Current Developments

By Steve Akers

EXECUTIVE SUMMARY:

In addition to sharing his notes on the annual Heckerling Estate Planning Institute, **Steve Akers** from time to time generously shares with **LISI** members his musings on current developments. Steve does much more than report on what happened, he puts things into context with his unique perspective. You'll find Steve's most recent set of comments on current developments in a hyperlinked format that is available only to **LISI** members.

Steve R. Akers is a managing director at **Bessemer Trust**, where he directs the family estate and legacy planning practice for the Southwest Region. Steve has lectured on a variety of estate planning, estate administration, and family business planning topics at national meetings of the American College of Trust and Estate Counsel; American Bar Association Real Property, Probate and Trust Law Annual CLE Meetings; the U.S.C. Tax Institute; the University of Miami Philip E. Heckerling Institute on Estate Planning; the Annual Notre Dame Tax and Estate Planning Institute and the Southern Federal Tax Conference – among*many* others. A number of other summaries prepared by Steve Akers and other resource information for professional advisors are available at www.bessemer.com/advisor.

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[14. Estate Tax Deduction for Claim Against Estate Limited to Amount Actually Paid Under "Ascertainable With Reasonable Certainty and Will Be Paid" Standard of Prior § 2053 Regulations, Estate of Saunders, 136 T.C. No. 18 (2011).]

[15. No Deduction For Claim Against Marital Trust; Claim of Estate Against Third Party Valued at Substantial Discount Compared to Amount Ultimately Received; Estate of Foster, T.C. Memo. 2011-95.]

1. Procedures for Making Carryover Basis Election to Avoid Estate Tax Regime for 2010 Decedents

a. Estate Tax Regime Is Default System. The default rule is that the estate tax applies to estates of decedents dying in 2010. An election is available for estates that prefer not to be subject to estate tax but to be subject to carryover basis instead. By far, most of the decedents dying in 2010 had estates well under $5 million and have no estate tax concerns in any event. Those estates do not have to file anything in order to be able to take advantage of the pre-2010 traditional basis step-up rules.

b. Procedures for Making Carryover Basis Election to Avoid Estate Tax Regime. Section 301(c) says the election is to be made "at such time and in such manner" as prescribed by the Secretary of the Treasury or his delegate (interestingly, not requiring regulations). An IRS Release on February 16, 2011, available at http://www.irs.gov/pub/irs-pdf/f8939.pdf, gave the first official preliminary guidance regarding procedures and filing dates for the Form 8939. An announcement on March 2, 2011, available at http://www.irs.gov/formspubs/article/0,,id=236791,00.html, described similar information regarding Publication 4895. These Releases give the following guidance:

The IRS will issue, in order, (1) Form 8939, and shortly thereafter (2) instructions for Form 8939, followed by (3) Publication 4895, Treatment of Property Acquired From a Decedent Dying in 2010. The final Form 8939 will be posted at least 90 days before it is required to be filed.

The Form 8939 should not be filed with the decedent's final income tax return (emphasis in original). (OBSERVATION: This is despite the literal wording of § 6075(a) providing that "[t]he return required by section 6018 with respect to a decedent shall be filed with the return of tax imposed by chapter 1 for the decedent's last taxable year" [(i.e., the decedent's final income tax return] (emphasis added).

The carryover basis election under § 301(c) of TRA 2010 should not be made on the decedent's final income tax return (emphasis in original).
Instructions on how to make the carryover basis elections under § 301(c) will be described on the Form 8939, in the instructions to Form 8939, and in Publication 4895. The March 2, 2011 Release says that "[t]he election is made by filing Form 8939."The March 2, 2011 Release says that Publication 4895 is only relevant for estates that file the Form 8939.
The latest information on these issues can be found at www.irs.gov/form8939.

A summary of a conversation between Robert Chapman, of the IRS Tax Forms & Publications Desk, and Carol Cantrell on February 3, 2011 (in response to comments filed by the American Bar Association Tax and Real Property, Trust and Estates Law Sections on January 31, 2011) was published by Leimberg Information Services on Feb 8, 2011. See: **LISI** Estate Planning Newsletter #1773.

Mr. Chapman's comments included the following:

- The Form 8939, Instructions to the Form 8939 and the Publication 4895 are expected to be released by May 2011.
- The IRS will issue guidance regarding whether appraisals are required and whether group and de minimis rules will be allowed.

- There is no place to report the surviving spouse's one-half of community property on the Form 8939 and the IRS will give guidance; he was asked to clarify that the surviving spouse's one-half would be eligible for the step-up and as well as a step-down in basis and he hinted that it is, by noting that the question of whether both halves of community property is adjusted is the same for both § 1014 and § 1022.
- The estate would be shown as the recipient of property not yet transferred by the time the Form 8939 is filed.
- An amendment would not be required to report subsequent transfers or distributions by the estate.
- Property that is sold by the estate cannot qualify for the $3.0 million spousal basis adjustment, even if the sale proceeds are distributed to the surviving spouse.
- The IRS may add Schedule R from Form 706 (for reporting generation-skipping transfers and exemption allocations) to the Form 8939 so that executors who need to report generation-skipping transfers or exemption allocations will not have to file both the Form 8939 and Form 706.
- The IRS prefers to make the mere act of filing the Form 8939 as the affirmative election under § 301(c) of the Tax Relief... Act of 2010 out of the estate tax regime and into carryover basis, rather than providing a box to check. He agrees that the Form 8939 should contain a statement to the effect that filing the form constitutes the election.
- The IRS is likely disinclined to allow a "protective election" out of the estate tax regime in the event an IRS audit adjustment makes the election more advantageous.

On March 1, 2011, the IRS filed another request for comments regarding the Form 8939, stating that comments should be received by May 6, 2011 to be assured of consideration (suggesting that the Form 8939 will not be released before that date).

c. Process for Determining Whether to Make Carryover Basis Election. For many estates, the decision will be easy whether to be subject to the estate tax or carryover basis (if the taxable estate is either well under $5 million or well over $5 million). However, the executor should carefully document and retain the analysis of the rationale for what ever decision is made regarding the carryover basis election. Consideration of the detailed tax effects of carryover basis is particularly sensitive for real estate or other depreciable property, especially if the property has a "negative basis" due to refinancing or other reasons.

d. Who Makes Carryover Basis Election? The IRS has indicated informally that it will give guidance regarding who makes the election if multiple persons are in possession of property where there is no court appointed executor.

e. No Spousal Basis Adjustment for Assets Sold During Administration. The IRS indicates that the $3 million spousal basis adjustment cannot be allocated to any assets sold during this administration, because they do not pass to the surviving spouse. If the IRS does not change that position, there will be a lot of "constructive receipts" by spouses before sales took place.

f. Attach or Keep Documentation Basis and Values Listed on Form 8939. There is no statute of limitations as to values described on the Form 8939. Attach documentation or at least keep documentation of basis and values listed on the form.

g. Extended Time for Filing Estate Tax Return. The act extends the time for filing estate tax returns of decedents dying before the date of enactment to nine months after that date (i.e., to September 19, 2011). Is a further extension available beyond that? We are not sure. The estate of the decedent who dies on December 17 can get an automatic six-month extension beyond September 19. It would seem that automatic extension should also be available for the decedent died before December 17.

2. Portability and Privity Requirement; Joint Committee on Taxation Technical Explanation ERRATA; Effect of Gifts With Portability Amount

The Joint Committee on Taxation on March 23, 2011 issued an ERRATA document replacing the estimated budget effects of the Tax Relief… Act of 2011, and adding a footnote to its "Example 3" describing the workings of the portability provision.

a. Estate Tax Exclusion Amount Definition Change. The portability concept is accomplished by amending § 2010(c) to provide that the estate tax applicable exclusion amount is (1) the "basic exclusion amount" ($5.0 million, indexed from 2010 beginning in 2012), plus (2) for a surviving spouse, the "deceased spousal unused exclusion amount." [§ 2010(c)(2), as amended by TRA § 302(a).]

b. Deceased Spousal Unused Exclusion Amount (or "DESUEA"). The "deceased spousal unused exclusion amount" of a surviving spouse is the lesser of (1) the basic exclusion amount or (2) the basic exclusion amount of the last deceased spouse of such surviving spouse over the combined amount of the deceased spouse's taxable estate plus adjusted taxable gifts (described in new § 2010(c)((4)(B)(ii) as "the amount with respect to which the tentative tax is determined under section § 2001(b)(1)").

The first item limits the unused exclusion to the amount of the basic exclusion amount. Therefore, if the estate tax exclusion amount decreases by the time of the surviving spouse's death, the lower basic exclusion amount would be the limit on the unused exclusion of the predeceased spouse that could be used by the surviving spouse.

The second item is the last deceased spouse's remaining unused exemption amount. Observe that it is strictly defined as the predeceased spouse's basic exclusion amount less the combined amount of taxable estate plus adjusted taxable gifts of the predeceased spouse. This appears to impose a "privity" requirement (discussed below).

c. Privity Requirement and Joint Committee on Taxation Technical Explanation Example 3. Some commentators have referred to the issue of whether a spouse may use his or her spouse's "deceased spousal unused exclusion amount" as the "privity" issue.

