

# **Recent Developments in Estate Planning**

**Stanley M. Johanson**

University Distinguished Teaching Professor and  
James A. Elkins Centennial Chair in Law  
The University of Texas School of Law  
Austin, Texas

**Trusts and Estates Section  
Dallas Bar Association**

Dallas, Texas  
May 27, 2014

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## I. Legislation Relating to Estate and Gift Tax

- A. American Taxpayer Relief Act of 2012.** On January 2, 2013, President Obama signed the American Taxpayer Relief Act of 2012 (ATRA) into law. The highlights (as they affect the estate tax, gift tax and generation-skipping transfer tax):
1. **Exemption stay “permanent” at \$5 million, indexed for inflation.** ATRA set the exemption amount for the estate tax, gift tax and GST tax at \$5 million—but the moment the law went into effect in 2013, an inflation adjustment brought the exemption to \$5,250,000. Thus, while the exemptions are now “permanent,” they are virtually certain to increase on an annual basis. (They are called “exemption equivalents,” but for all intents and purposes they are exemptions.) ATRA further provides that if gift tax or estate tax must be paid, the tax rate is 40 percent.
  2. **Portability of unused exemption of last deceased spouse.** “Portability,” introduced by the 2010 Tax Act, was made permanent. Portability enables a surviving spouse to succeed to the unused 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. As under the 2012 Act, there is no portability for any unused GST exemption of the last deceased spouse.
- B. Obama administration’s Fiscal Year 2015 Budget Proposal.** In On March 4, 2014, the Treasury Department published its Fiscal Year 2015 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 Greenbooks, but a few of them are new.
1. **Lower the exemption to \$3.5 million and increase tax rate to 45 percent—in 2018.** The Greenbook notes that “ATRA retained a substantial portion of the tax cut provided to the most affluent taxpayers under TRUIRJCA that we cannot afford to continue. We need an estate tax law that is fair and raises an appropriate amount of revenue.” The proposal would restore the 2009 estate tax, gift tax and GST parameters. The proposal would raise the transfer tax rate to 45 percent, and would lower the estate tax exemption the GST exemption to \$3,500,000, and the gift tax exemption to \$1,000,000, with no indexing for inflation—effective January 1, 2018.
  2. **Installment sales to defective grantor trusts would be includible in grantor’s gross estate.** As with the 2014 Budget Proposal, the 2015 Budget Proposal seeks to kill off installment sales to “defective” grantor trusts. 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)” will be includible in the deemed owner’s gross estate, will be subject to gift tax if during the deemed owner’s life the grantor trust treatment is terminated, and will 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.”
    - a. The proposal clarifies that it would not apply “to any irrevocable trust whose only assets typically consist of one or more life insurance policies on the life of the grantor and/or the grantor’s spouse.”

3. **Provide reporting on a consistent basis between estate tax valuation and income tax basis in the heir's hands.** Under IRC §1014, the decedent's assets receive a new basis at death, for income tax purposes, equal to their date-of-death value. The value of property as reported on the decedent's 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 take 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, carried over from prior years, would provide that the basis for income tax would be the same as values "as determined for gift or estate tax purposes."
  - a. It is curious that Treasury is still concerned about this issue, when few estates must file estate returns because of the current law's \$5.34 million (in 2014) exemption. One would think that, under current law, Treasury would be concerned about overvaluing assets so as to enhance the benefits of a basis step-up.
4. **Require minimum—and maximum—term for GRATs.** The Budget Proposal once again included a provision that would kill off short-term grantor retained annuity trusts [*cf. Walton v. Commissioner*, 115 T.C. 589 (2000)] by requiring a 10-year minimum GRAT term, requiring that the GRAT remainder interest must have a value greater than zero, and providing that the amount of the annuity payout could not be decreased during the GRAT term. Additionally, the proposal would impose a *maximum* term on GRATs—to the grantor's life expectancy plus ten years.
5. **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.
6. **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.
7. **Inherited retirement benefits: Five-year payout limit for beneficiaries other than spouses, minor children.** Under the proposal (first added in the 2014 Budget Proposal), 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 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.
  - a. **Limit total of accrued tax-favored retirement benefits.** As with the 2014 Budget Proposal, the 2015 Budget Proposal would limit the deduction for contributions to qualified plans and IRAs when total balances of all such plans are sufficient to provide an annual benefit of an indexed amount (about \$3.2 million for a 62-year-old).
  - b. **Eliminate minimum distribution requirements for small accounts.** The required minimum distribution rules would not apply if the aggregate value of an individual's qualified plan accumulations and IRAs are \$100,000 (indexed) or less.

8. **What isn't there: valuation discounts.** The 2013 Budget Proposal proposed an amendment to §2704 (the “disappearing rights and restrictions” special valuation rule) that would add a new category of “disregarded restrictions” relating to interests in family-controlled entities such as family limited partnerships and limited liability companies. Interestingly, this proposal does not appear in the 2014 Greenbook or this year’s Greenbook.

**C. Another take on lifetime gifts of assets likely to increase in value: The “new basis at death” rule.** We now have a \$5 million “permanent” estate and gift tax exemption—\$5.34 million in 2014 (and \$10.68 million in the case of spouses), which is likely to increase every year thanks to the annual inflation adjustment. As a result, one of the traditional estate planning techniques has been turned on its head: Lifetime gifts of assets with appreciation potential. In the past, the objective has been to make lifetime transfers of such assets, to remove the potential appreciation from the client’s gross estate. But now, when even the estates of “mere millionaires” are not likely to be subject to estate tax, 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.

1. **How the world has changed is illustrated by Estate of Williams v. Commissioner, T. C. Memo. 1998-59 (1998).** W, who had no immediate family, gave her nephew an undivided one-half interest in two large tracts of Florida land, one valued (by the Tax Court) at \$1.3 million and the other valued at \$1.7 million. Simple arithmetic would suggest that the total amount of the gift was one-half of \$3 million, or \$1.5 million. However, the Tax Court upheld the taxpayer’s expert witness testimony that a 44 percent discount should be granted due to lack of marketability (there is no ready market for fractional interests in real estate, and sale of the real estate in that particular market at that time would encounter delays), lack of control (a tenant in common cannot unilaterally decide how to manage the property), and the necessity of resorting to a partition action and related costs to liquidate one’s interest in a tenancy in common. The result was a \$660,000 discount, reducing the value for gift tax purposes from \$1.5 million to \$880,000. Taken from a 40% transfer tax bracket, the projected tax saving from the fractional interest gift would be \$330,000.

- a. W and the nephew later sold the two tracts, so W’s retained one-half interest in the land was not in her estate at death. However, W owned an undivided one-half interest in yet another tract (whose full value was \$630,000), which she devised to the nephew. Again, simple arithmetic would suggest that the value of W’s one-half interest for estate tax purposes was \$315,000. Once again, however, the Tax Court applied a 44 percent discount, reducing the gross estate inclusion to \$175,000.

- b. It must be noted that a 44 percent fractional interest discount is much higher than the discounts usually recognized in such cases (which typically range from 20 to 30 percent). The high discount was largely the result of a tactical error made by the government in trying the case before the Tax Court. The government “went to the mat” with its argument that any discount should be limited to the cost of a partition action.

- c. As a result of this good planning at a time when the exemption equivalent was \$600,000, the attorney who recommended the plan could be nominated for the Estate Planning Hall of Fame. But what if the gift was made in 2013, W died in 2014, and her estate (even counting the adjusted taxable gift) was less than \$5.4 million? The attorney who recommended the plan might find himself as a defendant in a malpractice plan. And privity of contract would not be a defense! Belt v. Oppenheimer, Blend, Harrison & Tate, 192 S.W.3d 780 (Tex. 2006).

- d. Suppose that you are representing the executor of a decedent who owned an undivided one-half interest in Ranch valued at \$3,000,000, but no estate tax will be due. What

should the executor do in reporting the value of the one-half interest that passes to a will beneficiary?

