



NAEPC  
**Journal**  
**of Estate & Tax Planning**

[Click here to view the First Quarter 2015 Issue](#)



# **Recent Developments Affecting the Estate Planning Practice**

**Stanley M. Johanson**

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

**National Association of Estate Planners & Councils**

San Antonio, Texas  
November 7, 2014

**TABLE OF CONTENTS**

- I. Legislation Relating to Estate and Gift Tax**
  - A. Obama administration’s Fiscal Year 2015 Budget Proposal..... 1
  - B. Another take on lifetime gifts of assets likely to increase in value—new basis at death rule..... 2
  - C. Estate planning in a high-exemption world..... 3
  - D. History lesson that lays an important predicate ..... 4
  - E. Review of existing estate plans ..... 6
  
- II. Section 401—Qualified Plans and IRAs**
  - A. One rollover per year for IRAs ..... 8
  - B. Inherited IRAs are not exempt from bankruptcy estate ..... 9
  - C. Time period in which designated beneficiary must commence distributions cannot be extended..... 9
  - D. The IRA did not authorize investment in real property ..... 9
  - E. Wife’s fraudulent withdrawal of funds from IRA not taxed ..... 10
  
- III. Section 671—Grantor Trust Rules**
  - A. Pending Tax Court case: Service challenges installment sale to defective grantor trust..... 10
  
- IV. Section 2010—Unified Credit Against the Estate Tax**
  - A. Portability is now permanent ..... 11
  - B. Which planning decision should be made: reliance on portability election or bypass trust? There is no one answer ..... 11
  - C. Reasons favoring the use of bypass trusts ..... 12
  - D. Reasons favoring the use of portable election..... 14
  - E. It’s not an “either/or” situation..... 14
  - F. The best of both worlds: a QTIPable trust?..... 15
  - G. Document, document, document! ..... 16
  - H. The DSUE Amount as an Estate Asset With Value..... 17
  
- V. Section 2032A—Special Use Valuation**
  - A. Special use valuation determined asset’s basis ..... 19
  
- VI. Section 2033—Property In Which Decedent Had Interest**
  - A. Tax Court rejects dollar-for-dollar discount for unrealized capital gain..... 20
  
- VII. Sections 2036 and 2038—Retained Interests or Powers**
  - A. Annuity trust includible in gross estate; too much retained control..... 21
  
- VIII. Section 2042—Life Insurance**
  - A. Spouse-owned life insurance—but the spouse died first..... 22
  - B. Transfer of policy to new trust: “Transfer for value” avoided because they created a partnership ..... 22
  - C. Insured’s right to receive policy dividends not an incident of ownership..... 22
  
- IX. Section 2056—Marital Deduction**
  - A. Trustee was supposed to segregate the revocable trust assets into separate trusts..... 23

B.	Spouse’s right to elect one of two benefits not “contingency” that will impair marital deduction.....	23
<b>X.</b>	<b>Section 2511—Transfers in General</b>	
A.	National Office says: Self-canceling (“SCIN”) “balloon” installment note transaction resulted in taxable gift .....	24
B.	Wait a minute! That Chief Counsel Advisory opinion involves <u>Davidson</u> case!.....	27
<b>XI.</b>	<b>Section 2512—Valuation of Gifts</b>	
A.	Tax Court reverses course as to “net, net gift” treatment of gifts made within three years of death .....	28
B.	No summary judgment on issue of adequate disclosure .....	30
C.	No summary judgment on issue of gift vs. transfer in ordinary course of business.....	30
<b>XII.</b>	<b>Section 6166—Extension of Time to Pay Tax—Closely Held Business</b>	
A.	Letters accompanying extension to file did not satisfy requirements for making Section 6166 election .....	30
<b>XIII.</b>	<b>Section 6511—Limitations on Credits or Refunds</b>	
A.	Was it a tax payment or a tax deposit?.....	31
B.	That was a tax payment, and the statute of limitations had run .....	31
C.	Second verse, same as the first.....	31
D.	If time is running out, don’t use the Post Office .....	31

## I. Legislation Relating to Estate and Gift Tax

- A. **Obama administration's Fiscal Year 2015 Budget Proposal.** In On March 4, 2014, the Treasury Department published its Fiscal Year 2015 Budget Proposal (“the Greenbook”), explaining the president’s budget proposals for 2015. Several of the proposals relating to transfer taxes were golden oldies, carried over from earlier Greenbooks, but a few of them are new.
1. **Lower the exemption to \$3.5 million and increase tax rate to 45 percent—in 2018.** The Greenbook notes that “ATRA retained a substantial portion of the tax cut provided to the most affluent taxpayers under TRUIRJCA that we cannot afford to continue. We need an estate tax law that is fair and raises an appropriate amount of revenue.” The proposal would restore the 2009 estate tax, gift tax and GST parameters. The proposal would raise the transfer tax rate to 45 percent, and would lower the estate tax exemption the GST exemption to \$3,500,000, and the gift tax exemption to \$1,000,000, with no indexing for inflation—effective January 1, 2018.
  2. **Installment sales to defective grantor trusts would be includible in grantor’s gross estate.** As with the 2014 Budget Proposal, the 2015 Budget Proposal seeks to kill off installment sales to “defective” grantor trusts. If a deemed owner under a grantor trust “engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes ... the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction)” will be includible in the deemed owner’s gross estate, will be subject to gift tax if during the deemed owner’s life the grantor trust treatment is terminated, and will be treated as a gift by the deemed owner as to any distribution to another person during the deemed owner’s lifetime. “The transfer tax imposed by this proposal would be payable from the trust.”
    - a. The proposal clarifies that it would not apply “to any irrevocable trust whose only assets typically consist of one or more life insurance policies on the life of the grantor and/or the grantor’s spouse.”
  3. **Provide reporting on a consistent basis between estate tax valuation and income tax basis in the heir’s hands.** Under IRC §1014, the decedent’s assets receive a new basis at death, for income tax purposes, equal to their date-of-death value. The value of property as reported on the decedent’s estate tax return raises a rebuttable presumption of the property’s basis in the hands of the heir—but in more than a few cases in the past, the heirs have successfully rebutted that presumption. Treasury’s concern is that the executor may take a low valuation to reduce estate taxes, yet the heirs would argue that the reported value was low-balled to save transfer taxes. The proposal, carried over from prior years, would provide that the basis for income tax would be the same as values “as determined for gift or estate tax purposes.”
    - a. It is curious that Treasury is still concerned about this issue, when few estates must file estate returns because of the current law’s \$5.34 million (in 2014) exemption. One would think that, under current law, Treasury would be concerned about overvaluing assets so as to enhance the benefits of a basis step-up.
  4. **Require minimum—and maximum—term for GRATs.** The Budget Proposal once again included a provision that would kill off short-term grantor retained annuity trusts [*cf. Walton*

*v. Commissioner*, 115 T.C. 589 (2000)] by requiring a 10-year minimum GRAT term, requiring that the GRAT remainder interest must have a value greater than zero, and providing that the amount of the annuity payout could not be decreased during the GRAT term. Additionally, the proposal would impose a *maximum* term on GRATs—to the grantor’s life expectancy plus ten years.

5. **Limit GST-exempt trusts to 90 years.** Carried over from earlier proposals is a provision under which the GST exemption would expire after 90 years. The 90-year period is inspired by the Uniform Statutory Rule Against Perpetuities (USTRAP), which has been enacted in about a dozen states.
6. **Extend duration of lien in Section 6166 deferral.** Under current law, if a §6166 election is made to defer taxes relating to a closely held business, the §6324(a)(1) lien continues for ten years. However, the deferral of payment of the tax can continue for up to fifteen years and three months after the decedent’s death. The proposal would extend the lien throughout the §6166 deferral period.
7. **Inherited retirement benefits: Five-year payout limit for beneficiaries other than spouses, minor children.** Under the proposal (introduced in the 2014 Budget Proposal), except for spouses (who could continue to make spousal rollovers) and minor children, disabled or chronically ill beneficiaries, and beneficiaries not more than ten years younger than the participant, beneficiaries could no longer stretch out required minimum distributions over their life expectancy. Instead, payouts would be limited to five years after the decedent’s death. Roth IRAs would be subject to the same five-year rule.
  - a. **Limit total of accrued tax-favored retirement benefits.** As with the 2014 Budget Proposal, the 2015 Budget Proposal would limit the deduction for contributions to qualified plans and IRAs when total balances of all such plans are sufficient to provide an annual benefit of an indexed amount (around \$3.2 million for a 62-year-old).
  - b. **Eliminate minimum distribution requirements for small accounts.** The required minimum distribution rules would not apply if the aggregate value of an individual’s qualified plan accumulations and IRAs are \$100,000 (indexed) or less.
8. **What isn’t there: valuation discounts.** The 2013 Budget Proposal proposed an amendment to §2704 (the “disappearing rights and restrictions” special valuation rule) that would add a new category of “disregarded restrictions” relating to interests in family-controlled entities such as family limited partnerships and limited liability companies. Interestingly, this proposal does not appear in the 2014 Greenbook or this year’s Greenbook.

**B. Another take on lifetime gifts of assets likely to increase in value: The “new basis at death” rule.** We now have a \$5 million “permanent” estate and gift tax exemption—\$5.34 million in 2014 (and \$10.68 million in the case of spouses), which is virtually certain to increase every year thanks to the annual inflation adjustment. As a result, one of the traditional estate planning techniques has been turned on its head: Lifetime gifts of assets with appreciation potential. In the past, the objective has been to make lifetime transfers of such assets, to remove the potential appreciation from the client’s gross estate. But now, when even the estates of “mere millionaires” are not likely to be subject to estate tax, the greater tax benefit to the heirs may be to hold the assets until death, in order to obtain a basis step-up under §1014. Under the “carryover basis” rule applicable to lifetime gifts, the donee takes the donor’s basis under §1015.

1. **How the world has changed is illustrated by Williams v. Commissioner**, T. C. Memo. 1998-59 (1998). W inherited two tracts timberland and farmland (in Clay County and Putnam

County, Florida) from her husband in 1962. In 1980 and 1983 W, who had no immediate family, gave her nephew an undivided one-half interest in the two tracts, one valued (by the Tax Court) at \$1.3 million and the other valued at \$1.7 million. No gift tax returns were filed at the time; returns were filed by W's executor after W's death in 1992. (The gift tax component of the case involved transferee liability.) For gift tax valuation purposes, Simple arithmetic would suggest that the total amount of the gift was one-half of \$3 million, or \$1.5 million. However, the Tax Court upheld the taxpayer's expert witness testimony that a 44 percent discount should be granted due to lack of marketability (there is no ready market for fractional interests in real estate, and sale of the real estate in that particular market at that time would encounter delays), lack of control (a tenant in common cannot unilaterally decide how to manage the property), and the necessity of resorting to a partition action and related costs to liquidate one's interest in a tenancy in common. The result was a \$660,000 discount, reducing the value for gift tax purposes from \$1.5 million to \$880,000. Taken from a 40% transfer tax bracket, the projected tax saving from the fractional interest gift would be \$330,000.

- a. W and the nephew later sold the two tracts, so W's retained one-half interest in the land was not in her estate at death. However, W owned an undivided interest in yet another tract (whose full value was \$630,000), which she devised to the nephew. Again, simple arithmetic would suggest that the value of W's one-half interest for estate tax purposes was \$315,000. Once again, however, the Tax Court applied a 44 percent discount, reducing the gross estate inclusion to \$175,000.
- b. It must be noted that a 44 percent fractional interest discount is much higher than the discounts usually recognized in such cases (which typically range from 20 to 30 percent). The high discount was largely the result of a tactical error made by the government in trying the case before the Tax Court. The government "went to the mat" with its argument that any discount should be limited to the cost of a partition action.
- c. As a result of this good planning at a time when the exemption equivalent was \$600,000, the attorney who recommended the plan could be nominated for the Estate Planning Hall of Fame. But what if the gift was made in 2013, W died in 2014, and her estate (even counting the adjusted taxable gift) was less than \$5.4 million? The attorney who recommended the plan might find himself as a defendant in a malpractice action!
- d. Suppose that you are representing the executor of a decedent who owned an undivided one-half interest in Ranch valued at \$3,000,000, but no estate tax will be due. What should the executor do in reporting the value of the one-half interest that passes to a will beneficiary?

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

Thanks to ATRA 2012, estate planning professionals will see their clients falling into one of three categories (and I am broadly oversimplifying here): (1) Mega-wealthy—over \$10 million—clients for whom sophisticated estate planning will continue to be called for; (2) couples in the (say) \$8-10 million range (or single clients in the \$4-5 million or so range), for whom transfer taxes could be (but are likely not to be) a concern down the road, and (3) modest estates—say, a married couple with estates of "only" \$4-8 million.

1. **Bypass trusts for spouses remain important.** For a couple in their 40s—or 50s, or 60s, or 70s, bypass trusts continue to be important even if there are not going to be any estate taxes to “bypass.” It must be conceded that clients like two-page wills because they can understand them on the first reading: “to my [spouse] if he survives me, otherwise to my children in equal shares”—or, perhaps, “to my descendants per stirpes.”
  - a. With increases in longevity over the past generation, a major concern is that if the surviving spouse later becomes incapacitated, the result will be a costly and a cumbersome guardianship or custodianship administration. If instead the client’s estate is left in trust, perhaps with the spouse serving as trustee for as long as he or she is able and so inclined, a guardianship administration will be avoided.
  - b. A bypass trust gives creditor protection via a spendthrift provision.
  - c. A trust settlement assures that on the spouse’s death, the remainder interest will pass to the children, rather than to that dreaded second husband, or that trophy second wife.
  - d. Such a trust should *always* give the spouse a special testamentary power of appointment, which has the benefit of tending to insure filial devotion. “It doubtless occurred to the testator that by restraining a disposition of his property except by will, which is in its nature revocable, [his widow] would, to the end of her life, retain the influence over, and secure the respect of, the several objects of his bounty.” Hood v. Haden, 82 Va. 588 (1886).

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

1. **The marital deduction.** The Revenue Act of 1948 introduced the marital deduction. Property left outright to a surviving spouse or to a “marital deduction trust” qualified for a deduction. Because the purpose of the marital deduction was to provide parity of treatment for residents of common law jurisdictions and community property states (only one-half of community property is subject to tax on the death of a spouse), the marital deduction was limited to one-half of a decedent’s “adjusted gross estate” (essentially, the gross estate minus debts and expenses). Community property was not eligible for a marital deduction, because under state law the community estate was “split” for transfer tax purposes, and only one-half the value of community property is includible in the deceased spouse’s gross estate.
  - a. This led to the use of **marital deduction formula clauses**, which made a bequest to the spouse or to a marital deduction trust of “the **maximum allowable marital deduction** available to my estate.” The remainder of the estate was (typically) left to the trustee of a “**bypass trust**” for the benefit of the surviving spouse and descendants that gave the spouse, at most, a life income interest. When the spouse died, the value of her life estate terminated and had no value, and thus the trust “bypassed” the spouse’s estate for purposes of the estate tax.
    - (i) If the trust continued for the benefit of descendants, the trust estate also bypassed the children’s estate—a circumstance that ultimately led to enactment of the generation-skipping transfer tax.

- b. With the increased use of bypass trusts, initially spurred by the desire to avoid estate taxes in the surviving spouse's estate, clients and professionals came to appreciate the non-tax benefits of trusts, including creditor protection via spendthrift provisions, avoidance of guardianships in the incapacity situation, and control of devolution of the assets on the spouse's death.
    - (i) Outside the East Coast, trusts were not widely used in estate planning before the 1940s and 1950s, which explains why much of our early trust was based on case law decisions from courts in Massachusetts, New York and similar eastern states.
  - c. The purpose of the marital deduction was *not* to eliminate tax on interspousal transfers. Rather, the purpose was to *defer* the tax until the death of the surviving spouse. The price for qualification for a marital deduction was that the interest passing to the spouse had to be includible in the spouse's gross estate, to the extent not consumed or disposed of by the spouse during his or her lifetime.
2. **Increase in the exemption.** In 1976, the estate tax (and gift tax) exemptions were increased to \$175,625, and in 1981 the exemption was increased to \$600,000 (phased in gradually).
- a. The 1981 tax act also introduced the **unlimited marital deduction**, with no quantitative limit on the amount of the deduction. Whereas the earlier purpose of the marital deduction was to provide parity of treatment for spouses residing in community property and common law states, the policy underlying the unlimited marital deduction was to give the opportunity to eliminate any tax on the spouse's death—regardless of the size of the decedent's estate, as long as property was left to the spouse in a qualifying way. Instead, tax on the property was deferred until the death of the spouse.
  - b. This resulted in a change in marital deduction formula clauses, which now provided for a bequest of “the **smallest marital deduction** needed to eliminate an estate tax in my estate.” The remainder of the estate—the largest amount that could pass tax-free by utilizing the decedent's exemption—was (typically) left to the trustee of a bypass trust.
  - c. Because many existing wills had been drafted containing a formula clause that provided for the maximum allowable marital deduction—which under the unlimited marital deduction could be the entire estate, Congress enacted a “**transition rule**”: For wills executed before 1982, marital deduction formula clauses making a “maximum allowable” bequest would be construed under the former law that placed a quantitative limit on the marital deduction.
3. **Further increases in the exemption.** In 1986, the generation-skipping transfer tax was enacted. In 2001, the exemption was raised to \$1 million. The 2001 tax act (the “Bush Tax Act”) further increased the exemption in steps, until it reached \$3,500,000 in 2009. Because of some convoluted Senate rules involving something called the “Budget Reconciliation Act,” all provisions of the Bush Tax Act expired on December 31, 2009. As Congress did not take immediate steps to extend the estate and gift tax rules, there was no federal estate tax in 2010. Congress finally took action in October 2009, and in 2011 and 2012 the exemption was \$5,000,000.
4. **Estate planning concern in those early years: Eliminate (or at least reduce) the estate tax.** Throughout all of these years (until 2011), with estate tax rates as high as 50 or 55 percent, for many clients a planning objective was to eliminate (or at least reduce) federal estate tax on the death of the client and his or her death. This could be accomplished through the use of not just marital deduction formula clauses and bypass trusts, but by way of some

rather sophisticated planning arrangements designed to reduce the value of the client's gross estate for estate tax purposes.

5. **Another take on lifetime gifts of assets likely to increase in value: The “new basis at death” rule.** We now have a \$5 million “permanent” estate and gift tax exemption—\$5.34 million in 2014 (and \$10.68 million in the case of spouses), which is likely to increase every year thanks to the annual inflation adjustment. As a result, one of the traditional estate planning techniques has been turned on its head: Lifetime gifts of assets with appreciation potential. In the past, the objective has been to make lifetime transfers of such assets, to remove the potential appreciation from the client's gross estate. But now, when even the estates of “mere millionaires” are not likely to be subject to estate tax, the greater tax benefit to the heirs may be to hold the assets until death, in order to obtain a basis step-up under §1014.
  6. **The purpose of the “new basis at death” rule** was to eliminate what might be seen as a form of double taxation. Suppose that Dad died leaving his estate to Daughter, and Dad's estate paid estate tax. Shortly thereafter, Daughter sells some of the assets (which had a very low income tax basis). If there were no step-up in basis on Dad's death, the same assets would generate (i) estate tax on Dad's death, and (ii) capital gains tax when Daughter sold the assets—deemed to be too heavy a hit. The “new basis at death” rule eliminated this concern.
    - a. That may have been a justification when the estate tax exemption was \$60,000, or \$600,000. In today's world, however, with a \$5 million-plus exemption very few estates are subject to estate tax, and yet the “new basis at death” rule lives on.
      - (i) Congress attempted, in the Tax Reform Act of 1976, followed by a Technical Corrections Act in 1977, and another Technical Corrections Act in 1978, to replace the “new basis at death” rule with a carryover basis rule applicable to decedents' estates. The result was a disaster—or fiasco; take your pick—to the point that Treasury supported its repeal in 1981.
    - b. **Community property.** All community property receives a new basis on the death of a spouse, even though only one-half of the community property is includible in the spouse's gross estate for estate tax purposes.
      - (i) This is not a gift to residents of community property states. In the old “maximum allowable marital deduction” days, all of a decedent's property would be includible in the decedent's gross estate (thus receiving a new basis under §1014), but through utilization of the marital deduction only one-half thereof would be subject to tax. In a community property state, only one-half of the deceased spouse's community interest is includible in her gross estate. To provide parity in treatment, all community property receives a new basis at death.
      - (ii) This is one of the reasons behind statutes recently enacted in Alaska and Tennessee that give their residents the option to elect into the community property regime.
- E. **Review of existing estate plans.** Should you consider contacting clients for whom you have prepared estate plans in the past—and, of course, are still with us? Well that is something you should be doing already: a tickler letter along the following lines:

Several years ago we prepared wills for you. As we discussed at that time, it is desirable for you to review your wills on a regular basis. Our records indicate that it is time for you to make this review.

Changes may be required by the birth of a new family member, by the death of a family member, by changes in financial circumstances, and by other factors such as changes in your goals and desires. Also, recent changes in the federal estate tax and gift tax laws—in particular, a substantial increase in the estate tax and gift tax exemptions—may have impacted your wills in a very substantial way.

At the time you signed your wills, you also executed a power of attorney giving [--] the authority to act on our behalf in the event of your disability. Some financial institutions are reluctant to transact in reliance on a power of attorney that is more than a couple of years old. To avoid this problem, we recommend that you re-execute your power of attorney.

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

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

1. **Marital deduction/bypass trust estate plans.** Under the prototypical formula QTIP/bypass trust plan, with a formula clause gifting “the smallest marital deduction needed to eliminate estate taxes in my estate,” under many clients’ wills all of the estate will pass to a credit shelter trust that (i) will no longer save estate taxes on the death of the surviving spouse because there are no estate taxes to save, (ii) will eliminate any step-up in basis on the spouse’s death, and (iii) may alter the dispositive plan if the marital trust and the bypass trust had different remainder beneficiaries.
  - (i) By increasing the exemption equivalent to \$5 million, just as in 1981 (when the unlimited marital deduction was introduced) Congress has functionally changed the estate plan of any client whose will contains a marital deduction formula clause. Unlike in 1981, however, **there is no transitional rule.**
2. **FLPs and LLCs.** If FLPs or LLCs were established primarily for valuation discount purposes (but of course they were not; there were substantial nontax reasons for the entities’ creation!), consider ways in which low-basis assets could be extracted from the entity. How to accomplish this is beyond my pay grade. However, one approach might be to taint the trust, by amending and restating the partnership agreement so as to intentionally “flunk” §2036, resulting the assets’ inclusion (and not the decedent’s partnership interest) in the decedent’s gross estate—an “intentionally defective” FLP!
3. **Loosey-goosey administration of FLPs and LLCs?** In at least a dozen cases involving FLPs and LLCs, a gross estate inclusion has resulted because the creator-donor has failed to respect the entity, and has continued to deal with the assets as though no FLP or LLC has been established. See, e.g., Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242; Estate of Harper v. Commissioner, T.C. Memo. 2002-121. In past CLE programs, these cases have been used to illustrate traps that should be avoided. But now, if a gross estate inclusion is to be desired rather than avoided, perhaps these cases illustrate traps that the client may want to fall into!

- (i) Also see Estate of Trombetta v. Commissioner, T.C. Memo. 2013-234, discussed *infra*, where the loosey-goosey creation and administration of an annuity trust resulted in a gross estate inclusion.
- 4. **Un-fractionalize fractional interests?** See the discussion of Estate of Williams v. Commissioner, *supra*. If ownership has been intentionally fractionalized in the past (perhaps with valuation discounts in mind), consider ways by which those interests could be consolidated.
- 5. **Move from minority discount to control premium?** In Estate of Frank v. Commissioner, T.C. Memo 1995-132, F's revocable trust owned 252 shares out of 501 shares of stock in a closely held corporation. F's wife owned 68 shares, and their three children owned the remaining 181 shares. F's son, acting under a durable power of attorney that expressly authorized the transaction, withdrew 91 shares from the revocable trust and gifted them to F's wife. (The gift qualified for the gift tax marital deduction.) F died two days later, and his wife died two weeks after that. F's estate took a minority discount for the 161 shares that Frank owned at his death. The government argued that the transaction, occurring only two days before Frank's death, should be disregarded under the substance over form doctrine, as the transfer was made solely to obtain a minority discount. The Tax Court held otherwise, and recognized a 20 percent minority discount.
  - (i) Suppose, when the story began, F, terminally ill and incapacitated, owned 161 out of the 501 shares. F's wife could give him her 91 shares, putting F (and shortly thereafter, his estate) in control premium posture.
- 6. **Grantor trusts.** The grantor could remove non-liquid low-basis assets from the trust by purchase or in exchange for high-basis assets.

## II. Section 401—Qualified Plans and IRAs

- A. **One rollover per year for IRAs.** In Bobrow v. Commissioner, T.C. Memo. 2014-21, the Tax Court ruled that the one-rollover-per-year limitation of §408(d)(3)(B) applies to all of a taxpayer's IRAs, and not to each IRA held by the taxpayer. Thus, Bobrow could not make a second IRA-to-IRA rollover if a rollover had been made in the preceding one-year period.
  - 1. On April 14, 2008, Bobrow, a tax attorney with Mayer, Brown & Platt in New York City, withdrew \$65,024 from IRA-1. On June 6, Bobrow withdrew \$65,024 from IRA-2 and transferred it to IRA-1. On July 31, Bobrow's wife withdrew \$65,024 from her IRA, deposited it in the couple's joint account, and on August 4, Bobrow withdrew \$65,024 from the joint account and transferred it to IRA-2. On September 30, Bobrow's wife transferred \$40,000 from the joint account and transferred it to her IRA. (Taxpayers unsuccessfully contended that the entire \$65,024 had been deposited in the wife's IRA, but the court found otherwise.) The court ruled that, under a correct interpretation of §408(d)(3)(B), the one-year waiting period applies to the taxpayer, and not to each IRA held by the taxpayer. The result was a \$51,298 deficiency and a \$10,260 accuracy-related penalty.
    - a. Bobrow contended that a §6662(a) penalty should not be assessed because he had analyzed the transaction and the statute as a seasoned tax attorney, an indication that he acted with reasonable cause and good faith. That didn't help at all, said the court, citing a case stating that "the 'experience, knowledge and education' proviso is fatal for

[taxpayer], who is a licensed attorney, certified public accountant and IRS audit supervisor.”

2. Wait a minute! Proposed Reg. §1.408-4(b)(4)(ii) and IRS Publication 590, Individual Retirement Arrangements (IRAs) provide that the one-year limitation is applied on an IRA-to-IRA basis! That is true, said the Service in Announcement 2014-15 (March 20, 2014). However, in light of Bobrow v. Commissioner, the IRS announced that it intends to withdraw the proposed regulations and revise its guidance to clarify the rules limiting rollovers of IRAs.
  - a. This rule is to be effective January 1, 2015. The Announcement states that the effective date was delayed in order to give IRA trustees time to make changes in the processing of IRA rollovers and in IRA disclosure documents.
3. This will kill of the use of tax-free distributions as short-term loans, by withdrawing funds from one IRA and redepositing the money in another IRA within 60 days.

**B. Inherited IRAs are not exempt from bankruptcy estate.** In Clark v. Rameker, 573 U.S. \_\_\_\_ (2014), the Supreme Court ruled that funds held in an “inherited” individual retirement account—acquired by the designated beneficiary on the death of the owner—are not “retirement funds” as defined by the Bankruptcy Code, and are not exempt from the designated beneficiary’s bankruptcy estate.

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

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

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

1. The court noted that while there are no laws preventing IRAs from holding real property, there is no requirement that an IRA trustee or custodian must give participants the option of investing in real property.
2. **No accuracy-related penalty, though.** “Although [Mr. Dabney] was mistaken in his understanding of the law, it was reasonable under the circumstances for Mr. Dabney to

believe that he had not received an early distribution from his IRA. We find that he had reasonable cause for failing to report the distribution on his return and acted in good faith.”

**E. Wife’s fraudulent withdrawal of funds from IRA not taxed.** In Roberts v. Commissioner, 141 T.C. No. 19 (2013), in 2008 Roberts’ former wife fraudulently withdrew \$37,000 from two IRAs accounts by forging his signature. The wife filed Roberts’ 2008 income tax return, telling him that she was filing a joint return; in fact, she prepared his return on a single filing basis, underreported his income, and overstated a credit for withheld tax. They filed for divorce in 2009.

1. The Service contended that the IRA distributions must be included in Roberts’ gross income, as the distributions were taken into account in the couple’s 2010 divorce settlement and Roberts took no steps to restore the funds to the IRAs.
2. The Tax Court held that the distributions were not includible in Roberts’ gross income or subject to the 10 percent penalty tax, because the former wife fraudulently withdrew funds without Roberts’ knowledge or consent and he received no economic benefit from the funds.

### III. Section 671—Grantor Trust Rules

**A. Pending Tax Court case: Service challenges installment sale to defective grantor trust.** For several decades, planners have implemented a sophisticated estate “freeze” transaction that results in converting appreciated assets with further appreciation potential into a fixed-yield non-appreciating asset (a promissory note) by way of an installment sale to an intentionally “defective” grantor trust. There are no income tax consequences resulting from the sale (no immediate gain recognition; no recognition of interest and principal payments) because the grantor is in effect selling the assets to himself. Rev. Rul. 85-13, 1985-1 C.B. 184. (*Cf.* Lord Keynes: “We owe it to ourselves.”) As is noted by Treasury’s Fiscal Year 2014 Budget Proposal (as well as in the Fiscal Year 2013 Budget Proposal), Treasury does not like the “DIGIT” transaction.

1. **Estate of Woelbing v. Commissioner.** On December 26, 2013, two companion cases (involving a husband and wife) were filed in the Tax Court. Docket Nos. 30260-13 and 30261-13. In 2006, H sold all of his non-voting stock in Carma Laboratories (Carmex Lip Balm and other skin care products) to an irrevocable grantor trust in return for a \$59 million promissory note bearing interest at the AFR rate (applicable federal rate). The sale was to an “Insurance Trust” that owned three life insurance policies on H’s life under a split dollar regime. The policies had an aggregate cash surrender value of \$12.6 million. Two sons (who were beneficiaries of the trust) executed personal guarantees for 10 percent of the purchase value of the stock. The sales agreement included a defined value feature along the lines of Wandry v. Commissioner, T.C. Memo. 2012-88, under which the number of shares transferred (the transfers were made long before Wandry v. Commissioner had been decided) would be adjusted to the value of the note. Gift tax returns based on split treatment were filed for 2006, 2008 and 2009. H died in 2009; W died in September 2013. Steve Akers (on whose Bessemer Trust commentary this summary is based) notes that “interestingly, [W died] only two days after receiving the IRS’s Notice of Deficiency of almost \$32 million against Mrs. Woelbing for her gift tax.” The deficiency notices for both estates aggregate \$125 million, plus \$25 million in undervaluation penalties.
  - a. **The Service’s position as to gift tax.** In Estate of Woelbing v. Commissioner, The Service has taken the position, first, that the note should be treated as having zero value and that, under §2702, the entire value of the non-voting shares transfers should be treated as a gift because the note payments were not structured as guaranteed annuity

payments. Second, the value of the transferred stock was \$116.8 million, not \$59 million.

- b. **The Service's position as to estate tax.** The Service has contended that, while the value of the note should not be included in H's gross estate, the value of the stock should be includible under §§ 2036 and 2038. Furthermore, the value of the stock had increased to \$162.2 million at the time of H's death.
2. **The case raises some rather interesting issues.** That is something of an understatement.
    - a. **Use of personal guarantees to partially seed the purchasing trust?**
    - b. **Basic validity of DIGIT transaction, and whether §2702 should apply?**
    - c. **AFR interest rate rather than the much higher §7520 interest rate?** Steve Akers points out that in several cases, the Tax Court itself has approved use of the AFR interest rate in intra-family sale transactions (Frezee v. Commissioner, 98 T.C. 554 (1992); True v. Commissioner, T.C. Memo. 2001-167), and several private letter rulings have also so ruled.
    - d. **Or, as Steve Akers posits, "is this primarily just a valuation case",** and will the parties settle? Stay tuned.

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

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

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

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

- B. **Which planning decision should be made: reliance on portability election or bypass trust? There is no one answer.** The portability option raises new questions and new decisions that must be made (i) at estate planning time and (ii) on the first spouse's death. Looking first at the planning issues, a variety of factors must be considered in the clients' determination of whether to rely on

traditional bypass trust planning or, instead, anticipate that a portability election is likely to be the best option on the first spouse's death. There is no "one size fits all" solution. The following factors (and probably some that I have not listed) will affect the clients' decision—and in many cases several of these factors will be in play at the same time, pushing in opposite directions. (In this initial discussion, I will contrast outright dispositions versus bypass trusts, leaving for later herein a discussion a "best of both worlds" option involving a QTIPable trust.)

1. **Size of the marital estate and likelihood of estate taxes on surviving spouse's death.** The estate tax exemption is destined to increase every year due to annual inflation adjustments. For "mere millionaires"—a couple in their 70s with a \$5 to \$6 million community property estate and a mix of assets that have little or no significant appreciation potential—it is highly unlikely that the surviving spouse will "need" any additional exclusion amount to eliminate estate tax on his or her death. Instead, the availability of a second basis step-up may be of greater potential value to the surviving family members.
  - a. But remember that Murphy's Law operates with a vengeance in this area of the practice! Do the clients play the lottery on a regular basis? Is there the possibility of a substantial inheritance from that uncle in East Texas? (This latter issue, of a potential inheritance, should of course be explored at that first client consultation in all cases.)
  - b. On the other hand, projecting estate values for a couple in their 40s or early 50s is problematic at best.
2. **Are all of his kids also her kids, or do we have a blended family?** If we have a second marriage situation and either or both spouses have children by an earlier marriage, a bypass trust that gives the spouse a special testamentary power of appointment, will insure that the client's assets will stay on his or her side of the house.

### C. **Reasons favoring the use of bypass trusts.**

1. **Portability election requires that an estate tax return must be filed.** In medium-sized estates of "mere millionaires," the cost and complexity of filing an estate return will be seen as too high a price to pay for the *potential* benefit of a portability election.
  - a. But even here it is important to discuss the topic with the clients, and to document that conversation.
2. **Traditional benefits of trust settlements rather than outright dispositions**
  - a. **Creditor protection via spendthrift provision.** Is spendthrift protection really a concern if the clients' investment strategy is conservative and neither spouse is a risk-taker? Yes it is—if either spouse occasionally drives on I-10 or I-35. All it takes is for the client to be the *alleged* negligent driver in a car collision where the damage claim exceeds the GEICO or USAA policy limits.
  - b. **Avoiding guardianship.** A major concern is that the surviving spouse may later become incapacitated. The consequence of an outright disposition would likely be a cumbersome and costly guardianship administration. If the client's estate is left in trust, perhaps with the spouse serving as trustee for as long as he or she is able and so inclined, a guardianship administration will be avoided.
    - (1) Attorneys and other professionals invariably recognize this as a topic of discussion if the clients are in their 70s—but the topic also merits discussion if

the clients are in their 40s. After all, the trust would continue for the spouse's lifetime, meaning (if all goes well) into his or her old age.

- c. **Management by a qualified manager.** The surviving spouse (whichever it may turn out to be) may be seen as not having sufficient management and investment skills, making it more appropriate to name a professional as trustee.
  - d. **Keeping it in the family.** While this concern is apparent in the second marriage-divided family situation, it can be a concern even in the one-marriage situation where all of his kids are also her kids. A trust settlement assures that on the spouse's death, the remainder interest will pass to the client's descendants, rather than to that dreaded second husband, that trophy second wife, or a too-solicitous caretaker.
  - e. **Special testamentary power of appointment tends to insure filial devotion.** Even in the one-marriage situation, a trust that gives the surviving spouse a special testamentary power of appointment can be beneficial. If the spouse has a power of appointment over a \$900,000 trust, it is highly unlikely that she will be alone at Thanksgiving! "It doubtless occurred to the testator that by restraining a disposition of his property except by will, which is in its nature revocable, [his widow] would, to the end of her life, retain the influence over, and secure the respect of, the several objects of his bounty." *Hood v. Haden*, 82 Va. 588 (1886).
  - f. **Appreciation in assets' value excluded from surviving spouse's gross estate.** If, through appreciation or otherwise, there is a likelihood that the surviving spouse's estate may push toward his or her estate tax exemption, assets in the bypass trust will pass to the next generation free of estate tax—that's why we call them bypass trusts! (On the other hand, appreciated assets in the bypass trust will not get a step-up in basis.)
3. **Avoids hostility, in the blended family situation, as to whether the portability election should be made.** If client's will names a child by his first marriage as executor and a portability election will benefit the spouse's family, "why should I go to the trouble and expense of filing an estate tax return which benefits that \*\*\*\*?"
  4. **Utilization of both spouses' GST exemption.** There is no portability election with respect to the generation-skipping transfer tax. Thus, an "all my property" estate plan utilizes only one GST exemption in passing property to the descendants. By allocating GST exemption to a bypass trust, both spouses' GST exemptions can be utilized. (It should be noted, however, that this benefit also can be secured through the use of a QTIP trust and a reverse QTIP election.)
  5. **Bypass trust can be funded with discounted and/or hard-to-value assets.** The bypass trust can be funded with, *e.g.*, FLP interests utilizing discounted values, with a low audit risk at the first spouse's death. The statute of limitations runs on values if a bypass trust is funded at the first spouse's death. If a portability election is made, both estates can be audited (*i.e.*, to see that the DSUE amount was properly determined).
  6. **Client owns real property in a jurisdiction that has state estate tax.** This would suggest that a bypass trust should be employed to utilize the state's estate tax exemption.
  7. **Possible loss of DSUE amount upon remarriage.** Portability applies only to the DSUE of the last deceased spouse. If the surviving spouse remarries and the new husband or wife then

dies, that new spouse becomes the last deceased spouse, meaning that the portability election that was made when the first spouse died will turn out to have been useless.

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

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

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

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

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

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

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

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

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

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

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

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

1. **Getting around the “negatives” of a QTIP trust by building in flexibility.** A QTIP trust doesn’t allow for much flexibility. All trust income must be paid to the spouse at least annually (the trust cannot have a spray or accumulation provision with respect to income) and no one other than the spouse can be a beneficiary during the spouse’s lifetime (no discretionary power to distribute principal to descendants or others). How can we build flexibility into the plan?
2. **Disclaimer-funded bypass trust.** Properly structured, this is a “second look” plan. H’s will is drafted (and, vice versa, W’s is drafted) to provide that the residuary estate shall pass to a QTIPable trust. The will further provides that if or to the extent W disclaims, the disclaimed interest shall pass to a bypass trust that contains more flexible terms—and which can name W as a beneficiary. On H’s death, W can (i) assess the financial and tax picture in H’s estate—how much marital deduction (if any) is needed to eliminate estate tax, and (ii) make an educated projection—with more information than was available when the estate plan was prepared—as to whether (or to the extent) portability is preferable to a bypass trust arrangement.
  - a. **Caveat.** In addition to meeting the nine-month deadline for making a disclaimer, W must not have accidentally “accepted the interest or any of its benefits.”
  - a. **Caveat.** The disclaimed interest must pass “without any direction on the part of the person making the disclaimer.” Thus, W cannot be a trustee or co-trustee if the trust gives her a discretionary distribution power (but an independent co-trustee could be given a discretionary distribution power). Also, W cannot be given a special testamentary power of appointment over the bypass trust.

3. **Clayton trust approach: Interest passing to spouse can be made contingent on QTIP election.** Suppose that property is devised to a QTIPable trust, but the will provides that, if or to the extent that the executor does not make a QTIP election, the property shall be added to a residuary trust that permits discretionary distributions. In the early 1980s, when the QTIP election first hit the scene, a number of wills were drafted along these lines. The QTIP regulations initially took the position that if the income interest given to the spouse was contingent on the executor's making a QTIP election, the interest was not QTIPable. The Tax Court initially agreed with this reading of the statute, but three Courts of Appeal rejected it. Estate of Clayton v. Commissioner, 976 F.2d 1486 (5th Cir. 1992); Estate of Robertson v. Commissioner, 94-1 U.S.T.C. ¶60,153 (8th Cir. 1994); Estate of Spencer v. Commissioner, 43 F.3d 226 (6th Cir. 1995). In 1997 the government threw in the towel, and new regulations were issued: An income interest that is contingent upon the executor's making a QTIP election is not precluded, on that basis, from qualifying for the marital deduction. Reg. §§20.2044-1, 20.2056(b)-7 and 20.2056(b)-10. The regulations make it clear that interests for which the QTIP election is not made may pass to another beneficiary.
  - a. Including this language in the client's will would enable the client's executor (in many cases, the surviving spouse) to determine, based on the tax and financial picture as of the first spouse's death, whether (or to what extent) a QTIP election should be made.
  - b. Unlike a disclaimer-funded bypass trust, in this situation the spouse can be given a special testamentary power of appointment over the bypass trust.

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

1. **Hindsight, anyone?** Perhaps you have noticed (he said with a modicum of understatement) that heirs and other disgruntled family members are blessed with perfect hindsight, and in this context would have no difficulty concluding the “obvious”: If it turns out that, in retrospect, the decision to elect portability [should] [should not] have been made, making the wrong decision (or making no decision at all because, it is alleged, the topic was not even discussed) was obviously the result of the attorney's negligence—so grossly negligent, in fact, to warrant the imposition of punitive damages.
2. **Make it clear that you gave the clients the opportunity to understand the topic.** This raises another question: Will your typical clients really understand the issue, and the implications of the decision? Clients never have a problem understanding what an exemption is—especially a \$5.34 million exemption, and can grasp the concept of an unlimited marital deduction. But new basis at death??? What's that all about? In teaching law students (a pretty sophisticated audience) over a number of years, I have seen that, especially for students who haven't (yet) taken the Federal Income Tax course, the new-basis-at-death concept is, for some, hard to grasp for some reason.
  - a. **Recommendation.** In addition to discussing the issue with the clients at estate planning time (in the appropriate case), consider preparing a two-or-so page handout for clients that explains (in lay language) how “new basis at death” works, the election

that will be faced by the surviving spouse (and give a few examples), and how the election would not be available as a practical matter (absent disclaimer) under a bypass trust plan. Then have the clients sign underneath a paragraph which says (along the following lines) We have considered the possibility of relying upon an estate plan that makes the portability election available, but given the benefits provided by a bypass trust, the cost filing an estate tax return to make the election, and the fact that it is highly unlikely that the survivor of us would have need for additional exemption, we have decided.

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

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

1. **Unjust enrichment claim made by daughter.** Shortly thereafter, Kathleen, as personal representative of Mary's estate, filed a claim for \$500,000 against Glenn's estate, contending that without additional compensation over the agreed-to \$5,000, Glenn's estate would be unjustly enriched by reducing its tax obligation.
  - a. **The daughter had standing as heir.** Glenn's estate contended that Kathleen had no standing to bring the action as personal representative because her mother's estate had been closed. That is true, said the court, but Kathleen had standing as her mother's heir.
  - b. **Unjust enrichment claim rejected.** Affirming the lower court's ruling, the court held that the DSUE was a bargained-for tax benefit under the parties' agreement for which Kathleen received consideration, and "she cannot now complain that she should have bargained for more."
  - c. **Breach of ethics claim rejected.** Kathleen also contended that Glenn's representative violated the Indiana Rules of Professional Conduct when they failed to explain the tax consequences of her signing the Form 706 (!). The court pointed out that Glenn's representative did not have such a duty, as Kathleen was represented by her own counsel and Glenn's counsel represented Glenn alone.
2. **Lesson: Address the portability issue at estate planning time.** This wasn't on the table in the Indiana case, where the wife died in May 2011 and the husband died in July 2012. For your clients, though, the issue should be addressed at the time estate plans are being prepared or reviewed. There are several advantages to this.

- a. **Avoids need to negotiate on first spouse's death.** Such negotiations can be awkward, especially where (as in Walton v. Estate of Swisher) the executor is a child by the deceased spouse's earlier marriage. "What's in it for me, or for Mom's estate? Mom's estate doesn't get any benefit at all, while your estate and beneficiaries will save big taxes. I'll agree, but it will cost you a bundle."
- b. **At estate planning time, the spouses are lovey-dovey.** Well, perhaps not love-dovey, but they are inclined to be cooperative because each spouse's will invariably makes some provision (if not substantial provision, or at least a trust income interest) for whoever turns out to be the surviving spouse. This isn't the time or place for either spouse to be argumentative.
- c. **In many cases, each spouse will have skin in the game.** This was not the situation in Walton v. Estate of Swisher, where the wife's gross estate was \$100,000; and while the value of the husband's estate was not mentioned in the opinion, it was sizeable enough to warrant bargaining for the DSUE. Also, in some situations because of age disparities or health issue, the predictability of who will be the first deceased spouse is high. In many situations, though, (i) which of them will be the surviving spouse is not predictable with certitude, and (ii) because of the projected value of their respective estates, the portability election will be attractive to whichever of them turns out to be the surviving spouse.
- d. **Draft of will provision.** Here is my first cut of a clause that might be inserted in each spouse's will. Critiques or suggested improvements would be appreciated.

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

3. **Lesson: Negotiating an agreement after death of first spouse.** Suppose (as in Walton v. Estate of Swisher) the issue was not issued at estate planning time? The estate and surviving spouse should enter into a written agreement regarding the DSUE election, addressing who will prepare the Form 706 and who will pay for it.
  - a. **Consideration for the agreement: Spousal or family allowance?** Looking at the issue from the surviving spouse's perspective, what should be the response if the decedent's executor takes the position, "What's in it for me and Mom's estate? This is very valuable to you and your heirs, and it's going to cost you a bundle." The answer is that the spouse does have a potent bargaining tool. The court's opinion in Walton v. Estate of Swisher mentions three times the \$5,000 the husband agreed to pay, but mentioned only in passing the husband's agreement "to waive his survivor allowance." Every state gives the surviving spouse an entitlement to a family allowance or spousal allowance, and in nearly every state there is no necessity of showing need. (In Indiana, the spousal allowance is \$25,000. Ind. Code §29-1-4-1.) Few states are as generous as Texas, where the family allowance is the amount needed for the spouse's maintenance for the period of one year, without regard to other resources (other than separate property) available for the spouse's support. Tex. Estates Code §353.102. In Estate of Wolfe, 268 S.W.3d 780 (Tex. App. 2008), the court affirmed a family allowance of \$126,840, even though the spouse received \$291,250 in insurance proceeds, was the beneficiary of IRA accounts totaling \$120,000, and had income of \$85,000.

- b. Because the family or spousal allowance is available for the asking, if the executor is being obstreperous, an offer to waive the allowance (or claim only a portion of it) should be a useful bargaining chip. (“Unless you agree to make a portability election, you are going to take \$\_\_\_ less under your mother’s will.”)
4. **Lesson: Advising the deceased spouse’s executor.** In Walton v. Estate of Swisher, the daughter’s contention of a violation of the Indiana Rules of Professional Conduct was silly: The daughter had her own attorney, and “Glenn’s counsel represented Glenn alone.” Besides, where was the detriment to the mother’s estate, when (i) with a \$100,000 gross estate the DSUE amount was of no use to the estate, and (ii) the husband prepared and paid for preparation of the Form 706?
- a. **Dual representation.** The situation is more sensitive if one attorney represents both the deceased spouse’s estate and the surviving spouse. And that attorney could be you! After all, you drafted both wills—after the couple’s written consent to dual representation—and the family looks to you as “their” attorney.
  - b. **Nuclear family; spouse named as executor.** This is the easiest case. If all of his kids are also her kids, absent unusual estate plans the portability election will inure to the benefit of *their* descendants.
  - c. **Blended family; spouse named as executor.** In this situation, where one or both spouses had children by an earlier marriage, dual representation is dicey, but doable. The spouse’s beneficiaries are not adversely affected by the portability election as long as her estate isn’t going to pay any estate taxes—with one exception: The cost of preparing the estate tax return. In this situation, it may be advisable for the parties to agree that surviving spouse is to pay the cost of preparation and filing, unless her agreement to give up the family allowance entitlement is seen as an adequate quid pro quo.
    - (1) In any case, full documentation and full disclosure is not just advisable but necessary.
  - d. **Blended family; child by first marriage named as executor.** In this situation, if the son or daughter wants to retain you to represent the estate, there is a potential conflict of interest that needs to be recognized and then addressed.

## V. Section 2032A—Special Use Valuation

- A. **Special use valuation determined asset’s basis.** In Van Alen v. Commissioner, T.C. Memo. 2013-235, D’s ranch was devised to a trust for the benefit of his children, Shana and Brett. A probate court referee determined that the value of the ranch was \$1.96 million, but the executor (Shana’s and Brett’s stepmother) elected a special use valuation under §2032A. As a result, the value of the ranch for estate tax purposes was \$98,735. As required by §2032A, Shana and Brett (a minor represented by his mother as his guardian ad litem) executed an agreement consenting to the special use valuation election. Some years later, the trust sold a conservation easement \$910,000. Although the trust’s income tax return reflected a \$620,000 gain from the sale, neither Shana nor Brett reported the gain on their individual income tax returns.
  - 1. Shana and Brett contended that they could report a basis for the ranch interest different from its special use value for income tax purposes, relying on Rev. Rul. 54-97, 1954-1 C.B. 113.

The ruling states that “for the purpose of determining basis ... the value of the property as determined for the purpose of the Federal estate tax shall be deemed to be its fair market value at the time of acquisition. Except where the taxpayer is estopped by his previous actions or statements, such value is not conclusive but is a presumptive value which may be rebutted by clear and convincing evidence.”

2. No go, said the Tax Court. Under the duty of consistency, Shana and Brett were estopped from claiming that their basis was greater than the special use valuation reported on the estate tax return. The Tax Court went on to say that it didn’t need to resolve the issue of the ruling’s applicability to the case at hand because the case could be determined by applying the doctrine of the duty of consistency. Shana and Brett (through his guardian ad litem) had executed the agreement consenting to the special use valuation election. They had taken a position relied upon by the Commissioner, and now they were attempting to change their previous representation in a manner detrimental to the Commissioner.
3. The real message of the case: With a \$5.34 million (and growing!) exemption equivalent under the estate tax, meaning that in the vast majority of cases “new basis at death” is the only tax consequence of a valuation decision. Congress has functionally repealed §2032A—or, more precisely, has laid a malpractice trap for the attorney or CPA who recommends a special use valuation.

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

- A. **Tax Court rejects dollar-for-dollar discount for unrealized capital gain.** Estate of Richmond v. Commissioner, T.C. Memo. 2014-26, involved a personal holding company (incorporated in 1928) whose assets consisted primarily of publicly traded stock. The PHC had a “hold” strategy with an investment philosophy of maximizing dividend income. The PHC held common stocks in ten major industries, with 43 percent of its holdings in Exxon Mobil, Merck, General Electric and Pfizer. R, who died in Pennsylvania in December 2005, held 23.5 percent of the PHC shares. The PHC’s portfolio value on the date of R’s death was \$52.2 million. The estate filed a Form 706 that valued R’s interest at \$3.15 million, based on a capitalization-of-dividends valuation method. The Service assessed a deficiency of \$2.85 million based on a \$9.2 million valuation and a \$1.42 undervaluation penalty.
1. **Net asset valuation method and not dividend capitalization was the better methodology.** The Service’s expert reported a value of \$7.33 million based on a net asset valuation methodology, which the Tax Court determined as the better approach. Dividend valuation an appropriate method, said the court, where the company’s assets are difficult to value, but was inappropriate for personal holding companies whose assets are marketable securities with ascertainable market values.
  2. **Fifteen percent discount for unrealized capital gain tax.** Of the PHC’s \$52.2 million value, unrealized appreciation on its assets was \$45.6 million, which under federal and state tax rates would generate a capital gains tax of \$18.1 million. The court noted that several Courts of Appeal had recognized a 100 percent discount for the potential capital gain tax liability. Estate of Jelke v. Commissioner, 507 F.3d 1317 (11<sup>th</sup> Cir. 2007); Estate of Dunn v. Commissioner, 267 F.3d 339 (5<sup>th</sup> Cir. 2002); Estate of Jameson v. Commissioner 366 (5<sup>th</sup> Cir. 2001). The Tax Court chose instead to follow other Courts of Appeal (and its prior decisions) that rejected the dollar-for-dollar approach. Estate of Eisenberg v. Commissioner, 155 F.3d 50 (2d Cir. 1998); Estate of Welch v. Commissioner, 208 F.3d 213 (6<sup>th</sup> Cir. 2000). The dollar-

for-dollar method is “plainly wrong in a case like the present one.... [A] prospective [built-in capital gain] is not the same as a debt that really does immediately reduce the value of a company dollar for dollar,” because the tax is susceptible of indefinite postponement. Instead, “the most reasonable discount is the present value of the cost of paying off that liability in the future.” The court concluded that a discount of \$7.8 million was appropriate.

- a. The case is appealable to the Court of Appeals for the Third Circuit, which has not yet weighed in on the issue.
3. **Twenty percent undervaluation penalty affirmed; estate did not use a certified appraiser.** The PHC’s value reported on the estate tax return, 65 percent of the determined value of \$7.33 million, was based on a report by Mr. Winnington, a CPA who had written 10-20 valuation reports and had testified on valuation issue, but who was not a certified appraiser. “[W]e cannot say that the estate acted with reasonable cause and in good faith in using an unsigned draft report prepared by its accountant as its basis for reporting the value of the decedent’s interest.... While we do not disagree with the estate’s ascertain that the decedent’s interest in PHC may be difficult to value, we believe this further supports the importance of hiring a qualified appraiser.”

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

- A. **Annuity trust includible in gross estate; too much retained control.** In Estate of Trombetta v. Commissioner, T.C. Memo. 2013-234, T transferred two rental properties to an annuity trust with a term of 180 months, but retained the power to reduce the trust’s term. The trust was to distribute to T an annuity of \$75,000 for the first 12 months, with a 4 percent increase in each successive 12-month period. Upon termination of the trust, the assets were to be distributed to T’s children and grandchildren. The rental properties were subject to mortgages, on which the trust paid the interest and principal even though the trust had never assumed the mortgages. When T was diagnosed with cancer and concluded that she would not live until the end of the trust term, she amended the trust by reducing its term to 156 months. T died six weeks after the end of the amended trust term.
1. The Tax Court ruled that the value of the two rental properties was includible in T’s gross estate because the transfers were not bona fide sales for adequate and full consideration. T’s attorney prepared the trust agreement without any meaningful negotiation or bargaining with the other co-trustees or future beneficiaries. T and her attorney determined how the annuity trust would be structured and operated and which properties would be contributed to the trust.
  2. T retained an interest in the properties, as evidenced by her retained control of the properties and the use of income from the properties to satisfy her personal legal obligation—the mortgage payment. As for control, T made all decisions with respect to the properties, and the other co-trustees (T’s children) generally acted on her recommendation. T alone retained signatory authority with respect to the properties. Because the trustees could distribute additional income to T, she maintained the same enjoyment of the properties and their income as she had before transferring the properties to the trust. The court concluded that there was an implied agreement that T would retain an economic benefit in the properties.
  3. The estate cited a number of family limited partnership cases in support of its position. However, T’s transfers were not comparable to a transfer to an FLP because no other individual received a present interest in the annuity trust. Consequently, there was no basis for discussing, let alone applying, the “legitimate and significant nontax reason” exception. In

any case, the nontax objectives that were met by the to the annuity trust were not significant said the court.

## VIII. Section 2042—Life Insurance

- A. **Spouse-owned life insurance—but the spouse died first.** In Ltr. Rul. 201327010, T’s wife W had purchased several policies on T’s life, naming W’s estate as the beneficiary. W died, and under her will the insurance proceeds passed to a discretionary trust for the benefit of T and W’s descendants. The trust, which gave T a special testamentary power of appointment, named T as the trustee and trust protector. As protector, he had the power to remove and replace trustees. As trustee, he held incidents of ownership in the life insurance policies.
1. **Quick thinking and quick action saved the day.** T resigned as trustee and trust protector, and relinquished his ability to be reappointed as a trustee and his special testamentary power. T did not, however, disclaim his beneficial interest in the trust. That’ll do it, said the Service. The policy proceeds will not be includible in T’s estate under §2042—if T survives the three-year period under §2035.
- B. **Transfer of policy to new trust: “Transfer for value” avoided because they created a partnership.** In Ltr. Rul. 201332001, H and W’s existing grantor trust (Trust 1) purchased a joint and survivor policy. Upon the death of the survivor, the corpus was to be distributed outright to the couple’s four children as beneficiaries. After Trust 1 was set up, Daughter was diagnosed with a severely limiting disability. H proposed to establish Trust 2 (also a grantor trust), with the same beneficiaries and trustee as Trust 1, but with a Special Needs provision for Daughter’s share. Trust 2 intends to purchase the policy from Trust 1 for the value of Trust 1’s interest in the policy—its interpolated terminal reserve value plus the gross premium last paid before the sale date. Trust 2 will be named the policy beneficiary, and H will make annual gifts to Trust 2 to pay the premiums. H and W have formed a partnership, owning several investments as partners.
1. That will not be a transfer for value, said the Service. Under §101(a)(2)(B), the transfer for value rule is not triggered when a life insurance policy is transferred for a consideration to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer. Accordingly, to the extent that the policy insures H’s life, this will be deemed a transfer to the insured because H is treated as owning Trust 2. To the extent that the policy insures W’s life, that portion of the policy is treated as being transferred to H as a partner of the insured. Therefore, the transfer for value rule is not triggered.
- C. **Insured’s right to receive policy dividends not an incident of ownership.** Under the facts of CCA 201328030, life insurance policies were acquired for the benefit of the insured’s former spouse in connection with a divorce settlement. The insured paid all premiums and could not borrow against or pledge the policies, but was entitled to policy dividends. That’s not an incident of ownership, said the Office of Chief Counsel. The term “incidents of ownership” includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to borrow against the policy’s surrender value. The right to dividends is nothing more than a reduction in the amount of premiums paid, and is not a right to the income of the policy. Policy dividends merely reduce the premiums needed to keep the insurance in force.

## IX. Section 2056—Marital Deduction

- A. Trustee was supposed to segregate the revocable trust assets into separate trusts.** In Estate of Olsen v. Commissioner, T.C. Memo. 2014-58, H and W created reciprocal revocable trusts, with H as trustee of both trusts. W died in 1998, and on the estate tax return H as personal representative reported that the assets in W trust (\$2.1 million) were to be segregated into Family Trust (\$600,000—the estate tax exemption at that time), Marital Trust A (\$1,000,000—the GST Exemption), and Marital Trust B (\$500,000). The principal and income of Family Trust was to be used for the benefit of the couple’s children and grandchildren, and H was given a lifetime and testamentary power of appointment in favor of the children, grandchildren, and charities. Principal and income of Family Trust could be used for H’s benefit only if the principal of the Marital Trusts was exhausted. However, H never segregated the funds into the three separate trusts as called for by the trust. Before H died in 2008, he donated \$1.08 million from W’s trust to Morningside College. He also withdrew \$394,000 from W’s trust and deposited it into his own account, from which he made gifts to family members.
1. The Service took the position that the entire value of W’s trust should be included in H’s estate. The Service’s position was that all of the withdrawals should be deemed to have been made from Family Trust or, in the alternative, to have been made pro rata. The estate contended that since it was W’s and H’s clear intent to reduce estate taxes and use W’s unified credit for the benefit of their descendants, and because H as trustee had a duty to minimize estate taxes for the benefit of the remainder beneficiaries, the withdrawals should be treated as having been made from the Marital Trusts.
  2. The Tax Court ruled that H’s withdrawals that were donated to Morningside College were exercises of the limited power of appointment in favor of charity, and thus were taken from Family Trust. However, the withdrawal that was deposited into H’s personal account was determined to be a distribution from Marital Trusts, because W intended that discretionary distributions from Family Trust were not to be made to H until Marital Trusts were exhausted.
  3. The opinion notes that the attorney working with H in the estate’s administration reminded H (in writing) on at least two occasions that H was to segregate the trust into three separate trusts.
- B. Spouse’s right to elect one of two benefits is not a “contingency” that will impair marital deduction.** In Ltr. Rul. 201410011, a prenuptial agreement provided for certain outright distributions to S and a distribution to a QTIPable marital trust for S’s benefit. A revocable trust provided for distributions to S and the marital trust pursuant to the prenuptial agreement, but gave S an election to forgo the distributions required under the prenuptial agreement. The election was to be made within 180 days after Taxpayer’s death. If the election were made, S and the marital trust would receive different amounts.
1. The Service ruled that the election provision will not impair qualification for the marital deduction. “In each event, Spouse will have an absolute right to any property passing outright to her as well as an absolute right to the income from any property passing to Marital Trust... The requirement that Spouse make a timely election is a mere procedural formality, and is not a contingency within the meaning of § 2056(b)(1).” If such an election is made, the property interest relinquished by the spouse isn’t considered as having passed from the decedent to the spouse, so it isn’t considered an impermissible terminable interest.

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

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

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

1. **Background: Self-canceling installment notes (SCINs).** In a SCIN transaction, a party sells assets in exchange for a promissory note to be paid in installments, with a provision that if the obligee dies during the term of the note (*i.e.*, before the note has been paid in full), the note is cancelled. As a result (if the transaction works as planned), there is no estate tax inclusion in the obligee’s estate. Of course, if the obligee outlives his life expectancy, he will have received more payments than if a standard promissory note had been employed. The ideal candidate for a SCIN transaction, then, is a client who is healthy enough to justify use of the §7520 term interest tables in valuing the note, but not healthy enough to likely outlive the term of the note.
  - a. **Risk premium.** For the value of the SCIN to be equal to the value of the property sold, the obligee must be compensated for the risk that he may die during the term of the note and thus not receive the full purchase price. The “risk premium” may take the form of a higher-than-market interest rate on the note—*e.g.*, a 10 percent interest rate in a 5 percent world. Alternative, the principal face amount of may be substantially higher than the value of the property sold.
  - b. **The seminal case: Estate of Moss.** The case that caught the estate planning community’s attention was Estate of Moss v. Commissioner, 74 T.C. 1239 (1980), acq. in result, 1981-2 C.B. 1. Moss, who was married but had no children, was president of a funeral home in Florida and owned 231 shares of the corporation’s common stock. The remaining 355 shares were owned by employees of the funeral home, who had either purchased the shares or acquired them by gifts from Moss. The shareholders accepted Moss’s offer to sell the 231 shares for \$800/share (the shares’ book value was \$440/share) under an installment note with a term of 9 years and 7 months.
    - (1) On the date of the transaction, “the physical and mental condition of decedent was average for a man of 72 years of age,” said the Tax Court. “There was nothing to indicate that his life expectancy would be shorter than the approximate 10 years of life expectancy which was indicated by generally

accepted mortality tables.” Seven months after the sale, Moss was diagnosed with cancer, and he was terminally ill for the remaining nine months of his life.

- (2) Although the parties had stipulated that the sale was a bona fide transaction for full and adequate consideration, the Service contended that the note’s value was includible in Moss’s gross estate under §2033, on the ground that the cancellation provision was no different from a will provision cancelling a promissory note. “Respondent contends that decedent ... simply chose to pass the funeral home business to his employees under the guise of the notes which were canceled upon death rather than through his will.” The court rejected the Service’s contention. “The cancellation provision was part of the bargained for consideration provided by decedent for the purchase price of the stock. As such, it was an integral provision of the note.... We believe there are significant differences between the situation in which a note contains a cancellation provision as part of the terms agreed upon for its issue and where a debt is canceled in a will.”
- (3) It bears emphasis that this was not an intrafamily sale, and could hardly be considered an abusive transaction. This is the likely explanation for the Service’s “acquiescence in result.”

2. **The Chief Counsel Advisory opinion.** In one set of transactions, D had transferred Y stock to grantor trusts in exchange for promissory notes bearing interest at [???], with a [???] term based on D’s life expectancy as determined under the §7520 term interest tables. (The CCA is heavily redacted as to key facts.) The notes required interest-only payments until the end of the term, at which D would receive the face value of the notes. If D died during the note term, the notes would be cancelled. “The total face value of the self-cancelling notes was ... almost double the value of the stock. The higher value of the notes supposedly compensated the decedent for the risk that he would die before the end of the note term and neither the principal nor a significant amount, if not all, of the interest would be paid. In fact, the decedent died less than six months after the transfer, and therefore, received neither the interest payments nor the principal due on the notes.” In another set of transactions, D transferred Y stock to another GRAT, and to other grantor trusts in exchange for interest-only self-cancelling notes bearing a considerably higher interest rate, another method of compensating for the risk that D might die during the note term.

- a. **The decedent’s health.** “Very shortly after the fourth and fifth set of transactions [involving the high-interest SCIN notes and the second GRAT], the decedent was diagnosed with [???]. After [that] diagnosis, he survived for less than six months. He died on Date 2.”
- b. **Section 7520 tables should not be employed.** “We do not believe that the §7520 tables apply to value the notes in this situation.... In the case at hand, the items that must be valued are the notes that decedent received in exchange for the stock that he sold to the grantor trusts. These notes should be valued based on a method that takes into account the willing-buyer willing-seller standard in §25.2512-8. In this regard, the decedent’s life expectancy, taking into consideration decedent’s medical history on the date of the gift, should be taken into account.... Because of the decedent’s health, it was unlikely that the full amount of the note[s] would ever be paid. Thus, [each] note was worth significantly less than its stated amount, and the difference between the note’s fair market value and its stated amount constitutes a taxable gift.”

- c. The CCA cites and discusses §§ 2033 and 2038, and discusses Estate of Moss v. Commissioner and Estate of Musgrove v. United States, 33 Fed. Cl. 657 (1995), both of which involved estate tax issues. However, the CCA does not give any discussion or conclusion regarding the estate tax ramifications of the SCINs, beyond noting that that they were disclosed on the Form 706.
3. The CCA also discusses Estate of Costanza v. Commissioner, 320 F.3d 595 (6th Cir. 2003). C decided to retire at age 73 and move back to his native Italy. He sold real estate and his restaurant to Son for an 11-year SCIN that was secured by a mortgage on the properties. The note provided that if C died before the note was paid, no further payments need be made. However, C never made it back to Italy. He had been suffering from heart disease for 15 years. Five months after the sale, and after three monthly payments had been made on the note, C died during bypass surgery. The Tax Court ruled that the conveyance was not a bona fide transaction for full and adequate consideration. Son's inconsistency in making payments due under the SCIN failed to establish that there had been a valid arm's length sale. Moreover, there was no showing that either C or Son intended to enforce the note payment provisions. T.C. Memo. 2001-128.
- a. The Court of Appeals reversed. The court noted that "there was no evidence that either Michael or Duilio presumed that Duilio would die within a few years of signing the SCIN, let alone within five months of the signing." The medical evidence at the Tax Court trial was to the effect that Duilio's life expectancy was between 5 to 13.9 years and not that he was in imminent danger of death. The court concluded: "Under these facts, taxpayer rebutted the presumption against the enforceability of an intrafamily SCIN by affirmatively showing that there existed at the time of the transaction a real expectation of repayment.... As such, we conclude that the Tax Court clearly erred in finding that the execution of the SCIN was not a bona fide transaction."
  - b. The CCA distinguishes Estate of Costanza v. Commissioner. "In Estate of Costanza, had the decedent lived, he would have received monthly payments consisting of income and principal throughout the term of the note. The decedent required the payments for retirement income and, thus, had a good reason, other than estate tax savings, to enter into the transaction. In contrast, the decedent in this case structured the note such that the payments during the term consisted of only interest with a large payment on the last day of the term of the note (balloon payment). Thus, a steady stream of income was not contemplated. Moreover, the decedent had substantial assets and did not require the income from the notes to cover his daily living expenses. The arrangement in this case was nothing more than a device to transfer the stock to other family members at a substantially lower value than the fair market value of the stock."
- (1) Keep the above CCA discussion in mind! Isn't the Office of Chief Counsel in effect giving tacit approval to the Costanza SCIN transaction?
- c. The CCA also distinguished Estate of Moss v. Commissioner, where "[a]t the time of sale, the physical and mental condition of the decedent was average for a man of 72 years of age. There was nothing to indicate that his life expectancy would be shorter than the approximate ten years of life expectancy that was indicated by generally accepted mortality tables." Rather, "[t]here are similarities between the decedent in the subject case and the decedent in Estate of Musgrove. In each case, the decedent who received a promissory note with a self-cancelling feature was in very poor health and

died shortly after the note was issued. In addition, there is a legitimate question as to whether the note would be repaid in each case.”

**B. Wait a minute! That Chief Counsel Advisory opinion involves the Davidson case!** It turns out that the CCA sets out the Service’s litigation position for Estate of Davidson v. Commissioner, Tax Court Cause No. 013748-13, for which the position was filed on June 14, 2013. As a result, we can fill in the blanks redacted in the CCA. D was the president and owned 78 percent of the common stock of Guardian Industries, a leading manufacturer of glass, automotive and building products. He was the owner of the Detroit Pistons (NBA), the Detroit Shock (WNBA) and the Tampa Bay Lightning (NHL), and was enshrined in the Basketball Hall of Fame in 2008. The Notice of Deficiency alleges gift tax, estate tax and GST tax deficiencies, along with penalties and interest, totaling **\$2.6 billion!** (We are talking about the Guinness Book of Records here—although the supposed deficiency may not be quite that high because the Service acknowledged that it “did not calculate certain deductions and credits to which [the estate] may be entitled.” The major issue in the case (in terms of the tax dollars involved) will be the valuation of D’s stock. The estate valued D’s common stock in Guardian Industries at \$2,999 per share and his preferred stock at \$531 per share on the gift-sale dates, whereas the Service took the position that the common stock was worth \$4,400 per share and the preferred was worth \$750 per share. On that issue—big numbers because D owned so many shares of Guardian stock—the Tax Court trial and resulting opinion will involve the usual battle of dueling experts, except on a rather stratospheric scale. Another issue in the case involves a transaction between D, his wife, and his son and daughter-in-law, as to whether this transaction, involving the purchase of a house in Bloomfield Hills, resulted in a taxable gift. As with the CCA opinion, the following discussion addresses only the SCIN issues. The facts are taken from the estate’s petition and the government’s response.

1. **D’s health and life expectancy.** D was 86 years old; his life expectancy (according to the mortality tables under §7520) was 5.8 years when the transactions occurred on December 22, 2008, and January 2 and January 21, 2009. An October 2008 letter from D’s primary physician stated that D was “in good health commensurate with his age group.” This was corroborated by another letter from the primary physician on December 16, 2008. The CCA states, however, that “[b]ecause of the decedent’s health, it was unlikely that the full amount of the notes would ever be paid.” The Service’s medical expert estimated (based on D’s medical records; he never examined D) that D’s life expectancy was 2.5 years. In connection with the estate tax audit, four medical consultants (two selected by the Service and two selected by the estate) reached a consensus that in January 2009, D had a greater than 50 percent probability of living at least one year.
2. **The SCIN transactions.** Several of the transactions involved standard (*i.e.*, non-SCIN) notes; all of the notes (SCIN and non-SCIN) were for a 5-year term with interest-only installment payments and a balloon payment at the end. On January 2, 2009, D sold \$162 million of Guardian stock (the estate’s valuation) to grandchildren’s trusts for \$306 million pursuant to a note with annual interest payments at 2.4 percent (the §7520 rate). Thus, the SCINs reflected a principal risk premium of almost 100 percent. On January 21, 2009, \$432 million of Guardian stock was sold to trusts for D’s children and step-daughter for 5-year balloon SCINs bearing interest at 13.4 percent (an interest-rate risk premium). D was diagnosed with a serious illness shortly after the January 21 transactions. D died on March 26, 2009, without having received any payments on the notes.
  - a. **The Service’s arguments.** The Service contends, first, that the SCIN transactions were not bona fide and that the notes provided no consideration for the transfers, because there was no reasonable expectation of repayment.

- b. **Section 7520 does not apply to valuation of the SCINs.** If the court gets past the “bona fide” issue, the Tax Court will squarely face the issue of whether D could rely on §7520 in valuing the SCINs, because all of the medical experts agreed that D had a greater than 50 percent probability of living for at least a year. The estate contends that §7520 applies to valuation of “any interest for life or a term of years,” and a SCIN involves both a life expectancy and a term of years. The Service relies on Reg. §1.7520-3(b)(3), under which the mortality tables can be used “to determine the present value of an annuity, income interest, remainder interest, or reversionary interest. And, says the Service, SCINs do not involve an annuity or an income interest.
3. **Unless the parties settle, this will be a major, major case concerning the use of SCINs in estate planning.** Given the time involved in the litigation process, and the likely appeal however the Tax Court decides the case, we are likely to be hearing about Estate of Davidson v. Commissioner for the next several years. Interestingly, any appeal from the Tax Court decision will be to the 6th Circuit, which ruled in favor of the taxpayer in Estate of Costanza v. Commissioner.

## XI. Section 2512—Valuation of Gifts

- A. **Tax Court reverses course as to “net, net gift” treatment of gifts made within three years of death.** In Steinberg v. Commissioner, 141 T.C. No. 8 (2013), 89-year-old S made gifts of cash and securities to her four daughters pursuant to a binding agreement under which the daughters agreed to assume and pay the federal gift tax liability imposed on the gifts, *and* any federal and state tax liability imposed under §2035(b) if she died within three years after making the gift. (The Tax Court labeled the transaction as a “net, net gift.” S filed a gift tax return reporting a net taxable gift of \$71.6 million, based on an appraisal that reduced the fair market value of the gift property by both (1) the gift tax paid by the donees and (2) the actuarial value of the donees’ assumption of potential §2035(b) liability, based on S’s age and life expectancy at the time of the gifts. This second factor reduced the gift tax liability by \$5.8 million. The Service accepted the net gift treatment but not the reduction in value relating to §2035(b), and assessed a \$1.8 million deficiency.
  1. **The government must have thought it had a winning case.** In McCord v. Commissioner, 120 T.C. 358 (2003), the Tax Court had ruled that approximating the potential burden of the estate tax, based on the probability that the donor might die within three years, was too speculative to warrant reducing the amount of the taxable gift. The decision was reversed and remanded on appeal by Succession of McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006), but (as noted in Steinberg v. Commissioner decision) the Tax Court was not obliged to follow Succession of McCord v. Commissioner because this case was appealable to the Court of Appeals for the Second Circuit. Nonetheless, the Tax Court reversed its position, and denied the government’s motion for summary judgment. Eight judges signed off on the majority opinion, six judges concurred in the result only, and Judge Halpern (who wrote the Tax Court opinion in McCord v. Commissioner) was the lone dissenting judge.
  2. **Background: The federal gift tax is “tax exclusive,” making lifetime transfers cheaper than transfers at death.** Although the Internal Revenue Code sets the tax rate for both taxable gifts and taxable estates at 40 percent, the effective gift tax rate is actually lower than the estate tax rate because the gift tax is computed on a “tax exclusive” basis—the 40 percent tax rate is applied to the gift amount that passes to the donee. In contrast, the estate tax is

computed on a “tax inclusive” basis—the 40 percent tax rate is applied to the entire estate, including the amount paid in estate taxes.

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

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

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

money or money's worth.” Thus, unless the parties settle before trial, there may be more to say about Steinberg v. Commissioner in the future.

**b. Postscript: Mrs. Steinberg survived by more than three years after making the gift.**

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

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

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

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

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

## **XII. Section 6166—Extension of Time to Pay Tax—Closely Held Business**

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

Form 706—2½ years late, and with the return made a §6166 election containing all of the information .

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

### **XIII. Section 6511—Limitations on Credits or Refunds**

- A. Was it a tax payment or a tax deposit?** A six-month extension to file the Form 706 does not, by itself, give you an extension to pay the estate tax. Well, then: What do you do when the calendar pages are rapidly turning toward that 9-month due date, you are not ready to file the return, and you’ve made a guesstimate of the tax that will be due? The first thing you should do is read Rev. Proc. 84-58, 1984-2 C.B. 501, where you will discover that the terminology used on the remittance check and in the accompanying correspondence is terribly, terribly important. If it’s a tax payment, the statute of limitations is in play. If it’s a tax deposit, the statute of limitations does not begin to run if it turns out that the tax was overestimated.
- B. That was a tax payment, and the statute of limitations had run.** In Winford v. United States, 2013-2 U.S.T.C. ¶ 60,672 (W.D. La. 2013), W’s executors filed a Form 4768 requesting an extension of time to file because the estate was in litigation with W’s son. With the request, the executors submitted a check for \$230,884 but did not indicate whether the remittance was a payment or a deposit. Five years later, the litigation ended, and the executors determined that the estate was due a credit of \$136,268. The court declined to follow Huskins v. United States, 2007-1 USTC ¶ 60,538, (Fed. Cl. 2007), which had ruled that an undesignated remittance was a deposit. Instead, the court used a six factor “facts and circumstances” test to determine whether the remittance was a payment or a deposit. After taking all of the factors into account, it was determined that the factors weighed in favor of the Service—and of course the statute of limitations had run.
- C. Second verse, same as the first.** No, that’s not Herman’s Hermits singing "I'm Henry the 8th I Am"; it was the result in Syring v. United States, 2013-2 U.S.T.C. ¶ 60,671 (W.D. La. 2013). (This is the fourth case in Louisiana on this issue in the past two years!) The estate’s accountant advised the executor to make a payment of \$170,000 to the IRS along with a request for an extension to file. In sending in the check, the executor failed to provide a written statement designating the remittance as a deposit. Further, she neglected to submit an affidavit, declaration, or other testimony describing her intent to make a deposit when the payment was made. Besides, the estate only requested an extension of time to file, not pay the estate tax. In addition, the accountant’s recommendation that the executor make a partial payment of the estate tax due suggested that the remittance was not meant to be a deposit but rather payment of tax. Thus, the estate’s claim for a refund fell outside the three-year recovery period.
- D. If time is running out, don’t use the Post Office!** In Langan v. United States, 2013-2 U.S.T.C. ¶ 60,668 (Fed. Claims 2013), a refund suit was untimely because it was filed more than two years after the date on which the Service’s disallowance of an executor’s refund claim was mailed. The complaint was mailed on the day before the deadline, but was not delivered until three days after the deadline. The executor’s attorney dropped the complaint off after the cut-off time at the post office’s 24-hour window. Despite the late drop-off, the executor sought to correct the filing date,

based on a postal employee's statement that the complaint was expected to reach government offices the next day. The executor did not "do everything that could be expected of him to ensure timely delivery."

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