For example, assume Husband 1 dies and Wife has his deceased spousal unused exclusion amount, and assume Wife remarries

Husband 2. If Wife dies before Husband 2 and if there is a privity requirement, Husband 2 may then use the deceased spousal unused exclusion amount from Wife's unused basic exclusion amount, but may not utilize any of Husband 1's unused exclusion amount. The definition of the "deceased spousal unused exclusion amount" has no element at all that might include a deceased person's unused exclusion from a prior spouse in determining how much unused exclusion can be used by a surviving spouse. The Joint Committee on Taxation issued a Technical Explanation that has an Example that appears inconsistent with this conclusion. Joint Committee on Taxation Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" Scheduled for Consideration by the United State Senate, 52 n.57 (Dec. 10, 2010)[hereinafter Joint Committee on Taxation Technical Explanation].

"Example 3. [Husband 1 dies with $2 million of unused exclusion amount.] Following Husband 1's death, Wife's applicable exclusion amount is $7 million (her $5 million basic exclusion amount plus $2 million deceased spousal unused exclusion amount from Husband 1). Wife made no taxable transfers and has a taxable estate of $3 million. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate). Under the provision, Husband 2's applicable exclusion amount is increased by $4 million, i.e., the amount of deceased spousal unused exclusion amount of Wife." Joint Committee on Taxation Technical Explanation at 53.

This example assumes that Wife's deceased spouse unused exclusion amount, which could be used by Husband 2, is Wife's $7 million exclusion amount (which includes the deceased spousal unused exclusion from Husband 1) less her $3 million taxable estate. This would suggest that Husband 2 does get to take advantage of the unused exclusion amount from Husband 1. One might argue that this is just a matter of determining whether Wife first uses her own exclusion or first uses Husband 1's unused exclusion before using her own. If she first uses the unused exclusion that she received from

Husband 1, her $3 million taxable estate, less Husband’s 1’s $2 million exclusion, would leave $1 million of taxable estate to be offset by $1 million of Wife’s basic exclusion, leaving unused exclusion of $4 million for Husband 2. However, that approach is not consistent with the statutory definition of the “deceased spousal unused exclusion amount.” Under the statutory definition, the deceased spousal unused exclusion amount that
Husband 2 could have from Wife is determined as follows:

Lesser of:

(1) Basic exclusion amount		$5 million
Or		
(2) Wife’s BASIC exclusion amount	$5 million	
Less		
Wife’s taxable estate plus adjusted taxable gifts	$3 million	
Item (2)		$2 million

There is nothing in the statutory definition that makes any references whatsoever to the amount of Wife’s unused exclusion from Husband

1 in determining the amount of the unused exclusion that Husband 2 has from Wife.

d. Joint Committee on Taxation Technical Explanation ERRATA. The ERRATA document issued by the Joint Committee on Taxation on March 23, 2011 adds a footnote following the word "amount" (the document does not make clear which of the two "amount" words the footnote would follow) in the following sentence of Example 3:

An election is made on Wife's estate tax return to permit Husband 2 to use Wife's deceased spousal unused exclusion amount, which is $4 million (Wife's $7 million applicable exclusion amount less her $3 million taxable estate)."

The footnote says that "[a] technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent."

If there is such a technical correction, Husband 2's DESUEA from Wife would be her applicable exclusion amount (which is defined as her $5 million basic exclusion amount plus her $2 million DESUEA from Husband 1) less her $3 million taxable estate, or $4 million. The effect is that Husband 2 can benefit from Husband 1's unused exclusion amount, to the extent that it is not used by Wife, but not in excess of an additional basic exclusion amount.

Some commentators have suggested this could have the effect resulting in a DESUEA of $10 million, which the surviving spouse would have in addition to his or her own $5 million basic exclusion amount. That is incorrect, because the DESUEA is the limited to the basic exclusion amount. For example, assume that Husband 1 leaves his entire estate to Wife. Her DESUEA from Husband 1 is $5 million. Assume Wife remarries Husband 2 and predeceases him, leaving all of her estate to him. The DESUEA that Husband 2 receives from Wife, under this revised statutory approach, is:

Lesser of:

(1) Basic exclusion amount		$5 million
Or		
(2) Wife's APPLICABLE exclusion amount, which is		
Wife's BASIC exclusion amount	$5 million	
Plus DESUEA from Husband 1	$5 million	
Less		

Wife’s taxable estate plus adjusted taxable gifts	$ 0	
Item (2)		$ 10 million

Husband 2’s DESUEA from Wife is the lesser of $5 million or $10 million, or $5 million.

e. Effect of Gifts With Portability. If one spouse dies leaving the surviving spouse with DESUEA, and if the surviving spouse subsequently makes gifts, do the gifts use the donor’s gift exemption amount or the gift exemption from the DESUEA? The statute does not say. The following discussion concludes that it makes no difference. It could make a difference if the donor were not treated as having the made the gift because it is covered by the DESUEA from the prior spouse. However, that is not the case; the gift exemption is the donor’s applicable exclusion amount if the donor dies as of the end of the calendar year, reduced by prior taxable gifts.

Assume Husband 1 dies leaving his entire estate to Wife, so Wife’s DESUEA from Husband 1 is $5 million. Therefore, Wife’s applicable exclusion amount is $10 million [§ 2010(c)(2)] and Wife’s gift exemption amount is $10 million [§ 2501(a)(1)]. Assume Wife makes a gift of $5 million. Does the gift use Wife’s DESUEA or does it use her basic exclusion amount? All of the following discussion assumes these facts, and builds on the facts with alternative scenarios.

Does it make a difference, for example, if the estate tax exemption amount is later reduced to $3.5 million? Wife's applicable exclusion amount is her basic exclusion amount ($3.5 million) plus her DESUEA (lesser of $3.5 million or $5 million unused exclusion from Husband 1, or $3.5 million), or $7.0 million. For gift purposes, her gift exclusion amount is her $7.0 million applicable exclusion amount less the $5 million she has already utilized, or $2.0 million. If Wife could somehow allocate the gift against the DESUEA from Husband 1 so that it would not reduce her gift exemption the she would have for later use, she would still have her full $3.5 million of gift exemption.

However, Wife in fact made the gift, and there is no reason under the gift tax statutes for not reducing her gift exemption by her prior taxable gifts. (In reality, the gift tax credit amount is determined from the applicable exclusion amount, and the gift unified credit is reduced by amounts allowable as a gift tax credit for prior years. For simplicity, however, this discussion will refer to the prior gifts as reducing the amount of available gift exclusion amount.) Therefore, in this scenario it makes no difference whether the $5 million gift used her own basic exclusion amount or the DESUEA from Husband 1.

Does it make a difference if Wife remarries and Husband 2 predeceases Wife leaving all of his estate to Wife? Assume the basic exclusion amount remains at $5 million. Wife's DESUEA from Husband 2 is $5 million. Her applicable exclusion amount is $10 million. For gift purposes, her gift exemption amount is her applicable exclusion amount ($10 million) less the gift exemption that she previously used ($5 million), or $5 million. Again, it made no difference whether the gift used Wife's DESUEA or her basic exclusion amount.

Does it make a difference if Wife remarries and Husband 2 predeceases Wife leaving all of his estate to his children by a prior marriage, leaving a DESUEA of zero? Wife's applicable exclusion amount is her own basic exclusion amount ($5 million) plus her DESUEA from Husband 2 ($0), or $5 million. Her gift exemption is $5 million less the $5 million gift exemption that she previously utilized, or zero. Again, it made no difference whether the gift used

Wife's DESUEA or her basic exclusion amount. Even if the gift somehow first used her DESUEA, following Husband 2's death her gift exemption amount would be $5 million ($5 million basic exclusion amount plus 0 DESUEA from Husband 2) less the $5 million of gift exemption previously used, or zero.

Does it make a difference if Wife remarries and predeceases Husband 2? Assume Wife leaves all of her estate to Husband 2 and that she does not utilize any of her exemption amount at her death. Husband 2's DESUEA from Wife is the lesser of the basic exclusion amount or Wife's unused exemption. Wife's unused exemption is her applicable exclusion amount ($10 million including her DESUEA from Husband 1); for this purpose, it makes no difference that Wife made a $5 million gift because that does not impact her estate tax applicable exclusion amount. Nevertheless, Husband 2's DESUEA from Wife is limited to the $5 million basic exclusion amount. Again, it made no difference whether the gift used Wife's DESUEA or her basic exclusion amount.

3. Administration's Fiscal Year 2012 Revenue Proposals

a. Overview. The Treasury on February 14, 2011 released the General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals (often referred to as the "Greenbook") to provide details of the administration's budget proposals. The President's Budget Proposal for Fiscal Year 2012 includes three repeated transfer tax related items from the prior two years and two new items dealing with estate and gift taxes. In addition, the proposal modifies the "Pay-As-You-Go (PAYGO)" baseline to assume that the 2009 estate tax system will be made permanent after the expiration of the Tax Relief … Act of 2010 provisions (at an estimated revenue cost of $270.21 billion from 2012 to 2021).