2. **Transfers by the grantor.** Is it possible to have the best of both worlds? One possibility that has been suggested is for the grantor to transfer assets to an irrevocable trust as a completed gift, but authorize a third party to give the grantor a special testamentary power of appointment. If such a power is given to the grantor, this will cause the assets to be included in grantor's gross estate under §2038. The authority would be exercised if down the road it turns out that the benefits of a basis step-up will be greater than the disadvantage of a gross estate inclusion. (The gross estate inclusion would override any adjusted taxable gift that resulted from the transfer.)
3. **Bypass trust.** The same approach could be taken with respect to a bypass trust that benefits a spouse or a child. A third party would be given the authority to give the beneficiary a general testamentary power of appointment. This would cause the assets to be included in the beneficiary's gross estate under §2041, in situations where the benefits of a basis step-up would be greater than the disadvantage of a gross estate inclusion.
4. **Would a third party be willing to take on that authority?** Is there any potential liability to that third person, given that the assets could be diverted to other beneficiaries if the power is exercised? At least in the grantor situation, the answer appears to be no for two reasons. First, it would be the grantor who made the decision to divert the assets to new beneficiaries, or to change the current beneficiaries' shares. Second, the trust would be drafted in such a way that if the grantor does not exercise the power of appointment, the "gift in default of appointment" will leave the property in the trust.
  - a. Giving the beneficiary a general power of appointment would appear to be dicier—but not if the class of permissible appointees is limited to creditors of the beneficiary's estate.

**D. Estate planning in a high-exemption world.** For 2014, the estate and gift tax exemptions are \$5.34 million (and \$10.68 million for married couples)—and with inflation adjustments, these amounts are destined to increase on an annual basis. What should we be telling clients, for most of whom federal (but not state!) transfer taxes have been functionally repealed?

Estate planning professionals will see their clients falling into one of three categories (and I am broadly oversimplifying here): (1) Mega-wealthy—well over, say, \$6 million to \$8 million—clients for whom sophisticated estate planning will continue to be called for; (2) couples in the (say) \$6 million range (or single clients in the \$3 million or so range), for whom transfer taxes may or may not be a concern down the road, and (3) modest estates of "mere millionaires"—say, a married couple with an estate of "only" \$4 million or less.

1. **Bypass trusts for spouses remain an important planning tool.** For a couple in their 40s—or 50s, or 60s, or 70s, bypass trusts continue to be important even if there are not going to be any estate taxes to "bypass." It must be conceded that clients like two-page wills because they can understand them: "to my [spouse] if he survives me, otherwise to my children in equal shares"—or, perhaps, "to my descendants per stirpes." A discussion of bypass trust planning versus reliance on portability is set out below.
2. **"Bypass" trusts for children (or other objects of client's bounty) also remain important.** Should a client's will ever say something like this? "If my [spouse] does not survive me, to my children in equal shares," or "to my descendants per stirpes." Not good. There are very

real advantages in creating trusts for the children's benefit rather than giving them outright ownership. Moreover, each child can be the trustee of his or her own trust, giving the child the power to make management and investment decisions (just as an outright owner can do) while also providing the following advantages.

- a. **Covering the contingency of divorce.** Today, over one-half of all marriages end in divorce. In Texas, only community property is subject to equitable ("just and right") division in a divorce proceeding. The rules in the other community property states are essentially the same—but when it comes to divorce, *every state in the country is a community property state*, only they call it, in North Carolina, Virginia, etc., etc., "marital property" as distinguished from "non-marital property," with the definitions almost identical to what in California and Texas we call community property and separate property. In Texas and the other community property states, any property on hand at the time of divorce is presumptively community property; in non-community property states, it is presumptively marital property. To keep its separate property or non-marital property status, the property cannot be commingled with community or marital property, and good records must be kept. Otherwise, it may not be possible to establish separate ownership so as to overcome the community (or marital) property presumption.

A trust (even one with the child serving as trustee) is a useful vehicle for segregating the assets and maintaining their separate property status.

- b. **Spendthrift provisions—protection from creditors' claims and malpractice suits.** If the child is in a profession or line of work in which malpractice suits are a concern (and, in today's litigious society, that includes just about everybody!), property left to a child in a trust can be given spendthrift protection, meaning that no creditors (other than for certain creditors such as for child support and federal tax liens) can reach the child's interest in the trust—even if the child declares bankruptcy.
- c. **Protection from in-law's bad business deals—"son-in-law trusts."** Even if the child's marriage is solid and the likelihood of divorce is remote, parents may be concerned that the child's spouse might take some action that places the child's inheritance at risk. (Several lawyers have told me that, in explaining the pros and cons of trusts for clients' children, this is the scenario that catches the clients' attention.)

*Example 1:* Donna, having inherited \$750,000 from her parent's estate, carefully places the inherited funds in a Paine Webber investment account. Donna has the account titled in her name as her "sole and separate property," to segregate the assets from her and her husband Steve's other assets. Donna and Steve have been married five years, their marriage is solid, and they have a young child. Steve has decided to start a business, and has negotiated a \$575,000 loan from First State Bank. Steve tells Donna that the bank won't make the loan unless Donna co-signs the note (or, perhaps, unless the loan is secured by Donna's Paine Webber account), and Steve asks her to co-sign.

Stop the camcorder! What is Donna going to tell Steve? "Sorry, Steve; I know this is important to you, but I'm not going to help you out by signing the note"? It's fair to say that Donna is in a rather dicey situation—as is her inheritance.

Need I continue the story? Donna co-signs the note. A year later, Steve's business folds—after the borrowed funds have been expended in leasing an office and purchasing supplies. Donna, having co-signed the note, is personally liable. There goes Donna's inheritance.

*Example 2:* Same facts, except that the \$750,000 that Donna inherited was left in a trust of which Donna is the trustee. The trust contains a spendthrift clause. Again, Donna co-signs Steve's note. She is personally liable on the obligation, but the trust assets cannot be reached because of the spendthrift provision.

*Example 3:* Same facts as in Example 2, except that Steve, instead of attempting to borrow money from the bank, asks Donna, as trustee, to either (i) loan the funds to Steve or (ii) invest trust funds in his business. Here, Donna has no choice but to point out that, in view of her fiduciary duties as a trustee, (i) a loan to a relative would constitute impermissible self-dealing, and (ii) investing the bulk of the trust funds in a start-up company would likely be an imprudent investment under the "prudent investor" standard.

- d. **Avoids guardianship** if the child, years and years from now, loses her capacity.
  - e. **Saves estate taxes** if the child turns out to be very successful in life, to the point that federal or state estate taxes are a concern.
- E. Review of existing estate plans.** Should you consider contacting clients for whom you 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.

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.** If you drafted the prototypical formula QTIP/bypass trust plan, what will be the effect on the will/s formula clause? Will all or most of the estate 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) and eliminate any step-up in basis on the spouse's death?
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. **Un-fractionalize fractional interests?** See the discussion of Estate of Williams v. Commissioner, *supra*. If ownership has been intentionally fractionalized in the past (perhaps with valuation discounts in mind), consider ways by which those interests could be consolidated.
4. **Grantor trusts.** The grantor could get non-liquid low-basis assets out of the trust by purchase or in exchange for high-basis assets.
5. **Crummey Trusts: A one-time withdrawal notice?** Lou Mezullo (past president of ACTEC) recommended this at a recent ACTEC meeting: If the client is relying on Crummey withdrawal powers to cover annual premiums, and giving those pesky Crummey “notices,” consider giving a one-time notice to beneficiaries of their withdrawal rights with respect to any future additions to the trust.

## **II. Section 401—Qualified Plans and IRAs**

- A. **Wife’s fraudulent withdrawal of funds from IRA not taxed.** In Roberts v. Commissioner, 141 T.C. No. 19 (2013), in 2008 Roberts’ former wife fraudulently withdrew \$37,000 from two IRAs accounts by forging his signature. The wife filed Roberts’ 2008 return, telling him that she was filing a joint return; in fact, she prepared his return on a single filing basis, underreported his income, and overstated a credit for withheld tax. They filed for divorce in 2009.
  1. The Service contended that the IRA distributions must be included in Roberts’ gross income, as the distributions were taken into account in the couple’s 2010 divorce settlement and Roberts took no steps to restore the funds to the IRAs.
  2. The Tax Court held that the distributions were not includible in Roberts’ gross income or subject to the 10 percent penalty tax, because the former wife fraudulently withdrew funds without Roberts’ knowledge or consent and he received no economic benefit from the funds.
- B. **One rollover per year for IRAs.** In Bobrow v. Commissioner, T.C. Memo 2014-21, the Tax Court ruled that the one-rollover-per-year limitation of §408(d)(3)(B) applies to all of a taxpayer’s IRAs, and not to each IRA held by the taxpayer. Thus, Bobrow could not make a second IRA-to-IRA rollover if a rollover had been made in the preceding one-year period.
  1. On April 14, 2008, Bobrow, a tax attorney with Mayer, Brown & Platt in New York City, withdrew \$65,024 from IRA-1. On June 6, Bobrow withdrew \$65,024 from IRA-2 and transferred it to IRA-1. On July 31, Bobrow’s wife withdrew \$65,024 from her IRA, deposited it in the couple’s joint account, and on August 4, Bobrow withdrew \$65,024 from the joint account and transferred it to IRA-2. On September 30, Bobrow’s wife transferred \$40,000 from the joint account and transferred it to her IRA. (Taxpayers unsuccessfully contended that the entire \$65,024 had been deposited in the wife’s IRA, but the court found otherwise.) The court ruled that, under a correct interpretation of §408(d)(3)(B), the one-year

waiting period applies to the taxpayer, and not to each IRA held by the taxpayer. The result was a \$51,298 deficiency and a \$10,260 accuracy-related penalty.

