch had valued B–10 at $25,200,000 on the assumption that B–10's highest and best use was residential development, with development of 360 dwelling units being reasonably probable. The IRS did not share Palmer Ranch's optimism."

1. The Tax Court ruled that Palmer Ranch was entitled to a charitable contribution deduction of at least $21 million as the pre-easement value, because the rezoning history of the property left open the reasonable probability that the local land use authority would approve a 360-dwelling development. The IRS argued that the land should be valued at $7.75 million based on the existing zoning at the time of the donation, and that while zoning changes were being considered at that time, the local government was unlikely to allow more than 100 units. The rather long decision recites the zoning law machinations and "dueling expert" assessments of which zoning changes were likely. In rejecting the Service's valuation, the court concluded that the highest-and-best-use test to value real property "includes within it an analysis of whether the proposed use is 'needed or likely to be needed in the reasonably near future.'" The Court of Appeals affirmed the Tax Court's decision that the highest-and-best-use valuation of the property should be based on the reasonable probability of land use law changes that would allow more development than that of existing law.

2. The case was remanded to the Tax Court because in reducing the contribution deduction from $25.2 million to $21 million, the Tax Court mishandled a "comparative sales" valuation issue. Thus, there is a good possibility that Palmer Ranch will get an even larger charitable deduction when the case is returned to the Tax Court. "With regard for B–10's proudest avian residents and for the enduring American principles they have come to symbolize, it is time now to close. We affirm the tax court's determination of B–10's highest and best use, but reverse the ensuing valuation."

E. How do you value the remainder interest in a NIMCRUT? In Estate of Schaefer v. Commissioner, 145 T.C. No. 4 (2015), S funded two trusts—Charitable Remainder Unitrust Number 1 and Charitable Remainder Unitrust Number 2. The trusts provided for distributions to the income beneficiaries of the lesser of the net income for the taxable year or 11 percent (for Trust 1) and 10 percent (for Trust 2) of the fair market value of the trust assets, valued annually. Each trust instrument authorized the trustee to make additional distributions, limited to trust income, if previous distributions did not equal the fixed percentage. The remainder interests were to be distributed to a charitable organization. S died a year after the trusts were established. At issue was whether the remainder interests satisfied the 10 percent test: Under §664(d)(2), to qualify as a charitable remainder trust, the value of the remainder interest must be at least 10 percent of the value of the property contributed.

1. The estate argued that the remainder interests should be calculated using the expected net income according to the applicable §7520 rate so long as the rate is above 5 percent. The government argued that in valuing the remainder interests, the fixed percentage should be employed. The court agreed with the government. "We hold that the parties must calculate the value of the remainder interest for each trust using a distribution amount equal to the fixed percentage." As a consequence, charitable deductions were denied because both trusts failed the 10 percent test.

2. The court noted that although §664(e) is ambiguous as to value the remainder interest in a NIMCRUT, "[w]ith regard to the statute before us, the legislative history and the administrative guidance point us to only one conclusion—that the value of the remainder interest of a NIMCRUT must be calculated using the greater of 5% or the fixed percentage stated in the trust instrument. Accordingly, the estate must use an annual distribution amount of 11% or 10%, respectively."

XII. Section 2056—Marital Deduction

A. Final regulations on portability election. On June 16, 2015, the IRS issued final regulations regarding the portability election (T.D. 9725), which enables a surviving spouse to succeed to the unused estate tax and gift tax exemption of his or her last predeceased spouse, but only if a portability election is made on an estate tax return for the deceased spouse's estate. The spouse can utilize the "deceased spouse's unused exclusion amount" [DSUE] for estate and gift tax purposes. (There is no portability for any unused GST exemption of the deceased spouse.)

1. Under the final regulations, an extension of time to elect portability under Reg. §301.9100-3 may be granted only to estates that are under the threshold filing amount and not otherwise required to file a return. An executor who timely files a complete return doesn't need to file a protective election to confirm the amount of the deceased spouse's DSUE. A timely filed return is sufficient to elect portability, and if factual elements of the return change (if, for example, a deduction is ultimately allowed), the recomputed amount of DSUE will be available without additional filings or any protective election.