The first three items below are repeats from the prior two years. The items after that are new.

b. Require Consistency in Value for Transfer and Income Tax Purposes. This continues the approach from prior Budget Proposals of requiring that the basis for income tax purposes be the same "as determined for estate or gift tax purposes (subject to subsequent adjustments)." The proposal does not adopt the approach suggested in a Joint Committee on Taxation report to require that the income tax basis be consistent with values as reported on gift or estate tax returns, even if the transfer tax values were subsequently adjusted on audit. (Estimated 10-year revenue: $2.095 billion)

c. Modify Rules on Valuation Discounts. This continues the proposal from prior years to revise § 2704 to add a new category of "disregarded restrictions" that would be ignored for transfer tax valuation purposes in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family. While this same provision has been in the Budget Proposal the last two years, it has not been included in a single statutory proposal. (Estimated 10-year revenue: $18.166 billion).

d. Require Minimum Term for GRATs. The proposal imposes three additional requirements on GRATs: (a) a 10-year minimum term would be required for GRATs, (b) the remainder interest must have a value greater than zero, and (c) the annuity amount could not decrease in any year during the annuity term. (Estimated 10-year revenue: $2.959 billion)

e. Make Portability Permanent. This proposal would permanently extend the provisions in the Tax Relief… Act of 2010 regarding the portability of unused exemption between spouses. (Estimated 10-year cost: $3.681 billion)

f. Limit Duration of GST Exemption. The proposal would limit the GST exemption to 90 years after a trust is created. At least 25 states have extended their perpetuities provisions far beyond the traditional lives in being plus 21 years. This would be accomplished by increasing the inclusion ratio of any trust to one on the 90th anniversary of the creation of the trust. Contributions to a trust by separate grantors are treated as separate trusts for GST purposes. For each such separate trust, the 90-year period would be measured from the date of the first contribution by the grantor of that separate trust. If an existing trust pours over or is decanted into another trust, the

90-year period would be based on the creation date of the initial trust unless the assets pass to a single beneficiary-"vested" trust (this exception permits an incapacitated beneficiary's distribution to continue to be held in trust without incurring GST tax on distributions to the beneficiary). The proposal would apply to trusts created after the date of enactment and to the portion of preexisting trusts attributable to additions after that date. (Estimated 10-year revenue impact: Negligible)

Planning. This year is a doubly good year to create long term trusts: (1) $5 million of GST exemption is available this year (and next); and (2) Trusts created before the effective date of this legislation (if it is enacted) would not be subject to the 90-year limitation.

Rationale. Four highly respected academics and attorneys have sent letters to the Treasury Department in late 2010 urging a proposal to limit the GST exemption to trusts for two generations. Letters have been sent by Professors Gregory S. Alexander (Cornell University Law School), John H. Langbein (Yale Law School), and Lawrence W. Waggoner (University of Michigan Law School), and by attorney Raymond H. Young. The authors state that there is a growing loophole in the GST tax system, as noted in Professor Langbein's letter:

"…the loophole arose because the drafters of the original GST exemption presupposed that the long-established state-law rule against perpetuities would limit the revenue loss. Congress had no reason to foresee a few lawyers and financial-services vendors would set off a race among some of the states to repeal the rule against perpetuities for the purpose of attracting trust business. The result has been that the GST exemption has now become a lure for the creation in such states of dynasty trusts, trusts that are designed to shelter wealth from GST taxation for centuries. In May of this year, the American Law Institute voted to urge Congress to plug the loophole, a decision that I think is indicative of the policy consensus on this matter in the bar and in legal academia. It is a rare occurrence that plugging a tax loophole can have such totally benign consequences: raising revenue within the spirit of the law, while preventing any evasion of the core policy of the estate tax, which is to prevent the untaxed accumulation of dynastic wealth."

Several years ago the Staff of the Joint Committee on Taxation proposed a rule that would prohibit allocating GST exemption to a "perpetual dynasty trust," which would include trusts permitting distributions to beneficiaries in the generations below the transferor's grandchildren's generation. (There was no discussion of how existing trusts would be treated.) The approach proposed by the Staff of the Joint Committee on Taxation might be referred to an "invalidation approach" — invalidating the allocation of any GST exemption to trusts that might last beyond the prescribed term. The Administration's 2012 Fiscal Year Budget uses another approach, which merely causes the exemption to expire at the end of the prescribed period.

The American Law Institute in May 2010 adopted a proposal that a trust would be required to terminate no later than the death of the youngest beneficiary who is no more than two generations younger than the trust settlor. See RESTATEMENT (THIRD) OF PROPERTY: WILLS AND OTHER DONATIVE TRANSFERS §§ 27.1-27.3 (Tent. Draft No. 6, Approved 2010). If the Administration's proposal of limiting the exemption's effectiveness to 90 years passes, query whether the American Law Institute will change its approach to be consistent?

Professor Lawrence Waggoner estimates that the following numbers of living beneficiaries could exist after the described number of years: 150 years-450 beneficiaries, 250 years-7,000 beneficiaries, 350 years-114,500 beneficiaries, 450 years-1.8 million beneficiaries. He points out that a trustee cannot hope to fulfill the duty of impartiality to all beneficiaries in administering a trust with 1.8 million beneficiaries.

4. Tax Patents Invalidated Under Senate Version of Patent Reform Act.

The Senate passed the Patent Reform Act, which it renamed the "America Invests Act" by a vote of 95-5 on March 8, 2011. Section 14 of that Act provides that tax strategy patents are not patentable because they are deemed prior art (not novel and non-obvious) since they require the Tax Code in order for the patent to work. The issue of tax strategy patents has been under study for several years, and the approach of this legislation was suggested by the Patent and Trademark Office staff in conjunction with the Senate Finance Committee and Senate Judiciary Committee staff as a way to deal with tax strategy patents that would not set a blanket exemption precedent that might apply to other types of patents.

This provision applies to any patent pending and any patent issued after the date of enactment. Therefore, for example, it would not invalidate the SO-GRAT patent. A floor statement by Sen. Grassley specifically noted a letter sent from a coalition of 15 groups describing why tax strategy patents are bad for taxpayers.

5. Deference to Regulations: Mayo Foundation Supreme Court Case

a. Significance. Regulations sometime seem suspect as to whether they are authorized by the relevant statutory provisions. However, the courts have given great deference to regulations. The Supreme Court reconfirmed that deference in the recent Mayo Foundation case.

b. Mayo Foundation; Supreme Court Analysis. The Supreme Court addressed the deference issue in the Mayo Foundation case, issued January 11, 2011. Mayo Foundation for Medical Education & Research v. U.S., 131 S. Ct. 704, 107 AFTR 2d 2011-341. In an 8-0 decision (Justice Kagan did not participate in the "consideration or decision of the case"), the Court resolved a challenge to a Treasury regulation defining the term "student" for purposes of the FICA rules. It upheld the regulation. The reasoning eliminated two possible grounds for future challenges of regulations.

Chevron As Exclusive Test; Rejection of National Muffler Factors.

First, the Court appears to have adopted the doctrine of the Chevron case [467 U.S. 837 (1984)] as the exclusive test for determining the validity of a Treasury regulation. The Chevron test involves two steps. First, if there is a statutory ambiguity, has Congress "directly addressed the precise question at issue?" Second, if not, is the regulation “arbitrary or capricious, in substance, or manifestly contrary to the statute” or instead, is it a “reasonable interpretation” of the statute? The Chevron decision said that the regulation should be upheld if it is based upon “a reasonable construction of what Congress has said.” May Foundation.

The taxpayers in Mayo were relying on an earlier case than Chevron, the National Muffler case [440 U.S. 472 (1979)], which had suggested a much more elaborate approach in the second step. The National Muffler case said there would be heightened scrutiny (1) if Treasury had not been consistent over time in its interpretation of the particular regulation, (2) if the regulation was enacted years after the relevant statute was enacted, or (3) because of the way the regulation evolved, including whether the regulation had been promulgated after an adverse judicial decision (as happened in the Gerson case [507 F.3d 435 (6th Cir. 2007)] involving the validity of the GST effective date regulations which were revised after IRS losses in Simpson [183 F.3d 812 (8th Cir. 1999) and Bachler [281 F.3d 1078 (9th Cir. 2002)]).

The Supreme Court appears to totally reject applying the National Muffler factors to tax regulations going forward:

> The Government... contends that the National Muffler standard has been superseded by Chevron…
>
> . . .
>
> Under National Muffler, for example, a court may view an agency’s interpretation of a statute with heightened skepticism when it has not been consistent over time, when it was promulgated years after the relevant statute was enacted, or because of the way in which the regulation evolved…
>
> Under Chevron, in contrast, deference to an agency’s interpretation of an ambiguous statute does not turn on such considerations…
>
> Aside from our past citation of National Muffler, Mayo has not advanced any justification for applying a less deferential standard of review to Treasury Department regulations than we apply to the rules of any other agency. In the absence of such justification, we are not inclined to carve out an approach to administrative review good for

tax law only.

. . .

The principles underlying our decision in Chevron apply with full force in the tax context. . . . Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes. [citation omitted] We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to Chevron to the same extent as our review of other regulations.