- a. Bobrow contended that a §6662(a) penalty should not be assessed because he had analyzed the transaction and the statute as a seasoned tax attorney, an indication that he acted with reasonable cause and good faith. That didn't help at all, said the court, citing a case stating that "the 'experience, knowledge and education' proviso is fatal for [taxpayer], who is a licensed attorney, certified public accountant and IRS audit supervisor."
2. Wait a minute! Proposed Reg. §1.408-4(b)(4)(ii) and IRS Publication 590, Individual Retirement Arrangements (IRAs) provide that the one-year limitation is applied on an IRA-to-IRA basis! That is true, said the Service in Announcement 2014-15 (March 20, 2014). However, in light of Bobrow v. Commissioner, the IRS announced that it intends to withdraw the proposed regulations and revise its guidance to clarify the rules limiting rollovers of IRAs.
  - a. This rule is to be effective January 1, 2015. The Announcement states that the effective date was delayed in order to give IRA trustees time to make changes in the processing of IRA rollovers and in IRA disclosure documents.
3. This will kill of the use of tax-free distributions as short-term loans, by withdrawing funds from one IRA and redepositing the money in another IRA within 60 days.

### III. Section 671—Grantor Trust Rules

- A. **Recently filed Tax Court case: 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 noted by Treasury's Fiscal Year 2014 Budget Proposal (as well as in the Fiscal Year 2013 Budget Proposal), 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 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. **Or, as Steve Akers posits, “is this primarily just a valuation case”,** and will the parties settle? Stay tuned.

#### **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’ve used the 2013 exemption of \$5.25 million throughout this outline, 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 than 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. **Privity of contract is not a defense.** But wait, you say: Under privity of contract, an attorney’s duty runs only to the client who contracted for his or her services, meaning that only the client can sue on a negligence theory. Thus, a disgruntled beneficiary or heir has no cause of action against the attorney. Barcelo v. Elliott, 923 S.W.2d 575 (Tex. 1996).

- a. However, there is a *cf.* case sidesteps the privity of contract defense. The Supreme Court has ruled that a decedent's executor can sue an attorney for estate taxes resulting from allegedly negligent estate planning advice. The court drew an analogy to cases involving injury to property, where an action to recover damages survives the death of the property owner. "A claim that an estate planner's negligence resulted in the improper depletion of a client's estate involves injury to the decedent's property." Belt v. Oppenheimer, Blend, Harrison & Tate, 192 S.W.3d 780 (Tex. 2006).
3. **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 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 my executor to 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.")

**I. Temporary regulations on portability election.** In Notice 2011-82, IRB 2011-42, published in October 2011, the Service provided guidance on the portability election. The decedent's executor must timely file an estate tax return on which the amount of the decedent's unused exclusion is computed. The Notice stated that the return requirement was selected over a check-the-box procedure to make the election process uncomplicated and straightforward. According to the Notice, the Service did not want executors to have to affirmatively elect portability.

1. **Temporary regulations.** On June 15, 2012, the Service issued temporary regulations (T.D. 9593, IRB 2012-28) and proposed rules (REG-141832-11) on the portability election. The election must be made on a "timely filed" Form 706, which, regardless of the size of the estate, must be filed within nine months of death or, if an extension has been granted, the last day of the extension period. However, the temporary regulations provide a special rule for estates filing a return solely to make the portability election. These estates don't have to report the value of property that qualifies for the marital or charitable deduction, but instead must report only the description, ownership and other information necessary to establish the right to the deduction. To take advantage of this special rule, the executor must estimate the total value of the gross estate, using ranges of dollar values that will be provided in the Form 706 instructions and rounded to the nearest \$250,000.
  - a. **Opting out of the portability election.** The executor may make an affirmative statement on the estate tax return signifying the decision not to have portability apply. Not filing a timely return will be considered an affirmative act signifying the decision not to make the election.
  - b. **Election is made by executor.** If an executor is appointed, only the executor (not the surviving spouse) can file the return and make the portability election. If no executor is

appointed, any person in actual or constructive possession of any of the decedent's property can file the return.

- c. **Returns of predeceased spouse can be examined.** The Service can examine returns of deceased spouses whose DSUE is included in a surviving spouse's applicable exclusion amount, regardless of whether the limitations period has expired for the earlier return. The DSUE amount reported on the earlier return can be adjusted, but additional tax on the earlier return can be assessed only within the applicable limitations period for that return.

**J. Simplified relief procedure for obtaining extension of time to elect portability.** Section 2010(c)(5)(A) requires that the portability election must be made on an estate tax return filed within "the time prescribed by law (including extensions)." However, for estates having a gross estate (plus adjusted taxable gifts) that is less than the exemption amount, there is no statutorily prescribed filing date. As noted above, this issue was addressed in temporary and proposed regulations to §§2010 and 2505 published on June 15, 2010. Because there is no statutory filing deadline for such estates, the Service has authority to grant extensions for filing the return under §201.9100-3. The Service has noted, in the revenue procedure discussed below, that it had issued several letter rulings granting an extension of time to file a return electing portability.

1. **Rev. Proc. 2014-18.** This revenue procedure, published January 27, 2014 (IRB 2014-7), "provides an automatic extension pursuant ... for certain estates having no filing requirement under § 6018(a) to elect portability.... The revenue procedure applies to estates of decedents dying after December 31, 2010, and before January 1, 2014, and includes estates of decedents survived by a same-sex spouse that were not eligible to elect portability until after the decision in *United States v. Windsor*, 570 U.S. \_\_\_, 133 S. Ct. 2675 (2013) and the publication of Rev. Rul. 2013-17, 2013-38 IRB 201."
2. This relief measure is beneficial to estates below the filing threshold who did not file a return because regulations were not published until June 2012, and also to estates of same-sex couples who were retroactively recognized as spouses. No longer will it be necessary to file a request (and pay the \$10,000 filing fee) to obtain an extension. Indeed, the revenue procedure explicitly states that until January 1, 2015, the procedure described therein must be used to obtain an extension, and "letter rulings will not be issued."
3. **Requirements for eligibility to use procedure.** The procedure applies only if (i) the decedent died after 2010 and on or before December 31, 2012, (ii) the decedent was citizen or resident of the United States, (iii) the estate was not otherwise required to file an estate tax return because it was under the statutory threshold, and (iv) the estate did not file a return making the election.
  - a. The return must state at the top of the Form 706 that the return is **FILED PURSUANT TO REV. PROC. 2014-18 TO ELECT PORTABILITY UNDER §2010(C)(5)(a)**.
  - b. "The taxpayer will receive an estate tax closing letter acknowledging receipt of the taxpayer's Form 706."
4. **Useful example is provided.** The revenue procedure closes with an example in which S-1 died on January 1, 2011 leaving a \$2 million estate, and S-2 died on January 11, 2011 leaving an \$8 million estate—and S-2's executor paid estate tax. The example closes with a happy ending (after S-1's executor files a portability return on November 1, 2014), and explains the procedure S-2's executor is to follow to obtain a credit or refund of the estate taxes paid by S-2's estate.

## V. Section 2032A—Special Use Valuation

- A. **Special use valuation determined asset's basis.** In Van Alen v. Commissioner, T.C. Memo 2013-235, D's ranch was devised to a trust for the benefit of his children, Shana and Brett. A probate court referee determined that the value of the ranch was \$1.96 million, but the executor (Shana's and Brett's stepmother) elected a special use valuation under §2032A. As a result, the value of the ranch for estate tax purposes was \$98,735. As required by §2032A, Shana and Brett (a minor represented by his mother as his guardian ad litem) executed an agreement consenting to the special use valuation election. Some years later, the trust sold a conservation easement \$910,000. Although the trust's income tax return reflected a \$620,000 gain from the sale, neither Shana nor Brett reported the gain on their individual income tax returns.
1. Shana and Brett contended that they could report a basis for the ranch interest different from its special use value for income tax purposes, relying on Rev. Rul. 54-97, 1954-1 C.B. 113. The ruling states that “for the purpose of determining basis ... the value of the property as determined for the purpose of the Federal estate tax shall be deemed to be its fair market value at the time of acquisition. Except where the taxpayer is estopped by his previous actions or statements, such value is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence.”
  2. No go, said the Tax Court. Under the duty of consistency, Shana and Brett were estopped from claiming that their basis was greater than the special use valuation reported on the estate tax return. The Tax Court went on to say that it didn't need to resolve the issue of the ruling's applicability to the case at hand because the case could be determined by applying the doctrine of the duty of consistency. Shana and Brett (through his guardian ad litem) had executed the agreement consenting to the special use valuation election. They had taken a position relied upon by the Commissioner, and now they were attempting to change their previous representation in a manner detrimental to the Commissioner.
  3. The real message of the case: With a \$5.34 million (and growing!) exemption equivalent under the estate tax, meaning that in the vast majority of cases “new basis at death” is the only tax consequence of a valuation decision. Congress has functionally repealed §2032A—or, more precisely, has laid a malpractice trap for the attorney or CPA who recommends a special use valuation.

## VI. Section 2042—Life Insurance

- A. **Spouse-owned life insurance—but the spouse died first.** In Ltr. Rul. 201327010, T's wife W had purchased several policies on Taxpayer's life, naming W's estate as the beneficiary. W died, and under her will the insurance proceeds passed to a discretionary trust for the benefit of T and W's descendants. The trust, which gave T a special testamentary power of appointment, named T as the trustee and trust protector. As protector, he had the power to remove and replace trustees. As trustee, he held incidents of ownership in the life insurance policies.
1. **Quick thinking and quick action saved the day.** T resigned as trustee and trust protector, and relinquished his ability to be reappointed as a trustee of Family Trust 1 and his special testamentary power. T did not, however, disclaim his beneficial interest in the trust. That'll do it, said the Service. The policy proceeds will not be includible in T's estate under §2042—if T survives the three-year period under §2035.

- B. Transfer of policy to new trust: “Transfer for value” avoided because they created a partnership.** In Ltr. Rul. 201332001: H and W’s existing grantor trust (Trust 1) purchased a joint and survivor policy. Upon the death of the survivor, the corpus is to be distributed outright to the couple’s four children as beneficiaries. After Trust 1 was set up, Daughter was diagnosed with a severely limiting disability. H proposed to establish Trust 2 (also a grantor trust), with the same beneficiaries and trustee as Trust 1, but with a Special Needs provision for Daughter’s share. Trust 2 intends to purchase the policy from Trust 1 for the value of Trust 1’s interest in the policy, its interpolated terminal reserve value plus the gross premium last paid before the sale date. Trust 2 will be named the policy beneficiary, and H will make annual gifts to Trust 2 to pay the premiums. H and W have formed a partnership, owning several investments as partners.
1. That will not be a transfer for value, said the Service. Under § 101(a)(2)(B), the transfer for value rule is not triggered when a life insurance policy is transferred for a consideration to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. Accordingly, to the extent that the policy insures H’s life, this will be deemed a transfer to the insured because H is treated as owning Trust 2. To the extent the policy insures W’s life, that portion of the policy is treated as being transferred to H as a partner of the insured. Therefore, the transfer for value rule is not triggered.
- C. Insured’s right to receive policy dividends not an incident of ownership.** Under the facts of CCA 201328030, life insurance policies were acquired for the benefit of the insured’s former spouse in connection with a divorce settlement. The insured paid all premiums and could not borrow against or pledge the policies, but was entitled to policy dividends. That’s not an incident of ownership, said the Office of Chief Counsel. The term “incidents of ownership” includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to borrow against the policy’s surrender value. The right to dividends is nothing more than a reduction in the amount of premiums paid, and is not a right to the income of the policy. Policy dividends merely reduce the premiums due to keep the insurance in force.

## VII. Section 2053—Administration Expense Deduction

- A. Nice try, but that undeposited \$200,000 check was not a debt.** In *Estate of Derksen v. United States*, 2012-2 U.S.T.C. ¶ 60,657 (E.D. Pa. 2012), nine months after her husband’s death, D, at the direction of Daughter, wrote a check to the husband’s estate for \$200,000, apparently to help equalize the estates. The check was never deposited, and Daughter, in her capacity as executor of D’s estate, claimed a deduction for the \$200,000 “debt.” No go, said the court. There was no evidence outside of a phone call to Daughter that the couple had agreed to equalize their estates. Also, there was no evidence that the purported agreement was part of an arm’s length transaction. Thus, the agreement was not bona fide, meaning no deduction.

## VIII. Section 2056—Marital Deduction

- A. Profit-sharing plan benefit awarded to same-sex spouse.** In what appears to have been the first reported decision following the Supreme Court’s ruling in *United States v. Windsor*, 570 U.S. \_\_\_, 2013 WL 3196928 (2013), a district court in Pennsylvania ruled that a same-sex spouse of a

deceased participant in a profit-sharing plan governed by ERISA was entitled to spousal death benefits under the plan. Cozen O'Connor, P.C. v. Tobits, No. 2:11-cv-00045-CDJ (E.D. Pa. 2013). Sarah Farley, who worked at the Cozen O'Connor law firm, married Jean Tobits in Canada in 2006. Shortly after the marriage, Farley was diagnosed with cancer; she died in 2010. Tobits laid claim to Farley's interest in the firm's profit-sharing plan, as did Farley's parents. Cozen O'Connor filed an interpleader. While the action was pending, the Supreme Court handed down United States v. Windsor, which ruled that the Defense of Marriage Act was unconstitutional, and allowed a marital deduction for interests passing to a same-sex spouse.

1. The parents had submitted a Designation of Beneficiaries form (whose authenticity was disputed) naming the parents as beneficiaries. Under the ERISA plan, however, a beneficiary designation was valid only if the plan participant's spouse had waived a pre-retirement survivor annuity by signing the beneficiary designation form.
2. "There can be no doubt that Ms. Tobits is Ms. Farley's 'surviving Spouse' under the Plan in light of the Supreme Court's decision in Windsor. Ms. Tobits and Ms. Farley were married in Toronto, Canada in 2006, just a year before Edith Windsor and Thea Spyer wed in Ontario. Ms. Tobits possesses uncontroverted evidence of a valid Canadian Marriage Certificate solemnizing that marriage. Ms. Tobits and Ms. Farley celebrated that marriage with another ceremony in Illinois, where the couple lived together until Ms. Farley's untimely death in 2010. Post-Windsor, where a state recognizes a party as a 'Surviving Spouse,' the federal government must do the same with respect to ERISA benefits—at least pursuant to the express language of the ERISA-qualified Plan at issue here.... [T]his Court finds that Ms. Tobits is Ms. Farley's 'Spouse' pursuant to the terms of the Plan."

## **IX. Section 2056A—Qualified Domestic Trust**

- A. What to do when one of the spouses is not a United States Citizen.** You don't have to have an LL.M. in Taxation to handle the situation where one of your clients is married to a non-citizen of the United States. The two most important things you need to know are these:
1. **First and foremost, identify the situation in the initial client interview.** (Or, if you have been retained to represent the decedent's estate, make an initial confirmation that the surviving spouse is—or is not—a United States citizen.) You should always ask: "Are both you and Ann United States citizens?"—that should be part of your standard client interview questionnaire. In the vast majority of cases, the answer will be "of course." But don't assume that this is going to be the answer even if you have known the couple for years.
    - a. Another (perhaps more tactful) way of handling the issue: "Where were you and Sally born?"
  2. **No marital deduction for property passing to non-citizen spouse unless left to a Qualified Domestic Trust.** The objective of the unlimited marital deduction is to defer estate taxation on qualifying dispositions until the death of the spouse. The premise of the deduction is that property left to the spouse will be subject to estate tax on the spouse's death, to the extent not consumed or disposed of during the spouse's lifetime. But what if the non-citizen spouse moves back to France, taking the inherited property with him? The property for which a marital deduction was allowed would escape the United States transfer tax system.
    - a. Under §2056(d), no marital deduction is allowed (and the qualified joint interest rule of §2040(b) does not apply) for property passing to a non-citizen spouse unless (i) the

spouse becomes a United States citizen before the date on which the decedent's estate tax return is due, *or* (ii) the property passes to a qualified domestic trust (a QDOT). To meet the tax deferral objectives the marital deduction, at least one QDOT trustee must be a United States bank or citizen, security and withholding provisions must be included to insure that any distributions of principal are subject to tax, and the trust must be in a form that is subject to estate tax on the spouse's death. As for the latter, the QDOT must take the form of a marital deduction trust: A §2056(b)(5) marital deduction power of appointment trust, an estate trust under which the remainder interest passes to the spouse's estate, or a QTIP trust for which a QTIP election is made. Finally, an election to treat the trust as a QDOT must be made on the decedent's estate tax return.

- b. But what if property is left outright the spouse, and not to the trustee of a QDOT? The spouse can transfer the property to a QDOT (under detail rules prescribed in the regulations), *and* the decedent's executor must make a QDOT election on the estate tax return.

**B. What happens if the “citizenship” route is not completed in time?** In Estate of Liftin v. United States, 2013-1 U.S.T.C. ¶60,660 (Fed. Cl. 2013), after D's death his spouse S decided to apply for United States citizenship in order to take advantage of the marital deduction. The estate requested an extension of time to file the estate tax return, but the naturalization process had not been completed by the extended deadline. The estate's attorney assured the executor that the estate would not be subject to penalties as long as the return was filed within a reasonable time after the spouse obtained citizenship and various ancillary issues had been resolved. The executor filed the estate tax return nine months after S obtained citizenship and her claims against the estate had been settled.

1. That was too late, said the court, and a late-filing penalty was imposed. In granting the government's motion for summary judgment, the court concluded that the executor's failure to file the return until after S had obtained her citizenship was due to reasonable cause. However, the nine-month delay in filing the return after the spouse's citizenship had been obtained was not reasonable.

**C. Despite delays, IRA rollover from 401(k) treated as transfer to qualified domestic trust.** In Ltr. Rul. 201243012, the executor timely filed the estate tax return and elected QDOT treatment for D's interest in a 401(k) plan. The spouse S agreed to report to the IRS all annuity payments received from the 401(k) or from any IRA to which she transferred the 401(k). Due to intervening events beyond S's control, delays were encountered in irrevocably assigning the 401(k) to the IRA. The executor filed a supplementary estate tax return that provided all of the required information. That will do it, said the Service. An extension was granted to treat the IRA as a qualified domestic trust.

## **X. Section 2511—Transfers in General**

**A. Tax Court tells Commissioner to go fly a *Kite*: Aggressive private annuity passed muster, as did an aggressive capital gain laundering transaction.** Estate of Kite v. Commissioner, T.C. Memo. 2013-43, involved the estate of a member of a prominent Oklahoma banking family. Mrs. Kite was the beneficiary of numerous trusts (a footnote tells us that there were 70 trusts for the benefit of Kite and her children), but only four of the trusts were involved in the case: three marital deduction trusts worth a combined \$15.2 million and Kite's revocable trust. The decision dealt with a number of interests and sophisticated transactions: in addition to the marital trusts (and some

issues related to them), an Oklahoma limited partnership that was restructured in Texas to avoid state income taxes, a general partnership, gifts and later sales (on secured notes totaling \$12.5 million) to Kite's children or trusts for the children, a private annuity transaction—those are the highlights. (As the above brief summary suggests, reading the court's finding of facts is a slog.) To my mind, two issues—only one of which was addressed by the court—are attention-getters.

1. **Balloon private annuity for a 75-year-old.** On March 30, 2001, a week before her 75th birthday, Kite sold assets valued at \$10.6 million to her three children in exchange for an annuity under which each child would make an annuity payment of \$1.9 million—beginning in 2011. (The court called this a “deferred annuity.”) The value of the annuity was determined by Kite and her advisors on the basis of the §7520 term interest tables, under which Kite's life expectancy was 12.5 years. Kite died three years later, shortly after her 78th birthday. As a consequence, the annuity terminated, and the children never made any annuity payments.
  - a. **No taxable gift because use of the §7520 term interest tables was appropriate.** In a private annuity transaction, if the value of the property transferred exceeds the discounted value of the annuity received in exchange, the party will have made a taxable gift. The government argued that this was the situation here; in view of Kite's age and her deteriorating health, use of the §7520 term interest tables was not appropriate, as Kite's death within ten years was foreseeable.
  - b. However, “[b]efore the annuity transaction, Mrs. Kite received a letter from her physician attesting to her health and longevity. He affirmed that Mrs. Kite did not have an incurable illness or other deteriorating physical condition that would cause her to die within one year. The physician further opined that Mrs. Kite had at least a 50% probability of surviving for 18 months or longer.” The fact that Kite had 24-hour home health care “[does] not suggest, let alone prove, that Mrs. Kite had a terminal illness or an incurable disease. Rather, Mrs. Kite's increased medical costs merely demonstrate that Mrs. Kite was a wealthy, 75-year-old woman who, when faced with certain health problems, decided to employ health care aids at her home. Her decision to hire home health care was not unusual for a woman who was accustomed to hiring personal assistants.”
  - c. “[B]ased on the unique circumstances of the case and, in particular, Mrs. Kite's position of independent wealth and sophisticated business acumen ... the annuity transaction was a bona fide sale for adequate and full consideration.” As a result, the private annuity transaction did not produce a taxable gift.
2. **Inter vivos QTIP trust used to secure step-up in basis.** As a general proposition, the inter vivos QTIP trust has been used to advantage primarily in one situation: to utilize the credit shelter of a non-propertied spouse to cover the contingency that he or she may predecease the propertied spouse. For example, wealthy W transfers assets to an irrevocable trust: Income to H for life, and on H's death income to W for life, and on W's death in further trust for descendants. W files a gift tax return that makes a QTIP election, securing a marital deduction. On H's death, the trust's value is includible in H's gross estate under §2044, and utilizes H's exemption via a credit shelter trust for the benefit of W and her descendants. (If the value of the trust exceeds H's available exemption, H's executor makes a QTIP election, securing a marital deduction for H's estate.)

- a. That was not the motivation here, because Mr. Kite was also quite wealthy, had more than enough assets to utilize his credit shelter—and, apparently, was in poor health. Rather, it is quite apparent that the motive was to obtain a step-up in basis. In 1995, Kite transferred stock with a basis of \$41,000 and a fair market value of \$4.25 million to a QTIPable trust and, in reporting the gift, made a QTIP election. Mr. Kite died a week later. (The opinion does not mention the state of Mr. Kite’s health at the time of the QTIP transfer, but it would appear that he was in poor health.) Judge Paris’s opinion discusses this inter vivos QTIP transaction in the Finding of Fact, but does not mention the consequence: With the §2044 inclusion in Mr. Kite’s gross estate, the stock obtained a new basis, wiping out unrealized gain of \$4.09 million.
  - b. **But what about §1014(e)?** Apparently, the government didn’t raise the issue. Under §1014(e)(1), the “new basis at death” rule does not apply if
 

“(A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent’s death, and (B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor).”
  - c. Perhaps the reason the Service did not raise this issue was that on Mr. Kite’s death the property did not pass to the donor of the property (*i.e.*, it didn’t pass into Kite’s outright ownership), but instead passed to a trust that gave the donor only a life estate. In Ltr. Rul. 9321050, the facts (as to this issue) were essentially the same as in Estate of Kite v. Commissioner: W transferred property to a QTIP trust that benefitted H, and then H died. The ruling concluded that only W’s income interest was affected by §1014(e), and that the trust’s remainder interest qualified for a step-up in basis.
  - d. Section 1014(e) was enacted in 1981—and Treasury has yet to publish regulations regarding the statute. Perhaps Estate of Kite v. Commissioner will stimulate action on this issue, because it presents an intriguing planning scenario.
3. **Postscript.** In a subsequent unpublished opinion, October 25, 2013 the Tax Court entered a judgment on against Virginia Kite’s estate for a gift tax deficiency of \$816,206 for the gift of the remainder interest. The court stated that although Kite received full and adequate consideration in the annuity transaction, that didn’t mean that she received full and adequate consideration for the transfer of the QTIP remainder interest. The remainder interest was owned by the remaindermen and not Kite; therefore, she couldn’t receive consideration for transferring it. This raises a caveat: The Service could use Estate of Kite v. Commissioner to challenge a transaction in which a QTIP trust is terminated and shortly thereafter the spouse-beneficiary sells the assets to a third party.

**B. National Office says: Self-canceling (“SCIN”) “balloon” installment note transaction resulted in taxable gift.** Under the facts presented to the Office of Chief Counsel (CCA 201330033), in the year before he died D made major revisions in his estate plan. Under the prior estate plan, Charity was the primary beneficiary of D’s estate. The revised estate plan, involving a series of transfers of Y Company common and preferred stock to newly created grantor trusts, primarily benefitted D’s family members. The revised plan included two GRATs; because D died during the GRAT terms, their value was included in D’s gross estate. D’s revised estate plan involved several self-canceling installment notes. After D’s death, the estate filed a gift tax return that reported the GRAT gifts and disclosed the SCIN transactions, “but did not report any taxable gift as a result of those transactions.” The CCA is devoted to the issue of the SCIN transactions

1. **Background: Self-canceling installment notes (SCINs).** In a SCIN transaction, a party sells assets in exchange for a promissory note to be paid in installments, with a provision that if the obligee dies during the term of the note (*i.e.*, before the note has been paid in full), the note is cancelled. As a result (if the transaction works as planned), there is no estate tax inclusion in the obligee's estate. Of course, if the obligee outlives his life expectancy, he will have received more payments than if a standard promissory note had been employed. The ideal candidate for a SCIN transaction, then, is a client who is healthy enough to justify use of the §7520 term interest tables in valuing the note, but not healthy enough to likely outlive the term of the note.
  - a. **Risk premium.** For the value of the SCIN to be equal to the value of the property sold, the obligee must be compensated for the risk that he may die during the term of the note and thus not receive the full purchase price. The "risk premium" may take the form of a higher-than-market interest rate on the note—*e.g.*, a 10 percent interest rate in a 5 percent world. Alternative, the principal face amount of may be substantially higher than the value of the property sold.
  - b. **The seminal case: Estate of Moss.** The case that caught the estate planning community's attention in the 1980s was Estate of Moss v. Commissioner, 74 T.C. 1239 (1980), acq. in result, 1981-2 C.B. 1. Moss, who was married but had no children, was president of a funeral home in Florida and owned 231 shares of the corporation's common stock. The remaining 355 shares were owned by employees of the funeral home, who had either purchased the shares or acquired them by gifts from Moss. The shareholders accepted Moss's offer to sell the 231 shares for \$800/share (the shares' book value was \$440/share) under an installment note with a term of 9 years and 7 months.
    - (1) On the date of the transaction, "the physical and mental condition of decedent was average for a man of 72 years of age," said the Tax Court. "There was nothing to indicate that his life expectancy would be shorter than the approximate 10 years of life expectancy which was indicated by generally accepted mortality tables." Seven months after the sale, Moss was diagnosed with cancer, and he was terminally ill for the remaining nine months of his life.
    - (2) Although the parties had stipulated that the sale was a bona fide transaction for full and adequate consideration, the Service contended that the note's value was includible in Moss's gross estate under §2033, on the ground that the cancellation provision was no different from a will provision cancelling a promissory note. "Respondent contends that decedent ... simply chose to pass the funeral home business to his employees under the guise of the notes which were canceled upon death rather than through his will." The court rejected the Service's contention. "The cancellation provision was part of the bargained for consideration provided by decedent for the purchase price of the stock. As such, it was an integral provision of the note.... We believe there are significant differences between the situation in which a note contains a cancellation provision as part of the terms agreed upon for its issue and where a debt is canceled in a will."

- (3) It bears emphasis that this was not an intrafamily sale, and could hardly be considered an abusive transaction. This is the likely explanation for the Service's "acquiescence in result."
2. **The Chief Counsel Advisory opinion.** In one set of transactions, D had transferred Y stock to grantor trusts in exchange for promissory notes bearing interest at [???], with a [???] term based on D's life expectancy as determined under the §7520 term interest tables. (The CCA is heavily redacted as to key facts.) The notes required interest-only payments until the end of the term, at which D would receive the face value of the notes. If D died during the note term, the notes would be cancelled. "The total face value of the self-cancelling notes was ... almost double the value of the stock. The higher value of the notes supposedly compensated the decedent for the risk that he would die before the end of the note term and neither the principal nor a significant amount, if not all, of the interest would be paid. In fact, the decedent died less than six months after the transfer, and therefore, received neither the interest payments nor the principal due on the notes." In another set of transactions, D transferred Y stock to another GRAT, and to other grantor trusts in exchange for interest-only self-cancelling notes bearing a considerably higher interest rate, another method of compensating for the risk that D might die during the note term.
- a. **The decedent's health.** "Very shortly after the fourth and fifth set of transactions [involving the high-interest SCIN notes and the second GRAT], the decedent was diagnosed with [???]. After [that] diagnosis, he survived for less than six months. He died on Date 2."
- b. **Section 7520 tables should not be employed.** "We do not believe that the §7520 tables apply to value the notes in this situation.... In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in §25.2512-8. In this regard, the decedent's life expectancy, taking into consideration decedent's medical history on the date of the gift, should be taken into account.... Because of the decedent's health, it was unlikely that the full amount of the note[s] would ever be paid. Thus, [each] note was worth significantly less than its stated amount, and the difference between the note's fair market value and its stated amount constitutes a taxable gift."
- c. The CCA cites and discusses §§ 2033 and 2038, and discusses Estate of Moss v. Commissioner and Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995), both of which involved estate tax issues. However, the CCA does not give any discussion or conclusion regarding the estate tax ramifications of the SCINs, beyond noting that that they were disclosed on the Form 706.
4. The CCA also discusses Estate of Costanza v. Commissioner, 320 F.3d 595 (6th Cir. 2003). C decided to retire at age 73 and move back to his native Italy. He sold real estate and his restaurant to Son for an 11-year SCIN that was secured by a mortgage on the properties. The note provided that if C died before the note was paid, no further payments need be made. However, C never made it back to Italy. He had been suffering from heart disease for 15 years. Five months after the sale, and after three monthly payments had been made on the note, C died during bypass surgery. The Tax Court ruled that the conveyance was not a bona fide transaction for full and adequate consideration. Son's inconsistency in making payments due under the SCIN failed to establish that there had been a valid arm's length sale.

Moreover, there was no showing that either C or Son intended to enforce the note payment provisions. T.C. Memo. 2001-128.

- a. The Court of Appeals reversed. The court noted that “there was no evidence that either Michael or Duilio presumed that Duilio would die within a few years of signing the SCIN, let alone within five months of the signing.” The medical evidence at the Tax Court trial was to the effect that Duilio’s life expectancy was between 5 to 13.9 years and not that he was in imminent danger of death. The court concluded: “Under these facts, taxpayer rebutted the presumption against the enforceability of an intrafamily SCIN by affirmatively showing that there existed at the time of the transaction a real expectation of repayment.... As such, we conclude that the Tax Court clearly erred in finding that the execution of the SCIN was not a bona fide transaction.”
- b. The CCA distinguishes Estate of Costanza v. Commissioner. “In Estate of Costanza, had the decedent lived, he would have received monthly payments consisting of income and principal throughout the term of the note. The decedent required the payments for retirement income and, thus, had a good reason, other than estate tax savings, to enter into the transaction. In contrast, the decedent in this case structured the note such that the payments during the term consisted of only interest with a large payment on the last day of the term of the note (balloon payment). Thus, a steady stream of income was not contemplated. Moreover, the decedent had substantial assets and did not require the income from the notes to cover his daily living expenses. The arrangement in this case was nothing more than a device to transfer the stock to other family members at a substantially lower value than the fair market value of the stock.”
  - (1) Keep the above CCA discussion in mind! Isn’t the Office of Chief Counsel in effect giving tacit approval to the Costanza SCIN transaction?
- c. The CCA also distinguished Estate of Moss v. Commissioner, where “[a]t the time of sale, the physical and mental condition of the decedent was average for a man of 72 years of age. There was nothing to indicate that his life expectancy would be shorter than the approximate ten years of life expectancy that was indicated by generally accepted mortality tables.” Rather, “[t]here are similarities between the decedent in the subject case and the decedent in Estate of Musgrove. In each case, the decedent who received a promissory note with a self-cancelling feature was in very poor health and died shortly after the note was issued. In addition, there is a legitimate question as to whether the note would be repaid in each case.”

**C. Wait a minute! That Chief Counsel Advisory opinion involves the Davidson case!** It turns out that the CCA sets out the Service’s litigation position for Estate of Davidson v. Commissioner, Tax Court Cause No. 013748-13, for which the position was filed on June 14, 2013. As a result, we can fill in the blanks redacted in the CCA. 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!** (We are talking about the Guinness Book of Records here—although the supposed deficiency may not be quite that high because the Service acknowledged that it “did not calculate certain deductions and credits to which [the estate] may be entitled.” The major issue in the case (in terms of the tax dollars involved) will be 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. On that issue—big numbers because D owned so many shares of Guardian stock—the Tax Court trial and resulting opinion will involve the usual battle of dueling experts, except on a rather stratospheric scale. Another issue in the case involves 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. As with the CCA opinion, 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. The CCA states, 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.
1. **Unless the parties settle, this will be a major, major case concerning the use of SCINs in estate planning.** Given the time involved in the litigation process, and the likely appeal however the Tax Court decides the case, we are likely to be hearing about Estate of Davidson v. Commissioner for the next several years. Interestingly, any appeal from the Tax Court

decision will be to the 6th Circuit, which ruled in favor of the taxpayer in Estate of Costanza v. Commissioner.

## XI. Section 2512—Valuation of Gifts

A. **Tax Court reverses course as to “net, net gift” treatment of gifts made within three years of death.** In Steinberg v. Commissioner, 141 T.C. No. 8 (2013), 89-year-old S made gifts of cash and securities to her four daughters pursuant to a binding agreement under which the daughters agreed to assume and pay the federal gift tax liability imposed on the gifts, *and* any federal and state tax liability imposed under §2035(b) if she died within three years after making the gift. (The Tax Court labeled the transaction as a “net, net gift.” S filed a gift tax return reporting a net taxable gift of \$71.6 million, based on an appraisal that reduced the fair market value of the gift property by both (1) the gift tax paid by the donees and (2) the actuarial value of the donees’ assumption of potential §2035(b) liability, based on S’s age and life expectancy at the time of the gifts. This second factor reduced the gift tax liability by \$5.8 million. The Service accepted the net gift treatment but not the reduction in value relating to §2035(b), and assessed a \$1.8 million deficiency.

1. **The government must have thought it had a winning case.** In McCord v. Commissioner, 120 T.C. 358 (2003), the Tax Court had ruled that approximating the potential burden of the estate tax, based on the probability that the donor might die within three years, was too speculative to warrant reducing the amount of the taxable gift. The decision was reversed and remanded on appeal by Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006), but (as noted in Steinberg v. Commissioner decision) the Tax Court was not obliged to follow Succession of McCord v. Commissioner because this case was appealable to the Court of Appeals for the Second Circuit. Nonetheless, the Tax Court reversed its position, and denied the government’s motion for summary judgment. Eight judges signed off on the majority opinion, six judges concurred in the result only, and Judge Halpern (who wrote the Tax Court opinion in McCord v. Commissioner) was the lone dissenting judge.

2. **Background: The federal gift tax is “tax exclusive,” making lifetime transfers cheaper than transfers at death.** Although ATRA 2012 sets the tax rate for both taxable gifts and taxable estates at 40 percent, the effective gift tax rate is actually lower than the estate tax rate because the gift tax is computed on a “tax exclusive” basis—the 40 percent tax rate is applied to the gift amount that passes to the donee. In contrast, the estate tax is computed on a “tax inclusive” basis—the 40 percent tax rate is applied to the entire estate, including the amount paid in estate taxes.

*Example:* Suppose that Taxpayer has utilized her gift tax applicable exclusion amount by prior gifts, to the point that any future lifetime gifts will be taxed at 40 percent, and that property transferred at Taxpayer’s death will be taxed at 40 percent. Taxpayer wants to put \$1,000,000 net of taxes in Daughter’s hands. If Taxpayer gives property worth \$1,000,000 to Daughter, the gift tax will be \$400,000, and Taxpayer’s net worth will be depleted by \$1,400,000. [To simplify the example, I have eliminated application of the annual exclusion.]

If, instead, Taxpayer wants Daughter to receive \$1,000,000 from Taxpayer’s estate, the estate assets needed to put \$1,000,000 in Daughter’s hands net of taxes would be \$1,666,667. [The estate tax would be \$1,666,667 x 40% = \$666,667.]

- a. **Gift tax is removed from the estate tax base.** Moreover, in the above example, on Taxpayer’s death the \$1,000,000 gift will be included in the estate tax base as an adjusted taxable gift, but the \$400,000 gift tax paid will have been removed from the estate tax base. This technique is known as “saving the estate tax on the gift tax.”
3. **Background: The “gross-up” rule of Section 2035(b).** To mitigate the disparity of treatment between the taxation of lifetime transfers and transfers at death—in particular, to take away these advantages for taxable gifts made shortly before death, under §2035(b) the gross estate includes gift taxes paid on taxable gifts made within three years of death. If in the above example Taxpayer died within three years of making the gift, the estate tax base would include the \$1,000,000 adjusted taxable gift, and also the \$400,000 gift tax paid on the gift.
  4. **Background: Net gifts.** Suppose in the above example Daughter entered into an enforceable agreement with Taxpayer that Daughter would pay the gift tax resulting from the \$1,000,000 gift. The courts (and now the IRS) have concluded that the donee’s assumption of liability is consideration in money or money’s worth that can be subtracted in determining the amount of the “net gift” on which the gift tax is imposed. Rev. Rul. 75-72, 1975-1 C.B. 310. As a result, the gift tax rate on the net gift can be determined under this formula: tentative tax/[1 + tax rate]. The tax rate on net gifts is thus 400,000/1,400,000, or 28.57 percent.
  5. **The *Steinberg* case.** In Steinberg v. Commissioner, the government filed a motion for summary judgment on the ground that that the donees’ assumption of the potential §2035(b) liability did not constitute consideration that would reduce the value of the gift. Specifically, the assumption of liability did not satisfy the “estate depletion” theory because it would benefit the donee’s estate (and the beneficiaries of the estate) and not the donee. The majority opinion denied the motion, concluding that (1) the potential estate tax liability was not too speculative to consider, and (2) the estate depletion theory was satisfied because any tax would replenish the estate, and the donor and her estate were “inextricably bound.” A concurring opinion contended that the government did not raise, and thus the court should not have addressed, the “too speculative” issue.
    - a. **What happens next?** The majority stated that the court would no longer follow its decision in McCord v. Commissioner that the potential estate tax liability was too speculative to consider in valuing a net, net gift. However, the majority concluded that “[t]here are genuine disputes of material fact as to whether the donees’ assumption of petitioner’s potential section 2035(b) estate tax liability constituted consideration in money or money’s worth.” Thus, unless the parties settle before trial, there may be more to say about Steinberg v. Commissioner in the future.
    - b. **Postscript: Mrs. Steinberg, 89 years old when the transfer was made, survived by more than three years after making the gift.**

## XII. Section 2519—Disposition of QTIP Life Estates

- A. **Net gift treatment upon spouse’s renunciation of QTIP interest.** In Ltr. Rul. 201303003, a QTIP trust was divided into two separate trusts as part of a settlement agreement. The spouse S then renounced her interest in Trust 1, which resulted in a taxable gift by S. Her renunciation was conditioned upon her three sons paying all gift taxes, which resulted in a reduction of the amount of the gift.

1. **Donees took carryover basis.** The ruling notes that as a result of S's renunciation, under §1015 the donees took the property with a carryover basis, increased by the amount of gift tax paid by the recipients.

### **XIII. Section 2601—Generation-Skipping Transfer Tax**

- A. **Exercise of special power of appointment to extend duration of grandfathered trust.** One of the nicest things to have in the family is a pre-1985 trust that gives the current beneficiary a special testamentary power of appointment. If the trust was established prior to September 25, 1985, all interests created by the exercise of the special power, including the creation of new trusts and extending the duration of existing trusts (but not beyond the period of perpetuities established by the grandfathered trust) are grandfathered for GST purposes. This year's addition to a long list of rulings affirming this principle includes Ltr. Ruls. 201218001, 201218002, and 201136017.
- B. **Service gives favorable treatment to a formula bequest tied to old (and long since repealed) GST.** In Ltr. Rul. 201322025, a will (drafted many years before) provided that at the death of the survivor of D and his wife, the greater of \$250,000 or an amount specified in §2613 (the old GST exemption statute) was to be distributed to a trust for the benefit of D's son and his descendants. Slight problem: When that time arrived, §2613 had been repealed and replaced by the current GST. A state court found an ambiguity, and concluded that D intended to take full advantage of the GST exemption available at his death. We'll buy that, said the Service. The court's order resolved a bona fide issue, and was consistent with applicable state law as it would be interpreted by the highest court of the state. Accordingly, the distribution did not cause the inclusion ratio of the trust to be greater than zero.
- C. **A year's supply of letter rulings pertaining to the GST.** At the October 2012 Fall ACTEC meeting in Washington, D.C., James Hogan, Branch Chief of Branch 4 of the Chief Counsel's office, which handles estate and gift tax matters), noted that Branch 4 had worked on 150 letter rulings during the last fiscal year. Rulings adverse to a taxpayer are rarely released because the taxpayer usually withdraws the request before a determination is made that becomes public. Hogan said that although the user fee is high, the requests that come in regarding estate and gift taxes involve situations in which "the money really big." Not surprisingly, a sizeable number of last year's rulings dealt with the GST.
  1. **Late allocation of GST exemption.** In several rulings, extensions were granted to allocate GST exemption to trusts. A record of sorts was made by Ltr. Rul. 201315005 where, although an accounting firm had prepared gift tax returns for each of the *21 years* in which the decedent had made transfers to an irrevocable trust, none of the returns allocated GST exemption to the transfers.
    - a. In Ltr. Rul. 201303006, the estates of a deceased husband and wife were granted extensions to allocate their available GST tax exemptions to inter vivos trust. The attorney handling the deceased husband's estate discovered that the accountant hired to prepare gift tax returns had failed to allocate the husband's and wife's GST exemptions to the initial funding and subsequent transfers to the trusts. To the same effect, see Ltr. Ruls. 201222033 (involving split gift treatment) and 201240010.
  2. **Extension to elect out of the automatic allocation rules** was granted in Ltr. Rul. 201321005. Although the attorney who had created the trusts notified the donor of his need to file the gift tax return, the attorney did not notify the donor's accountant who prepared and

filed the return. Also see Ltr. Ruls. 201307004 and 201316001, granting extensions where an accountant had failed to give advice regarding the elect-out option.

3. **Inadvertent allocation of GST exemption to 2010 transfer.** Under the facts of Ltr. Rul. 201250005, a tax professional retained to prepare the donor's gift tax return allocated GST exemption to a 2010 transfer to a trust established solely for skip persons. Under Notice 2011-66, 2011-35 IRB 184, a timely filed gift tax return reporting an outright, inter vivos direct skip made in 2010 other than by reason of the donor's death is sufficient to prevent an allocation of GST exemption. Thus, the inadvertent allocation of GST exemption was void, and did not use up any of the donor's GST exemption.
4. **Reverse QTIP election.** In Ltr. Rul. 201316011, an estate was granted an extension of time to sever a trust into GST tax exempt and non-exempt shares, to make a reverse QTIP election with respect to the exempt share, and to apply the automatic allocation of GST exemption rules to the exempt share. Also see Ltr. Rul. 201232019.
5. **Severance and merger.** Ltr. Rul. 201238004 lays out and discusses the test the must be satisfied if the severance of a GST-exempt trust is to pass muster. Settlor had created an irrevocable trust for the benefit of his son and daughter and each child's four children. To accommodate the different economic needs of the children, the trustees proposed a division of the trust into two separate trusts. The division was a qualified severance because (1) the trust was severed pursuant to the terms of the governing instrument or pursuant to applicable local law, (2) the severance was effective under local law, (3) the assets were valued on the date of the severance and the trusts were funded within 90 days of the severance date, (4) the original trust was divided on a fractional basis, (5) the terms of the new trusts provided for the same succession of interests as the original trust, and (6) the inclusion ratio for both of the resulting trusts was zero.
  - a. Ltr. Rul. 201243006 approved a division of a GST-exempt trust with individual and charitable beneficiaries, under which the trustee has been granted full discretion in determining distributions, to create separate trusts for the family lines of each great-grandchild of the grantor.
  - b. A severance followed by a merger of six irrevocable trusts was approved in Ltr. Rul. 201322010.
6. **No problem raised by modification of trust with inclusion ratio of zero.** Ltr. Rul. 201320004 involved an agreement to modify the duties of the trustees with respect to the trust's requirement of annual distributions of net income. There's no problem with that, said the Service, because sufficient GST exemption had been allocated to give the trust an inclusion ratio of zero.
7. **Mental incompetency exception.** Under §1433(b)(2)(C) of the Tax Reform Act of 1986, the GST does not apply to a direct skip occurring on a decedent's death, "but only if such decedent was, on the date of enactment of the Act, under a mental disability to change the disposition of his property" and did not regain capacity prior to his death. If the individual had not been adjudicated incompetent, the executor must file, with the Form 706, evidence of the individual's incapacity. In Ltr. Rul. 201314017, an estate was granted an extension of time to provide a physician's certification establishing the decedent's mental incompetence.

- a. Under the facts of Ltr. Rul. 201316004, D executed her will prior to September 25, 1985. Shortly thereafter, but before September 25, 1985, D was declared mentally incompetent. Following D's death, charitable and noncharitable beneficiaries under the will failed to agree on the proper interpretation of D's will. The individual beneficiaries (represented by separate counsel) and the charities (represented by the state attorney general) entered into a court-approved settlement agreement. The ruling concludes that the resulting distributions to individual beneficiaries pursuant to the settlement were exempt from the GST, and that the distributions to charities qualified for a charitable deduction.

#### **XIV. Section 6161—Extension of Time for Paying Tax**

- A. **Extension of time to file, by itself, is not enough: \$999,000 penalty (!) affirmed.** In Estate of Thouron v. United States, 2012 U.S.T.C. ¶60,656 (E.D. Pa. 2012), the executor made a timely submission of a request for an extension of time to file and included an estimated estate tax payment, but did not request an extension of time to pay tax. Six months later, the executor filed the estate tax return and requested an extension of time to pay the tax. Too late, said the court. The instructions for Form 4768 clearly state that a request for an extension of time to file does not relieve the estate of its obligation to also request an extension of time to pay the tax. The fact that the executor relied on an attorney was no excuse. A late-payment penalty of \$999,072 was affirmed.

#### **XV. Section 6166—Extension of Time to Pay Estate Taxes**

- A. **Election could not be made after deficiency was assessed on account of non-business properties.** In CCA 201302037, the Chief Counsel's Office concluded that when an estate failed to make a §6166 election on its estate tax return, the estate could not later pay a deficiency in installments because the deficiency was not attributable to the closely held business. The estate had paid the estate tax due in full and did not make a regular or protective election under §6166. A deficiency was assessed, but none of the deficiency related to the closely held business. Only that portion of the deficiency attributable to a closely held business can be paid in installments.
  1. Similarly, in CCA 201304006 an estate was not allowed to expand its installment payment election to the entire interest in a business after the assessment of a deficiency that was not attributable to the business portion of the estate.
- B. **Election has to be made on estate tax return, not in an accompanying letter.** In CCA 201226027, the election to pay taxes in installments under §6166 was made in a letter accompanying an extension request, and not on the estate tax return that was filed. Not good enough, said the Chief Counsel's Office. Because the election was not made on the return, the payment submitted was not an installment payment under §6403. The payment did not exceed the total tax due and therefore there was no overpayment of tax that could be refunded.

#### **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 payment or a deposit. Five years later, the litigation ended, 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 of course the statute of limitations had run.
- C. Second verse, same as the first.** No, that's not Herman's Hermits singing "I'm Henry 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 in Louisiana on this issue 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 6601—Interest on Underpayment or Nonpayment of Tax**

- A. When does interest start to run on unreported gift that used up some of donor's unified credit?** Under the facts of CCA 201249015, Donor made a taxable gift in Year 1 but did not file a gift tax return. As a result, Donor did not utilize any of her available unified credit to offset the gift.

In Year 2, Donor made additional taxable gifts, which were reported and which exhausted her available unified credit. After Donor's death, the Year 1 taxable gift was reported on the estate tax return for her estate. Well, then: When did §6601 underpayment interest start to accrue on the Year 1 gift tax deficiency?

1. The Chief Counsel's Office advised that interest on the underpayment interest began to run on the due date for the Year 1 gift tax return. Under §6501(a), "the amount of any tax ... shall be assessed within 3 years after the return was filed," but if the taxpayer fails to file a return, under §6501(c)(3) "the tax may be assessed ... at any time." That was the situation here, because Donor never filed a gift tax return disclosing the Year 1 gift. "It is the Service's position that the available unified credit for an unreported gift must be reduced to reflect the use of the credit in a subsequent year for a reported gift." As Donor used the entire §2505 unified credit with respect to the reported Year 2 gifts, there was no unified credit available to apply to the unreported Year 1 gift. Consequently, said the CCA, interest on the assessed deficiency began to accrue on the due date for the gift tax return.

### **XVIII. Section 6651—Failure to File Tax Return or to Pay Tax**

- A. **No; an extension to file is for six months, not one year.** In Knappe v. United States, 2013-1 U.S.T.C. ¶ 60,663 (9th Cir. 2013), when it became apparent that several appraisals would not be completed in time to file the estate tax return before its due date, the estate's CPA advised the executor to request an extension of time to file and pay the estate tax. Relying on the CPA's advice that the Service had granted a one-year extension, the executor filed the estate tax return several months after the six-month deadline. Slight problem: the Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate Taxes states quite clearly that the maximum available extension to file is six months. In this situation, the executor's reliance on his CPA was not a reasonable cause, and the Service's assessment of a late-filing penalty was affirmed.