2. Interesting, the final regulations do not address the issue of whether it will respect a QTIP election that wasn't necessary to reduce the estate tax liability to zero. Rev. Proc. 2001-38 took the position that the Service will disregard QTIP elections that aren't necessary to eliminate estate tax. With portability, a planning strategy may involve electing QTIP treatment to preserving portability even if the election will not eliminate any estate tax. The preamble to the regulations states that the Service will provide guidance on this issue in a future Internal Revenue Bulletin.

B. Extension to file return making portability election. In Ltr. Rul. 201551008, the Service granted an extension of time to file a return electing portability of the deceased spouse's unused extension. The significance of the ruling is that the Service that the regulation governing portability is considered a regulatory election are not a statutory regulation. As a consequence, the Commissioner has the authority to grant an extension of time to make to elect portability.

XIII. Section 2511—Transfers in General

A. **No adequate disclosure relating to transfer of interests in partnership; statute of limitations did not start to run**. So advised in Field Service Advice 20152201F. Under §6019, the Service must assess gift tax within three years after a gift tax return is filed. However, the three-year statute of limitations does not apply if the transferred interest is not adequately disclosed on a gift tax return. This was the situation here, said the Office of Chief Counsel. The case involved gift transfers of interests in two limited liability partnerships. The partnership names were abbreviated on the Form 709, and both EINs were missing one digit. The description of interests transferred did not indicate whether they were in a general or limited partnership or a limited liability company. A one-paragraph supplement attached to the Form 709 stated that the farmland held by the partnerships was appraised by a certified appraiser and that an overall discount was applied for minority interests and lack of marketability. However, the return and its supplement did not disclose the valuation method used by the appraiser, did not describe the method used to determine the value of the LLP interests, and did not explain the basis for the valuation discounts taken by the taxpayer.

B. **Should a durable power of attorney grant the power to make gifts?** In drafting durable powers of attorney, for clients with more-than-modest estates it has been a common (and desirable) practice to grant the attorney-in-fact the power to make gifts, with the objective being to minimize or eliminate estate taxes in the principal's estate. Under the Texas Statutory DPOA, by initialing a box the attorney-in-fact can be given the authority to make gifts not to exceed annual exclusions (and "Special Instructions" can be added to authorize larger gifts). Tex. Estates Code Ann. §752.051.

1. **… when the estate tax exemption is $5.45 million?** I should say, it *used to be* a common (and desirable) practice to give the DPOA agent the power to make gifts. This made sense back when the estate tax exemption was $175,625, or $600,000, or $1,000,000 (or even today, in jurisdictions that have a state estate tax with modest exemptions). But with a $5.45 million estate tax exemption—destined to increase annually with CPI adjustments—for the vast majority of clients (even those who are "mere millionaires"), potential estate taxes are not a planning concern. Instead, the power to make gifts may open the door to what has become an increasing concern: the use—the exploitation—of DPOAs as instruments of financial abuse of the elderly.

2. **Gifts to qualify for Medicaid and other governmental programs.** While estate planning attorneys have, in the past, recommended the DPOA authorization to make gifts as a means of reducing estate taxes, in today's world the gift-making authority is likely to be of greater importance to clients at the other end of the economic spectrum, where qualification for Medicaid long-term care benefits or some other governmental program may be a concern. The bottom line is that, except for mega-wealthy clients for whom potential estate taxes are an issue (or clients in a jurisdiction with a state estate tax), DPOAs should *not* grant the authority to make gifts unless qualification for a government benefit may be a potential objective, and the gift-making authority should be limited to that purpose.

C. **Fiduciary duties arose as soon as attorney-in-fact knew that she had been named in durable power of attorney (!)**. In Vogt v. Warnock, 107 S.W.3d 778 (Tex. App.—El Paso 2003, writ denied), the court held that a party who knew she had been named under a durable power of attorney stood in a fiduciary relationship with the principal even though she had never exercised her authority under the power. (The court ruled, however, that the evidence did not support a jury verdict that gifts and business transactions were unfair to the principal.) We now have another case that follows Vogt v. Warnock. In Jordan v. Lyles, 455 S.W.3d 785 (Tex. App.—Tyler 2015), the court upheld a jury verdict that an agent breached her fiduciary duties of fairness and full disclosure notwithstanding the agent's contention that there was no evidence that, in the transactions in dispute, her actions were pursuant to the power of attorney.