Rejection of Distinction for Interpretive vs. Legislative Regulations.

In addition, the Court also eliminated the theory that regulations are entitled to less deference if they are an interpretation of statutes than if they are regulations that are promulgated pursuant to a specific direction by Congress to enact regulations.

[B]oth the full-time employee rule and the rule at issue in National Muffler were promulgated pursuant to the Treasury Department's general authority under 26 U.S.C. §7805(a) to "prescribe all needful rules and regulations for the enforcement" of the Internal Revenue Code…. In two decisions predating Chevron, this Court stated the "we owe the [Treasury Department's] interpretation less deference" when it is contained in a rule adopted under that "general authority" than when it is "issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision." [citing Rowan Cos. and Vogel Fertilizer cases]

Since Rowan and Vogel were decided, however, the administrative landscape has changed significantly. We have held that Chevron deference is appropriate "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority. [citation omitted] Our inquiry in that regard does not turn on whether Congress's delegation of authority was general or specific.

c. Application to Deference Standard in Walton. In Walton v.

Comm'r, 115 T.C. 589 (2000), the infamous "Example 5" regulation [Reg. §25.2702-3(e)(Ex. 5)] provided if the grantor of a GRAT died before the end of the GRAT term, the value of the contingent right of the grantor's estate to receive the remaining annuity payments could not be treated as part that the retained value of property contributed to the GRAT. The Tax Court did a Chevron analysis, and concluded that the regulation was invalid under Chevron as well as National Muffler. It recognized that § 2702 did not address the permissible term of a qualified annuity, then determined Congressional objectives from the legislative history, and based on an understanding of that objective the court determined that the regulation was an unreasonable interpretation of § 2702 and was invalid. Mayo does not appear to change the Walton result.

6. Step Transaction Doctrine; Transfers to LLC and Transfers of Interests in LLC; Ninth Circuit Reversal of Linton v. U.S., (9th Cir. 2011)

a. Background. When assets are contributed to an FLP or LLC and interests are conveyed the same day or soon thereafter, the IRS argues that the step transaction should be applied to treat the transaction as if there were a transfer of the those actual assets to the donees without any discount. The step transaction doctrine was suggested in the Shepherd case, and in dictum by the Eighth Circuit in the Senda case supported the IRS's argument (the case referred to "integrated steps in a single transaction"). Two Tax Court memorandum cases (Holman and Gross) addressed the step transaction doctrine in this context, but held that the doctrine did not apply where the entity interest transfers were made long enough after the date of funding (6 days and 11 days, respectively) that there was a "real economic risk of a change in value." In two subsequent cases where the funding and transfers of interests in the entity occurred on the same day, a federal district court had applied the step transaction doctrine (Heckerman and Linton). The district court in Linton had granted summary judgment in favor of the IRS as to the step transaction doctrine (as well as another issue).

b. Ninth Circuit Reversal. The Ninth Circuit has reversed the Linton case. Linton v. U.S., 630 F.3d 1211 (9th Cir. January 21, 2011). The facts in Linton were messy (and the court remanded the case for further factual determinations), but the contributions to an LLC and transfers of interests in the LLC may have occurred on the same day. The IRS argued that even if the funding of assets to the LLC clearly occurred before the transfers of interests in the LLC, the gifts should still be characterized as gifts of the assets to the donees (without a discount) under the step transaction doctrine, which collapses "formally distinct steps in an integrated transaction" in order to assess federal tax liability on the basis of a "realistic view of the entire transaction."

The court considered the three alternative tests for the step transaction doctrine (which have been applied mostly in income tax cases). The district court concluded that all three of the alternative tests applied. The Ninth Circuit held that none of them applied.

(1) The end result test did not apply because the end result sought was for the trust to end up with the LLC interest (not specific assets).

(2) The interdependence test requires that the steps are so interdependent that legal relations created by one transaction would have been fruitless without a completion of the series of transactions. The court concluded that putting assets in LLCs was a reasonable activity that made sense whether or not there was a gift, so the various steps have independence.

(3) The binding commitment test requires that there be a binding commitment to enter into the later steps of the transaction. The court concluded that test only applies to transactions spanning several years.

c. The Dreaded Footnote — Economic Risk of Changed Value Test Still Applies. The Ninth Circuit concluded specifically that the step transaction doctrine did not apply, and reversed the lower court's grant of summary judgment in favor of the IRS. However, in footnote 9 the court said that there are "timing requirements" between the funding of the LLC and the transfer of interests in the LLC "for the same reason that they apply the step transaction doctrine: to ensure that the two transactions are adequately distinct that the second transaction merits independent, and more favorable tax treatment" (pointing to Holman and Gross and quoting the "real economic risk" test of those cases). The court suspects that the timing requirements are "in essence a working out of the step transaction doctrine in a particular set of circumstances," and that once the lower court subsequently determines the timing facts and the effects of those facts, "there would be no need to apply the three traditional step transaction doctrine tests."

However, the court reiterates that on remand the court will apply the timing test issues that have been raised by Holman and Gross:
To obtain favorable tax treatment, the Lintons needed to transfer assets to the LLC and then wait at least some amount of time before they gifted the LLC interest to their children. The waiting period would subject the gifted assets to some risk of changed valuation before they were transferred, through the LLC, to the children's trusts. That would make the two transactions distinct for tax purposes. (The government has not challenged that the nine days between January 22 and January 31 is a sufficiently long to make the transactions distinct, notwithstanding that some of the value transferred to the LLC was cash.)

7. Continued Use of Residence Following End of QPRT Term Where Decedent Intended to Pay Rent But Died Suddenly Before Fair Market Rental Was Determined and Before Payments Were Made Did Not Result in §2036 Inclusion; Estate of Riese v. Comm'r, T.C. Memo. 2011-60

In Estate of Riese v. Comm'r, T.C. Memo. 2011-60, the decedent remained in a residence following the end of the QPRT term and died unexpectedly before any rent was paid. The IRS argued that § 2036 applied.

When the QPRT was being considered, there had been discussions between the attorney and the decedent and the decedent's daughter (who assisted the decedent with her financial matters) that she would have to pay rent if she remained in the residence following the end of the QPRT term. Following the end of the QPRT term on April 19, 2003, the daughter discussed with the attorney how to determine the fair market rent. The attorney advised that the rent could be determined and paid by the end of that calendar year. The decedent had a stroke and died unexpectedly in October, 2003 before the fair market rent had been determined and before any rent payments had been made.

The IRS argued that there was an implied agreement of retained enjoyment in light of the fact that the decedent continued living in the residence without paying rent. The court disagreed, pointing to various facts suggesting that there was not an implied agreement of retained enjoyment. Some of these facts included that the necessity of paying rent was discussed on multiple occasions with the decedent and her daughter before the QPRT was created, and that the daughter discussed with the attorney how to determine fair market rent following the decedent's death.

"While counsel's advice to determine rent by the end of the year was not the most prudent course of action, i.e., executing a lease and determining rent before the QPRT terminated would have been the ideal, we accept the parties' good faith testimony that they intended to determine rent by the end of the year... The Secretary had not issued any regulations or guidance as to how and when rent should be paid upon the termination of a QPRT. We believe that doing so by the end of the calendar year in which the QPRT expired would have been reasonable under the circumstances."

The underlying premise of the reasoning is that § 2036 is not triggered if a donor must pay fair market rent for continued use of the property. Interestingly, that underlying premise was never discussed, and it seemed well enough established that the court assumed § 2036 would not apply if the donor intended to pay rent following the end of the QPRT term.
The court allowed a debt deduction for the amount of rent determined up to the date of death, but refused to allow and administrative expense deduction for the post-death rent, reasoning that the estate "did not require a roof over its head" and had no need to rent the house following the decedent's death.

8. Transfers With § 2036 Retained Interests, Adler and Van

Cases. Aggregation of Various Undivided Interests Included in Estate Under § 2036; Adler v. Comm'r, T.C. Memo. 2011-28

a. Transfer of Residence With Continued Occupancy by Donor Without Paying Rent Resulted in § 2036 Inclusion; Van v. Comm'r In a rather involved (and somewhat comical) fact situation, the court in Van v. Comm'r, T.C. Memo. 2011-22, ultimately determined that the decedent had acquired a beneficial interest in a residence and later gave the residence to a trust but continued to live there as the exclusive occupant for the rest of her life without paying rent. The court concluded that § 2036 applied. The court's reasoning seems to focus on the fact that the decedent never paid any rent, and cited two prior cases (Disbrow and Trotter) that had applied § 2036 where the decedent either paid no rent or made irregular rent payments for less than the amount stated in a lease agreement.

b. Aggregation of Various Undivided Interests Included in Estate Under § 2036; Adler v. Comm'r

In Adler v. Comm'r, T.C. Memo. 2011-28, the decedent had made gifts of undivided one-fifth interests in property to his five children, retaining a life estate. Those transfers were brought back into the estate under § 2036. The court concluded that they should be aggregated for valuation purposes, and no undivided interest discount was allowed. The court distinguished the Mellinger case, which did not require aggregating undivided interests included in the estate under § 2044 (QTIP property) and § 2033, because in this case the donor/decedent was able to control the disposition of all of the interests.

