

# **Recent Developments Affecting Estate Planning**

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## I. The Federal Estate Tax—What Happens Now?

- A. It All Began With the Tax Reform Act of 1976**, which “unified” the federal estate tax and gift taxes, increased the estate tax exemption from \$60,000 to \$175,625, introduced the first (mercifully short-lived) version of the generation-skipping transfer tax, repealed (for a few years) the carryover basis rule, and made other significant changes (and some insignificant changes—remember the orphan’s deduction?)—the one constant with respect to transfer taxes has been constant change. Consider: ERTA 1981 increased the estate tax exemption to \$600,000, introduced the unlimited marital deduction, and gave us QTIP trusts. The Tax Reform Act of 1986, which increased the exemption, reduced the maximum estate & gift tax rate, and gave us the current version of the generation-skipping transfer tax. In 1990, we were introduced to the Special Valuation Rules of Chapter 14. EGTRRA 2001 (the “Bush Tax Act”) repealed the estate tax under the Budget Reconciliation procedure’s “sunset” rule—a slow-burning fuse.
1. And these are just the bold-face highlights! These same Acts, and sundry statutes in between, made more-than-tinkering changes to our transfer tax laws on an almost annual basis.
  2. And here we are again—maybe!
- B. Will the Estate Tax Be Repealed?** In his campaign, President Donald Trump called for repeal of the estate tax, as did the House Republicans in “A Better Way: Our Vision for a Confident America” in June 2016. But even with the Republicans holding both houses of Congress, they have only 52 senators, and it would take 60 votes to override a likely Senate filibuster. (On the other hand, several Democrat senators will soon be up for reelection in states that went for President Trump.) A filibuster could be avoided if Republicans took the Budget Reconciliation route (as with the Bush Tax Act in 2001), producing a “repeal” that would expire in ten years.
1. **State Estate Tax Laws Can Be a Concern Even for Texans.** Although New Jersey has repealed its estate tax (effective in 2018), 20 states and the District of Columbia have estate or inheritance taxes. And don’t smugly assume that those state death taxes are of no concern to us Texans. The situs rule raises a concern for any Texan who holds an interest in real property in one of those states. In many of these states, for real property owned by a nonresident the exemption is prorated, meaning that absent planning, a condominium in New York City can produce a substantial estate tax.
- C. And What About the Gift Tax?** Repeal of the estate tax would no doubt include repeal of the generation-skipping transfer tax. But would the federal gift tax also be repealed? Neither President Trump in his campaign rhetoric nor the Republicans in June 2016 made any mention of whether, or how, the gift tax might be changed.
- D. And What About the “New Basis at Death” Rule?** A Trump administration is hardly likely to repeal the “new basis at death” rule—at least for most Americans. However, on the campaign trail Trump proposed a capital gain tax for assets held at death and valued at more than \$10 million. How in the heck would that work? Would there be a step-up in basis for the first \$10 million—and if so, how would assets be selected for the step-up? We of course have no clue, and neither does anybody else.
- E. What Do We (and Our Clients) Do in the Meantime?** Daily Tax Reports (12-28-16) had a choice quote from Cynda Ottaway, president of ACTEC: “You’ve got to say, ‘keep your plan in place and

stay healthy,' because you don't know what's going to happen." Deeping further into history, also helpful is a quotation attributable to Oliver Cromwell, the 17th Century British revolutionary: "put your trust in God; but keep your powder dry."

1. **Did Benjamin Franklin Have It Wrong?** It was Benjamin Franklin, in a 1789 letter, who wrote that "Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes." Death, yes; income taxes, yes; but death taxes can hardly be said to be certain.
2. The annual Short Course on Estate Planning given by the Center for American and International Law (formerly the Southwestern Legal Foundation) in Dallas, at which I have lectured for 50 years, was scheduled this year for the first week in February. However, we decided to postpone the course because none of the speakers had a clue as to whether anything they might say would have any relevance six months from now.
3. For the short run (and possibly for the long run—we just don't know), clients should shelve plans for that proposed installment sale to a defective grantor trust or any other sophisticated planning transaction. (And this is yet another reason to not text while driving.)

**F. One Thing That Won't Change: Trusts Will Remain the Linchpin in Estate Planning.**

1. **For spouses:** spendthrift protection against creditors, protection from predators (including that dreaded second husband or wife), avoidance of a guardianship administration in the event of incapacity, avoidance of ancillary probate if client owns real property in another state, assurance of filial devotion (if the spouse has been given a testamentary power of appointment), flexibility to adjust to changes in the tax environment, and assurance that upon the spouse's death the assets will pass downstream to descendants.
2. **For children and other descendants:** spendthrift protection against creditors, in-law protection, divorce protection, avoidance of ancillary probate for real property in another state, incapacity protection in later years, and avoidance of taxes if federal (or state) estate taxes turn out to be a concern.

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

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

will mark account transcripts for estate tax returns with Transaction Code 421 that says “closed examination of tax return.”

2. **But this new system isn’t working.** Carol Cantrell (Houston) has advised me that, from her personal experience and the experience of others, this new procedure is not working as planned. Carol and others have had the experience of one CPA who emailed the AICPA: “My experience in getting an account transcript in lieu of a closing letter has been frustrating. I am on the POA for the estates for which I have attempted to get the transcript. However, the IRS website said my CAF was denied. I called the IRS and the agent said I was denied because I wasn’t marked to receive notifications on the POA. A partner who was marked to receive such notifications on the POA also tried to pull the transcript and also had his CAF denied. Thus, we have no choice but to call the IRS for all estates. This new process is tedious and time consuming.”
  - a. Eileen Sherr, AICPA Senior Technical Manager, sent this email in response to a CPA’s inquiry: “We are hearing good and bad news regarding the closing letters. Good news - It appears that when someone calls the IRS and gets through and the estate is closed, they are getting the closing letter in about a week. Bad news - If the estate is not closed yet, they need to keep calling to get it. It would be good if their initial call request could be noted in the IRS system so they do not need to keep calling back and wasting their and IRS time in repeated requests. Bad news - We have heard from several practitioners that there seems to be a stumbling block with POAs not working easily (as they should) for practitioners to get transcripts instead of closing letters. Instead, the practitioners need to fax in repeated POAs and often end up having to call to get the closing letter. There seems to be an issue with the IRS system’s POA approval function, resulting in practitioners not able to easily get the transcripts with the closing letter code.”
  - b. Ms. Sherr emailed this concern to Alfredo Valdespino, Acting Director, IRS SB/SE Specialty Examination Policy, and received this response via email on July 20, 2016: “Thanks for sharing this concern. I’m working with my staff to assess the issue and determine what might be the causing the CAF to be denied. I will keep you posted on what we find out.”