1. A bill introduced at the 2015 legislative session, sponsored by the Real Estate, Probate and Trust Law section of the State Bar, would have overruled these cases by providing that only an agent who accepts appointment is a fiduciary. However, the bill was not enacted.

2. In light of these rather troublesome decisions, unless and until the issue is clarified it may be appropriate for attorneys to recommend "springing" durable powers of attorney that become effective on the principal's incapacity. Alternatively, for a durable power that is presently operative, in a paper presented at the June 2015 Advanced Estate Planning & Probate course, Dallas attorney Donald Totusek suggested the following provision (giving attribution for its drafting to Dallas attorney William McRae):

   > **Fiduciary relationship**. I intend that a fiduciary relationship is not created between my Agent and me unless and until my Agent acts under this power of attorney, and then only with respect to those matters on which my Agent acts in accordance with this power of attorney.

D. Davidson case (balloon self-cancelling installment note) settled—but estate has sued Deloitte. In Estate of Davidson v. Commissioner, Tax Court Cause No. 013748-13, D was the president and owned 78 percent of the common stock of Guardian Industries, a leading manufacturer of glass, automotive and building products. He was the owner of the Detroit Pistons (NBA), the Detroit Shock (WNBA) and the Tampa Bay Lightning (NHL), and was enshrined in the Basketball Hall of Fame in 2008. The Notice of Deficiency alleges gift tax, estate tax and GST tax deficiencies, along with penalties and interest, totaling ***$2.6 billion!*** The major issue in the case (in terms of the tax dollars involved) was the valuation of D's stock. The estate valued D's common stock in Guardian Industries at $2,999 per share and his preferred stock at $531 per share on the gift-sale dates, whereas the Service took the position that the common stock was worth $4,400 per share and the preferred stock was worth $750 per share. Another issue in the case involved a transaction between D, his wife, and his son and daughter-in-law, as to whether this transaction, involving the purchase of a house in Bloomfield Hills, resulted in a taxable gift. The following discussion addresses only the SCIN issues. The facts are taken from the estate's petition and the government's response.

1. **D's health and life expectancy.** D was 86 years old; his life expectancy (according to the mortality tables under §7520) was 5.8 years when the transactions occurred on December 22, 2008, and January 2 and January 21, 2009. An October 2008 letter from D's primary physician stated that D was "in good health commensurate with his age group." This was corroborated by another letter from the primary physician on December 16, 2008. A Chief Counsel Advisory stated, however, that "[b]ecause of the decedent's health, it was unlikely that the full amount of the notes would ever be paid." The Service's medical expert estimated (based on D's medical records; he never examined D) that D's life expectancy was 2.5 years. In connection with the estate tax audit, four medical consultants (two selected by the Service and two selected by the estate) reached a consensus that in January 2009, D had a greater than 50 percent probability of living at least one year.

2. **The SCIN transactions**. Several of the transactions involved standard (*i.e.*, non-SCIN) notes; all of the notes (SCIN and non-SCIN) were for a 5-year term with interest-only installment payments and a balloon payment at the end. On January 2, 2009, D sold $162

million of Guardian stock (the estate's valuation) to grandchildren's trusts for $306 million pursuant to a note with annual interest payments at 2.4 percent (the §7520 rate). Thus, the SCINs reflected a principal risk premium of almost 100 percent. On January 21, 2009, $432 million of Guardian stock was sold to trusts for D's children and step-daughter for 5-year balloon SCINs bearing interest at 13.4 percent (an interest-rate risk premium). D was diagnosed with a serious illness shortly after the January 21 transactions. D died on March 26. 2009, without having received any payments on the notes.

a. **The Service's arguments**. The Service contends, first, that the SCIN transactions were not bona fide and that the notes provided no consideration for the transfers, because there was no reasonable expectation of repayment.

b. **Section 7520 does not apply to valuation of the SCINs**. If the court gets past the "bona fide" issue, the Tax Court will squarely face the issue of whether D could rely on §7520 in valuing the SCINs, because all of the medical experts agreed that D had a greater than 50 percent probability of living for at least a year. The estate contends that §7520 applies to valuation of "any interest for life or a term of years," and a SCIN involves both a life expectancy and a term of years. The Service relies on Reg. §1.7520-3(b)(3), under which the mortality tables can be used "to determine the present value of an annuity, income interest, remainder interest, or reversionary interest. And, says the Service, SCINs do not involve an annuity or an income interest.