9. Failure to Pay Penalty Applied Despite Reliance on CPA; Baccei v. U.S. (9th Cir. 2011)

In Baccei v. U.S., 107 AFTR 2d 2011-898 (9th Cir. February 16, 2011), the Ninth Circuit affirmed the lower court decision applying a failure to file penalty. The CPA filed a Form 4768 extension request for an estate tax return, but forgot to indicate the date for the extended request and also did not check the box for extension of time to pay the tax. There was a cover letter sent with the incomplete form that indicated there was no ability to pay the tax and that was the reason for seeking the extension. The IRS denied the request because those items were left blank. The taxpayer made three arguments: substantial compliance, affirmative misconduct by the IRS, and reasonable cause. The court rejected all three.

As to substantial compliance, the court determined that the regulation was clear that the request for an extension of time to pay estate tax must state the period of the extension requested, and there was no substantial compliance.

Furthermore the court also determined that the IRS's inaction, namely failing to notify the executor that the payment extension request was deficient, was not affirmative misconduct.

Perhaps most important from a legal standpoint, the court noted the rule recognized in a number of cases that reliance on professionals is not "reasonable cause" to excuse the failure to file penalty, and the court extended that reasoning to the failure to pay penalty:

> Although we have found no cases evaluating whether a taxpayer's reliance on an accountant to obtain an extension of time to pay taxes owed constitutes 'reasonable cause' under § 6651(a)(2), we draw guidance from United States v. Boyle, 469 U.S. 241 [which held that reliance on an agent] is not 'reasonable cause' for a late filing under § 6651(a)(1)...
>
> . . .
>
> We extend these determinations of reasonable cause under § 6651(a)(1) [failure to file penalty] to determinations of reasonable cause under § 6651(a)(2) [failure to pay penalty]. There is no reason to distinguish between reasonable cause for a failure to timely file an estate tax return and reasonable cause for a failure to timely pay an estate tax, and we refuse to do so.

10. No FLP Discount Allowed; Jury Determined Value Based on Sale Price of Partnership Interest About Two Years After Estate Valuation Date; Levy v. U.S., (5th Cir. 2010)(per curiam)

The Fifth Circuit affirmed a jury finding at the district court setting the value of a partnership interest at $25 million without allowing any discount for lack of control and marketability due to partnership ownership. Levy v. U.S., 106 AFTR2d 2010-7205 (5th Cir. 2010)(per curiam).

The facts are not well developed in the appellate opinion. The estate owned an interest in a limited partnership that owned undeveloped land, and apparently, the partnership sold the land about two years after the estate valuation date, resulting in the estate receiving $25 million.

The jury determined that the value of the estate's interest was $25 million, without a discount for lack of control and marketability due to partnership ownership. The court rejected the estate's various arguments for setting aside the jury verdict.

The trial court did not abuse its discretion in admitting evidence of the sale two years after the valuation date. ("The estate's expert testified that the Plano real estate market was relatively flat-- increasing approximately 3%-- so the sales price would be an accurate comparator.") However, attorneys involved in the case indicate that there was testimony that the property was not zoned for commercial development at the date of death, and a number of sales fell through before the eventual purchaser was able to obtain a zoning change several years after the date of death, but those facts were not mentioned in the Fifth Circuit's opinion.

As to the jury verdict allowing no discounts, the court concluded that "[t]he jury could have rationally found that no discounts for lack of control or marketability were merited because the estate controlled the general partnership interest, which has nearly unfettered control over the Partnership's assets."

A confusing final footnote stated that while the appellate court "declined to set aside the jury's verdict of zero discount, we note that the actual discount applied in taxing the Estate was thirty percent. Given the valuation found by the jury, it would have had to find a discount of larger than thirty percent for the verdict to have made a difference to the judgment in this case."

Practical Lesson: Actual subsequent sales are highly persuasive absent changed economic conditions. That may be particularly true for jury trials. In this case, the jury refused to allow any discount and set the value at the amount of the actual sale proceeds received by the estate.

Section 2036: The court ruled against the IRS with respect to § 2036, finding that there was a legitimate non-tax purpose of the partnership. The court did not allow the § 2036 issue to go to the jury, but the jury heard all of the evidence related to § 2036 (presumably including testimony suggesting that the partnership was created primarily to generate discounts).

11. Collection Action Against Transferees Under Transferee Liability Allowed 17 Years After Date of Death, U.S. v. Kulhanek; No Necessity for Assessment Against Transferee, Mangiardi v. Comm'r

a. Collection Action Against Transferees 17 Years After Date of Death; U.S. v. Kulhanek, 106 AFTR2d 2010-7263 (W.D. Pa. 2010). In this case, the IRS "came knocking on the door" of the recipients of retirement benefits and life insurance and collected estate taxes from them 17 years after the decedent's death!

Facts. The defendants were recipients of a $300,000 retirement account and a $10,000 life insurance policy. Each of them received distributions shortly after the decedent's death. The estate tax return was filed in 1992, making a § 6166 election. The stock of the business interest was sold in 1999. Over nine years later, the IRS filed an action against the defendants pursuant to § 6324(a)(2), which addresses transferee liability, to collect unpaid estate taxes of about $200,000 plus statutory interest.

Analysis. Under § 6324(a)(1) there is an absolute 10-year limit on the special automatic estate tax lien, without extensions or tolling. However, the court said that the IRS was not proceeding under that section but under the transferee liability provision of §6324(a)(2), which does not contain the absolute 10-year limitation by its terms.

Because transferee liability is derivative of the transferor's liability, courts addressing the limitations applicable to § 6324(a)(2) have looked at the generally applicable statutes of limitations created under §§ 6501-6502.

Section 6501 requires that the IRS assess tax within three years after the return was filed. Section 6502 requires that an action to collect tax must be commenced within 10 years after the assessment of the tax, and that period can be suspended or extended. There was a tolling of the statute of limitations in this case under §6503(d) during the § 6166 deferral period. Because the § 6166 election preceded the assessment of tax liability, the assessment did not trigger the running of the statute of limitations until the end of the § 6166 extension period. The collection action was filed almost 9 1/2 years after the §6166 deferral period ended by reason of the sale of the stock — so it was filed within the allowed 10-year period.

Planning Concerns. (1) Transferees are personally liable up to the value they received at the date of the original transfer to them (in this case the date of death), even if they do not have that much value still remaining from those assets at the time of the later collection action. Recipients of gifts and recipients of assets following an individual's death must understand that this potential personal liability exists, and that it could arise well over a decade later without notice.

(2) There is no indication in this case that the IRS ever made an assessment against the defendants personally under the transferee liability provision, despite the fact that § 6901(c) provides that the period of limitations for assessment of transferee liability against an initial transferee is one year after the expiration of the period of limitation for assessment against the transferor. The IRS must assess tax against the estate within three years of filing the estate tax return (§ 6501(a)), so § 6901(c) requires assessment against the transferee within four years after the return was filed. The case did not discuss whether the IRS made an assessment against the recipients of the retirement accounts and life insurance policy within four years (which would be unusual), and did not address the effect of a failure to make such an assessment.

Again, this raises the concern that transferees may conceivably first get notice of an unpaid estate tax liability when a Complaint is filed many years (in this case 17 years) after the date of death. (In this case, presumably the defendants had notice that an estate tax liability was unpaid, because they were the decedent's daughters, although the case did not indicate whether they were also the executors of the estate.) The potential injustice of this possibility, without prior assessment against the transferees, was raised in the recent Mangiardi case, discussed immediately below.

b. No Necessity for Assessment Against Transferee, Estate of Mangiardi v. Comm'r, T.C. Memo. 2001-24. In this case, the IRS proceeded to collect estate taxes from an IRA beneficiary eight years after the IRA owner's death, without ever having assessed tax against the beneficiary — and the IRS won.

Facts. The decedent's estate consisted almost entirely of nonprobate assets, a revocable trust valued at $4.6 million and IRAs valued at $3.4 million. The IRAs passed to the decedent's nine children. The decedent died in April, 2000 and the estate tax return was filed in July, 2001. The IRS granted six extensions for payment of the estate tax under § 6161. The extensions ended in December, 2004. The letter granting the last extension said that it could not be extended past December, 2004, because "we must ensure that the transferee assessments are made prior to the assessment expiration date to make those assessments." (The four-year period for making assessments against transferee would end four years after filing of the estate tax return, or in April, 2004.) However, assessments were never made against the IRA beneficiaries.

About 1 ½ years after the last extension expired (in July 2006), the IRS gave notice of intent to levy to collect tax. Maureen Mangiardi, a co-trustee of the revocable trust and statutory executor (perhaps one of the decedent's children) timely submitted a hearing request, arguing that the IRS was precluded from collecting estate tax liability from the IRA beneficiaries because the time for making a transferee assessment against them under § 6901 had expired. That proceeding was ultimately concluded in January, 2008 when the IRS sent a notice of determination that it could collect the estate tax liabilities either from the executor or from the beneficiaries without a prior assessment against the transferees under § 6901.

