# 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

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# I. Legislation Relating to Estate and Gift Tax

A. **At last! We finally know where we stand regarding the estate and gift tax—for the next 15 months.** On December 17, 2010, President Obama signed a bill whose "short title" is the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." (How's that for a short title?) The Act, known by its acronym, TRUIRJCA, generally provided that the tax provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Bush tax bill") were extended through 2012.

1. **"I'll be baaack."** (And where is the Terminator when we need him?) **All of TRA 2010's tax provisions expire on December 31, 2012**. On January 1, 2013, the law as it existed in 2001, including a $1,000,000 estate tax and gift tax exemption equivalent and estate tax rates than can reach 55 percent, will arise like Phoenix from the ashes—or from a molten puddle, like that relentless "policeman" in Terminator II.

    a. But surely Congress will do address the situation and give a "permanent" solution regarding transfer taxes long before the end of 2012!

    b. The problem is, that was the universal (I didn't say near-universal; I said *universal*) consensus after the Bush tax bill was enacted in 2001: *Surely* Congress would do something by the end of 2009! Well, they didn't (and don't call me Shirley).

2. **There is more than a likelihood that Congress will do *nothing* about transfer taxes until the next lame duck session.** Consider the political situation. The Republicans control the House of Representatives, and are likely to want (among other things) to make the $5 million exemption equivalent permanent—which is about as close to total repeal of the estate tax as you can get. The Repubs, who for sure do *not* want to see a $1 million exemption equivalent on January 1, 2013, will certainly have their way in the House.

    a. However, the Democrats control the Senate (51 Dems plus Bernie Sanders from Vermont plus Joe Lieberman from Connecticut), and more than a few of them believe that Mr. Obama gave up 'way too much in exchange for getting a 13-week extension of unemployment benefits and a nuke agreement. Can we expect the Senate—at least as it is constituted before the November 2012 election—to go along with any form of relief regarding transfer taxes unless there is some not-yet-identified bargaining chip that works in their favor?

       And if the federal deficit continues to loom large, won't the projected revenue from a "mere" $1 million exemption equivalent look rather appealing?

    b. But the Democratic Senate is in pretty much the same fix when it comes to any proposals to tightening the transfer tax rules. Consider some of the items that were either in the Obama administration's fiscal year 2012 budget proposal (published February 14, 2011) or on the Joint Committee on Taxation's wish list: limit valuation discounts to active businesses, replace the willing buyer-willing seller test with family attribution rules, kill off short-term GRATs, etc. Any attempt to tighten the estate & gift tax rules is highly unlikely to even get *on* the launching pad in the Senate.

    c. The estate tax (whether it is seen as a "death tax" or "a give-away to the wealthy") could well be an issue in the 2012 presidential campaign.

d. There is one topic that could well get bipartisan support: Spousal portability, discussed below. Several Democrat-sponsored bills introduced in 2009 and early 2010, and Sen. Max Baucus's Senate Finance bill introduced in early December, included this provision. However, that bipartisan spirit applied to much lower exemption levels. Can we expect that same spirit to exist when the effect will be to give the surviving spouse an exemption equivalent of as much as $10 million?

3. **Bottom line: There is only one thing that is certain: more uncertainty for at *least* the next two years.** This will be a continuing concern for clients and their attorneys.

Wait a minute! Did I say "and their attorneys"??? The moment I typed that, I thought of Alfred E. Neuman, of Mad Magazine fame: "What, me worry?" for the foreseeable future, estate planning attorneys and CPAs are going to pretty busy the next two years.

**B. Exemption equivalent increased to $5 million under estate tax, gift tax, and generation-skipping transfer tax.** For estates of decedents dying in 2010, the estate tax (and GST) exemption equivalent is $5 million and the maximum transfer tax rate is 35 percent. The gift tax exemption was left at $1 million for 2010, and became $5 million on January 1, 2011. The $5 million exemption amounts may even be somewhat higher in 2012, because the new law provides for a cost-of-living increase that year.

1. **It is important for clients to understand that for gift tax purposes, this is *not* an exemption!** This simply means that for taxable gifts (over annual exclusions) of up to $5 million, no front-end gift tax has to be paid. However, the taxable gift will come into the donor's estate tax computation as an adjusted taxable gift. If a client makes a $5,013,000 gift, with a $13,000 exclusion the client will have made a taxable gift of $5 million, which will come back in the estate tax computation as a $5 million adjusted taxable gift. If the estate tax exemption equivalent reverts back to $1 million in 2013, the estate tax will be horrific .

**C. Portability of last deceased spouse's unused estate tax exemption.** Several of the bills relating to the estate tax in 2009 and early 2010 included this feature, under which any unused exemption equivalent of the deceased spouse would be carried over to the surviving spouse. This provision is included in TRA 2010, but with one important change from the earlier proposals. To prevent spouse-stacking—what one CLE speaker referred to as the Larry King rule—portability of the unused estate tax exemption is limited to the unused exemption of ***the last deceased spouse***. The "deceased spouse unused exclusion amount" is the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the surviving spouse's last deceased spouse over the combined amount of the deceased spouse's taxable estate over adjusted taxable gifts."

1. **Estate of deceased spouse must to file and make election on estate tax return**. To secure the carryover of the deceased spouse's unused exemption equivalent, the spouse's executor must file a timely (including extensions) estate tax return.

a. As a consequence, executors of even small estates will want to consider whether to file an estate tax return for the first deceased spouse's estate—if the spouse dies in 2011 or 2012.

b. **Statute of limitations applicable to first deceased spouse's estate remains open**. Notwithstanding any period of limitation on assessing estate or gift taxes for the predeceased spouse, the Service may examine the return of a predeceased for purposes of determining the deceased spouse's unused exclusion amount. §2010(c)(5)B). This would be after the surviving spouse's death, of course.

2. **Portability applies for gift tax purposes as well**. TRA 2010 amends §2505(a)(1) to define the "applicable credit amount" for gift tax purposes by referring to the applicable credit amount under §2010(c) "which would apply if the donor died at the end of the calendar year."

3. **No portability for unused GST exemption**. Portability applies only to any unused portion of the deceased spouse's estate tax exemption. Portability does not apply to any unused GST exemption.

4. **Planning opportunities involving "spousal rollover."** Back when the unlimited marital deduction was introduced in 1981, some CLE speakers (not always with tongue in cheek) suggested that the best estate plan for a wealthy widow was to log onto eharmony.com, and marry a younger man certain to outlive her, thereby securing a marital deduction via a QTIP election.

   a. Portability has changed all of that because the objective, now, will not be to secure a marital deduction but, instead, to secure unused estate tax exemption. That widow should log onto eharmony.com, only now she should be looking for an older man with a small estate—ideally in poor health. This will enable the widow to effectively increase her estate tax exemption to $10 million.

   b. **Divorce and two remarriages in contemplation of death?** Let's take this a step further. H and W, happily married for 40 years, have each accumulated wealth of $10 million, and want to pass as much as they can via dynastic trusts for their children. Good tax planning strongly suggests that they divorce each other (one of them spending six weeks in Reno or Las Vegas if time is short), and then each should marry an elderly, sickly and impecunious bride or groom. With portability, they'll each have up to $10 million in estate tax exemption!

   c. **An even better plan**. Even better, the widow may want to … OK; I'll quit. I think I've carried this far enough.

4. **Effective date: Both spouses must die after 2010 and before 2013**. The portability provision disappears along with the rest of TRA 2010 at the end of 2012. As a consequence, it is not enough for the first deceased spouse to die in 2011 or 2012; both spouses must die within that two-year period—unless Congress extends the portability rule into future years.

   a. This makes planning in reliance on the portability provision problematic, to say the least. Consider the couple with an $8 million community estate. If the first deceased spouse (H) leaves his community share in a form that qualifies for the marital deduction (*e.g*, a QTIPable trust), he would not utilize any of his credit shelter, and portability would leave W with a total of $8 million in exemption equivalent—but only if W dies before 2013 or Congress has extended the portability rule.

   b. In most situations, it probably would be a better idea for the clients to utilize a standard bypass trust plan: There is no assurance that portability will apply after 2012; portability is lost if the surviving spouse remarries and survives his or her next spouse; there is no portability of the GST exemption; and there will be all the benefits of a trust settlement.

**5. What are the chances of the portability provision being made permanent?**

   a. At first blush, chances would appear to be pretty good. Nearly every bill relating to the estate tax introduced in 2009 and early 2010 contained a portability provision—

including several bills introduced by Democrat senators and representatives. The portability idea has support on both sides of the aisle.

b. On the other hand, if the estate tax exemption equivalent remains at $5 million, there may be some queasiness on the Democrat side of the aisle in going along with portability at that level.

c. The Obama administration fiscal year 2012 budget proposal, published on February 14, 2011 ("the Greenbook"), recommends making portability permanent. It begins discussion of the idea, though, by noting that TRA 2010 increased the exemption equivalent to $5 million. "However, after 2011, the amount of this exclusion is scheduled to revert to the amount that would have been in effect had [EGTRRA] never been enacted (thus, $1 million)."

**D. These provisions were not enacted**. Three significant transfer tax proposals, included in several bills that were introduced in 2009 and 2010, are *not* part of TRA 2010. However they *are* included once again in the Obama administration's fiscal year 2012 budget proposal.

1. **GRATs are still with us**. The Obama Administration budget proposal 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. TRA 2010 makes no mention of GRATs.

2. **Provide reporting on a consistent basis between estate tax valuation and income tax basis in the heir's hands.** Under §1014, assets receive a new basis, 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 more than a few heirs have successfully rebutted that presumption. For estate tax purposes, the executor may take a low valuation to reduce estate tax, yet the heir would prefer a higher basis for income tax purposes. As the Obama Administration 2011 budget proposal puts it, "[t]his proposal would require that the basis of the property in the hands of the recipient be no greater than the value of that property as determined for estate or gift tax purposes." No such provision appears in TRA 2010.