3. **The parties settled the case**. In <u>Estate of Davidson v. Commissioner</u>, T.C. No. 13748-13, stipulated decision July 6, 2015), The Service stipulated to estate and generation-skipping taxes totaling $321 million, and also stipulated to $3.5 million of the $10 million in gift taxes that it had claimed were owed by D's widow.

4. **Estate has filed suit against Deloitte Tax LLP**. Daily Tax Reports (9/25/15) reported that the Davidson estate has sued Deloitte to recover $500 million in taxes, fees and penalties, on the ground that Deloitte Tax failed to disclose the risks of the plan that it recommended to Davidson in order to secure him as one of its "marquee clients" who could generate large fees and serve as a "showpiece" to promote its services to other wealthy people, the estate said in the action filed on September 24. According to the petition, Deloitte Tax promised a tax plan under which Mr. Davidson would "win if he lived, or win if he died." As noted above, however, it didn't work out that way.

XIV. Section 2512—Valuation of Gifts

A. Private annuity for a 95-year-old! Although the taxpayer lost the issue before the Tax Court in <u>Estate of La Sala v. Commissioner</u>, T.C. Memo 2016-42, give the estate planner credit for trying—and the estate didn't do too badly. In 2001, 93-year-old L formed an LLC, and on January 1, 2005, (at age 95) L sold a 99 percent interest in the LLC to his daughter and two grandchildren in exchange for a private annuity. On a gift tax return, L valued his retained one percent LLC interest at $28,000, and valued the transferred interest at $2,782,000, taking discounts of 50 percent and 35 percent for two fractional equity shares held by the LLC.

1. The Service assessed an estate deficiency of $1,999,000, contending that the LLC was includible in L's gross estate (essentially disregarding the annuity transaction), that the estate had taken excessive discounts, and that the proper valuation of LLC was $4.37 million. The parties reached a settlement in which the Service conceded that on the date of the annuity

transaction L was reasonably expected to survive for at least one year (and he did), and the estate conceded that the valuation discounts were excessive. However, the settlement did not explicitly set out the terms of the settlement. Further negotiations led to the estate's payment of $235,000 gift tax for the 2005 gift—but that payment did not include interest on that amount.

2. In the reported case, the estate argued (unsuccessfully) that an implied term of the settlement was that no interest would be paid on the gift tax. Thus, the estate lost—but as losses go, not too bad a bottom line.

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

A. **Children's alleged reliance on attorney was not reasonable cause for late filing and late payment of tax**. In West v. Koskinen, 2015-2 U.S.T.C. ¶60,691 (E.D. Va. 2015), Mom died on December 27, 2009. On January 3, 2010, one of the children emailed Attorney, seeking guidance as to "what legal followups are needed in the short term." Attorney replied by email the next day, advising that the children would "need to pay [Mom's] final bills, and . . . possibly file a Federal Estate tax return, [Mom's] final 1040, and a trust income tax return…. This all takes as short as a few months or (if an estate tax return is required) as long as [two] years." One of the children responded the following day, stating that he was "sure there will be tax due" on the estate and that he "assume[d]" that the accountant hired to do Mom's 2009 taxes, "would also take care of preparing estate taxes." In early February, at a meeting with Attorney to discuss issues relating to the estate, the issue of filing and payment deadlines for the estate tax was not discussed or mentioned. Following this meeting, the children had no further contact with Attorney until November 2010, when they emailed Attorney asking what they "need[ed] to do next in order to start work on the estate taxes." Oops! Attorney was not concerned that the deadlines had already passed, as he mistakenly assumed that the accountant, had obtained the appropriate extensions, as one of the children had earlier advised that the account would "take care of preparing estate taxes." In March 2011, Attorney advised that the final estate tax due was $1.25 million, and that amount was paid. In response, the Service assessed $335,000 in late filing and late payment penalties.

1. The Tax Court ruled that the estate's reliance on an attorney was not reasonable cause so as to excuse the late filing and late payment of tax. Attorney's January 4 email was insufficient as a matter of law to constitute legal advice as to tax filing or payment deadlines. "Information that an estate tax process might take 'as long as [two] years' is not advice about deadlines for filing a return or paying any tax due.