Analysis. The issue is whether a § 6901(c) assessment against transferees (which would have been required in this case within four years of filing the estate tax return) is required before the initiation of a collection action under the transferee liability provisions of § 6324(a)(2). The court held that it was not, and allowed the collection action to continue. The court's reasoning was rather terse, acknowledging that "[f]ew courts have considered this issue directly; however the Courts of Appeals for the Third Circuit and Tenth Circuit have held that respondent may collect estate tax from a transferee pursuant to section 6324(a)(2) without a prior assessment against the transferee under section 6901. United States v. Geniviva, 16 F.3d 522, 525 (3d Cir. 1994); United States v. Russell, 461 F.2d 605, 607 (10th Cir., 1972)," and that it found those cases persuasive.

The court also upheld the IRS's denial to accept $700,000 as an offer-in-compromise. The court reiterated that the IRS could proceed against the IRA beneficiaries in the amount of the IRA distributions, and the IRS had determined that the reasonable collection potential "was at least $3 million given that the beneficiaries received $3,433,007 in IRA distributions." The court agreed that the IRS did not abuse its discretion in refusing the offer-in-compromise because the petitioner did not offer an acceptable amount.

Reasoning That § 6901(c) Assessment is Not Required. The Geniviva case reasons that § 6901(c) and § 6324(a)(2) are "cumulative and alternative — not exclusive or mandatory" (quoting Russell). The Geniviva case relies on a Supreme Court case for this result:

Before 1926, when section 6901 was enacted, the only means by which the Government could impose liability against the transferee was a bill in equity or an action at law brought under the precursor to section 6324 [citation omitted]. Section 6901 did not eliminate or limit such an action; rather, it provided an ADDITIONAL means by which the Government could enforce the collection of taxes. Leighton v. United States, 289 U.S. 506, 507-08 (1933). Thus, in Leighton the Supreme Court held that a failure by the Government to personally assess the shareholders of a defunct corporation did not bar an action to impose transferee liability against them… Leighton has never been overruled, either by the Court or by statute, and is binding upon us.

At least one district court opinion refused to go along with this reasoning. United States v. Schneider, 92-2 U.S.T.C. ¶60,119 (D.N.D. 1992). Geniviva distinguished that case, but noted the extreme unfairness of not requiring assessment against the transferees:

[W]e express a certain sorrow that what seems inherently unfair is also quite in accordance with the law, and note a compassion for the equitable position of the appellants. They received their inheritance apparently believing that the affairs of their late mother's estate had been competently represented both professionally and personally, and handled in accordance with the law. Years later they found out that the estate had been poorly advised and represented, and had an unresolved, serious tax problem. Now they find themselves defendants in a lawsuit for the collection of those taxes, and under circumstances amounting to a forfeiture of their entire inheritance.

Planning Concerns.

(1) The Geniviva court was correct that the result seems "inherently unfair." In a case where there is a § 6166 deferral (like the Kulhanek situation), it is conceivable that the IRS could first contact IRA or life insurance beneficiaries up to 24 years (the § 6166 14-year deferral period plus the additional 10 years allowed under § 6324(a)(2), by reference to § 6502) after the decedent's death that there are unpaid estate taxes, and that they are personally liable for the unpaid taxes (plus accrued interest over 24 years!) up to the amount of the benefits they received from the decedent 24 years earlier, without ever having had prior notice from the IRS of an assessment against them. Yes, that seems "inherently unfair."

(2) This concern is exacerbated with respect to IRA beneficiaries or beneficiaries of other retirement accounts. For example, in Kulhanek the IRS concluded that a reasonable offer-in-compromise "was at least $3 million given that the beneficiaries received $3,433,007 in IRA distributions." That simple conclusion ignores that the IRA beneficiaries will owe income taxes at ordinary income tax rates on the IRA receipts. For example, using the Kulhanek facts assume that beneficiaries of the $3,433,0 IRA were in the 35% income tax bracket when they received their distributions years earlier. They would have paid income taxes of $1,201,552, leaving them net proceeds of $2,231,454. That does not matter; they are still personally liable under § 6324(a)(2) for the full $3,433,007 that they received from the decedent. Even assuming they still have the $2,231,454 net proceeds many years later, they would still have to cough up the additional $1,201,552 out of their other assets. Yes, there is a § 691(c) deduction against the income tax for estate tax attributable to the IRD asset, but the statute of limitations for getting a refund of those income taxes has long passed. Hello bankruptcy!

(3) I have been under the misimpression for lo these many years that the transferees' concern about liability lasted for four years after the estate return was filed because of the limitations period for assessment under § 6901(c). That is flat wrong under the reasoning of these cases, and transferees may have potential liability for estate tax many years beyond that. In many ways, the § 6901(c) time limit is meaningless.

12. Deductibility of Palimony Claim; Estate of Shapiro v. U.S. (9th Cir. 2011)

An unmarried couple lived together 22 years in Nevada. "After learning that Shapiro was involved with another woman," the cohabitant brought a palimony claim, which was outstanding when the decedent died. His estate claimed a §2053 deduction for the value of the palimony claim, and estimated the claim at $8 million. The palimony case settled the next year for $1 million. The IRS denied any deduction. The lower court granted summary judgment disallowing a deduction for the palimony claim, because the woman paid no consideration that was valid to support a contract under

Nevada law.

In a 2-1 decision, the Ninth Circuit reversed the summary judgment that disallowed the palimony deduction, saying that “twenty-two years of cooking, cleaning and other homemaking services” does in fact constitute consideration that is good enough to support a contract under Nevada law. It noted that the lower court never reached the issue of whether those services constituted “adequate and full consideration in money or money’s worth,” which is necessary to support a deduction under § 2053. It remanded the case for the lower court to consider that question, and if it determined that it did meet that standard, to determine the value of the claim as of the date of death. Estate of Shapiro v. Comm’r, 107 AFTR 2d 2011-942 (9th Cir. February 2, 2011)

The dissent reasoned that § 2053 requires consideration “in money or money’s worth,” that other regulations and cases define that term to exclude love and affection, and that there were no allegations that the cohabitant had enhanced the value of the estate in money or money’s worth. While “she cooked, cleaned and provided emotional support to Shapiro, the Estate presented no evidence that these services have a cash value or what that cash value would be.” The dissent would have held that a § 2053 deduction should not be allowed because there were no facts suggesting that the “in money or money’s worth” standard was satisfied.

13. No Unbundling of Fiduciary Fees Required For Taxable Years Beginning Before Final Regulations Issued Under Section 67

In Knight v. Commissioner, 128 S. Ct. 782 (2008), the Supreme Court rejected Judge Sotomayor’s reasoning in the Second Circuit case (Rudkin) that “would equals could” and that the §67(e) exception for trusts applies only if a particular expense “could not” be incurred by taxpayers other than trusts or estates. In light of the Supreme Court’s reasoning, it would seem that the §67(e) proposed regulations that were issued in 2007 (Prop. Reg. § 1.67-4) will need to be substantially changed.

Beginning in 2008, the IRS has issued Notices for every taxable year making clear that investment advisory fees of non-grantor trusts and estates that are integrated as part of the overall fee paid to a trustee or executor will not have to be "unbundled" and made subject to the 2-percent floor under § 67. Notices 2010-32 (2009 returns), 2008-116 (2008 returns), and 2008-52 (pre-2008 returns). The IRS has issued a similar annual Notice for 2010 returns, except that the Notice now applies to returns for taxable years beginning before the final regulations are issued. Notice 2011-37, 2011-20 IRB. This approach will alleviate the need for such annual Notices in the future. Query whether this suggests that the IRS is not close to issuing final regulations under § 67 and that final regulations will likely not be issued in 2011?

14. Estate Tax Deduction for Claim Against Estate Limited to Amount Actually Paid Under "Ascertainable With Reasonable Certainty and Will Be Paid" Standard of Prior § 2053 Regulations, Estate of Saunders, 136 T.C. No. 18 (2011).

The Tax Court refused to allow an estate tax deduction for a claim against an estate, other than the amount actually paid, based on a strict reading of the standard under the prior § 2053 regulation in Estate of Saunders v. Commissioner, 136 T.C. No. 18 (April 28, 2011)(opinion by Judge Cohen). Under the court's analysis, even under the prior § 2053 regulation, claims against an estate where there is an ongoing lawsuit will likely be limited to amounts that are actually paid. This result is not surprising, because the case is appealable to the Ninth Circuit Court of Appeals, and prior Ninth Circuit cases (unlike the courts of appeal in the Fifth, Tenth, and Eleventh Circuits) have stated that no deduction is allowed for contingent or contested claims.

a. Basic Facts. The decedent's husband ("Saunders") was an attorney who represented Stonehill. The IRS sued Stonehill for tax fraud. Following Saunders' death on November 3, 2003, Stonehill sued his estate "based on the claim that Saunders, while Stonehill's attorney, had informed the IRS that Stonehill maintained a Swiss bank account." Documents received under a Freedom of Information Action "suggested that Saunders had acted as a secret IRS informer." Stonehill filed suit against the Saunders' estate on September 24, 2004, alleging over $90 million in compensatory damages plus additional punitive damages. The decedent (Saunders' surviving wife) died 64 days later on November 27, 2004.Discovery continued for several years and a jury ultimately determined that Saunders breached his duty to Stonehill "but was not a legal cause of injury or damage to Stonehill." Judgment was entered in October 2007 awarding costs of $289,000 to Saunders' estate. Following an appeal, the parties ultimately came to a settlement, with Saunders' estate paying $250,000 in attorney's fees and waiving its right to the $289,000 of costs awarded in the state court judgment.