3. **Valuation discounts—amendments to §2704.** The Obama administration's 2012 budget proposal once again recommends amending §2704 (the "disappearing rights and restrictions" special valuation rule). The statute as amended would add a new category of "disregarded restrictions." These restrictions would be ignored for transfer tax valuation purpose in valuing an interest in a family-controlled entity (*e.g.*, a family limited partnership) that is transferred to a member of the family if, after the transfer, the restriction could be removed by the transferor or the transferor's family. No such provision appears in TRA 2010.

   a. **Can we expect to see regulations, then?** Section 2704(b)(4) gives the Secretary authority to issue regulations regarding a restriction that has "the effect of reducing the value of the transferred interest for purposes of this subtitle, but does not ultimately reduce the value of such interest to the transferee." For the past six years, (beginning in 2003-2004), the Priority Guidance Plan has included "guidance under §2704 regarding restrictions on the liquidation of an interest in a corporation or partnership." At the Fall 2008 ACTEC meeting, Cathy Hughes, of Treasury's Office of Tax Policy, said that work on such regulations is "at the top of the list," and that regulations would likely be issued by the end of the year. Needless to say, that did not happen. At an ABA meeting

in September 2009, Hughes indicated that the regulations were ready to be published, but were being held back pending possible by Congress.

b. Well, Congress did not amend §2704. Will we see the proposed regulations, then? Time will tell.

**E. Limit GST-exempt trusts to 90 years?** The Obama administration budget proposal published on February 14, 2011, contained a new provision that was not part of last year's budget proposal. The Greenbook notes that many states have either repealed or limited the application of the rule against perpetuities. "As a result, the transfer tax shield provided by the GST exemption effectively has been expanded from trusts funded with $1 million and a maximum duration limited by the RAP, to trusts funded with $5 million and continuing (and growing) in perpetuity." Under this proposal, the duration of a GST exemption would expire after 90 years.

3. Where did the get the 90-year idea? That is the alternate vesting period under the Uniform Statutory Against Perpetuities, which has been enacted in several states.

**F. Planning implications are enormous.** In view of a $5 million exemption equivalent under the estate tax, gift tax and GST, it's a whole new world. For the vast majority of clients, the estate, gift and GST taxes have been functionally repealed.

1. **Up to $5 million ($10 million if married) can be given with no front-end gift tax.** Clients can transfer as much as they would like to their descendants, removing future appreciation from the transfer tax base, with no front-end gift tax cost. If settled in a dynastic trust, $5 million (or $10 million) of GST exemption can be allocated to the trust, effectively removing the property from the transfer system forever (or virtually forever).

2. **The $5 million (or 10 million) exemption can be leveraged with traditional planning tools,** such as family limited partnerships, LLC,s gifts of fractional interests, etc.

3. **More substantial funding with respect to installment sales to defective grantor trusts**. There has always been a concern that unless that grantor trust is funded with assets having a value of at least 10 percent of the value of the asset to be sold to the trust, the trust as a purchaser of the grantors assets may not be recognized and the transaction may be treated as a sham. But now, Client could transfer assets worth $5 million to the trust with no front-end gift tax cost, and then sell $50 million of assets on an installment note with a very low interest rate. If the grantor pays the tax on trust income without reimbursement, his estate is further depleted by the "tax burn."

   a. Because of the ability to allocate GST exemption to a grantor trust, in most instances a DIGIT likely to be far more attractive than a transfer to a GRAT.

4. **Virtually no cap on life insurance trusts.** Until now, there has been essentially a cap on how much can be transferred to an ILIT to cover future premium payments without gift tax consequences—the former $1 million gift tax exemption was the cap. That cap has been essentially removed. With $5 million (or $10 million) gift tax exemption, an extraordinary amount of life insurance can be acquired, to pass to the children and more remote descendants free of tax.

   a. **Why play the Crummey withdrawal power game?** The Crummey withdrawal power is a good way to secure annual exclusions for future premium payments, but it involves an ongoing hassle, especially if the policy premiums are so substantial that we have to worry about "hanging powers." It also precludes or caps annual exclusion gifts of other assets to that beneficiary. Why not, instead, initially fund the trust with (say) $2

million—with no front end gift tax cost? The $2 million then could be used either to acquire a rather whopping single-premium policy or as trust fund to cover future premiums for the first several years. The trust would be a grantor trust, meaning that all income would be taxed to the grantor, but a grantor who might be interested in this transaction likely would not care.

G. **What should we be telling past clients?** For many former clients, Congress has just changed their wills! Consider the couple with standard A Trust/B Trust wills: a formula gift to the spouse or a marital trust that produces "the smallest marital deduction (and thus the largest taxable estate) that will result in no federal estate tax being payable by my estate," with a residuary gift that passes to a bypass trust. If the decedent's estate is less than $5 million, the smallest marital deduction needed to eliminate estate tax will be zero. ***For any will or trust with a marital deduction formula clause, Congress has radically changed the dispositive plan***.

1. In 1981, Congress enacted the unlimited marital deduction, at a time when formula clauses made a gift of "the largest marital deduction available to my estate." Because the "largest marital deduction" would be the entire estate, Congress enacted a transitional rule under which such formula clauses in pre-1982 wills were to be construed under the former "one-half the adjusted gross estate" rule. Under the 2010 Act, however, t***here is no transitional rule!***

2. If we are dealing with the traditional nuclear family (*e.g*., Ward and June Cleaver, Wally and Beaver), this may not be a concern. But if they have different natural beneficiaries, there could be real problems. I think it is strongly desirable to ***contact those former clients!*** Their estate plans should be reexamined. You will be doing them a service! (And you'll be doing them a service when you contact them again at the end of 2012!)

3 **And what are states doing about all of this?** About 20 states and the District of Columbia have enacted statutes protecting beneficiaries from the unintended consequences of the federal estate tax repeal for estates of decedents dying in 2010. Most of these laws interpret such formula clauses as though they refer to the estate tax laws of 2009. However, the Florida and South Carolina laws simply permit the personal representatives, trustees and beneficiaries to bring an action to determine the decedent's intent, when the estate planning document contains a formula provision based on the transfer tax laws.

# II. Section 401—Qualified Plans and IRAs

A. **Service not impressed by court-approved trust amendment designed to create designated beneficiaries.** In Ltr. Rul. 201021038, D, who died after his IRA's required beginning date, had named a bypass trust created by his deceased wife as IRA beneficiary. On D's death, the trust was to be divided into two trusts and continue for two daughters' lifetimes. The trustees were authorized to make discretionary distributions to the daughters and their descendants pursuant to an ascertainable standard. Each daughter was given an inter vivos and testamentary power to appoint among a class of beneficiaries that included charities. The trust had a saving clause providing that it was intended that the trustees make appropriate elections to defer IRA distributions pursuant to the required minimum distribution rules.

1. The daughters realized that they had a problem. The trust was not a conduit trust, because the trustees were allowed to accumulate IRA distributions in the trust. The trust was not a look-through trust, because all trust beneficiaries were not individuals—the daughters had the power to appoint to a charity. The daughters obtained a court order approving a trust

amendment that (i) required the trustees to distribute all amounts received from the IRA, and (ii) removed charities as permissible appointees.

2. The Service ruled that it was not about to give effect to a local court order that modified the dispositive provisions of a trust after the government had the right to tax revenues from the trust property. As distributions could be made to charity, the IRA did not have a designated beneficiary, and minimum distributions were to be calculated using D's life expectancy based on his age at death.

**B. Separate account treatment not available where trust was named as IRA beneficiary**. In Ltr. Rul. 201038019, D's revocable trust named his three children as beneficiaries and as successor co-trustees. D had two IRAs that named the trust as beneficiary. The children propose to divide each IRA into three IRAs, with each child to have two IRAs for his or her benefit. Subsequently, by means of trustee-to-trustee transfers, the six IRAs would be established in D's name without containing any reference to the trust.

1. Sorry, said the Service. The "separate account" rule is not applicable in this situation. At the time of D's death the trust (and not the children) was the named beneficiary. As a result, the separate account rules were inapplicable, and required minimum distributions are to be made based on the life expectancy of the oldest child.

## III. Section 671—Grantor Trusts

**A. Section 678 beneficiary-grantor trust qualifies as a Sub-S shareholder**. Your client (A) is the sole shareholder of Company, which has filed a §1362 election to be treated as an S Corporation. A wants to get a portion of the stock settled in a trust that will benefit A and his children without disqualifying Company's Sub-S status. How should he go about it?

1. Here's one way. Under the facts of Ltr. Rul. 201039010, B created an irrevocable Trust for the benefit of A and A's children. The independent trustee of Trust was given absolute discretion to distribute income to any one or more of the beneficiaries. Under the trust agreement, whenever a gift is made to Trust during B's lifetime, A has the power to withdraw from Trust an amount not to exceed the amount of the gift, with the amount subject to withdrawal in any calendar year limited to the "$5,000 or 5 percent" provisions of §§2041(b)(2) and 2514(e). In each of two years, B made gifts of cash in amounts not greater than the amounts subject to A's withdrawal power. A did not exercise the withdrawal power in either year. The trustee of Trust now wants to purchase stock in Company. A and Company requested rulings that A will be treated as owner of Trust under §678 and that Trust is a permitted S corporation.

2. That will work, said the Service. A will be treated as the owner of Trust under §678 and Trust is a permitted S corporation shareholder, "assuming no gift is made to Trust in excess of the amount subject to A's withdrawal power."

## IV. Section 2010: Unified Credit Against the Estate Tax

**A. Guidance given on portability election.** In Notice 2011-82, IRB 2011-42, published in early October, the Service provided guidance on the §2010(c)(5) portability election to secure the decedent's unused exclusion amount for the surviving spouse. The decedent's executor must timely file an estate tax return (including extensions) on which the amount of the decedent's unused exclusion is computed. The Notice states 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. Estates that must file a return but do not wish to make the portability election are to follow the instructions set out on the Form 706.

1. **Regulations are forthcoming**. Notice 2011-82 advised that the Service intends to issue regulating implementing the portability provisions, and asked for written comments by October 31.

2. **Malpractice concerns**. In comments set out in the October 12, 2011 issue of Daily Tax Reports, attorney John Olivieri (White & Case, New York) and CPA Albert Isacks (Erie, Pennsylvania) expressed the concern that the return requirement creates a malpractice risk. In many situations there will appear to be no need for portability because the decedent's and surviving spouse's estates are relatively small. However, Olivieri said, executors can never be certain. "You would be filing that return to get [the surviving spouse] a bunch of exemption she is never going to use." But if the spouse wins the lottery, her executor is will want to make the executor of the first decedent's estate accountable for not making the portability election.