## II. Section 401—Qualified Plans and IRAs

- A. **Inherited retirement benefits: Five-year payout limit for beneficiaries other than spouses, minor children?** Under the Obama administration’s Fiscal Year 2017 Budget Proposal (also included in the 2014, 2015 and 2016 Budget Proposals), except for spouses (who could continue to make spousal rollovers), minor children, disabled or chronically ill beneficiaries, and beneficiaries less than ten years younger than the participant, beneficiaries could no longer stretch out required minimum distributions over their life expectancy. Instead, payouts would be limited to five years after the decedent’s death. Roth IRAs would be subject to the same five-year rule.
- B. **What are the consequences if a community property IRA names someone other than the surviving spouse as beneficiary?** That was the situation in Ltr. Rul. 201623001. H and W were married and had a child C. H named C as beneficiary of three IRAs. After H’s death, W filed a claim against H’s estate for her one-half interest in community property. W and C negotiated a settlement under which W’s community property interest in the estate was determined. A state court

approved the settlement, and ordered that the IRA custodians assign Amount of the inherited IRA for C to A “as a spousal rollover IRA.”

The family dynamics must have been interesting. The ruling did not concern the “usual” pattern of a divided family, involving a second spouse and children by a first marriage. C was the child of H and W, and H named the child rather than his spouse as IRA beneficiary. Interesting!

1. **State law governs spouse’s interest in community property IRA.** W made four ruling requests. In request 1), W asked that the Amount of the IRAs naming C as sole beneficiary be classified as W’s community property interest. The Service declined to issue the requested ruling. “Whether an amount of the inherited IRA for [C] is classified as [W’s] community property interest is a matter of state property law and not a matter of federal tax law.”
2. **Under federal tax law, spouse’s interest does not qualify for spousal rollover.** In the other ruling requests, W asked 2) that W be treated as payee of the inherited IRA, 3) that the custodian can distribute Amount to W in the form of a surviving spouse rollover IRA, and 4) that the distribution of Amount from C to W will not be considered a taxable event.
  - a. The Service declined to grant these ruling requests. C was beneficiary of the inherited IRAs. “Section 408(g) provides that section 408 shall be applied without regard to any community property laws, and, therefore, section 408(d)’s distribution rules must be applied without regard to any community property laws.” Because W was not the named beneficiary of the IRAs, she cannot be treated as a payee and cannot rollover any amounts from C’s inherited IRAs, “and therefore any contributions of such amounts by [W] to an IRA for [W] will be subject to the contribution limits governing IRAs.”
  - b. Additionally, because Child is the named beneficiary of the IRAs “and because we disregard [W’s] community property interest, any ‘assignment’ of an interest in the inherited IRA for [C] to [W] will be treated as a taxable distribution to [W]. Therefore, the order of the state court cannot be accomplished under state law.”
3. **Ruling applies only to federal tax consequences.** The ruling concludes by noting that “[t]his ruling expresses no opinion on the property rights of the parties under state law, and only provides a ruling on the federal tax law impact of the specific facts presented.”
  - a. The ruling does not identify the state in which H and W resided. As far as W’s rights are concerned, this would be important. In California and Washington, except for de minimus gifts one spouse cannot make a donative transfer of community property without the other spouse’s consent or acquiescence. In Texas and Louisiana, a spouse can make “reasonable” gifts of community property so long as the gifts are not so excessive as to constitute a “fraud on the other spouse’s community rights.” A number of factors are to be considered in determining whether a gift is reasonable or excessive. Because an IRA involves a nontestamentary transfer, as with life insurance policy designations the beneficiary designation is subject to the “fraud on the spouse” doctrine, and not the “widow’s election will” doctrine.
4. **Federal law does control if the nonparticipant spouse under a qualified plan predeceases.** In *Boggs v. Boggs*, 520 U.S. 833 (1997), the Supreme Court ruled that if the nonparticipant spouse (“NPS”) under a qualified plan predeceases the participant, the NPS does not have a devisable interest in her community share of the plan. The court concluded that it would be contrary to ERISA’s purpose to permit testamentary beneficiaries to acquire an interest in pension benefits at the expense of the plan participant and his beneficiaries.

Dorothy's testamentary transfer was a prohibited "assignment or alienation" as far as ERISA is concerned.

- a. *Boggs v. Boggs* was a 5-4 decision. The dissenting opinion pointed out that if W had divorced H, her community property interest would be recognized, and she could have obtained a Qualified Domestic Relations Order. "That being so, it would be anomalous to find a congressional purpose in ERISA that would in effect deprive Dorothy of her interest because, instead of divorcing Isaac, she 'stayed with him till her last breath.'".

**C. Testamentary trust was a valid look-through trust.** As a general rule, only individuals may be considered designated beneficiaries for purposes of stretching out required minimum distributions. If an IRA names a trust as beneficiary and the IRA owner dies before her required beginning date, the IRA fund must be distributed under the five-year rule—by December 31 of the fifth year following the owner's death. However, the trust can qualify as a "look-through" trust, and the life expectancy of the oldest trust beneficiary can be used in computing required minimum distributions if the following test is met: (1) the trust must be a valid trust under state law, (2) the trust is irrevocable, (3) the beneficiaries are identifiable from the trust instrument, and (4) certain documentation must be provided to the plan administrator within a specified period. If this test is satisfied, the five-year rule does not apply, and the life expectancy of the oldest trust beneficiary can be used in calculating required minimum distributions.

1. This test was satisfied in Ltr. Rul 201633025—and the facts on which the ruling is based provide a useful model as to how such a trust might be drafted. D named a testamentary trust as beneficiary of three IRAs. The trust provided for payment of all trust income to Child, and gave the trustee discretion to distribute principal to Child or Child's issue for health, education, support or maintenance. Child had three children. "Since Decedent's death, Trust has taken distributions ... that comply with the minimum distribution requirements that would apply if the applicable distribution period is based in [Child's] life expectancy." The trust is to terminate when Child attains age 50, at which time the trust estate is to be distributed to Child. If Child before age 50, the trust estate is to be distributed to Child's issue (with any share to be held in trust until age 21 if a distributee is under that age). If none of Child's issue is then living, the trust estate is to be distributed to D's two siblings.
  - a. The concern raised by these facts is that if the siblings as remainder beneficiaries are considered contingent beneficiaries, the period for required minimum distributions would be much shorter because they would be in the same age range as D. Far more basic, if the charity's contingent remainder interest is to be considered, the five-year rule would apply because only individuals can be designated beneficiaries, and a charity is not an individual.
3. Under Reg. §1.401(a)(9)-5, Q&A-7(b), a contingent beneficiary who might take upon the participant's death—even on a remote contingency—is to be considered for purposes of determining the designated beneficiary and determining whether an entity rather than an individual is a beneficiary. However, says the cited regulation, a person will not be considered a beneficiary merely because that person could become the successor to the interest of one of the beneficiaries after the beneficiary's death.
  - a. That was the situation here. When D died, the beneficiaries—and thus the designated beneficiaries—were Child and his issue. "All other potential recipients of the funds in the Trust are mere successor beneficiaries within the meaning of the regulations." Therefore, the life expectancy of Child, as the oldest beneficiary, is to be considered in making required minimum distributions.



**D. No look-through trust here; court order did not cure financial advisor's error.** In Ltr. Rul. 201628004, D maintained two IRAs with Custodian A and worked with a financial advisor employed by Custodian A. D named three trusts, all in compliance with the "look-through" provisions of the regulations, as the IRA beneficiaries. The financial advisor moved to another firm, and D transferred the IRA assets to a new IRA with Custodian B. The financial advisor provided a beneficiary designation form, which D signed, that named D's estate as beneficiary. Oops! After D's death, the trustees brought a declaratory judgment action and secured a court order that named the trusts as beneficiaries, with the order retroactive to the date D signed the new beneficiary designation form.

1. That doesn't work, said the Service. "[A]lthough the Court order changed the beneficiary of IRA X under State law, the order cannot create a 'designated beneficiary' for purposes of section 401(a)(9)." Citing and quoting from *Van Den Wymelenberg v. United States*, 397 F.2d 443 (7<sup>th</sup> Cir. 1968), and several Tax Court cases, "Courts have held that the retroactive reformation of an instrument to change the tax consequences of a completed transaction." D had named his estate as beneficiary, and an estate cannot be a designated beneficiary for purposes of calculating required minimum distributions. As D had not named a designated beneficiary and died after his required beginning date, required minimum distributions must be computed on the basis of D's life expectancy (determined on the basis of D's age in the year of his death).

**E. Waiver of 60-day rollover requirement: Treasury makes it easier.** Until recently, if a plan participant or IRA account owner missed the 60-day deadline for making a rollover, to request an extension from the IRS it was necessary to apply for a private letter ruling, with all of the attendant costs and complications. Rev. Proc. 2003-16, 2003-4 I.R.B. 59. No longer. Effective August 24, 2016, Rev. Proc. 2016-47, IRB 2016-37, provides for a self-certification procedure (subject to verification on audit) that may be used to claim an extension. Plan administrators and IRA custodians and trustees can rely on the self-certification, which must satisfy one of eleven listed conditions, including financial institution error, misplaced and uncashed check, distribution deposited in non-plan or non-IRA account, severe damage to taxpayer's residence, a death in the family, serious illness of taxpayer or family member, and postal error.

1. Contribution to the plan or IRA must be made "as soon as practicable," a requirement that is deemed to be satisfied if the contribution is made within 30 days after the reason for the delay no longer prevents the taxpayer from making the contribution.
2. The Revenue Procedure includes a model "Certification of Late Rollover Contribution."

**F. Waiver of 60-day rollover requirement granted to W but not to H.** In Ltr. Rul. 201612017, H and W each owned SEP-IRA accounts at the same financial institution. They instructed the financial institution to wire distributions from the accounts to new accounts at a different financial institution, to receive better protection in the FDIC-insured accounts. However, the new accounts were non-IRA accounts. W did not make any withdrawals from her new account, but for several months H withdrew funds from his account to pay living expenses. When they became aware of the error in preparing their income tax return, they transferred their funds to new IRA accounts. They requested a waiver of the 60-day rollover requirement (the full balance as to W's account and the balance after living expense distributions as to H's account).

1. Applying the test set out in Rev. Proc. 2003-16, 2003-4 I.R.B. 359, the Service determined that none of the factors set out in the Rev. Proc. applied to H, and thus the full amount distributed from the SEP-IRA account was includible in H's gross income for the year of the distribution. Because H had used the account as a checking account for living expenses, he had not established that he intended to roll over the SEP-IRA account to a new IRA account. H's lack of knowledge of the 60-day rollover requirement was not an acceptable excuse.

- (Significantly, no assertion of financial institution error was made.) The Service determined, however, that the Rev. Proc. factors supported W's request, and that she had relied on H's financial decisions.
2. A number of ruling requests for an extension were successful: e.g., Ltr. Rul. 201629013 (financial institution error), 201629014 (Alzheimer's), 201629015 (mental condition impaired ability to process information and read printed material), 201634030 (cancer surgery), and 201635012 (financial institution error).

### **III. Section 671—Grantor Trust Rules**

- A. *Estate of Woelbing v. Commissioner* settled.** A case that would have addressed a number of important issues regarding installment sales to a defective grantor trust, *Estate of Woelbing v. Commissioner*, Docket Nos. 30260-13 and 30261-13 (Dec. 26, 2013), was recently settled. The case involved a sale of Woelbing's stock in Carma Laboratories (Carmex Lip Balm and other skin care products) to an irrevocable grantor trust in return for a \$59 million promissory note bearing interest at the AFR rate. Among the issues: Use of personal guarantees to partially seed the purchasing trust, the basic validity of a DIGIT transaction, whether the §2702 special valuation rule should apply, and whether the AFR interest rate rather than the much higher §7520 interest rate could be employed in valuing the transaction. There was also an enormous variation in the parties' valuation of the Carma Laboratories stock (\$117 million versus \$59 million).
1. The outline of the parties settlement is set out in stipulated decisions (*Estate of Woelbing v. Commissioner*, T.C. Nos. 30260-13 and T.C. No. 30261-13 (March 25 and 28, 2016)). Under the settlement, Woelbing's successors owe no estate or gift tax deficiencies, no penalties are due, and the IRS does not have to make overpayments back to the estate.

### **IV. Section 1014—Basis of Property Acquired From a Decedent**

- A. Proposed regulations answer some questions and raise others.** Proposed regulations under §§ 1014 and 6035, relating to basis reporting, were published in T.D. 9757 on March 3, 2016. The proposed regulations give workable answers to some issues, but raise vexing problems on other issues.
1. **Return filed to make portability election—no requirement for basis reporting.** The proposed regulations make it clear that the valuation statement requirement does not apply to an estate tax return filed only for the purposes of making a portability election. The basis consistency reporting rules apply only to property that increases the federal estate tax liability, and property that qualifies for the charitable or marital deduction isn't subject to these rules.
  2. **Reporting requirement on beneficiary who transfers inherited property.** The proposed regulations impose a new reporting requirement imposed on a beneficiary who transfers the inherited property to a related recipient—a member of the beneficiary's family, an entity controlled by the beneficiary, or a grantor trust. The transferee takes the basis of the original beneficiary, of course—but the beneficiary has a duty to file an information statement with the Service and the related recipient within 30 days of the transfer. There is no explicit (or even implicit) language in §6035 to support this requirement, which considerably expands the reporting requirements by imposing a duty on not just executors but also beneficiaries. Of course, §6035(b) provides that "The Secretary shall prescribe such regulations as necessary to carry out this section."

- a. If a beneficiary disposes of property before its value is finally determined, the beneficiary must provide the executor with the information, and the executor will send the recipient the supplemental statement once the value is finally determined.
3. **Zero basis for unreported assets?** Suppose that property is discovered after the federal estate tax return was filed, or was omitted from the return for some other reason? If the executor reports that property before expiration of the assessment period, the basis of the property will be the estate tax value as finally determined. If, however, the property is not reported before the limitations period on assessment expires, property's basis is *zero*.
    - a. To say that this is an interesting "interpretation" of §1014(f) is—a stretch. Put simply, there is nothing in the statute to support what amounts to a rewriting of the statute. The statutory language does not impose a "zero basis" rule in any circumstance.
    - b. If valid, this rule would have extraordinarily negative tax consequences to the property's beneficiaries, which in some cases could be recouped by suing the executor if the situation arguably was of the executor's action or inaction.
  4. **These items need not be reported.** Under the proposed regulations, the following items need not be included on an information statement: cash, income in respect of a decedent, tangible property (unless an appraisal is required because an item's value exceeds \$3,000), and property sold or otherwise disposed of by the estate. If, however, an executor is not sure what property will be used to satisfy a beneficiary's interest, the executor must list all of the properties that could possibly be used.
  5. **Supplemental statements.** Supplemental statements are required for discovery of property not reported on a return, a change in value due to an audit or litigation, or a change in the identity of the beneficiary due to death or disclaimer.

## V. Section 2031—Definition of Gross Estate—Valuation Issues

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

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

1. The estate tax return filed on October 28, 2010, reported the Picasso's value at \$5 million. On February 2, 2011—three months after the estate tax return was filed—the Picasso sold at

auction for nearly \$13 million. The Service issued a deficiency, determining that the Picasso had a date-of-death value of \$13 million.

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

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

1. The court noted that if a higher use of land is possible if it land is combined with other parcels, the court could consider that higher use, but only if there is a reasonable probability that the lands will be combined with the other tracts in the near future. The court concluded that on the facts presented, assemblage of the parcels was unlikely. While assemblage would yield the greatest economic benefits, there was nothing to suggest that the land trust stakeholders were interested in selling. Also, the land ownership of Pulling's family members was to be disregarded because the courts have rejected family attribution for purposes of valuing property.
2. The estate's expert offered an opinion as to the value of the three parcels if assemblage was not reasonably likely, but the government's expert did not. “[R]espondent argues that even if the estate's property's value should not be based on assemblage, we should recognize a ‘premium to fair market value’ that a buyer of TCTL's property would place on the adjacent property owned by the estate. We find that respondent's theory is too speculative and is not supported by the record.” The court accepted the valuations presented by the estate's expert.

## **VI. Section 2033—Property In Which the Decedent Had an Interest**

**A. Income tax refunds includible in gross estate.** In *Estate of Badgett v. Commissioner*, T.C. Memo. 2015-226, the court ruled that income tax refunds that were due prior to death were includible in the decedent's gross estate because the estate had the right to compel the Service to issue a refund. Involved were a \$404,315 refund from the 2011 tax year and a \$14,126 refund from the 2012 tax year, both distributed to Badgett's estate after his death. The court distinguished cases in which taxpayers had offsetting liabilities. When no offsetting liability exists, §6402(a) “mandates that the

IRS ‘shall’ refund any balance to the taxpayer. There is no indication that decedent was subject to any liability or obligation against which the IRS could offset his overpayments.”

## VII. Sections 2036 and 2038—Retained Interests or Powers

- A. Tax court rules in favor of estate on three issues relating to transfers to a limited liability company.** In *Estate of Purdue v. Commissioner*, T.C. Memo. 2015-249, the Tax Court ruled that (1) assets transferred to a limited liability company (“LLC”) were not includible in the decedent’s gross estate, (2) the gift transfers qualified for annual exclusions, and (3) the estate could deduct the interest on loans from beneficiaries to pay the estate tax. W’s husband H (who predeceased her) was a founding partner of a major Seattle law firm. Beginning in 2000, W and H entered into several planning arrangements recommended by one of H’s partners, an estate planning attorney. Among them, D and H transferred assets to an LLC. The LLC agreement listed seven (“round up the usual suspects”) non-tax purposes for establishing the LLC. H died in 2001; W died in 2007 at age 95.
1. The Service contended that W’s interest in the LLC assets was includible in her gross estate: that W’s transfers to the LLC were not bona fide sales for an adequate and full consideration, that the LLC was a testamentary substitute, and that transfer tax savings were the primary motivation for the formation and funding of the LLC. After reviewing the facts involved in the LLC’s creation (the elderly couple’s five children made most of the planning decisions), the court ruled in favor of the estate. While one of the motives for creating the LLC was to simplify the gift-giving process and secure transfer tax savings, this was not the only motive. The court bought into the estate’s contention that a significant purpose was to consolidate investments into a family asset to permit management by a single adviser.
  2. The Service also contended that W’s gift transfers to the LLC did not qualify for annual exclusions. Because members of the LLC could not transfer their interests without unanimous consent, the donees did not receive unrestricted and noncontingent rights to the LLC interests themselves. However, the donees received rights in the LLC’s income, and the facts satisfied the requirement that, for an income interest to be a present interest, (1) the LLC would generate income, (2) some portion of that income would flow steadily to the donees, and (3) that portion of income could be readily ascertained. Here, the LLC receive interest income from a building that was subject to a 55-year lease, and also held dividend-paying marketable securities. The rent amount for the building was readily ascertainable, and the marketable securities were publicly traded for which expected dividends could be estimated.
  3. With a substantial estate tax to be paid, the estate’s attorney discussed with D’s five children various options that might be pursued. Among the options listed were loans from the LLC and a substantial dividend from the LLC. One child refused to approve a dividend sufficient to pay the estate tax in order to induce her siblings to approve a much larger dividend. When the children were deadlocked, several of them made loans to the estate. Concluding that the loans were bona fide, the Tax Court ruled that the estate could deduct the accrued interest on the loans.
- B. This family limited partnership did not pass muster.** In *Estate of Holliday v. Commissioner*, T.C. Memo. 2016-51, involving a \$785,000 deficiency, the Tax Court ruled that the full value of marketable securities transferred to an FLP was includible in H’s gross estate under §2036 because H retained rights in the securities. The Tax Court concluded that there was an implied agreement that Holliday retained economic benefits in the transferred securities, and that H had an unqualified

right to receive distributions from the FLP, and there was no legitimate and significant non-tax reason for the transfer.

1. H moved into a nursing home in 2003, and her financial affairs were managed by her two sons. In December 2006, H transferred \$5.9 million in marketable securities to a family limited partnership and an LLC with a 0.1 percent general partnership interest. She then sold the LLC to her sons and transferred a ten percent limited partnership interest to an irrevocable trust. On her death two years later, the estate claimed a combined 40 percent discount for H's remaining 89.9 percent LP interest. The Service contended, and the Tax Court agreed, that the 0.1 percent general partnership interest and the ten percent LP interest were includible in H's gross estate, and that the assets in the remaining 89.9 percent LP interest were includible in her gross estate at their undiscounted value.
2. The court concluded that H retained, by implied agreement, the possession or enjoyment of or the right to income from the transferred property. The FLP agreement required the periodic distribution of "distributable cash," defined in the agreement (as it is in many partnership or operating agreements) as cash in excess of current operating needs, as determined by the general partner. One of the son testified that "this seemed to come from some sort of boilerplate for Tennessee limited partnerships, this sort of gave you broad powers to do anything you needed to do, including make distributions. But that wasn't necessary; no one needed a distribution." Oops! Although only one distribution of \$35,000 had been made, this interpretation would essentially give the GP unlimited discretion with respect to setting the level of distributable cash. Also, no books or records other than brokerage statements had been kept, and there was nothing to show that no "distributable cash" was available.
3. The court also ruled that the transfer was not a bona fide sale for adequate and full consideration. Taxpayer cited three non-tax reasons for establishing the FLP, and the Tax Court didn't buy any of them.
  - a. **Protection from trial attorney extortion?** The court noted H had never been sued and she lived in a nursing home, and thus her risk of being sued was minimal. Also, H had retained significant other assets that could be reached by a claimant.
  - b. **Protection against undue influence of caregivers?** The court noted that while caregivers had taken advantage of or stolen from other family members, H's situation was different because her sons managed her affairs and visited her often. Also, this concern was not discussed when the FLP was formed.
  - c. **Preservation of assets for the decedent's heirs?** This argument was unpersuasive, as the assets of H's deceased husband were being managed in trusts without difficulty. Also, H was not involved in selecting the structure to preserve her own assets.
4. **The transfer was not an arm's-length transaction.** There was no meaningful negotiation or bargaining, and H agreed to whatever her sons and attorney decided. The court concluded that the assets were transferred to the FLP solely to take advantage of valuation discounts, and that the transaction was testamentary in character.

## VIII. Section 2042—Life Insurance

- A. Exculpatory clause no help to trustee where insurance policies lapsed.** In *Rafert v. Meyer*, 290 Neb. 219 (2015), Rafert established an irrevocable insurance trust to own three insurance policies whose death benefits totaled \$8.5 million. The beneficiaries were to be Rafert’s daughters. Rafert’s attorney (Meyer) drafted the trust and was the trustee. Meyer completed the policy applications and although the client lived in Nebraska, Meyer used a false address (in South Dakota!) for his contact information. (Why the false address? No explanation is given in the court’s opinion.) The trust contained an exculpatory provision: “The Trustee shall be under no obligation to pay the premiums which may become due and payable under the provisions of such policy of insurance, or to make certain that such premiums are paid by the Grantor or others, or to notify any persons of the non-payment of such premiums, and the Trustee shall be under no responsibility or liability of any kind in the event such premiums are not paid as required.” However, the trustee did have an obligation to furnish annual reports to trust beneficiaries.
1. Rafert made the initial premium payments totaling \$262,000. She made a second set of premium payments, which “were paid directly to an insurance agent by issuing checks to a corporation owned by the agent. However, the premiums were never forwarded to the insurers by the agent or his company, and Appellants do not know what happened to the premiums.” The notices of nonpayment, sent to the South Dakota address, were never received by Meyer. As a result, Rafert and her daughters were unaware that the policies lapsed. Rafert and her daughters sued for breach of fiduciary duty, but the trial court held that Meyer wasn’t liable by reason of the trust’s exculpatory provision.
  2. The Nebraska Supreme Court reversed, and remanded the case for trial. Under the Nebraska statutes, the terms of a trust do not prevail over a trustee’s duty to act in good faith and in the interests of the beneficiaries, and the duty to keep qualified beneficiaries reasonably informed about facts necessary to protect their interests. Further, even if an exculpatory can prevail over the statute, it cannot prevail in this case because Meyer did not adequately explain the exculpatory clause and its consequences to his client.
  3. Moral: If an instrument you draft contains an exculpatory clause, make sure that you explain its implications to the client—and memorialize that you gave that explanation.

## **IX. Section 2053—Administration Expense Deduction**

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

1. Seeking an increase in the amount of the §2053 deduction, the estate filed a motion to have the case restored to the Tax Court's general docket, which the court denied. On appeal, the Court of Appeals for the Seventh Circuit ruled that the Tax Court did not abuse its discretion by refusing to set aside the settlement agreement. The court rejected the estate's argument that there was a mutual mistake of fact. The estate's failure to foresee the daughters' lawsuit did not involve a fact about which the parties were mistaken at the time they reached the settlement. Moreover, the \$14 million claim was the basis for the Service's settlement offer, not the amount actually paid to the children. Also, said the court, the fact that the settlement was calculated as a percentage made no difference; "all monetary settlement amounts can be expressed as a percentage of the amount claimed by the plaintiff."
2. Finally, "the Estate's argument is contrary to the very nature of settlements.... Settlements are meant to substitute certainty for risk, but that does not make them risk free. By settling, parties close the door to new information; that's risky because they do not know whether new information will be helpful or harmful."

## X. Section 2055—Charitable Deduction

- A. Bequest to "the church that I regularly attend"? No charitable deduction for amount paid in settlement.** That's what the will said in *Estate of DiMarco v. Commissioner*, T.C. Memo. 2015-184, which means that you don't have to know what happened to produce this litigation! Immediately before his death, DiMarco regularly attended *two* churches: the Calvary Tabernacle Assembly of God and the New Life Ministries. The will named DiMarco's father as executor, but because the father predeceased the alterante executor was ... the pastor of the church that DiMarco regularly attended. The two pastors of the respective churches sought appointment as co-executors. Not surprisingly, the heirs contended that the bequest was invalid for failing to name an identifiable beneficiary. After several pretrial skirmishes and an attempt to locate other heirs, the parties reached a settlement on March 22, 2012 (approved by the Surrogate's Court on April 26). Under the settlement, the estate was split three ways; one share for each church and one share for the heirs.
1. In the meantime, the estate's Form 1041 for the 2010 taxable year was filed (late) on April 19, 2012—a week before the Surrogate approved the settlement, reporting \$336,000 of income and a \$315,000 charitable deduction as a charitable set-aside. At issue was whether the estate could prove that the possibility that the amount set aside would go to noncharitable beneficiaries was so remote as to be negligible. The estate could not do so, said Judge Laro. The parties' settlement in March allocated the beneficial interest in the estate, but not legal fees, expenses of administration and the co-executor's commissions, which were not resolved until January 2013. "By virtue of the fact that the settlements pertaining to designation of the beneficiaries and consequential legal and administrative expenses were not finalized until after the year at issue and the estate filed its income tax return, we find that the possibility that the funds would go exclusively to noncharitable beneficiaries was not so remote as to be negligible."
  2. Did someone purporting to be a competent attorney prepare draft this rather embarrassing will? Apparently not. "[D]ecedent executed a will while living in Hartford, Connecticut. Decedent had three witnesses sign the will."
- B. No deduction for conservation easement where mortgage on property not subordinated to easement at time of donation.** So held in *Minnick v. Commissioner*, 796 F.3d 156 (9<sup>th</sup> Cir. 2015). Minnick took out a mortgage loan on property in Idaho. Two days after receiving approval of development plans, Minnick donated a conservation easement on parts of the land that were not to



be developed, and took charitable deductions on income tax returns. The Service assessed a deficiency, which Minnick challenged. As the case was approaching trial in Tax Court, Minnick entered into an agreement with the bank subordinating the mortgage to the easement. Following trial in the Tax Court but before the court had issued a ruling, the Tax Court decided *Mitchell v. Commissioner*, 138 T.C. 324 (2012), which held that a mortgage must be subordinated at the time of the donation in order to be deductible. On the basis of *Mitchell v. Commissioner*, the Tax Court ruled for the IRS. Minnick filed an appeal, but while the appeal was pending the Court of Appeals for the Tenth Circuit affirmed the Tax Court in *Mitchell v. Commissioner*, 775 F.3d 1243 (10<sup>th</sup> Cir. 2015).

1. To all of this, the Ninth Circuit Court of Appeals said: “We reject Taxpayers' argument and hold, like the Tenth Circuit in *Mitchell II*, that Treasury Regulation §1.170A-14(g)(2) requires that the mortgage be subordinated at the time of the gift for the gift to be deductible.”
2. **On top of that, an accuracy-related penalty because of that law degree.** The court affirmed the Tax Court’s imposition of a 20 percent accuracy-related negligence penalty under §6662(a). “The record supports the Tax Court's finding of fact that Taxpayers were negligent, so this finding was not clearly erroneous. Even if Taxpayers' ignorance of the subordination requirement was in good faith, it was not clear error for the Tax Court to find that Taxpayers ‘did not have reasonable cause for claiming a charitable-contribution deduction’ because Minnick has a law degree and reading the Treasury Regulation would have given him notice that subordination may have been required.”

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

**D. Taxpayer is arguing for higher valuation of property and Service is arguing for a lower valuation? It must be a conservation easement case.** And it was, in *Palmer Ranch Holdings Ltd. v. Commissioner*, 812 F.3d 982 (11th Cir. 2016). The land’s history is fascinating. Bertha Palmer, the widow of Chicago department store magnate Potter Palmer (he built the Palmer House hotel on State Street in Chicago), purchased 80,000 acres of land in Sarasota, Florida. The land, initially developed for orange groves and livestock pastures, now consists of upscale housing (including more than a few mansions), malls, and the PGA’S Tournament Players Club at Prestancia. Coming down to the present, the case involved 82 acres of Palmer Ranch, for which the bad news—or the good news, depending on your perspective—was that one bald eagle nest was located on the eastern side of the tract. Palmer Ranch, managed by Hugh Culverhouse, Jr., son of the former owner of the Tampa Bay Buccaneers, donated 82 acres as a conservation easement, and took a \$25.2 million deduction on that year’s tax returns. And where are those 82 acres? As Judge Goldberg puts it in his opinion:

“To the west of B-10 lies Sarasota Bay, where the eagles would fly to feed. To allow the eagles to reach their feeding grounds safely, B-10 sported a nest-to-coast flyway in the form of a ‘wildlife corridor.’ The wildlife corridor also provided a habitat to small urban animals of considerably less patriotic interest. Freedom isn't free. Concern over the eagle nest, wildlife corridor, and wetlands on B-10 thwarted plans by the parcel's owner, Palmer Ranch, Inc. (‘Palmer Ranch’) to sell B-10 and the adjacent B-9 for residential development. Ever resourceful, Palmer Ranch turned around and donated a conservation

easement on B-10 to Sarasota County in 2006, a strategy that allowed the corporation to deduct the easement's value from that year's tax returns. But Palmer Ranch's backup plan fell prey to a sharp-eyed IRS, who disallowed the deduction on grounds that Palmer Ranch had overvalued B-10 in calculating the associated easement's worth. Palmer Ranch had valued B-10 at \$25,200,000 on the assumption that B-10's highest and best use was residential development, with development of 360 dwelling units being reasonably probable. The IRS did not share Palmer Ranch's optimism.”

1. The Tax Court ruled that Palmer Ranch was entitled to a charitable contribution deduction of at least \$21 million as the pre-easement value, because the rezoning history of the property left open the reasonable probability that the local land use authority would approve a 360-dwelling development. The IRS argued that the land should be valued at \$7.75 million based on the existing zoning at the time of the donation, and that while zoning changes were being considered at that time, the local government was unlikely to allow more than 100 units. The rather long decision recites the zoning law machinations and “dueling expert” assessments of which zoning changes were likely. In rejecting the Service’s valuation, the court concluded that the highest-and-best-use test to value real property “includes within it an analysis of whether the proposed use is ‘needed or likely to be needed in the reasonably near future.’” The Court of Appeals affirmed the Tax Court’s decision that the highest-and-best-use valuation of the property should be based on the reasonable probability of land use law changes that would allow more development than that of existing law.
2. The case was remanded to the Tax Court because in reducing the contribution deduction from \$25.2 million to \$21 million, the Tax Court mishandled a “comparative sales” valuation issue. Thus, there is a good possibility that Palmer Ranch will get an even larger charitable deduction when the case is returned to the Tax Court. “With regard for B-10's proudest avian residents and for the enduring American principles they have come to symbolize, it is time now to close. We affirm the tax court's determination of B-10's highest and best use, but reverse the ensuing valuation.”

**E. Charitable deduction reduced where post-death redemption plan reduced the amount passing to charity.** In *Estate of Dieringer v. Commissioner*, 146 T.C. No. 8 (2016), the Tax Court upheld a \$4.125 million estate tax deficiency and an \$825,000 accuracy-related penalty. D was the majority shareholder in DPI, a closely held C corporation real property management company in Portland, Oregon. D’s will left her entire estate to Trust which, after making several charitable bequests, left the bulk of her estate to Foundation. In early 2009, the DPI directors discussed the possibility of redeeming some of the DPI shares, in part because of the declining real estate market. However, the plan was not implemented before D’s unexpected death in April 2009. In November 2009, DPI elected S Corporation status, primarily to avoid a \$1374 tax on built-in gains on corporate assets, and also to avoid Foundation being subject to unrelated business income tax. D’s sons implemented a plan taking steps to have DPI redeem some of Foundation’s shares and subscribe for the purchase of other shares. Valuation of the redeemed and subscribed shares included a 50 percent minority discount for D’s substantial majority interest.

1. The estate tax return claimed a charitable deduction based on the date-of-death value of D’s majority interest. Not surprisingly, the court agreed with the Commissioner that the charitable deduction must be limited by the amount that actually passed to Foundation. While there were valid business reasons for the redemption and subscription by D’s sons, the record did not support the redemption valuation. There was no valid business reason for redeeming the shares at a reduced value. The sons thwarted D’s testamentary plan by altering the date-of-death value of her intended donation.
2. **Accuracy-related penalty imposed despite reliance on an attorney.** The court sustained an accuracy-related penalty under §6662(a) despite the estate’s contention that reliance was

made on the advice of DPI's seasoned attorney. The "lawyer's advice regarding the charitable contribution deduction was based on an errant appraisal. The date-of-death appraisal and the redemption appraisal—performed only seven months apart—differed substantially in value. The estate knew that a significant percentage of the value" of the bequeathed shares did not pass to Foundation and that the sons were acquiring a majority interest DPI at a discount.

## **XI. Section 2056—Marital Deduction**

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

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

- A. No adequate disclosure relating to transfer of interests in partnership; statute of limitations did not start to run.** So advised in Field Service Advice 20152201F. Under §6019, the Service must assess gift tax within three years after a gift tax return is filed. However, the three-year statute of limitations does not apply if the transferred interest is not adequately disclosed on a gift tax return. That was the situation here, said the Office of Chief Counsel. The case involved gift transfers of interests in two limited liability partnerships. The partnership names were abbreviated on the Form 709, and both EINs were missing one digit. The description of interests transferred did not indicate whether they were in a general or limited partnership or a limited liability company. A one-paragraph supplement attached to the Form 709 stated that the farmland held by the partnerships was appraised by a certified appraiser and that an overall discount was applied for minority interests and lack of marketability. However, the return and its supplement did not disclose the valuation method used by the appraiser, did not describe the method used to determine the value of the LLP interests, and did not explain the basis for the valuation discounts that were taken.
- B. Should a durable power of attorney grant the power to make gifts?** In drafting durable powers of attorney, for clients with more-than-modest estates it has been a common (and desirable) practice to grant the attorney-in-fact the power to make gifts, with the objective being to minimize or eliminate estate taxes in the principal's estate. Under the Texas Statutory DPOA, for example, by initialing a box the attorney-in-fact can be given the authority to make gifts not to exceed annual exclusions (and "Special Instructions" can be added to authorize larger gifts). Tex. Estates Code Ann. §752.051.
1. **... when the estate tax exemption is \$5.45 million?** I should say, it *used to be* a common (and desirable) practice to give the DPOA agent the power to make gifts. This made sense back when the estate tax exemption was \$175,625, or \$600,000, or \$1,000,000 (or even today, in jurisdictions that have a state estate tax with modest exemptions). But with a \$5.45 million estate tax exemption—destined to increase annually with CPI adjustments—for the vast majority of clients (even those who are "mere millionaires"), potential estate taxes are not a planning concern. Instead, the power to make gifts may open the door to what has become an increasing concern: the use—the exploitation—of DPOAs as instruments of financial abuse of the elderly.

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

### **XIII. Section 2512—Valuation of Gifts**

- A. **Private annuity for a 95-year-old!** Although the taxpayer lost the issue before the Tax Court in *Estate of La Sala v. Commissioner*, T.C. Memo 2016-42, give the estate planner credit for trying—and the estate didn't do too badly. In 2001, 93-year-old L formed an LLC, and on January 1, 2005, (at age 95) L sold a 99 percent interest in the LLC to his daughter and two grandchildren in exchange for a private annuity. On a gift tax return, L valued his retained one percent LLC interest at \$28,000, and valued the transferred interest at \$2,782,000, taking discounts of 50 percent and 35 percent for two fractional equity shares held by the LLC.
  1. The Service assessed a deficiency of \$1,999,000, contending that the LLC was includible in L's gross estate (essentially disregarding the annuity transaction), that the estate had taken excessive discounts, and that the proper valuation of LLC was \$4.37 million. The parties reached a settlement in which the Service conceded that on the date of the annuity transaction L was reasonably expected to survive for at least one year (and he did), and the estate conceded that the valuation discounts were excessive. However, the settlement did not explicitly set out the terms of the settlement. Further negotiations led to the estate's payment of \$235,000 gift tax for the 2005 gift—but that payment did not include interest on that amount.
  2. The estate argued (unsuccessfully) that an implied term of the settlement was that no interest would be paid on the gift tax. Thus, the estate lost—but as losses go, not too bad a bottom line.

### **XIV. Section 2704—Lapsing Rights and Restrictions**

- A. **Long-awaited proposed regulations published.**
  1. **The background: Section 2704.** Section 2704 was enacted in 1990, as one of four Special Valuation rules designed to rein in certain planning strategies that Treasury perceived as having too many cake-and-eat-it elements. The objective of §2704 was to limit valuation discounts for family partnership and LLC interests transferred to family members, where the family continued to control the entity after the transfers. Under §2704(a), a lapse of voting or liquidation rights in a corporation or partnership is to be treated as a taxable transfer if members of the transferor's family hold control of the entity both before or after the lapse. Under §2704(b), certain specified "applicable restrictions" on liquidation are disregarded in determining the value of the transferred interest. However, §2704(b)(3) states that an

“applicable restriction” does not include “any restriction imposed, or required to be imposed, by any Federal or State laws.” As many states have a default rule limiting the ability of a limited partner or member of an LLC to withdraw, this in Treasury’s view provided an easy path to plan around the §2704 restrictions and undercut the statute’s purpose.

- a. In the Obama administration’s Fiscal Year 2010 Budget Proposal (and also the budget proposals for Fiscal Years 2011, 2012 and 2013), a proposal was made to amend §2704, but no bills were even introduced to enact the proposal. The administration stopped working on a legislative solution, and dropped the proposed amendments in the Budget Proposals beginning with Fiscal Year 2014.
  - b. Meanwhile, the §2704(b) regulation project was listed in every annual Treasury-IRS Priority Guidance Plan. Treasury was working on proposed regulations that would implement the administration’s recommended amendments. Section 2704(b)(4) gives the Secretary authority to promulgate regulations to “provide that other restrictions shall be disregarded ... if such restriction has the effect of reducing the value of the transferred interest ... but does not ultimately reduce the value of such interest in the transferee.” For several years now, Treasury officials have been advising professional groups that “we are working on the regulations,” which will be published “soon,” or “any day now.” As for reasons for the delay, one reason may have been that Treasury was waiting—and waiting—to see whether the administration’s proposed amendments would be enacted by Congress. Another reason for the delay was that the issues to be addressed—as are the proposed regulations—are quite complex.
2. **Proposed regulations were promulgated on August 2, 2016.** The proposed regulations, if and when finalized, would dramatically reduce if not eliminate lack-of-control valuation discounts in intra-family transfers of interests in entities. The proposed regulations defy easy summary, and I’m not going to try. (The internet already has a goodly number of good and detailed analyses of the proposed regulations.) Just a few highlights:
- a. **Three-year-year-of death rule.** The lapse of liquidation rights with respect to transfers within three years of death (shades of the old §2035 “in contemplation of death” rule!) would be treated as additional transfers, requiring inclusion of the liquidation value in the transferor’s gross estate—a phantom value—that would not qualify for a marital or charitable deduction.
  - b. **State law default rule restrictions on liquidation are to be disregarded** in valuing a transferred interest if they are not mandated by state law.
  - c. **Disregarded restrictions.** The proposed regulations create a new category of “disregarded restrictions.” The interests of unrelated parties (*e.g.*, a charity) are not to be considered in determining whether the family can remove disregarded restrictions unless an impossible-to-meet test is satisfied.
  - d. **Assignees.** Transfers to mere assignees will be subject to the “disregarded restrictions” rules.
3. **Proposed regulations not effective immediately.** The most significant provisions of the proposed regulations will apply only to transfers made 30 days after the regulations become final. A hearing on the proposed regulations is scheduled for December 1, 2016. Treasury is

sure to receive many comments on the far-reaching (too far-reaching? Where did that three-year rule come from?) proposed regs.

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

- A. Children’s alleged reliance on attorney was not reasonable cause for late filing and late payment of tax.** In *West v. Koskinen*, 2015-2 U.S.T.C. ¶60,691 (E.D. Va. 2015), Mom died on December 27, 2009. On January 3, 2010, one of the children emailed Attorney, seeking guidance as to "what legal follow-ups are needed in the short term." Attorney replied by email the next day, advising that the children would "need to pay [Mom's] final bills, and . . . possibly file a Federal Estate tax return, [Mom's] final 1040, and a trust income tax return.... This all takes as short as a few months or (if an estate tax return is required) as long as [two] years." One of the children responded the following day, stating that he was "sure there will be tax due" on the estate and that he "assume[d]" that the accountant hired to do Mom's 2009 taxes "would also take care of preparing estate taxes." In early February, at a meeting with Attorney to discuss issues relating to the estate, the issue of filing and payment deadlines for the estate tax was not discussed or mentioned. Following this meeting, the children had no further contact with Attorney until November 2010, when they emailed Attorney asking what they "need[ed]" to do next in order to start work on the estate taxes." Oops! Attorney was not concerned that the deadlines had already passed, as he assumed that the accountant had obtained the appropriate extensions, as one of the children had earlier advised that the accountant would "take care of preparing estate taxes." In March 2011, Attorney advised that the final estate tax due was \$1.25 million, and that amount was paid. In response, the Service assessed \$335,000 in late filing and late payment penalties.
1. The Tax Court ruled that the estate’s reliance on an attorney was not reasonable cause so as to excuse the late filing and late payment of tax. Attorney’s January 4 email was insufficient as a matter of law to constitute legal advice as to tax filing or payment deadlines. “Information that an estate tax process might take ‘as long as [two] years’ is not advice about deadlines for filing a return or paying any tax due.”
  2. In that first conference with the executor (or the family members), it is important to discuss the due date for an estate tax return (and income tax returns).