Saunders' estate tax return reported a deduction of $30 million regarding the Stonehill malpractice claim. A closing document for his estate concluded that the value of the malpractice claim would be resolved in the estate tax audit of Mrs. Saunders' estate. Her estate tax return also claimed a $30 million deduction relating to the malpractice claim as of the date of her death. The IRS determined a deficiency of $14.4 million and applied a penalty of $5.76 million (but later conceded the penalty).

Expert Opinions. A letter dated August 30, 2005 from the lead defense attorney in the underlying malpractice action was filed with the estate tax return for decedent's estate. The underlying malpractice action was still underway (and would not be resolved until over two years later), and the defense attorney understood that his letter might be used against him in the underlying malpractice action. Even so, he concluded that the claim against the estate was valued at $30 million. His analysis included this reasoning:
"Jury instructions add to the significance of fiduciary duties and an attorney's duties are certain to be powerful, and are likely to provoke a verdict on the high end of the probable range between one dollar ($1) and ninety million dollars ($90,000,000.00)."

A subsequent letter from that attorney, after the state malpractice action had been settled, reduced his estimate of the value of the claim in 2003-2004 to $25 million. An independent appraiser hired by the estate estimated the value of the "contingent liability" at $19,300,000. Another defense attorney in the underlying malpractice action submitted a letter estimating the value of the claim at $22.5

million.

One of the government's experts valued the claim has having "no merit (at most a 3% chance of recovery if pursued fully)," and another government expert valued the contingent liability of the claim at $3.2 million.

b. Court Analysis. The regulation (in effect prior to the § 2053 final regulation finalized in 2009) provides in part:

"An item may be entered on the return for deduction though its exact amount is not then known, provided it is ascertainable with reason able certainty, and will be paid. No deduction may be taken upon the basis of a vague or uncertain estimate." Treas. Reg. § 20.2053-1(b)(3).

The court drew a distinction between valuing of claim owned by an estate and a claim against an estate. A claim in favor of an estate is determined "by assuming various outcomes, assigning probabilities to those outcomes, and quantifying the results." The court said it is "essentially undisputed that postdeath events are not considered in valuing assets." However, there are stricter provisions under the § 2053 regulations for valuing claims against an estate.

The case notes that courts have differed as to what events subsequent to the date of death may be considered in valuing the deductibility of a claim against an estate, but that the Ninth Circuit Court of Appeals (to which this case is appealable) has stated that subsequent events (i.e., settlement agreements or the actual payment amounts) are taken into account for determining the deduction for "disputed or contingent claims" (citing Propstra v. United States and Estate of Van Horne v. Commissioner).

The court quoted from the recent Naify Revocable Trust case, which is now on appeal to the Ninth Circuit, to support the strict interpretation approach:

"[I]t cannot be that simply because one can assign a probability to any event and calculate a value accordingly, any and all claims are reasonably certain and susceptible to deduction. To so hold would read the regulatory restriction... out of existence... The regulation... explicitly contemplates that some claims will be simply too uncertain to be taken as a deduction, regardless of the fact that it is always possible to come up with some estimate of a claim's value." Marshall Naify Revocable Trust v. United States, 106 AFTR 2d 2010-6236 (N.D. Cal. 2010), on appeal (9th Cir. Oct. 19, 2010).

The court concluded that a review of the estate's expert reports, standing alone, was sufficient to demonstrate that the claim against the estate is too uncertain to be deducted as of Mrs. Saunders' date of death:

"Based on these reports presented by the estate for use at trial, the suggested values are $30 million, $25 million, $19.3 million, and $22.5 million — prima facie indications of the lack of reasonable certainty. None of the estate's experts opined, nor could they reasonable opine, that the $30 million claimed on the estate tax return or any specific lesser amount would be paid, as required by the applicable regulation. The stark differences between their reports and those of respondent's experts merely reinforce the uncertainties inherent in the process... In summary, stating and support a value is not equivalent to ascertaining a value with reasonable certainty."

The court did not allow a deduction based on estimates of the value of the claim on the date of decedent's death, but did allow a deduction for the amount actually paid on the claim during the administration of the estate pursuant to Treas. Reg. § 20.2053-1(b)(3).

c. Observations. The court's strict interpretation of the prior regulation would generally disallow any deduction, other than the amount actually paid on a claim, for any claim where there is a pending lawsuit against the estate at the date of death or any other claim where the amount of the claim is not a liquidated amount. If all other courts had followed this strict literal interpretation of the prior regulation, there would have been no incentive for the IRS to adopt the revised regulation restricting the deductibility of claims against estates where there is not a fixed liquidated amount that will be

paid. However, the Tax Court's analysis in Estate of Saunders is not surprising in light of the fact that the case is appealable to the Ninth Circuit Court of Appeals and Ninth Circuit cases have taken that strict approach as well.
Older cases in the First, Second, Fifth, Eighth and Ninth Circuits have considered post-death events in valuing uncertain claims. The line of cases on the opposite side strictly follow the 1929 Supreme Court decision in Ithaca Trust Co. v. U.S., 279 U.S. 151 (1929), and its general rule that post-death events must not be considered in valuing the amount of the deduction, because so far as possible, the estate must be settled as of the date of the testator's death.

Cases in the Fifth, Tenth, and Eleventh Circuits now agree in refusing to consider post-death events (such as settlement agreements) in valuing claims against the estate that are uncertain in value at the date of death. Estate of Smith v. Comm'r, 198 F.3d 515 (5th Cir. 1999), nonacq. 2000-19 IRB; Estate of McMorris v. Comm'r, 243 F.3d 1254 (10th Cir. 2001); Estate of O'Neal v. U.S., 258 F.3d 1265 (11th Cir. 2001). (In the Estate of Foster case issued by Judge Cohen the same day as Estate of Saunders, Judge Cohen acknowledged that in Estate of Saunders she "declined to attempt to reconcile these cases" that are conflicting among the various courts of appeal.)

Ninth Circuit cases refused to consider post-death events in valuing claims that are "sum certain and legally enforceable as of the date of death," even though a lower amount is actually paid in settlement of the claim. However, those Ninth Circuit cases have suggested in dictum a different result for disputed or contingent claims. Estate of Van Horne v. Comm'r, 720 F.2d 1114 (9th Cir. 1983) (allowed deduction for $596,387 actuarial value of spousal support obligation for ex-husband's lifetime, even though he died after receiving only $35,000; dicta that post-death events are relevant in cases where the claims are potential, unmatured, contingent, or contested at the date of death); Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982) (allowed deduction for full amount of past due assessments and penalties to Water Association even though the claims were settled for a lower amount after the estate tax return was filed; court observed in dictum that "[t]he law is clear that post-death events are relevant when computing the deduction to be taken for disputed or contingent claims"). Some of the subsequent decisions in other circuits have specifically rejected that distinction between those two different types of claims.

Final Regulations Regarding Contingent or Uncertain Claims Against Estates.

The IRS has issued final regulations, taking the general approach that a deduction is allowed for contingent or uncertain claims only as payments are actually made by the estate. This general rule does not apply to estimated amount for claims that the IRS is satisfied are "ascertainable with reasonable certainty" and "will be paid." Treas. Reg. §20.2053-1(d)(4). A protective claim for refund can be filed for contingent or uncertain claims before the statute of limitations runs on refunds, and a deduction is allowed when the claim is resolved and paid. Treas. Reg. §20.2053-1(d)(5). The new regulations apply to decedents dying on or after October 20, 2009.

15. No Deduction For Claim Against Marital Trust; Claim of Estate Against Third Party Valued at Substantial Discount Compared to Amount Ultimately Received; Estate of Foster, T.C. Memo. 2011-95.

On the same day that the Tax Court issued Judge Cohen's decision in Estate of Saunders, Judge Cohen issued another decision addressing the valuation of claims against an estate (really against Marital Trusts that were included in the decedent's estate) and of other claims that the estate held against a third party. Estate of Foster v. Commissioner, T.C. Memo. 2011-95. Both the potential claim against the Marital Trusts and the claim that the estate owned were still involved in litigation at the time of the decedent's death. The court did not allow any deduction of valuation offset for the claims against the Marital Trusts but allowed a very substantial discount in valuing the claim that was owned by the estate as compared to the amount that was actually received.

a. Basic Facts. Mr. Foster founded a closely held business. Under a stock restriction agreement, the company was required to purchase the stock owned by Mr. Foster's family following the death of he and his wife. The company purchased a second-to-die life insurance policy on their lives, and the agreement prohibited the company from encumbering the policy. Mr. Foster and other shareholders later sold most of their shares to an ESOP (Mr. Foster received over $33 million for the shares that the sold). The ESOP borrowed money from four lenders with unsecured loans to finance the purchase of the shares. (An important fact is that one of the lenders was a trust company that also served as the corporate co-trustee of Marital Trusts created at Mr. Foster's death.)