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

**A. All sorts of (very favorable) valuation decisions in this case!** *Estate of Mitchell v. Commissioner*, T.C. Memo. 2011-94, involving a $10.2 million deficiency, addressed several significant valuation issues: How to value real property subject to long-term leases; whether substantial discounts should be available with respect to gifts made six days before death; and valuation of artwork where the government's appraisal was significantly higher than the appraisal given by the IRS Art Advisory Panel.

1. **Property subject to long-term lease**. M had inherited a beachfront property in Santa Barbara and a 4,000-acre ranch in Santa Ynez, California. M spent little time at either property because he lived in San Francisco. M had great fondness for the beachfront property, his childhood home, and also for the ranch, which has a rich history in California. M had inherited the properties subject to leases executed by his father, and he continued the leasing practice in order to keep both properties in the family. In 2002, M leased the beachfront property to Schwartz (at a $15,000 monthly rent with an escalator provision). Schwartz wanted to buy it so that he could make improvements, but M did not want to sell. The parties negotiated a five-year lease with optional five-year extensions, for a total of 20 years. M died in 2005, and at issue was the value of his "leased-fee interest" in the properties. In a case involving the usual dueling experts, the court had to (i) determine the fee simple value of each property, (ii) value the reversions following the leases, and (iii) place a value on the lessor's rental income streams. The different valuation methodologies are discussed at length in the opinion; the bottom line is that the court was more favorably impressed with the reports of the estate's valuation experts.

2. **Fractional interest discounts**. In 2004, after learning that he had cancer, M deeded 5 percent interests in the beachfront property and the ranch to trusts for the benefit of his two sons. M died six days later, but his death was apparently unexpected. The parties stipulated as to the following discounts: As to the beachfront property, a 32 percent discount for the five percent gifted interest and a 19 percent discount for the 95 percent interest M owned at death. As to the ranch property, a 40 percent discount for the five percent gifted interest and a 35 percent discount for the 95 percent interest M owned at death. The opinion gives no insights as to how these discounts were arrived at.

3. **Artwork**. At issue was the valuation of several important paintings by well-known Western artists Frederic Remington and Charles Russell. The dispute centered on two paintings: Remington's "Casual" and Russell's "Creased." "It is unknown when or from whom his father acquired the paintings. Decedent's father crated the paintings at a general storage facility where they remained for over 30 years. The paintings were not discovered until after decedent's death. It is unclear whether decedent ever knew the paintings were in storage." There were mile-wide differences in the valuations given by the parties' experts. The court came down on the side of the estate's experts, finding that the Remington painting was valued at $1.2 million, and the Russell painting at $750,000.

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

**A. Poorly implemented FLP leads to estate tax inclusion.** *Estate of Turner v. Commissioner*, T.C. Memo. 2011-209, is a case that (1) not surprisingly on the facts, found a gross estate inclusion under §2036(a)(1)—implied retention of economic benefits, (2) somewhat disconcertingly, also held that §2036(a)(2) applied—power to control beneficial enjoyment, and (3) had a most interesting take on Crummey withdrawal powers and the annual exclusion. T and Wife transferred marketable securities and investment assets to an FLP retaining a 1 percent general partnership interest and 99 percent LP interests. Shortly thereafter, they transferred 43.6 percent of the LP interests to family members and family trusts. T died two years later. The Tax Court that one-half the value of the partnership, and not just the value of T's retained interest was includible in T's gross estate.

1. **Implied agreement for retained enjoyment of the transferred assets.** The Tax Court had no difficulty applying §2036(a)(1) to the partnership. The court ruled first that the transfers were not bona fide sales for adequate and full consideration. There were no legitimate and significant non-tax reasons for creating the FLP. "The usual" reasons trotted out—centralized management, resolution of family discord, asset protection—were not persuasive. T sat on both sides of the transaction in setting up the LP. Second, there was ample evidence of an implied retention of economic benefits. The LP paid T and his wife a $2,000/month management fee although they actually provided few services, T and his wife had the right to amend the agreement without consent of the limited partners, and T transferred most of his assets o the LP. [Hmmm. T and his wife retained $2 million in assets, which generated $90,000 per year.]

2. **Retention of power to control beneficial enjoyment.** Having concluded that §2036(a)(1) resulted in a gross estate inclusion, the Tax Court could have stopped there. However, the court went on to conclude that §2036(a)(2) (the right to designate the persons who will enjoy the property or its income) also applied. (1) T was effectively the sole general partner—Wife was also a general partner but, said the court, §2036(a)(2) applies if the power is exercisable "alone or in conjunction with any person." (2) As general partner, T could amend the partnership agreement without the consent of the limited partners. (2) As general partner, T had sole and absolute discretion to make pro rata distributions of partnership income.

**B. And another basket FLP case.** *Estate of Liljestrand v. Commissioner*, T.C. Memo. 2011-259, involving a $2.57 million deficiency, is another "bad facts" case. D's revocable trust transferred 13 real estate properties (all of D's income-producing assets), to an FLP, leaving D with his house and some minor assets. D initially received 98.98 percent of the partnership interests, but he transferred 14.8 percent of the interests to trusts for his children. Thereafter—here we go again—nothing was done right. No bank account or capital accounts were created for two years, the FLP and revocable trust commingled funds, disproportionate distributions were made to D to pay living expenses, no

partnership returns were filed for the first two years, there was one meeting of FLP members in seven years, the transactions were not at arm's length; etc. etc.

1. The Tax Court ruled that all of the partnership assets were includible in D's gross estate. D had retained the economic benefits of the property, and the transfers did not involve bona fide sales: The court did not accept the purported nontax reasons for establishing the FLP s; and the transactions were not at arm's length.

**C. And yet another FLP basket case.** *Estate of Jorgensen v. Commissioner*, 2011-1 U.S.T.C. ¶60,619 (9th Cir. 2011), involving a $797,000 deficiency, affirmed the Tax Court ruling that transfers to two family limited partnerships were properly included in J's gross estate. J had retained the economic benefits and control of the property, and the transfers did not involve bona fide sales: There were no legitimate nontax purpose for forming the FLPs; the transactions were not at arm's length; and the partners failed to follow partnership formalities, such as maintaining sufficient records and treating the FLPs as separate entities. Also, the record reflected an implied agreement that J would retain economic benefits in the transferred property.

1. After her husband's death J transferred securities to two FLPs on the recommendation of the family estate planning attorney, who advised that "hopefully your limited partnership interest in JMA partnership will qualify for the 35% discount…. Obviously, no one can guarantee that the IRS will agree to a discount of 35%, however, even if IRS agreed to only a discount of 15%, the savings to your children would be $145,066.00, and there can be no discount if the securities owned by you continue to be held directly by you." The attorney never personally met with J. Instead, all of the planning discussions relating to the LP were with Son, Daughter and Son-in-Law, none of whom made contributions to the LP. Son and Daughter were named general partners. J then made gifts of LP units to children and grandchildren in excess of annual exclusions; no gift tax returns were filed.

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   a. At one point, Son asked attorney whether there was a way "to access some of this money that's mine." The attorney explained that Son could take a loan, but Son "was surprised that he would have to pay interest." Son testified that "it took a while to get my head around the fact that it wasn't just like a bank account you can get money out of." Loans totaling $133,000 were made, and Son paid interest. (The loans were repaid after J's death.)

2. The estate argued that while J had retained *some* benefits in the transferred property (by writing checks on partnership accounts to pay personal expenses and to make gifts), the amounts should be considered *de minimus*, and application of §2036 should be limited to the actual amounts accessed by J. *De minimus* indeed! J had written $90,000 in checks on the accounts, and the FLPs paid $200,000 in estate taxes on her behalf. Because the Tax Court did not clearly err in concluding that there was an implied agreement that J could have accessed *any* amount, the actual checks she wrote did not undermine the lower court's finding that she could have accessed more.

3. The assets transferred (marketable securities) did not require significant or active management, there was a disregard of partnership formalities, and the nontax justifications for creating the partnerships were either weak or refuted by the record. The Tax Court properly found that the overriding objective purpose appeared to be a mere "recycling of value" into the partnership vehicle to permit discounted gift-giving and/or reduce the ultimate estate tax owed by reducing the stated value of the securities by way of discounts.

4. **But children and grandchildren entitled to equitable recoupment for income taxes paid.** After J's death, her children and grandchildren paid capital gains tax on the sale of certain partnership assets. The Tax Court concluded that as a result of the gross estate inclusion and

the resulting step-up in basis, the estate was entitled to equitable recoupment for the overpayment of income taxes paid by the partners. The doctrine of equitable recoupment applied because (1) the taxpayers were barred by the statute of limitations from recovering the overpayment, (2) the stock included in the gross estate and the stock sold by the partnership were the same items; (3) the estate tax and the income tax were both imposed on the same assets inconsistently; and (4) there was a sufficient identity of interest between J's estate and her descendants. (This portion of the Tax Court decision was not appealed.)

D. **Deed gave fractional interests of remainder interests, but grantor retained right to possession**. In *Estate of Adler v. Commissioner*, T.C. Memo 2011-28, Adler owned a 1,100-acre tract of land in Carmel, California. A 1965 deed conveyed one-fifth interests in the land to Adler's five children. However, the deed expressly reserved to Adler the "full use, control, income and possession" of the property for his natural life. Not surprisingly, the Tax Court ruled that, as Adler had made a transfer with a retained right to possession for life, the full $6.4 million value of the land was includible in Adler's gross estate, with no fractional interest discounts.

E. **After all of those deeds, grantor still retained possession of the property for life**. In *Estate of Van v. Commissioner*, T.C. Memo 2011-22, Van purchased a home in San Mateo, California for $250,000, but the $170,000 downpayment and the $80,000 in note payments were all made by Van's daughter and son-in-law. Immediately after acquiring title, Van conveyed title to herself and two grandchildren as joint tenants. Some years later, the grandchildren conveyed their interests back to Van Several years after that, Van transferred title to a revocable trust and, several years later, transferred title to herself as trustee of a trust for a daughter and grandchildren. However, "Van retained possession or enjoyment of the … house until she died, even after title to it began ducking and weaving throughout her extended family." Thus, the full value of the house was includible in Van's gross estate as a transfer with a retained life estate.

1. **No purchase money resulting trust on these facts**. The estate contended that a purchase money resulting trust in favor of the daughter and son-in-law should be found, as they had furnished the consideration for the property's acquisition. In California, however (as in most states), no presumption of resulting trust arises when the transaction is between child and parent. Instead, a presumption of gift arises. Moreover, the circumstances surrounding the purchase of the home led to the conclusion that neither Van nor her daughter and son-in-law intended that she was taking title on the couple's behalf.

## ViI. Section 2041—General Powers of Appointment

A. **Ascertainable standard issue: modification to clarify meaning of "or other life emergency" passes muster.** In Ltr. Rul. 201039003, a trust gave the income beneficiary-trustees the power to advance income to a beneficiary for "reasonable care, maintenance, or education, or on account of any illness, infirmity, ***or other life emergency.***" The Service approved a judicial modification clarifying that "or other life emergency" modified the trust's ascertainable standard provisions. Noting that the applicable state law gave no guidance on interpretation of this phraseology, the ruling reviewed relevant court decision to make its determination. Citing *Estate of Budd v. Commissioner*, 49 T.C. 468 (1968), and *Estate of Pardee v. Commissioner*, 49 T.C. 140 (1967), the Service ruled that the use of the word "other" before the word "emergency" limited the meaning of the emergency to the type of emergencies that could arise with respect to the ascertainable standard provisions. As a consequence, the beneficiary-trustees were not treated as having released a general power of appointment as a result of the trust modification.

1. The ruling also determined that division of the trust into five trusts for the benefit of the settlor's grandchildren and great-grandchildren did not affect the trusts' GST-grandfathered status.

B. **Modification to restrict "5 or 5" drawdown power to month of January approved.** The two trusts involved in Ltr. Rul. 201042004 gave the trustee-income beneficiary an annual noncumulative power to withdraw principal, not to exceed five percent of the trust assets. Oops! The trusts did not limit the time period during which the withdrawal power could be exercised, meaning that regardless of the day on which the beneficiary died, five percent of the trust's value would be includible in his gross estate under §2041.

1. The Service gave its blessing to a state court modification that limited exercise of the beneficiary's withdrawal power to the month of January. The ruling also concluded that merger of the two trusts (which had nearly identical terms) into one trust would not affect the trusts' GST-grandfathered status.

2. **Drafting tip**. The provision in Ltr. Rul. 201042004 was an access-to-principal provision, not a means of securing annual exclusions to cover additions to the trust. In drafting such withdrawal provisions, the beneficiaries should be given 30 days to exercise the withdrawal power after receiving given written notice. Such a provision is expressly sanctified in Rev. Rul. 73-405, 1973-2 C.B. 321. Don't use "during the month of December," for the donor may make an addition to the trust during the last two weeks of the year. While such a provision passed muster in *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), keep in mind that the Service really doesn't like Crummey withdrawal powers, and you'd be rubbing sand in the Commissioner's face.

## VIII. Section 2053—Administration Expense Deduction

A. **Contingent and uncertain claims—guidance on filing protective claim for refund**. In October 2009, the Service issued final regulations taking the position that except for claims that are "ascertainable with reasonable certainty," no deduction will be allowed for contingent or uncertain claims until actually paid by the estate. The regulations briefly addressed the filing of protective claims, and advised that further guidance would be forthcoming. That guidance has been given by Rev. Proc. 2011-48, 2011-42 I.R.B. 527. The revenue procedure describes, in considerable detail, the timing of filing a protective claim, who can file the protective claim, the specifics required in identifying the particular claim or expense, and the advisability of contacting the Service if the taxpayer does not receive acknowledgement that the IRS has received the protective claim within a specified period of time.

1. **Dot all i's and cross all t's**. In *Lewis v. Reynolds*, 284 U.S. 281 (1932), the Supreme Court held that the IRS can examine all items on a return to offset any refund claim, even after the statute of limitations has run on a particular claim. In Notice 2009-48, the Service advised that "generally" it will limit the scope of review to the deduction that was the subject of the protective claim. In Rev. Proc. 2011-48, the Service advises that the limited review will not apply to "[a] taxpayer that chooses not to follow or fails to comply with the procedures set forth in this revenue procedure.

B. **Interest on 15-year balloon *Graegin* note was deductible where loan was from trust with same trustees and same beneficiaries.** In *Estate of Duncan v. Commissioner*, T.C. Memo. 2011-255, D had transferred a substantial part of his estate, including illiquid oil and gas businesses, to a revocable trust. By his will, D exercised a special power of appointment over assets in a trust created by D's father to appoint the assets to an irrevocable trust whose terms were virtually

identical to the terms of his revocable trust. The revocable trust borrowed $6.5 million from the irrevocable trust to pay federal and state estate taxes, debts and expenses. Inspired by *Estate of Graegin v. Commissioner*, T.C. Memo. 1988-477, the loan was evidenced by a 15-year balloon note that prohibited repayment. The 6.7 percent interest rate on the note was quoted by the banking department of the corporate co-trustee, at a time when the AFR was 5.02 percent and the prime rate was 8.25 percent. (Those were the days!) It turned out that the revocable trust was able to generate $16 million in cash in the first three years, but the Tax Court was persuaded that the revocable trust was not expected to generate sufficient cash to repay the loan within three years. The estate claimed a $10.7 million deduction for the interest that would be paid at the end of the 15-year term of the loan. The Service denied the deduction (although at trial the government stated that it was willing to recognize a deduction for three years of interest).

1. **The Tax Court allowed the deduction in full**. Although the lender and borrower trusts had the same trustees and the same beneficiaries, this was a bona fide debt between two separate entities. The loans were actually and reasonably necessary because the revocable trust could not meet its obligations without selling assets at discounted prices. On the facts presented, the 15-year term of the trust and the interest rate were reasonable, and the court refused to second-guess the trustees' decision in making the loan.

C. **But in this case, interest on loan to pay estate taxes was not deductible**. So ruled in *Estate of Stick v. Commissioner*, T.C. Memo 2010-192. D's trust, which was the residuary beneficiary of his estate, borrowed $1.5 million from Foundation to pay the estate's federal and state estate tax liabilities. The estate deducted $656,250 of interest on the loan, and also took interest expense deductions on its Forms 1041. No go, said the Tax Court. Because the estate presented no evidence to establish that the loan was necessary to meet its tax obligations, the estate did not prove that the government's denial of the deduction was in error. In addition, the estate appeared to have sufficient liquid assets to pay the tax obligations without having to borrow the funds.

D. **Deduction denied for uncertain value of claim against estate**. *Estate of Saunders v. Commissioner*, 136 T.C. No. 18 (2011), involved a $14.4 million deficiency and a $5.8 million accuracy-related penalty. (The penalty was conceded by the estate.) A malpractice claim for $90 million was filed against D's predeceased spouse's estate. The allegation was that the spouse, a lawyer, had acted as a secret IRS informer against his client regarding some Swiss bank accounts. The $30 million appraised value of the claim was taken as a deduction against D's estate. Three years after the claim was filed, the parties settled for $250,000. D died in 2004, long before the effect of the 2009 amended regulations to §2053 that address in detail the deductibility of contingent claims. The controlling regulation provided that a claim was deductible if the value of the claim was "ascertainable with reasonable certainty, and will be paid." Reg. §20.2053-1(b)(3) (as applicable to decedents dying before Oct. 20, 2009).. That this test was not met was reflected by the reports of the estate's four valuation experts, whose appraisals varied by $11 million.

1. The Tax Court noted that various court of appeals decisions differed as to the extent to which events subsequent to the date of death may be considered in determining he deductibility of a claim. Here, the case was appealable to the Ninth Circuit, which had stated, in dictum in *Propstra v. United States*, 680 F.2d 1253 (9th Cir. 1982), that "[t]he law is clear that post-death events are relevant when computing the deduction to be taken for disputed or continent claims." Thus, said the court, the claim was limited to the $250,000 paid during the estate administration.

E. **Homemaking and providing other services not sufficient consideration to support a cohabitation contract**. So held in *Estate of Shapiro v. United States*, 634 F.3d 1055 (9th Cir. 2011), reversing a Nevada district court decision that had granted summary judgment in favor of the estate. D and C lived together for 22 years but never married. During those 22 years, C cooked, cleaned, and managed household employees such as the gardener, housekeeper, and pool man. D

paid for C's living expenses and provided her with a weekly allowance. In 1999, C, having learned that D was having an affair with another woman, sued in Nevada state court, claiming breach of express and implied contract, breach of fiduciary duty, and quantum meruit. C contended that she and D had agreed to pool their resources and to share equally in each other's assets. D died in February 2000, while C's action was pending. The estate filed an estate tax return in May 2001, paying $10.6 million in estate tax and GST tax. In the state case, in September 2001 a jury returned a verdict in favor of the estate. C appealed, and the parties settled her claim for $1 million.

1. The estate filed an amended estate tax return, seeking to deduct $8 million under §2053(a)(3). When the service disallowed the deduction, the estate filed suit in federal court seeking a $2 million refund. According to the complaint, an expert valued the claim at $5 million as of the -date of D's death. The estate later amended its claim, seeking a refund for the decrease in property value due to notices of lis pendens recorded by C on D's properties during her lawsuit. In response to a motion for summary judgment, the court concluded that the value of the claim is "a factual issue that precludes summary judgment" and the value of the claim "remains for the district court to determine on remand."

2. The district court concluded that C did not make sufficient contributions to the estate to provide consideration for the support she received from D, that there was no contract between them, and that the money she sought in the contract action was, in fact, a gift from D.

**F. But these were proper medical expenses!** (I couldn't pass this one up.) In *Halby v. Commissioner*, T.C. Memo. 2009-204, H claimed medical expense deductions that included "therapeutic sex" and "massage therapy to relieve osteoarthritis and enhance erectile function through frequent orgasm." H also claimed medical expense deductions for pornography, which he claims to have sometimes used in lieu of taking Viagra. H supported the deductions from entries in a journal in which he recorded his visits to prostitutes (referred to in the journal as "service providers") and their costs, as well as the cost of pornography and books on sex therapy.

1. The Tax Court was not impressed, and denied the deductions. Moreover, "[p]etitioner did not have reasonable cause or a reasonable basis for claiming the deductions at issue. Petitioner has been an attorney for 40 years and specialized in tax law. Petitioner should have known that his visits to prostitutes in New York were illegal and that section 213, the regulations thereunder, and case law do not support his claimed deductions. Accordingly, petitioner is liable for the section 6662 [accuracy-related] penalty."29001

# IX. Section 2055—Charitable Deduction

**A. Property passing pursuant to settlement qualified for deduction**. In *Estate of Palumbo v. United States*, 2011 WL 860418 (W.D. Pa. 2011) (unpublished) P had created a charitable trust. At the time P died, a 1999 will was in effect. The will's residuary clause was supposed to name the charitable trust as the trust remainder beneficiary, but due to a scrivener's error the will contained no such provision. As a result, P's son claimed that as the sole heir, he was entitled to the residuary estate. The parties reached a settlement agreed to by P's son, the charitable trust, P's wife and daughter-in-law, and the Pennsylvania attorney general. Under the agreement, the trust received $11.7 million and P's son received $5.6 million and real property. The agreement was approved in state court.

1. The court held that P's estate was entitled to a $11.7 million charitable deduction. P "repeatedly manifested his intent to leave the residuary of his estate to the Charitable Trust as is evidenced by earlier iterations of his Last Will and Testament and other documents provided to this Court by the parties." P's attorney had admitted to making the error in

preparing the Will during a malpractice action brought against him. Because the negotiations were held at arm's length, all of the legatees signed the settlement agreement (which was approved by the court) and there is no evidence of collusion among the parties to the agreement or their respective attorneys, the charitable donation should be allowed.

2. **But no court costs and attorney's fees for the taxpayer**. Having met with success on its charitable deduction claim, the estate filed under §7430 for court costs and attorney's fees on the ground that the position taken by the government was not substantially justified. Not so, said the court in *Estate of Palumbo v. United States*, 2011-12 U.S.T.C. ¶60,616 (W.D. Pa. 2011). Although the taxpayer prevailed on the charitable deduction issue, the Service's position that a charitable contribution through a settlement agreement was not deductible was not unreasonable.

# X. Section 2056—Marital Deduction

**A. Be careful if you super-copy from one clause to the next; judicial modification saves the marital deduction**. It is likely that Ltr. Rul. 201132017 arose in a community property state, as the estate plan involved is frequently employed in such states. H and W were co-trustees of a trust (probably a revocable trust). On the death of the first to die, the surviving spouse was to be the sole trustee, and the trust was to be divided into three trusts: a Marital Trust, a By-Pass Trust, and a Survivor's Trust. Under the trust, debts, expenses and taxes in the decedent's estate were to be charged against the By-Pass Trust. (So far, so good; that's where such expenditures should come from.) However, as drafted by Attorney 1 the trust further provided that on the surviving spouse's death, debts, expenses and taxes were to be charged against the By-Pass Trust, not the Survivor's Trust. (Oops! Not only would that reduce the bypass trust corpus; it could be seen as giving the spouse a general power of appointment over the Bypass Trust.) The problem was discovered by Attorney 2.

1. **Attorney eats crow**. Attorney 1submitted an affidavit stating (according to the ruling) that "the language in Section 4.01 [the Survivor's Trust] was copied from Section 3.01 [the By-Pass Trust] but improperly edited and, therefore, the reference to the By-Pass Trust, rather than the Survivor's Trust, remained."

2. **Relief granted**. Concluding that the parties' intent was clear and that a drafting error had occurred, the Service gave its blessing to a judicial modification that moved the obligations to the Survivor's Trust. The modification did not constitute the exercise or release of a general power of appointment.

**B. "It is my desire" given mandatory and not precatory construction; marital deduction bequest reduced.** In Ltr. Rul. (T.A.M.) 201126030, Article III of T's will, captioned "Statement of Intent," provided: "To the extent that I own any equity interest at my death in any of the following closely held investments, *i.e.* [assets], it is my desire that such equity interests be retained and that each of them be distributed so that all such equity interests are ultimately owned in equal shares by" T's children. The will made several other specific bequests (including bequests to T's spouse S), and the residuary estate was devised to a family trust. T's estate was heavily indebted, and at issue was the operation of the state's "abatement of legacies" statute. Under the statute, (which is typical), debts are first charged against the residuary estate, and then specific bequests are abated pro rata.

1. If the language of Article III was determined to be mandatory (meaning that specific bequests were made), the residuary estate would be much smaller and other bequests (including the marital bequests to S) would be sharply reduced by the payment of debt. If the Article III language was construed as precatory and the Article III assets were part of the residuary, the

residuary estate would still be exhausted, but the impact on specific bequests would not be as substantial. In a detailed analysis of the state's will construction cases, the National Office concluded that the Article III language was mandatory notwithstanding the "it is my desire" language. As a result, the bequests to the spouse, and thus the marital deduction, were reduced.

2. What's the lesson here? It is (or should be) well understood that if an estate must pay estate tax, the will provision relating to apportionment of taxes is not simply an administrative provision designed to give guidance to the executor; it has a substantive effect on the amount passing to the respective beneficiaries. So also here, where the estate was heavily indebted. If that was the situation when T's estate plan was prepared, the issue of "against whom should debts be charged" would be an important one—not only substantively (who gets what?) but in this case also for marital deduction purposes.

3. Another lesson: Mandatory provisions should be just that: "I direct," or "the executor shall." If the client's objective is to give a non-enforceable precatory suggestion, don't leave the question open to interpretation, as occurred here.

C. **Long-term relationship did not add up to a common-law marriage; marital deduction denied**. In *Beat v. United States*, 2010-2 U.S.T.C. ¶60,602 (D. Kan. 2010), D and S (named as executor under D's will) were in a romantic relationship for 26 years, which began while each was married to another person. However, the evidence established that the couple did not hold themselves out to be married, as required for a common-law marriage under state law. To the contrary, the evidence showed that the couple worked to avoid the implication that they were married, and even tried to conceal their relationship at times. They reported that they were single on all property conveyances, business transactions, and tax filings. Evidence was presented showing that D was aware of the potential estate tax savings that the marital deduction would provide, but chose to consider himself unmarried. The executor's contention that she claimed the marital deduction in good faith was unconvincing. D's attorney testified that he told S that she was not D's common-law wife, and there was evidence that S concealed certain information from her attorney in order to establish that such a marriage existed.

1. **Duty of consistency was also a bar**. During the course of their relationship, D and S filed separate income tax returns on which they claimed to be either single or head of a household. S now attempted to change her position regarding their relationship status after the statute of limitations for the income tax returns had expired. Because the IRS relied on S's and D's representations that they were not married and the Service was barred from claiming otherwise by the statute of limitations, S was estopped from claiming a marital deduction under the duty of consistency.

D. **Property received pursuant to settlement agreement qualified for deduction**. In Ltr. Rul. 201046004, the terms of an irrevocable trust were inconsistent with the terms of the marital agreement D and S had entered into. S and D's daughter from an earlier marriage both obtained legal representation to resolve the inconsistencies. Because the amount S received in the settlement was the product of arm's length negotiations and the interests each received reflected their economic interests, the property passing to S pursuant to the settlement agreement qualified for the marital deduction.

E. **Protective QTIP election was made too late**. In *Estate of Le Caer v. Commissioner*, 135 T.C. 288 (2010), a QTIP election was made on D's timely filed estate tax return with respect to a certain portion of D's gross estate. Three years after the return was filed, the estate's attorney filed a document purporting to make a protective QTIP election with respect to D's personal residence.

Too late, said the Service. Under Reg. §20.2056-7(b)(i), a protective QTIP election must be made no later than the due date for the estate tax return.

# XI. Section 2501—Imposition of Gift Tax

A. **California law extending community property system to registered domestic partners—no gift tax consequences.** Effective January 1, 2007, a California statute treats the earned income of either partner as community property for state income tax and property law purposes. In Ltr. Rul. 201021048, the Service ruled that a division of income under the statute does not constitute a gift to the non-employed spouse. In support of the ruling, the Service cited *Poe v. Seaborn*, 282 U.S. 101 (1930), and *United States v. Malcolm*, 282 U.S. 792 (1931). Although those cases involved the federal income tax, their rationale also applied to the federal gift tax. The ruling noted, however, that the domestic partiers must file separate income tax returns, each reporting one-half of their community income. They cannot file a joint return, as they are not husband and wife.

# XII. Section 2503—Taxable Gifts

A. **Wow! This Crummey drawdown provision qualified for annual exclusions**. *Estate of Turner v. Commissioner,* T.C. Memo. 2011-209, had a most interesting take on Crummey withdrawal powers and the annual exclusion. For the three tax years in question, with respect to a policy in an irrevocable life insurance trust, T paid the premiums directly to the insurance company and not to the ILIT trustee. The premium payments qualified for annual exclusions—even though the beneficiaries did not know of the additions to the trust, and didn't even know that the trust gave them withdrawal rights! "The terms of Clyde Sr.'s Trust gave each of the beneficiaries the absolute right and power to demand withdrawals from the trust after each direct or indirect transfer to the trust. The fact that Clyde Sr. did not transfer money directly to [the] Trust is therefore irrelevant. Likewise, the fact that some or even all of the beneficiaries may not have known they had the right to demand withdrawals from the trust does not affect their legal right to do so."

1. In this respect, the facts and holding are right in line with *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), and *Cristofani v. Commissioner*, 97 T.C. 74 (1991)—but *Crummey* was a 9th Circuit case and *Cristofani* was appealable to the 9th Circuit. *Estate of Turner* arose in Georgia, and is appealable to the 11th Circuit.

B. **Drafting the Crummey withdrawal right—how to avoid a serious drafting error**. More than a few Crummey withdrawal provisions are drafted along the following lines:

> Notwithstanding any other provisions of the trust, the trustee shall, ***within seven days after receipt*** of any additional contributions to the trust by the Grantor or any other person, give written notice to each beneficiary of the addition to the trust, whereupon each such beneficiary shall have the unrestricted right ***for a period of 30 days after the date of the receipt of such notice*** to demand and withdraw from the trust a share of such property equal in value to….

1. The problem: What if the trustee gives written notice but not within the seven-day period; or—as happens all too often—the trustee does not give the beneficiary written notice at all? Because the beneficiary's right to make a demand is conditioned upon the timely receipt of written notice from the trustee, if no such notice is given the beneficiary has no demand right, and the addition does not qualify for an annual exclusion.

2. Solution: The Crummey withdrawal right should be drafted along the following lines:

If at any time any additional contribution is made to the trust by the Grantor or any other person, each designated beneficiary of the addition shall have the absolute right, at all times during the 30-day period ***commencing at the time of such addition***, to withdraw from such addition….

a. But isn't there a problem if the beneficiary does not know that an addition to the trust has been made? The answer is no. In *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968), the beneficiaries did not know that additions had been made to the trust. In fact, the Crummey children did not know that a trust existed that gave them a demand right! See *Commissioner v. Estate of Noel*, 380 U.S. 678 (1965): Application of the estate tax "depends on a general legal power to exercise ownership, without regard to the owner's ability to exercise it at a particular moment."

# XIII. Section 2511—Gift Tax Transfers in General

A. **Gifts of LLC interests—no summary judgment based on application of step transaction doctrine.** In *Linton v. United States*, 630 F.3d 1211 (9th Cir. 2011), involving the valuation of gifts of LLC units, the Court of Appeals reversed the district court's grant of summary judgment in favor of the government because there were genuine issues of material fact as to the sequence of the transactions at issue.

1. Linton formed an LLC in December 2002. On January 22, 2003, Linton transferred one-half of his interest to his wife and funded the LLC with property and securities. On the same day, the Lintons created trusts for their children and gifted a percentage of their LLC interests to the trusts. The Lintons signed but did not date the trust and gift documents. Several months later, the couple's attorney filled in the missing date by dating the documents January 22, 2003, when the intent, according to the Lintons' accountant and attorney, was to date the documents January 31, 2003. On their gift tax returns, the Lintons took 47 percent lack of control and marketability discounts. The Service denied the discounts on the ground that the Lintons' gifts were not gifts of the LLC interests, but instead were indirect gifts of the underlying assets. The district court granted the government's motion for summary judgment. The court also denied the Lintons' request to reform the documents to indicate that the trusts' creation and funding occurred on January 31, noting that even if the trusts were so reformed, the step transaction doctrine would apply.

2. The Court of Appeals reversed on two grounds. First, there were material issues of fact as to when the couple had satisfied the "intent to donate" element of a completed gift, and when the gifts were considered complete under Washington law. Second, summary judgment was not appropriate with respect to application of the step-transaction doctrine because the transfer did not meet the requirements for any one of the three tests used to determine the applicability of that doctrine. The step transaction doctrine "collapses 'formally distinct steps in an integrated transaction' in order to assess federal tax liability on the basis of a 'realistic view of the entire transaction.'" To apply the doctrine, a transaction must satisfy at least one of three tests: the end result test, the interdependence test, or the binding commitment test.

   a. The "end result" test asks whether a series of steps was undertaken to reach a particular result and, if so, treats the steps as one. The court held that even if the end result test applied to merge the steps into a single transaction, the Lintons' gifts would still be of LLC interests and the tax results wouldn't change.

b. The "interdependence" test asks whether the steps were so interdependent that the legal relations created by one transaction would have no meaning without completing the other steps. Here, said the court, the Lintons' creation and funding of the LLC was a separate transaction with an independent purpose from gifting the LLC interests.

c. The" binding commitment" test asks whether, at the time the first step of a transaction was entered, there was a binding commitment to take the later steps. On the facts presented, the test was inapplicable because the transactions took place over the course of a few months, and possibly over only a few weeks.

# XIV. Section 2512—Valuation of Gifts

A. **"Defined value" clause upheld in gifts of LLC interests.** In *Petter v. Commissioner*, 2011 W.L. 3332532 (9th Cir. 2011), the court affirmed the Tax Court decision upholding the use of defined value clauses in making gifts of hard-to-value interests. Oral argument before the Ninth Circuit was made on June 14, 2011, with John Porter (Baker Botts, Houston) arguing on behalf of the estate. The decision was handed down on August 4, 2011—seven weeks later!

1. Mother, having inherited a large amount of United Parcel Service (UPS) stock, transferred $22.6 million of stock to an LLC and created trusts for two of her children, with grantor trust status established by giving the trustee a power to purchase and pay premiums on life insurance policies on Mother's life. Mother then made gifts and sales of LLC units to the grantor trusts, with the gifts comprising about 10 percent of each trust's assets. (Both the Tax Court and the Court of Appeals noted in footnotes, and tacitly approved, that the attorney indicated that he believed that a trust capitalized with a gift of at least 10 percent of its assets would be viewed by the IRS as a legitimate, arms-length purchaser in a later sale.) "The transfer documents include both a dollar formula clause—which assigns to the trusts a number of LLC units worth a specified dollar amount and assigns the remainder of the units to the foundations—and a reallocation clause—which obligates the trusts to transfer additional units to the foundations if the value of the units the trusts initially receive is finally determined for federal gift tax purposes to exceed the specified dollar amount. Based on an initial appraisal of the LLC units, each foundation received a particular number of units." A footnote observes that Mother's estate planning attorney, Richard LeMaster of Seattle, called the estate planning technique a "charitable freeze." ´Mother's gift was of 940 LLC units to each of the children's trusts and to a donor advised fund maintained by the Seattle Foundation. The gift to each children's trust was "the number of units … that equals one-half of the maximum dollar amount that can pass free for federal gift tax by reason of Transferor's applicable exclusion amount allowed by Code Section 2010(c)." The gift to Seattle Foundation was the difference between (i) the total 940 units transferred and (ii) the units transferred to that child's trust under the formula gift.

a. Three days later, Mother transferred 8,459 LLC units in separate transactions relating to each of the grantor trusts and several Community Foundations. The assignment document allocated the units by formula, with each trust receiving units worth $4,085,190 "as finally determined for federal gift tax purposes," and with any excess units passing to Foundations. In return, each trust gave Mother a 20-year secured note for $4,085,190. There were reallocation provisions that applied if either party received more than its appropriate number of units after values were finally determined.

b. The gift tax return, based on a formal appraisal, took a 53.2 percent discount, and the units were allocated accordingly. The return made a full disclosure of the gift transaction and also the sales transaction (as to the latter, no doubt to start the statute of limitations running). In the Tax Court's words, "she hid nothing." On audit, the Service

(i) determined that discounts should be limited to 29.2 percent, (ii) took the position that the reallocation clause would not be recognized for gift tax purposes even if additional units passed to Foundations, and (iii) disallowed a charitable deduction for any units passing to Foundations pursuant to the reallocation clause. Mother's estate (Mother having died) filed a petition in the Tax Court. The parties settled on a 35 percent discount, and on issues (ii) and (iii) the court ruled in favor of the estate.

2. **Government's contention: gifts were subject to a condition precedent**. On the appeal, the government argued that "[t]he adjustment feature of the defined-value clauses—requiring the trusts to transfer additional LLC units to the foundations, if the value of the units, as finally determined for federal gift tax purposes,' exceeds a defined value—make the additional charitable gifts subject to the occurrence of a condition precedent," because the adjustment was conditioned upon an IRS audit. In response, the court noted that "either of the trusts or either of the foundations could also have challenged the Moss Adams valuation of the units, although it was unlikely that they would have done so. But this practical reality does not mean that the foundations' rights to additional units were contingent for their existence upon the IRS audit."

3. **Government abandoned "against public policy" argument**. The Tax Court addressed and rejected the government's argument that such a defined value clause was void as against public policy. The Court of Appeals noted in a footnote that "[a]lthough the Taxpayer's estate addresses this argument extensively in its answering brief, the IRS has now abandoned it because the IRS explicitly disclaims pursuing this argument on appeal. Accordingly, we do not address whether the Taxpayer's dollar formula clauses and reallocation clauses are void as against public policy."

4. This decision and the decisions in *Estate of Christianson v. Commissioner*, 586 F.3d 1061 (8th Cir. 2009), and *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006), lead to two important conclusions. (1) Arguing against the validity of defined clauses, at least of the type of clauses involved in *Petter, Christiansen* and *McCord* is now a lost cause as far as the Service is concerned. Indeed, the government's next challenge to the validity of such clauses would likely lead to the imposition of court costs and attorney's fees under §7430 by taking a position that is not "substantially justified." See *Estate of Perry v. Commissioner*, 931 F.2d 1044 (5th Cir. 1991): "A policy decision to continue to whip a dead horse in circuit after circuit in the hope, however vain, of establishing a conflict is clearly an option within the discretion of the Commissioner. That does not, however, substantially justify his causing an innocent taxpayer in each other circuit to expend attorneys' fees for the dubious honor of being the Commissioner's guinea pig." (2) In cases involving hard-to-value assets, practitioners should give serious consideration to recommending the form of defined value clauses that these decisions have approved.

**B. And a fourth "defined value" case!** In *Hendrix v. Commissioner*, T.C. Memo. 2011-33 (2011), handed down on June 15—2½ years after the trial—the court concluded that a transfer of closely held stock in a gift-sale transaction to family trusts and a gift to a Foundation under defined value formula provisions was at arm's length and was not contrary to public policy. The case is appealable to the Fifth Circuit, which announced its position in *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006). The defined value clause in *Hendrix* is quite similar to the provision in *McCord*. The Tax Court decision addresses the government's arm's length and public policy arguments, which were not addressed in McCord.

1. The court stated that having negotiations is not essential to the existence of an arm's length transaction. Moreover, even the family trusts had adverse interests because they assumed "economic and business risks" relating to their purchase of some of the stock. The court also found that there was no collusion between the donors and the Foundation.

**C. How about a defined value clause in the instrument of transfer?** *Petter*, *Christiansen* and *McCord* all involved allocations to charity of interests in excess of the defined value amount, and the opinions in those case attached considerable significance to the fact that a charity was in the picture. But what if a charity is not involved? Suppose that the instrument of transfer reads as follows: "I, [donor], a limited partner of XYZ, give to [donee] that percentage of my partnership interest in XYZ which is equal in value to the unused portion of my federal gift tax applicable exclusion amount." Or, "which is equal in value to $488,129" [which is dollar amount of the unused portion of the donor's gift tax exemption equivalent].

# XV. Section 2516—Certain Property Settlements

**A. Decedent was not transferor of trust created pursuant to settlement of support obligation.** In Ltr. Rul. 201116006, pursuant to a court order in a marital dissolution proceeding, the former spouse established a trust in satisfaction of the former spouse's support obligation. The trust provided for income to D for life and gave her a special testamentary power of appointment. There we no estate tax consequences in D's estate because the transfer was for a full and adequate consideration under §2516. The trust did result in a gift of the remainder interest that would pas to D's issue. However, the former spouse, not D, was the transferor for gift tax purposes.

# XVI. Section 2518—Qualified Disclaimers

**A. Estate of spouse could disclaim retirement accounts, but not required minimum distributions already received.** In Ltr. Rul. 201125009, required minimum distributions from an IRA and three 403(b) plans were automatically deposited in the joint bank account of D and his wife S. D died, having named his S as designated beneficiary on the four accounts. The beneficiary designations provided that if S survived and disclaimed her interest, the trustee of a testamentary trust was as contingent beneficiary. S survived D, and quarterly RMDs from the four accounts were automatically deposited in the bank account. S died intestate, and Daughter as administrator sought court approval, and the Service's blessing, to a disclaimer on behalf of S. (The dates are not given in the letter ruling, but this obviously took place within nine months after D's death.)

1. Citing Rev. Rul. 2005-36, 2005-1 C.B. 1368, the Service ruled that S is deemed to have accepted the RMD deposited in the bank account and could not disclaim as to the RMDs. However, Spouse may make a qualified disclaimer of the balance of the Retirement Accounts if the requirements of § 2518 have been met."

# XVII. Section 2523—Gift to Spouse

**A. Earlier letter ruling revoked; Service will not grant extensions to make inter vivos QTIP elections.** In Ltr. Rul. 201025021, W created an irrevocable trust for the benefit of her husband H. The trust included a statement that W intended "to the extent that QTIP elections are made on the gift tax returns with respect to Trust, to be entitled to the maximum federal gift tax marital deduction." Despite this clear signal in the trust, the law firm that prepared and filed W's gift tax return did not make a QTIP election on the return. When the oversight was discovered after H's death, the Service granted an extension of time to make the QTIP election, as S had relied on a qualified tax professional.

1. "That ruling "was in error and not in accord with the current views of the Service," said the Service in Ltr. Rul. 201109012, and the earlier ruling was revoked. The regulation

authorizing extensions of time (Reg. §301.9100-3) applies only to requests relating to times that are fixed by regulations or other published guidance. The Service does not have discretion to grant an extension where the time period is expressly dictated by a statute—here, §2523(f)(4). The ruling points out that the taxpayer could limit the retroactive effect of the revocation by following the procedures set out in Section 11.11 of Rev. Proc. 2010-1, 2010-1 C.B. 1

# XVIII. 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.

1. In Ltr. Rul. 201029011, D's will exercised her power of appointment by directing that the trust property be distributed to a different trust, which ultimately was divided in shares and allocated among trusts for each of her children. Each beneficiary of a Child's Trust was granted a special testamentary power to appoint among the issue of D and her husband. The Service ruled that D's exercise of the power of appointment did not cause loss of the trusts' GST-grandfathered status.

**B. Modification of pre-1985 trust to permit distributions to grandchildren**. The pre-1985 trust in Ltr. Rul. 201122007 provided that all net income was to be accumulated for the ultimate benefit of Child's issue, but gave the trustees discretion to distribute income and principal as deemed necessary for Child's health, support or maintenance. The problem: Child didn't need any trust distributions to meet her support needs, and no distributions to grandchildren could be made until after Child's death. Child sought to modify the trust so as to permit distributions to the grandchildren. She submitted an affidavit with the ruling request stating that (1) her income and resources were sufficient to maintain her current standard of living for the remainder of her lifetime and any foreseeable emergencies, (2) her financial condition prevented her from receiving any distributions from the trust, and (3) she had not received any trust distributions in the past and did not anticipate receiving any distributions in the future.

1. The Service gave its blessing to the modification. The modification will not affect the trust's GST-exempt status, no capital gain will be realized by reason of distributions to the grandchildren, and Child will have made a gift of her income interest in the trust. Although Child has never received distributions in the past and is not likely to be entitled to distributions in the future, "that does not negate the fact that … Taxpayer has an income interest entitling her to distributions of income in the case of emergency and at the discretion of the trustees. The interest may be nominal, however, the value of the gifted interest is a factual determination, not a determination of whether or not Taxpayer has made a gift of the interest. … The value of this gift is a question of fact and the Service does not rule on such factual determination."

# XIX. Section 2702—Special Valuation Rules: Trust Transfers

**A. Six-month occupancy without paying rent after QPRT terminated did not result in gross estate inclusion**. In *Estate of Riese v. Commissioner*, T.C. Memo 2011-60, 80-year-old Riese received estate planning advice from attorney Stefan Tucker, a former chair of the American Bar

Association Section of Taxation. This led to extensive consultations between Riese, her son-in-law and financial advisor Grimes, and Tucker. On Tucker's recommendation, Riese established a three-year QPRT for her residence in Kings Point, New York, with Tucker having made it clear that when the QPRT term expired, Riese would have to pay market rental for her continued occupancy of the residence. On termination of the QPRT, the residence was to pass into trusts for Riese's two children. The QPRT terminated on April 19, 2003. Shortly thereafter, Riese's daughter called Tucker, inquiring about how to determine the proper amount of rent to charge for Riese's continued occupancy. "Mr. Tucker explained to her that fair market rent could be determined by contacting local real estate brokers and that this could be done by the end of the year (*i.e.*, December 31, 2003). Mr. Tucker entered a 'tickler' in his pocket calendar to remind himself to call Mrs. Grimes by Thanksgiving to make sure everything was taken care of. However, before Thanksgiving arrived decedent suffered a stroke and died unexpectedly on October 26, 2003…. We believe … that Mr. Tucker would have made sure a lease was executed, rent was determined, and all appropriate changes were made to effect the change of ownership. Unfortunately, decedent died unexpectedly in October before any of this occurred."

1. The court determined that, with the payment of rent having been extensively discussed, corroborated by the daughter's call to Tucker, Riese had agreed to pay rent after the QPRT had ended. Finding the witnesses' testimony to be credible, a tenancy at will was created. "The Secretary had not issued any regulations or guidance as to how and when rent should be paid upon the termination of a QPRT. We believe that doing so by the end of the calendar year in which the QPRT expired would have been reasonable under the circumstances."

2. After Riese's death the estate assumed responsibility for the property, paying property taxes, insurance, and maintenance expenses until the property was sold a year later. The court allowed a §2053 deduction of $46,298 in accrued rent as a debt of the decedent. However, a $46,298 claim of rent owed to the estate was disallowed. "[A]s there was no formal lease between the Property Trusts and decedent, the tenancy-at-will ceased upon decedent's death. The estate did not require a roof over its head and was not obligated to pay rent." The court also disallowed a deduction for $125,000 paid to son-in-law Grimes. The estate failed to adequately explain how services provided to the estate through an investment company were a reasonable and necessary expense.

**B. QPRT modified to give remaindermen special power of appointment**. In Ltr. Rul. 201039001, S deeded her residence to a qualified personal residence trust for a term of X years. After expiration of the term, the trust was to continue for the benefit of S's issue until the death of S and her spouse, at which time the trust estate was to be distributed to S's issue per stirpes. "On Date 2, Settlor, in her capacity as Trustee of Trust, with the joinder and consent of Son 1 and Son 2 [her two adult sons], executed Modification to modify Trust." [Hmm. A nonjudicial "modification" of an irrevocable trust, apparently.] The modification provided that at the end of the QPRT term, Sons were to hold a power to appoint the trust property in equal shares to themselves or, alternatively, to direct the trustee to amend the trust so as to provide a term interest to S, her spouse, or both, as a gift by Sons. Sons exercised their power to grant S an additional term of years under the QPRT.

1. That's fine with us, said the Service. The trust modification resulted in Sons' making a gift of their term interest in the residence to S, and the QPRT exception to §§ 2702(a)(1) and (2) applies to the transfer. However, "no opinion is expressed or implied concerning whether the transfer of Residence to Settlor, pursuant to the modification of Trust, would result in Residence being included in the gross estate of Settlor under §2036."

2. Reaching the same conclusion on similar facts, see Ltr. Rul. 201118014.

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

A. **The chutzpah defense: Reliance on a qualified tax professional??? *You* were the qualified tax professional!** In *Estate of Cederloff v. United States*, 2010-2 U.S.T.C. ¶60,604 (D. Md. 2010), an estate was liable for a late-filing penalty because the executor failed to prove that he fell within the reasonable cause exception of §6651(a). The executor's reliance upon the advice of a professional was not a valid defense because the executor was the professional upon whose advice he relied. Lowe, appointed as the estate's personal representative, was an experienced attorney (and former IRS attorney) whose practice includes estate law. As such, he was fully aware that he was required to file an estate tax return within nine months after the decedent's death.

B. **Filing for extension to file return and pay tax is executor's responsibility; reliance on a CPA not an excuse**. In *Baccei v. United States*, 632 F.3d 1140 (9th Cir. 2011) the executor retained a CPA to prepare and file an estate tax return. The estate tax return was due on June 19, 2006. On June 16, the CPA filed a Form 4768 for an extension of time to file a return and pay estate tax, but failed to complete Part III, captioned "Extension of Time to Pay. The CPA enclosed a supplemental letter explaining that the projected estate tax was $131,327, and that the estate did not have sufficient liquid funds to pay the tax. The estate tax return, filed in December, reported an estate tax of $1,684,408. The Service assessed a late-payment penalty of $58,954 plus interest of $69,801.

1. The District Court upheld the government's position, and the Ninth Circuit affirmed. The court noted that the request for an extension for paying the estate tax "shall state the period of the extension requested" and is "neither unclear nor unimportant; rather it is essential to the IRS's tax collection efforts because it allows the IRS to assess the reasonableness of the taxpayer's request." The doctrine of substantial compliance was inapplicable because the statute and regulations establish clear and strict deadlines for the payment of tax.

2. **Service had no duty to inform executor that extension request was deficient**. The executor contended that the IRS had an obligation to inform him that his payment extension request was deficient and to provide him with an opportunity to amend the application. No go, said the court. A claim based on equitable estoppel must establish that the government engaged in affirmative misconduct. "Baccei has not pointed to any 'affirmative' misconduct by the IRS at all."

3. **Reliance on CPA not an excuse**. The executor contended that he had exercised "ordinary business care and prudence" in relying on the CPA. No go on this one either. In *United States v. Boyle*, 469 U.S. 241 (1985), the Supreme Court held that "[t]he failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for a late filing under §6651(a)(1)."

C. **No reasonable cause on these facts, said the National Office.** C.C.A. 201116018 discusses the meaning of "reasonable cause" as an excuse for failing to file and pay tax. Reasonable cause requires the taxpayer to demonstrate that he or she exercised ordinary business care and prudence, but was still unable to timely file the return. Circumstances beyond the taxpayer's control, such as illness, may be evidence of reasonable cause. Here, however, the taxpayer had been competent enough to conduct a real estate transaction during the time period in which the gift tax return at issue was to have been filed. Consequently, it was not improper to impose the failure-to-file penalty, as the facts presented did not establish reasonable cause.

## XXI. Section 6662—Imposition of Accuracy-Related Penalty

A. **Estate not subject to penalty where executor relied on disbarred "Enrolled Agent."** *Estate of Robinson v. Commissioner*, T.C. Memo. 2010-168, involved a $380,000 deficiency, a $76,000

accuracy-related penalty, and a dangerously loose cannon. D's son James was a computer programmer with a high school education. After James had acquired some rental properties, he needed help in filing his income tax returns. A friend recommended Schlaback. On a visit to Schabach's office, James noted an "Enrolled Agent" plaque on the wall. (James didn't know that Schlabach had been disbarred from practicing before the IRS.) James noticed that Schlabach's business card contained the legend "Estate Planning," and Schlabach told James that he was certified in estate planning. James' wealthy father was suffering from Alzheimer's, and pursuant to a power of attorney James commissioned Schlabach prepare an estate plan. Part of the estate plan was to transfer assets to a "pure trust" whose assets, on D's death, were not reportable on the estate tax return. (Hmm…) After D's death, James as executor retained Schlabach to prepare the estate tax return. When Schlabach saw that the taxable estate would exceed the exemption equivalent, he advised James to establish a charitable foundation and transfer assets to the foundation, thereby securing a charitable deduction for the estate (!). James did so.

1. The estate tax return was audited and the Service assessed a deficiency—which the estate did not challenge. The Service also assessed an accuracy-related penalty, but Judge Vasquez ruled for the taxpayer. Schlabach may not have been a qualified tax professional, but James reasonably believed that he was. James' reliance on Schlabach was reasonable and was made in good faith.

B. **No summary judgment for either side where there were factual issues as to the position taken by taxpayer.** Under the facts of *Haggar v. United States*, 2011-1 U.S.T.C. ¶60,615 (D. S.D. 2011), D made gifts to Daughter and her children in 1998. S consented to split the gifts and signed a gift tax return. D died in 2004, and S and Daughter were appointed co-personal representatives. During preparation of the estate tax return, their accountant asked whether D had made any taxable gifts and filed gift tax returns; S and Daughter answered that he had not. In response to the assessment of a 20 percent penalty for failure to report the gifts, S and Daughter claimed that they did not know that the tax return was filed and were not aware that the gifts had tax consequences. Because there was disputed evidence as to whether there was reasonable cause for the misstatements on the estate tax return and whether S and Daughter acted in good faith, the court ruled that neither party was entitled to summary judgment.

# XXII. Section 6901—Transferee Liability

A. **Statute of limitations no help where estate had made a §6166 election**. In *United States v. Kulhanek*, 2010-2 U.S.T.C. ¶60,610 (W.D. Pa. 2010), the court ruled that the government's action to collect unpaid estate tax from the estate's beneficiaries was timely, even though the action was brought sixteen years after the estate tax return was filed. The estate's election to defer the estate tax under §6166 caused the statute of limitations period to be suspended. The ten-year limitations period did not begin to run until seven years after the estate tax return was filed, the date on which the decedent's interest in a closely held corporation was disposed of.

B. **Transferee liability imposed with respect to property acquired by beneficiaries in settlement**. In *Upchurch v. Commissioner*, T.C. Memo 2010-169, Tasker had two children (Bruce and Carl) by his first marriage, and his wife Judith had three children by her first marriage. Tasker adopted Judith's children, but Judith did not adopt Tasker's children. In June 1999 (after Tasker's death), Judith executed a will that devised two residential properties to the five children in equal shares. Weeks before her death in August 2000, Judith quitclaimed the two properties to two of her children. As a result, the two properties were not part of the probate estate subject to the will's terms—if the quitclaim deeds were valid. Bruce and Carl brought suit, contending that the quitclaims were not valid for a variety of reasons. The parties reached a settlement under which Bruce and Carl each were to receive, from the estate, $53,500, one-third of which was to be paid to their attorney as a contingent fee. On the estate tax return for Judith's estate, the executor took a

$107,000 deduction as a claim against the estate. The Service disallowed the deduction and assessed a deficiency. When the estate failed to pay the deficiency, the Service asserted transferee liability against Bruce and Carl.

1. Bruce and Carl argued that they were not transferees of estate property within the meaning of §6901 because the settlement payment they received was an arm's-length exchange for the waiver of their right to sue to enforce the terms of the will. Finding for the government, the Tax Court disagreed. "[T]he settlement payment they received was a substitute for the real property that was devised to them in Judith's will but was not available for distribution to them upon her death. For tax purposes, it is appropriate to treat the settlement payment as a transfer from the estate."

2. Bruce and Carl also were liable for the portion of the settlement distributed to their attorney. In support of this ruling, the court cited *Commissioner v. Banks*, 543 U.S. 426 (2005), where the Supreme Court held that the amount of damage payments includable in a plaintiff's gross income should not be reduced by the contingent fee paid to the plaintiff's attorney. "In the case of a litigation recovery the income-generating asset is the cause of action that derives from the plaintiff's legal injury. The plaintiff retains dominion over this asset throughout the litigation. Although the attorney can make tactical decisions without consulting the client, the plaintiff still must determine whether to settle or proceed to judgment and make, as well, other critical decisions." Thus, the beneficiaries were liable for the full amount of the deficiency.

## XXIII. Section 7623—Expenses of Detection of Underpayments and Fraud

**A. No whistleblower award if Commissioner determines that no additional tax is due.** In *Cooper v. Commissioner*, 136 T.C. No 30 (2011), Cooper, a Nashville attorney, had reported two alleged estate and GST tax violations. According to the attorney, through his representation of the widow of D's grandson he learned that D's estate had failed to report a $100 million trust as part of D's gross estate, and that to avoid the GST tax D had impermissibly modified two trusts worth over $200 million. The Service denied the claims, and Cooper appealed to the Tax Court. In an earlier proceeding, the government contended that since no award determination had been made, the Tax Court had no jurisdiction. The court disagreed. As §7623 expressly permits individuals to seek Tax Court review of the amount or denial of an award determination, the court's jurisdiction is not limited to the amount of an award determination. The Service's denial letter sent to the attorney conferred jurisdiction because it constituted a final administrative decision regarding the attorney's claims. *Cooper v. Commissioner*, 135 T.C. 70 (2010).

1. In this subsequent proceeding, in response to the government's motion for summary judgment Cooper asserted that there were genuine issues of material fact, because the Service had failed to properly investigate facts relevant to the whistleblower claims and failed to apply the correct law in determining the merits of his claims. Cooper asked the court to direct the government to undertake a complete re-evaluation of the facts, begin an investigation, open a case file, and take whatever other steps were necessary to detect an underpayment of tax

2. No go, said the Tax Court. In effect, Cooper sought to litigate whether any tax is due from taxpayer D. "Our jurisdiction in a whistleblower action is different from our jurisdiction to review a deficiency determination. We have jurisdiction in a deficiency action to redetermine whether there is any income, estate or gift tax due…. In a whistleblower action, however, we have jurisdiction only with respect to the Commissioner's award determination…. Congress did not authorize the Court to direct the Secretary to proceed with an administrative or

> judicial action…. Respondent has explained why he determined that there was no estate or gift tax due on the facts petitioner presented. Petitioner may disagree with respondent's legal conclusions for why there was no Federal estate or gift tax due [but] whistleblower awards are preconditioned on the Secretary's proceeding with an administrative or judicial action…. If the Secretary does not proceed, there can be no whistleblower award. Finally, respondent properly processed petitioner's whistleblower claims but did not collect any amount of tax, interest or penalty from the taxpayer based on petitioner's information. Because a whistleblower award is calculated as a percentage of collected proceeds, if the Commissioner collects no proceeds there can be no whistleblower award."

# XXIV. In Conclusion

A. **Having a conference with a married couple for wills and estate planning advice? Here's a question you need to ask.** In *Estate of Gardiner*, 42 P.3d 2002 (Kan. 2002), 42-year-old J'Noel Ball, a Finance professor at Park University in Parkville, Missouri, married 86-year-old Marshall Gardiner in September 1998. Marshall, a long-time donor to the university, had met J'Noel at a school function. Marshall died intestate in August 1999, leaving a $2.7 million estate. He was survived by J'Noel and his 53-year-old son, Joe. Under Kansas law, J'Noel and Joe each inherited one-half of Marshall's estate. Joe was not pleased with the situation: although he knew that his father had remarried, he met his "stepmother" for the first time at the funeral, and he didn't like what he saw. What should Joe have done? A will contest was not an option, because there was no will. What would *you* have done on Joe's behalf?

   1. Here is what happened: ….

B. **How does this case (or, rather, its fact setting) affect your practice?** If a married couple comes to you for estate planning advice, what additional question do you need to ask them?