Mr. Foster died in July 1996, and his estate was divided into three Marital Trusts. (Mrs. Foster had the right to withdraw assets from Martial Trust #3.) A trust company (the "Corporate Trustee/Lender") and Mrs. Foster were the co-trustees. The company suffered severe financial difficulties beginning in 1998, and the drop in earnings caused the ESOP to violate the financial covenants in the loans. The lenders sought to restructure the unsecured loans to gain a security interest in the company's assets.

In 1999, the Corporate Trustee/Lender waived the restriction in the stock restriction agreement from encumbering the life insurance policy and allowed the company to borrow against the policy. In late 1999, the Corporate Trustee/Lender again waived the encumbrance restriction and assigned the life insurance policy to itself as collateral for the ESOP loans. The company also demanded that Mrs. Foster lend $6.8 million to the company (the "Founder's Loan") and she borrowed $6.8 million from the Corporate Trustee/Lender, securing the loan with over $12 million of assets that she withdrew from Marital Trust #3. An attorney (Kavanagh) represented both Mrs. Foster and the company in connection with the 1999 transactions.

Claim Against Estate. In 2001, the company filed for bankruptcy and the life insurance policy lapsed for failure to pay the premiums. Just before the bankruptcy filing, various ESOP beneficiaries sued the ESOP trustee and Mr. Foster (the "Keach lawsuit") for breaches of fiduciary duty, and also sought to recover funds from the Marital Trusts as restitution. In light of that lawsuit, the Corporate Trustee/Lender unilaterally froze Mrs. Foster's right to withdraw

assets from Marital Trust #3. In February 2004, a state court found that Mr. Foster and the ESOP trustee did not commit any breaches of fiduciary duty and a judgment and amended judgment were entered in March and April 2004 in favor of the ESOP trustee and Mr. Foster. The ESOP plaintiffs appealed that judgment later in April 2004.
Mrs. Foster (hereafter referred to as the decedent) died on May 15, 2004. In September 2004, the ESOP plaintiffs released their claims against Mr. Foster's estate. Foreshadowing Observation: In light of the judgment that had been entered (though still appealable) prior to the decedent's death, it is not surprising that the court did not allow a deduction or valuation offset for a huge estimated value of the Keach lawsuit claim.

Claim Held by Estate. With respect to claims that the decedent's estate (and the Marital Trusts) held against others, a new law firm for the decedent's estate by September 2004 identified and began investigating claims against Kavanagh regarding his representation of decedent. In November 2004, the estate attorneys first learned about the life insurance policy and that it had lapsed. In July 2005, the law firm began investigating the Corporate Trustee/Lender's involvement in the lapse of the insurance policy, but initially determined that a claim against the Corporate Trustee/Lender would not be viable.

After the estate tax return was filed in August 2005 (see below), the Corporate Trustee/Lender produced a memorandum suggesting that the entity "had been concerned only with justifying the encumbrance of the life insurance and had ignored its duty to investigate the merits of the transaction and advise decedent as to what rights she was surrendering." In October 2006, the estate joined the Corporate Trustee/Lender in a lawsuit alleging that it engaged in self-dealing and facilitated decedent's withdrawal of assets from Marital Trust #3 to overcollateralize the loan, the proceeds of which the decedent used to make the Founder's Loan to the company. In March 2008, the estate settled with Kavanagh for approximately $850,000 (his $1 million insurance limit less litigation costs of $150,000).

In April 2008, the Corporate Trustee/Lender produced hundreds of documents (following a Motion to Compel the production of documents) that the estate believed showed that the Corporate Trustee/Lender's "legal department had concealed from its own trust department the fact that [the Corporate Trustee/Lender's] lending department had deliberately disregarded [the Corporate Trustee/Lender's] conflict of interest arising from its roles as co-trustees of the Marital Trusts and creditor of F&G and decedent." A trial against the Corporate Trustee/Lender began on October 22, 2008, and a settlement agreement was reached two days later in which the Corporate Trustee/Lender agreed to pay $17 million plus the return of previously withheld trust funds.

Estate Tax Return and Audit. In August 2005, an estate tax return was filed for decedent's estate including the value of the three Marital Trusts in the gross estate. Nothing was listed on the return as an estate asset regarding any potential claim against the Corporate Trustee/Lender or Kavanagh. (As indicated by the facts described above, the claims and lawsuit against them primarily came to light and proceeded after the estate tax return was filed.) However, the return listed as a liability of the Marital Trusts almost $14.7 million relating to the Keach lawsuit.

In January 2007, the return was selected for audit, and four months later the estate advised the IRS of the claim against the Corporate Trustee/Lender and Kavanagh as an additional asset of the estate. In April 2008, the IRS issued a notice of deficiency, disallowing any discount in the value of the Marital Trust as a result of the Keach lawsuit against Mr. Foster's estate. The estate filed its Tax Court petition in July 2008. In July 2009 (about nine months after the settlement with the Corporate Trustee/Lender), the IRS amended its answer in the tax litigation to assert an increased deficiency in which the IRS valued the claims held by the estate at $20.6 million.

b. Court Analysis.

Value of Marital Trusts. The estate claimed that the value of the Marital Trust should be reduced first by a discount for the liability against the Martial Trusts in the Keach lawsuit. The court distinguished cases that had allowed discounts in valuing an entity because of actual or threatened litigation, because in this case a willing buyer of assets from the Marital Trusts would not have been impaired by the Keach lawsuit and would not have insisted on a discount. Indeed, the court determined that the ESOP plaintiffs had not properly preserved their right to appeal the judgment dismissing their claim prior to the decedent's death. The estate countered that if the Keach lawsuit could not be considered in valuing the assets of the Marital Trust, a deduction under § 2053 should be allowed for the value of the claim against the Marital Trusts.

This case is appealable to the Ninth Circuit, so Judge Cohen repeated her analysis from the Estate of Saunders case (issued by the Tax Court the same day), reiterating that a deduction would be allowed for the date of death estimated value of a claim against an estate only if the value was ascertainable with reasonable certainty. The estate's experts estimated varying discounts for the hazards of litigation (29% by one and 12.9 to 17.2% by another), and the court determined that the value of the claim could not be determined at the date of death with reasonable certainty.

Next, the estate claimed that there should be a lack of marketability and lack of control discount in determining the value of Marital Trust #3 on account of the freeze placed on Marital Trust #3 by the Corporate Trustee/Lender. The court disagreed, drawing a distinction between the value of the Marital Trust to the decedent as a beneficiary vs. the value of the Marital Trusts assets includible in the estate under § 2044. The court reasoned that the freeze restrictions "applied only to decedent, not the underlying assets of the trust themselves." Observation: One phrase in the opinion is rather curious. In noting that a freeze that prevented the decedent from selling trust assets does not affect the value of the trust assets, the court added that "we must assume that such a sale would take place even if it could not actually occur."

Value of Claims Held by Estate. The IRS had the burden of proof because it raised the claims as additional assets of the estate in an amended answer rather than in the notice of deficiency. The IRS produced no evidence regarding the value of the claim against Kavanagh, so the IRS failed to carry its burden of proof as to that claim. As to the value of the estate's claim against the Corporate

Trustee/Lender, the court rejected the valuation reports by the IRS's experts because they assumed that a hypothetical purchaser would have knowledge of all facts in the Corporate Trustee/Lender's files, "including specifically those discovered by the estate's counsel after time-consuming and contested discovery." The court would not treat hypothetical purchasers as having knowledge of facts on the date of death — "over two years before the claims were actually discovered by the estate's counsel." The estate's experts valued the claims against Kavanagh and the Corporate Trustee/Lender at only $33,000. The court found the minimal value unbelievable because the estate would not have pursued the claims at all if it believed they only had that much value.

Observation: The estate pursued a claim against Kavanagh relatively soon after the decedent's death, but did not investigate and seriously pursue the claim against the Corporate Trustee/Lender until well over a year after the decedent's death. Indeed, the estate's attorneys concluded fifteen months after decedent's death that a claim against the Corporate Trustee/Lender was "weak and speculative" and another attorney who joined the attorneys in examining the transactions concluded seventeen months after the decedent's death that the estate "did not have a viable claim" against the Corporate Trustee/Lender. The court did not draw a distinction between the claim against Kavanagh and the Corporate Trustee/Lender regarding the estate's expert's opinion that the claims had minimal value on the date of the decedent's death.

As a result, the court dismissed each side's experts and went through its own analysis of applying its own probabilities of a successful preliminary investigation (10% rather than the estate's expert's 1% estimate) and of a successful comprehensive investigation (50% vs. the estate's expert's 20% estimate), and using the IRS's expert's estimate of a 39.5% lack of marketability discount, to arrive at a fair market value of the claims against the Corporate Trustee/Lender of $930,000 (as compared to the $17 million plus return of withheld trust assets [the opinion does not say what that value was] that the Corporate Trustee/Lender actually paid pursuant to the settlement).

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Steve Akers

CITE AS: