CURRENT DEVELOPMENTS IN FEDERAL TRANSFER TAXES

ABA MEETING OF
THE SECTION OF TAXATION

ESTATE AND GIFT TAXES COMMITTEE
OF THE SECTION OF TAXATION

NEW ORLEANS, LA
January 18, 2019

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By: Beth J. Kerwin & Megan M. Curran

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I. TREASURY MATTERS AND LEGISLATIVE UPDATE

A. IRS Releases Anti-Clawback Proposed Regulation 25.2010-1

1. Summary

The 2017 Tax Cuts and Jobs Act (P.L. 115-97) (the “TCJA”) temporarily increased the estate and gift tax basic exclusion amount (the “BEA”) from $5 million to $10 million per person (from $10 million to $20 million for married couples), indexed for inflation, for decedents dying or gifts made after December 31, 2017. This increased BEA is set to expire on December 31, 2025, at which time the law will revert to the pre-TCJA basic exclusion amount of $5 million indexed for inflation (the “additional BEA period”).

Practitioners have been concerned about a potential “clawback” – where a taxpayer uses the additional $5 million BEA before Dec. 31, 2025 but later makes a gift or dies after Dec. 31, 2025 and whether such gift will increase the gift or estate tax on the later transfer. Also, practitioners have been concerned about a potential “reverse clawback” – where a taxpayer has used up his or her pre-TCJA BEA, paid gift tax on a pre-TCJA transfer, then makes an additional gift or dies during the additional BEA period and whether such pre-TCJA gift (on which gift tax was paid) will absorb the new increased BEA.

With respect to this topic, Treasury has statutory authority to issue regulations. Specifically, the TCJA delegated authority to Treasury to prescribe regulations, in carrying out the estate tax, to address any differences between the BEA applicable at the time of the decedent’s death and the BEA applicable with respect to any gifts made by the decedent. See Section 2001(g)(2); see also Section 2010(c)(6).

On November 20, 2018, Treasury and the IRS released Proposed and Temporary Regulations (REG-106706-18) regarding how to “ensure that a decedent’s estate is not inappropriately taxed with respect to gifts made during the increased [basic exclusion amount] period” (i.e., that there would be no clawback or reverse clawback).

The preamble to the Proposed Regulations covers four examples addressing issues with respect to the estate tax and gift tax calculations that could arise as a result of the temporary additional BEA. Treasury determined that only the last situation involving clawback in the estate tax context created an issue and warranted a regulatory remedy.

The first situation covers the following: where a taxpayer made pre-TCJA gifts exceeding the then-applicable BEA, paid gift tax on such gifts and then makes gifts during the additional BEA period using the additional BEA. Treasury illustrated that, based on the gift tax computation, the additional BEA would not be reduced by any pre-TCJA gifts on which gift tax was paid, so as to deny the taxpayer the full benefit of the additional BEA (i.e., no reverse clawback in the gift tax context).

The second situation covers the following: where a taxpayer made the same pre-TCJA gifts and paid gift tax on them (as in situation 1), did not make any gifts during the additional BEA period but then dies during the additional BEA period. Treasury, likewise, illustrated that, based
the estate tax computation, there is no reduction of the additional BEA by any prior gifts on which gift tax was actually paid (i.e., no reverse clawback in the estate tax context).

The third situation covers the following: where a taxpayer makes gifts during the additional BEA period that are sheltered from gift tax by the additional BEA and then makes gifts after Dec. 31, 2025. Treasury illustrated that, based on the gift tax computation, the gift tax on a gift made after the additional BEA period is not inflated by a theoretical gift tax on a gift made during the additional BEA period that was sheltered from gift tax when made (i.e., no clawback in the gift tax context).

The fourth situation covers the following: where a taxpayer makes gifts during the additional BEA period that are sheltered from gift tax by the additional BEA and then dies after Dec. 31, 2025. Treasury acknowledged that “[i]n this case, the statutory requirements for the computation of the estate tax, in effect, retroactively eliminate the benefit of the increased BEA that was available for gifts made during the increased BEA period.” To implement the TCJA and to remedy this outcome, Treasury proposes to amend Treas. Reg. Sec. 20.2010-1, first, to provide that, for decedents dying or gifts made from Jan. 1, 2018 through Dec. 31, 2025, the increased BEA is $10 million and, second, to provide a special rule for when the portion of the credit as of the decedent’s date of death that is based on the BEA is less than the sum of the credit amounts attributable to the BEA allowable in computing gift tax payable within the meaning of Section 2001(b)(2) – the BEA, therefore, is the greater of the BEA at the death of the taxpayer or the BEA used during the taxpayer’s lifetime. See the Example under Prop. Reg. Sec. 20.2010-1(c)(2). Treasury notes that the Proposed Regulations “ensure that a decedent's estate is not inappropriately taxed with respect to gifts made during the increased BEA period.” (i.e., no clawback in the estate tax context).

2. **Bottom Line**

In sum, the Proposed Regulations illustrate how to calculate differences in the BEA in order to ensure that there will be no clawback or reverse clawback. For taxpayers dying after Dec. 31, 2017, to prevent a clawback in the estate tax context, the Proposed Regulations allow estates to determine their estate tax credit against the tax using the higher of the BEA that was (i) applied to prior gifts during the taxpayer’s lifetime and (ii) in effect at the time of death. Also, note that the Proposed Regulations take a use-it-or-lose-it approach – if the additional BEA expires in 2026 before the taxpayer has used up such additional BEA (including inflation adjustments), then such unused additional BEA is lost.

The Proposed Regulations do not expressly address whether the deceased spousal unused exclusion (“DSUE”) amount is measured by the BEA applicable at the first spouse’s death or at the surviving spouse’s death. The statute provides that, “with respect to a surviving spouse of a deceased spouse dying after December 31, 2010,” the DSUE means the “lesser of – (A) the basic exclusion amount, or (B) the excess of – (i) the applicable exclusion amount of the last such deceased spouse of such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.” Code Sec. 2010(c)(4) (emphasis added). The regulations clarify that the DSUE amount of a decedent with a surviving spouse (the first-to-die) is the lesser of “(i) The basic exclusion amount in effect in the year of the death of the decedent . . . .” Treas. Reg. Sec. 20.2010-2(c)(1) (emphasis added); see
also Treas. Reg. Sec. 20.2010-1(d)(4) (“The term DSUE amount refers, generally, to the unused portion of a decedent’s applicable exclusion amount to the extent this amount does not exceed the basic exclusion amount in effect in the year of the decedent’s death”). Also, the preamble with respect to the June 2012 temporary regulations states that “[t]he temporary regulations in Sec. 20.2010-2T(c)(1)(i) confirm that the term ‘basic exclusion amount’ referred to in section 2010(c)(4)(A) means the basic exclusion amount in effect in the year of the death of the decedent whose DSUE amount is being computed.” T.D. 9593 (June 2012). The TCJA did not override these existing regulations and the IRS is bound by its regulations. See Internal Revenue Manual 4.10.7.2.3.4. Therefore, arguably, it appears that the DSUE amount should be measured by the BEA in effect in the year of the first deceased spouse’s death, meaning that the additional BEA is preserved where the first spouse dies before 2026 and the second spouse dies after 2026.

Also, although the generation-skipping transfer tax is not specifically addressed in the Proposed Regulations, application of the GST exemption likely would be similarly affected.

Note that it is possible that a new Congress could change the tax code before the TCJA sunset date or a new administration could revoke or amend the regulations (especially since the additional BEA is a highly political issue).


The IRS announced in Revenue Procedure 2018-57 that, for 2019, (1) the gift and estate tax exemption and GST tax exemption is $11.4 million per taxpayer and (2) the annual exclusion from gift tax will remain at $15,000.


The IRS 2018-2019 Priority Guidance Plan was released on November 8, 2018. It includes a number of additional items in order to implement the TCJA that were not included in the last fourth quarter update of the 2017-2018 plan.

One such items is Item 3 of Part 1, which states “Guidance clarifying the deductibility of certain expenses described in Sec. 67(b) and (e) that are incurred by estates and non-grantor trust.” Notice 2018-61 noted that the IRS will issue clarifying regulations to provide that estates and non-grantor trusts may continue to take the appropriate administration expenses deductions under IRC §67(e)(1). The Notice also indicated that regulations will address the availability of “excess deductions” to individual beneficiaries under Sec. 642(h) on the termination of a trust or estate but did not give insight on its expected guidance.

Item 37, which identified regulations on clawback of the additional BEA as an issue for guidance, was addressed by the new Proposed Regulations discussed above.

In addition, under the general gifts, estates and trusts heading, only four items are listed. They are as follows:

1. Guidance on basis of grantor trust assets at death under §1014.
2. Final regulations under §2032(a) regarding imposition of restrictions on estate assets during the six-month alternate valuation period. Proposed regulations were published on November 18, 2011.

3. Regulations under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate.

4. Regulations under §7520 regarding the use of actuarial tables in valuing annuities, interests for life or terms of years, and remainder or reversionary interests.

The last item is new since the last fourth quarter update. Commentators speculate that this last item was added because Sec. 7520(c)(2) mandates a revision to the mortality tables at least once every ten years.

D. House of Representatives Bills H.R. 6757 and H.R. 6760 (passed on Sept. 27, 2018)

On September 27, 2018, the House of Representatives passed two bills, known as Tax Reform 2.0. H.R. 6760 would make the doubling of the estate and gift tax and GST tax exemptions permanent and make several other tax changes set to sunset in 2025 permanent, including the Sec. 199A deduction and the 60% limitation on the deductibility of cash gifts made to public charities. H.R. 6757 would make certain changes to retirement and education accounts, like 529 plans. However, the Senate is unlikely to debate these bills.

E. Senate Bill Introduced by Sen. Kyl to Reduce Estate Tax Rate

On November 15, 2018, Senator Jon Kyl introduced the Estate Tax Rate Reduction Act (S. 3638) that would reduce the estate tax to 40% from 20%.

II. STATE LAW

A. Matter of Seiden

The New York Surrogate’s Court ruled that a QTIP trust created for New York estate tax purposes in 2010 (when the federal estate tax lapsed for one year) was not includible in the surviving spouse’s New York estate.

1. Summary

The New York Surrogate’s Court ruled that a QTIP trust created for New York estate tax purposes in 2010 (when the federal estate tax lapsed for one year) was not includible in the surviving spouse’s New York estate upon her death in 2014.

2. Facts

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Husband died in 2010, survived by Wife. Wife was a beneficiary of a marital trust under Husband’s Will. Wife died in 2014. Since there was no federal estate tax in 2010, the executor of Husband’s Will did not elect federal QTIP treatment. The executor did file a New York estate tax return and elected QTIP treatment under New York’s procedure. The Husband’s estate took a marital deduction for the trust property in calculating the New York estate tax.

Upon Wife’s death, her executor did not include the marital trust property on the federal estate tax return because there was no QTIP election and, therefore, Section 2044 was not triggered. The IRS issued a closing letter. Her executor also excluded the trust property on the New York estate tax return taking the position that New York law defines the New York gross estate by reference to the federal gross estate and, therefore, the trust property is excluded. The New York Tax Department assessed a deficiency notice.

3. **Analysis**

The Surrogate’s Court found that the NY Tax Department analysis incorrectly referenced a prior version of New York law applicable in 2010. Since Wife’s estate was at issue, the law applicable in 2014 governed. Based on the 2014 New York law, the marital trust property would not be included in Wife’s federal gross estate on her death and, therefore, would not be included in Wife’s New York gross estate.

4. **Bottom Line**

If a surviving spouse is a beneficiary of a marital trust that was created in 2010 and such surviving spouse died a resident of a state with a state estate tax, this case may be a useful to consider along with the state law in effect at the time of the surviving spouse’s death.

B. **Changes to New York Gift Add Back Law**

1. **Summary**

As of the writing of these materials, New York law currently provides that the New York gross estate of a deceased resident will be increased by the amount of any taxable gift made by the decedent within three years of the decedent’s death. See New York Tax Law Sec. 954(a)(3). However, this rule does not apply to donors dying on or after Jan. 1, 2019. Id. Therefore, even if a taxable gift is made before Jan. 1, 2019, if the donor dies on or after such date, such gift will not be included in the decedent’s gross estate for New York estate tax purposes.

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2 New York Tax Law Sec. 954(a)(3).
C. Blalock v. Sutpin,3 - The Alabama Supreme Court ruled that divorce revokes beneficiary designations on will substitutes, like life insurance, unless the owner takes steps to reinstate the beneficiary designation after the divorce is final.

1. **Summary**

The Alabama Supreme Court considered whether the decedent’s divorce revoked a beneficiary designation on a life insurance policy in favor of his former spouse and whether the decedent’s reunion with the former spouse constituted a common law marriage sufficient to reinstate the beneficiary designation. The Alabama Supreme Court held that the Alabama statute (modeled off of the Uniform Probate Code version) nullified the beneficiary designation and the life insurance proceeds belonged to the decedent’s daughter.

2. **Facts**

In 2011, Loyd Sutphin, Jr. obtained a $250,000 life insurance policy and named his daughter, Crimson Jade Sutphin, as the sole beneficiary. When Loyd purchased the policy, he was an Alabama resident working in Tennessee. The contract was executed in Tennessee and delivered to his workplace in Tennessee. In 2012, Loyd married Kimberly D. Blalock and Loyd changed the beneficiary designation to provide half to Blalock and half to his daughter. In 2016, Loyd and Blalock divorced, but the divorce judgment did not address the life insurance policy. In October of 2016, Loyd and Blalock reconciled. In December 2016, Loyd died having never updated the beneficiary designation. At his death, the beneficiary designation provided half to Blalock and half to his daughter. The lower courts applied Alabama law, specifically §30-4-17 of the Alabama Code of 1975, and held that the divorce revoked the beneficiary designation as to Blalock, so Loyd’s daughter was entitled to all the proceeds. On appeal, there were three issues for the court to consider. First, whether Alabama law applied. Second, whether the Alabama statute nullified the beneficiary designation upon divorce was constitutional. Third, whether Loyd’s and Blalock’s reconciliation rose to the level of a common law marriage sufficient to reinstate the beneficiary designation.

3. **Analysis**

First, the Alabama Supreme Court interpreted Blalock’s subject matter jurisdiction argument as a choice of law argument and determined that Alabama law governed. Alabama applies *lex loci contractus* to determine which state’s law applies. Even though the contract was entered into and delivered to Loyd in Tennessee, Tennessee’s substantive law conflicted with Alabama’s fundamental public policy because Tennessee has not adopted the Uniform Probate Code section regarding nontestamentary will substitutes but Alabama did. In adopting the statute, Alabama determined that the Uniform Probate Code’s statute more closely reflects the presumed intent of divorce. Given that the case involved Alabama residents, an Alabama divorce judgment and an Alabama decedent, Alabama law should apply.

Second, the Alabama Supreme Court considered the Alabama statute in light of the recent United States Supreme Court decision in *Sveen* and determined that the Alabama statute was

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3 #1170879 (Ala. 10/26/2018)
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nal because the statute was designed to reflect a policyholder’s intent and it does not disrupt a policyholder’s expectations because most people assume that divorce truncates a former spouse’s rights to the other spouse’s assets. Moreover, the statute serves as a default rule and provides a method for the policyholder to override the default rule. Therefore, the Alabama Supreme Court found the Alabama statute was constitutional and to hold that the divorce did not revoke Loyd’s beneficiary designation would create confusion and would contradict the analogous ruling the United States Supreme Court made in Sveen.

Third, the Alabama Supreme Court ruled that the two months of reconciliation plus a plan to remarry in the future was not enough to constitute a common law marriage or to reinstate the beneficiary designation.

4. Bottom Line

This case follows Sveen in upholding a statute designed to revoke beneficiary designations in nontestamentary will substitutes upon divorce unless the owners take steps to confirm the designation. Only 26 states have adopted the Uniform Probate Code statute nullifying beneficiary designations upon divorce, so it is a good reminder to follow up with clients going through a divorce to make sure their beneficiary designations reflect their wishes.

D. In re Trust Under Deed of Kulig⁴ - The Supreme Court of Pennsylvania determined that a surviving spouse’s elective share under the Pennsylvania pretermitted share statute excludes a revocable trust.

1. Summary

In a case of first impression for the Pennsylvania Supreme Court, the court had to determine whether a decedent’s revocable trust was available as an asset when calculating the surviving spouse’s elective share under the pretermitted spouse statute. The court considered the statutory language and the pre-existing scheme and determined that a decedent’s revocable trust is not included in the calculation for the pretermitted spouse’s share.

2. Facts


Given that Mary Jo was omitted from David’s 2010 Will, Pennsylvania provides two options for omitted spouses. First, 20 Pa.C.S. §2507 (“pretermitted spouse statute”) provides that an omitted spouse is entitled to receive the same share of the decedent’s estate that she would have received if the decedent died intestate. The “intestate estate” is defined as any part of the estate that decedent did not effectively dispose of “by will or otherwise.” Alternatively, the spouse ma

⁴ 175 A.3d 222 (2017)
elect to receive one-third of the probate estate as well as any assets nominally transferred during
the decedent’s lifetime to which he retained control to dispose of at his death, as reduced by any
property that transferred to the spouse by other means ("elective share statute"). A new statute
enacted in 2006 requires the same rules of construction that apply to the testamentary trusts to
apply to revocable trusts when calculating the pretermitted spouse’s share under the pretermitted
spouse statute.

Under the pretermitted spouse statute, if the revocable trust was included in the share
calculations, Mary Jo would receive $1.5 million more than if she took the elective share statute
because the revocable trust is expressly excluded from the elective share statute.

The main issue before the court was whether the revocable trust must be included in the
pretermitted spouse statute share calculations due to the requirement that the same rules of
construction must be applied to inter vivos revocable trusts.

3. Analysis

In order to determine whether a revocable trust should be included in the pretermitted share
calculations, the court evaluated the statutory language to determine whether the legislature
expressly intended the pretermitted share statute to modify or disrupt the existing pre-2006 regime.
Before 2006, Pennsylvania only had the elective share statute. After 2006, the Pennsylvania
legislature added the pretermitted share statute. Given that the language of the statute was
ambiguous, the court reviewed the legislative intent and comments to the statute to determine that
the statute did not require the revocable trust to be included in the pretermitted share calculations.

4. Bottom Line

Under the Pennsylvania pretermitted statute, a revocable trust is not included to calculate
the spouse’s pretermitted share. Given the prevalence of revocable trusts, it might be worth
evaluating your jurisdiction’s elective share statutes to determine whether the revocable trust
would be included in the elective share calculations.

III. FEDERAL CASE LAW

A. Chrem v. Comm’r,5 – The Tax Court denied cross motions for summary judgment
in a case involving charitable gifts of stock prior to the completion of a sale pursuant
to a tender offer because genuine disputes of material facts existed.

1. Summary

The Tax Court denied cross motions for summary judgment because genuine disputes of
material facts existed in a case involving charitable gifts of stock of a closely held corporation
prior to the completion of a sale pursuant to a tender offer, which gave rise to an assignment of
income doctrine issue and a qualified appraisal challenge.

5 T.C. Memo 2018-164 (Sept. 26, 2018).
2. **Facts**

Petitioners (along with eight others) owned 100% of the stock of Comtrad (a closely held Hong Kong corporation). A related company proposed to purchase 100% of Comtrad for $4,500 per share. After Comtrad’s shareholders agreed to tender 87% of their shares, petitioners donated the balance of their Comtrad stock to a charitable organization. The acquiring company then completed the acquisition by purchasing the donated stock for $4,500 per share from the charity. On their 2012 tax return, petitioners claimed a charitable deduction for their gifts, valuing the donated stock at $4,500 per share.

Because the acquiring company and target were related parties and the acquiring company was owned by an ESOP, the acquiring company hired an appraiser to provide a fairness opinion supported by a valuation report with respect to the stock purchase price. The use of the valuation report was expressly restricted by its terms and the appraisal did “not take into consideration any tax consequences related to Comtrad’s selling shareholders.”

The IRS assessed a deficiency based on the assignment of income doctrine with respect to the transfer of the stock to charity. The IRS also determined that the petitioners had failed to obtain qualified appraisals with respect to the donated shares.

3. **Analysis**

**Assignment of Income.** The anticipatory assignment of income doctrine provides that a person anticipating the receipt of income cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person. In the scenario at issue, one relevant question is whether the prospective acquisition is a mere expectation or a virtual certainty. Another relevant question is whether the charity is obligated or can be compelled by one of the parties to the transaction to surrender the donated shares to the acquirer. The existence of an understanding among the parties or the fact that transactions occur simultaneously or according to prearranged steps may be relevant to this question. Since there were genuine disputes of material facts regarding the dates on which the events occurred, the extent to which the charity was obligated to tender the shares to the acquiring company and other facts, the Tax Court dismissed the summary judgment motions by both parties.

**Charitable Contribution Deductions.** A taxpayer who claims a deduction for a contribution of property (other than publicly traded securities) valued in excess of $5,000 must obtain a “qualified appraisal” of the property. Sec. 170(f)(11)(C). In addition, the taxpayer must attach information that the Secretary may require, including an appraisal summary on Form 8283. Id. If the property is valued in excess of $500,000, the taxpayer must attach a copy of that appraisal to his or her return. Sec. 170(f)(11)(D). A “qualified appraisal” is defined under Treas. Reg. Sec. 1.170A-13(c)(3)(ii). Failure to satisfy the reporting requirements is excused if it is shown that such failure is due to reasonable cause and not willful neglect. Sec. 170(f)(11)(A)(ii)(II). Reasonable cause requires that the taxpayers have exercised ordinary business care and prudence as to the challenged item and is determined on a case-by-case basis. The petitioners alleged that their returns were prepared by an experience CPA and that the CPA did not direct the petitioners to attach the appraisal report, but the record is silent regarding the CPA’s advice and petitioners’
good faith reliance. Therefore, the Tax Court could not resolve whether the petitioners’ failure to satisfy the reporting requirements was excused by reasonable cause because of the disputed material facts.

4. **Bottom Line**

Caution should be taken when a client seeks to donate shares of a closely held business to a charity. In such situations, it is important to determine how far down the road the proposed sale transaction is – if it is too far along and a virtual certainty that the sale transaction will take place, then the assignment of income rule will be triggered. Note that many public charities will not accept the ownership of closely held business interests unless the charity can be assured that it can dispose of the interest for cash shortly thereafter, creating an issue for the assignment of income doctrine.

Also, it is important to ensure, where required under the Code, that a formal valuation of the donated interest is obtained to substantiate the charitable gift and deduction. Here, a valuation was used with no minority discount (and a very small marketability discount).

B. **Streightoff v. Comm’r,** The Tax Court determined whether a decedent’s transfer of a controlling LP interest to his revocable trust constituted an assignment or a substitution under the partnership agreement and determined an appropriate valuation of the LP interest for estate tax purposes.

1. **Summary**

The Tax Court determined whether a decedent’s transfer of a controlling LP interest to his revocable trust constituted an assignment or a substitution under the partnership agreement and determined an appropriate valuation of the LP interest for estate tax purposes.

2. **Facts**

On Oct. 1, 2008, the decedent, through his daughter acting as attorney-in-fact, formed a Texas LP, Streightoff Investments (“SILP”). Streightoff Management LLC was SILP’s sole general partner. Decedent’s daughter was the manager of the LLC in her individual capacity. The initial limited partners of SILP were decedent (88.99% interest), his children and his former daughter-in-law. Decedent had gifted the LP interests to such family members upon formation (reported on the decedent’s 2009 Form 709). Decedent funded the LP with cash and marketable investments.

The parties entered into an LP agreement for SILP, which included certain transfer and assignment provisions.

On the same day as the creation of SILP, decedent established a revocable trust and his daughter, as attorney-in-fact, transferred decedent’s 88.99% LP interest to his revocable trust whereby the revocable trust agreed to abide by the terms of the LP agreement.

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Decedent died on May 6, 2011. The estate filed an estate tax return, reporting the gross estate using the alternative valuation date of Nov. 6, 2011. As of Nov. 6, 2011, the LP had a net asset value of $8,212,103. Decedent’s 88.99% interest in the LP on the estate tax return was valued at $4,588,000 after applying a 37.2% discount.

The IRS assessed a deficiency, finding that the decedent’s LP interest had a value of $5,993,000.

3. **Analysis**

The Tax Court examined two issues—first, the type of interest transferred by the decedent to his revocable trust and, second, the value of the transferred interest.

**Type of Transferred Interest – limited partnership interest v. assignee interest.** First, the Tax Court determined whether the 88.99% interest held by the revocable trust on decedent’s date of death was an assignee interest or a limited partnership interest under Texas law and the terms of the partnership agreement. The Tax Court acknowledged that state law generally defines a property interest that has been transferred for estate tax purposes. However, the Tax Court noted that the substance of a transaction rather than its form can change the tax implications of the state law determination. The Tax Court found that the transferred interest was a limited partnership interest and not an assignee interest because the assignment was sufficient for transferring the limited partnership interest under the LP agreement and admitting the revocable trust as a partner. Additionally, there was no material difference between the revocable being a limited partnership interest or an assignee interest because, in addition to other facts, decedent’s daughter was a partner entitled to information about the partnership and the trustee of the decedent’s revocable trust.

**Value of the LP Interest.** Second, the Tax Court determined the value of the LP interest, examining the valuations of the parties’ expert appraisers. The experts agreed that the proper method for valuing the transferred interest was based on its pro rata share of the net asset value less discounts. However, the experts did not agree on the appropriate lack of control and marketability discounts. Regarding the lack of control discount, the Tax Court determined that, since the revocable trust’s interest was a limited partnership interest (and not an assignee interest), as a holder of a 88.99% interest, decedent had significant influence and control over the LP’s management as provided for in the LP agreement. Therefore, the revocable trust was not entitled to a lack of control discount. Regarding the lack of marketability discount, the Tax Court found that the IRS expert’s 18% discount was reasonable and more appropriate than the estate expert’s 27.5% discount, which was based on older studies and the transferred interest being an assignee interest.

4. **Bottom Line**

This case highlights the types of arguments a court may examine when reviewing the valuation of a closely held business interest for estate tax valuation purposes. The IRS often revisits the basis for discounts with respect to closely held business interests on audit GF Family Management, LLC ("GFM"), an investment management firm owned and operated by petitioners, claimed expense deductions. Each petitioner held a 25% profits interest in GFM.
C. **Hellmann v. Comm’r** - The Tax Court denied cross motions for summary judgment on the issue of whether family office expenses were deductible under Section 162 (requiring a trade or business) and discussed, at length, the *Lender* case.

1. **Summary**

The Tax Court denied cross motions for summary judgment on the issue of whether family office expenses were deductible under Section 162 (requiring a trade or business) and discussed, at length, the *Lender* case.

2. **Facts**

GF Family Management, LLC (“GFM”), an investment management firm owned and operated by petitioners, claimed expense deductions. Each petitioner held a 25% profits interest in GFM. GFM managed six investment partnerships and held a 1% interest in each partnership. The trusts of which petitions are beneficiaries held the remaining 99% of each partnership.

The Tax Court considered whether GFM was conducting a trade or business within the meaning of Section 162 during the years at issue. If so, GFM was entitled to claim ordinary business expense deductions for its operating costs, including salaries, rent and investment expenses. The IRS argued that GFM was not engaged in a trade or business but, rather, was engaged in an activity for the production or collection of income or management of property held for the production of income under Section 212. If GFM is not engaged in a trade or business, it is entitled to less favorable tax treatment of its expenses.

3. **Analysis**

The Tax Court examined *Lender Management, LLC v. Comm’r*, T.C. Memo. 2017-246 in significant detail, which emphasized that a case-by-case examination of the facts is required to determine if a family office is operating as a trade or business under Section 162.

The Tax Court concluded that the parties needed to develop a number of facts relevant to its determination of whether the family office was operating as a trade or business, including, but not limited to: (1) the education and professional background of each investor-employee, (2) the work schedules of the investor-employees and descriptions of their work, (3) details regarding the decision process by which GFM was selected as the management company and the decision process by which GFM’s manager was appointed (and the identities of any other candidates for these two roles), (4) the net asset value of each partnership managed by GFM and the percentage ownership interest each of the four family members had in the total assets held by the investment partnerships, (5) information on the major investments held by each partnership, (6) the similarities and distinctions between the investment strategies and objectives of each investment partnership, (7) if the investment strategies were tailored to the individual needs and preferences of the four family members.

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7 T.C. Memo 2018-___ (Oct. 1, 2018).
4. **Bottom Line**

The determination of whether a family office qualifies as a trade or business is a highly fact intensive issue. The *Lender* case involved very good facts for the family office indicating that it was a trade or business and, therefore, based on *Lender*, practitioners have a high bar to meet to demonstrate that a family office is a trade or business.

*Lender* and *Hellmann* both involved pass-through entities as family offices. In general, it is more common for family offices to be organized as a C corporation. Although using a C corporation adds a layer of taxation, with a C corporation, the entity is presumed to be conducting a trade or business and, therefore, receives the more beneficial treatment of the expense deductions.

**D. U.S. v. Estate of Schoenfeld** – FBAR penalties survive a decedent’s death and an estate’s distributees may be held liable.

1. **Summary**

The U.S. District Court for the Middle District of Florida considered whether FBAR penalties survive a decedent’s death and whether an estate’s distributees may be held liable. The court determined that because the FBAR penalties are considered remedial and not penal, the action survives a decedent’s death. Furthermore, even though a new claim cannot be brought against an estate under 28 U.S.C. §2404 when the decedent has already died, an estate’s distributee may still be held liable.

2. **Facts**

In 1993, Steven Schoenfeld, a U.S. citizen, established a Swiss bank account with the proceeds of the sale of his New York apartment. In 2009, the bank notified Steven that it would provide account information to the IRS. Steven informed the bank that he did not authorize the bank to release his information. In July 2010, the bank closed Steven’s account and later wired the funds to a U.S. based brokerage account in Steven’s name. Steven’s son, Robert, was listed as the sole beneficiary and trading agent of the new account. In August 2010, Robert was informed that his father had not authorized the Swiss bank to release the account information to the IRS. Thereafter, Robert assisted with his father’s financial affairs.

On September 30, 2014, the IRS assessed a civil penalty for 50% of the account balance ($614,300) against Steven for willfully failing to file a FBAR for 2008. Steven died testate on August 21, 2015. His will named Robert as personal representative and sole beneficiary of his estate. Robert never offered Steven’s will for probate, so there was no administration of his estate.

On September 29, 2016, the government sued Steven to collect on its assessment. The complaint was delivered to Steven’s residence, where Robert now resided. On October 27, 2016, an attorney representing the Schoenfeld family responded to the complaint and informed the

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8 2018 WL 4599743 (M.D.Fl. Sept. 25 2018)
government that Steven had predeceased the litigation. The government amended its complaint to substitute Steven’s estate as a defendant and added Robert as a defendant due to his distributee status after the statute of limitations expired.

Robert and Steven’s estate contested the government’s complaint on three grounds: (1) the government may not rely on 28 U.S.C. §2404 to pursue its claim against Steven’s estate, (2) Steven’s estate may not be sued under FRCP Rule 17, and (3) that the FBAR claim did not survive Steven’s death.

3. Analysis

In order to decide whether the FBAR claim survived Steven’s death, the court first had to consider whether the appropriate parties were included in the lawsuit. Because the lawsuit was brought against Steven when he was already dead, and the complaint was then amended after the statute of limitations expired, the court had to determine whether the original complaint could be amended and if so, whether that amendment related back to the time the original complaint was filed. After reviewing the precedent of other federal courts, the court determined that the complaint may be amended when the proper party institutes a suit but named a dead person.

Furthermore, under FRCP Rule 15, the complaint may relate back to the original complaint when the correct party received notice of the action such that it will not be prejudiced in defending on the merits and the correct party knew or should have known that the action would have been brought against it but for a mistake about the proper party’s identity. Given that the government was mistaken about Steven’s status and it delivered notice of the complaint to Robert’s residence, the court found that the complaint could relate back to the original complaint.

Next, the court considered whether Section 2404 allowed the government to substitute the estate for Steven after he died. Under FRCP Rule 17, the estate’s capacity to be sued is determined by the law of state where the court is located. Under Florida law, an “estate” is not a proper party, but the personal representative is the appropriate party. Therefore, the government improperly sued Steven’s estate when it did not name Robert in his capacity as the named (though not confirmed) personal representative. Nevertheless, the court continued its analysis by looking at the plain language of Section 2404. It concluded that since the plain language of the statute contemplates substituting an estate for a decedent once the case has already commenced, the government could not proceed against Steven’s estate because Steven had already died before the government initiated the suit. Therefore, the only remaining proper party was Robert, as distributee under FRCP Rule 17.

Finally, the court reached the decision as to whether the FBAR penalties survive Steven’s death. The decision turned on whether the penalties were remedial or penal in nature. To decide, the court considered the framework outlined in Hudson v. U.S., 552 U.S. 93 (1997) and the seven “Kennedy factors.” The seven Kennedy factors include: (1) whether the sanction involves an affirmative disability or restraint, (2) whether it has historically been regarded as a punishment, (3) whether scienter is required, (4) whether its operation promotes retribution and deterrence, (5)

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whether it applies to criminal behavior, (6) whether there are alternative purposes for the penalties, and (7) whether it appears excessive relative to the alternative purpose served by the penalties. After evaluating the seven factors, the court determined that the FBAR monetary penalties were remedial in nature and designed to deter tax evasion. Therefore, the FBAR penalties survived Steven’s death.

4. **Bottom Line**

Death does not extinguish exposure to FBAR penalties when the decedent fails to comply with the filing and reporting requirements in life. Caution must be exercised to make sure the proper parties are named in the complaint pursuing FBAR penalties, as each state’s law governs whether an estate is a proper party in a lawsuit. Section 2404 is not an avenue for recovery when the lawsuit does not commence until after the decedent has died.

**E. U.S. v. Estate of Chicorel**

- The government’s timely filing of a proof of claim in a Michigan probate court proceeding tolled the statute of limitations in 28 U.S.C. 6502(a) beyond the ten-year collection period.

1. **Summary**

Merely timely filing a proof of claim in a probate proceeding is enough to toll the statute of limitations for the collections period under 28 U.S.C. 6502 beyond the ten-year statutory period.

2. **Facts**

Albert Chicorel died in 2006 owing $140,903.52 to the government for unpaid income taxes for the 2002 calendar year. In April 2007, Albert’s nephew, Richard Behar, was named the estate representative in the Michigan probate proceeding. In May 2007, Richard published a notice to creditors of the four-month deadline to present claims, but he failed to notify the government even though it was a known creditor. The government assessed the tax on September 12, 2005 and filed a proof of claim on January 29, 2009 in the Michigan probate proceeding. The government instituted a collection proceeding on March 11, 2016. Richard never responded to the government’s proof of claim and the estate is still under administration.

The government contends that a timely filed proof of claim in the Michigan probate proceeding constitutes a “proceeding in a court...begun within 10 years after the assessment of tax” under 26 U.S.C. §6502(a) such that the statute of limitations is tolled.

3. **Analysis**

To determine whether a timely filed proof of claim is a “proceeding in a court” within the meaning of Section 6502, the U.S. Court of Appeals for the Sixth Circuit evaluated the nature, function, and effect of the proof of claim under Michigan law. Because the Michigan statute equated presenting a proof of claim to a proceeding and specifically permits a proof of claim to
toll the statute of limitations, the court concluded that presenting a proof of claim qualifies as a “proceeding in a court” under Section 6502.

Next, the court evaluated whether the government timely filed the proof of claim. Because Richard did not properly notify the government, the four-month claim period did not apply to the government. Under Michigan law, if the four-month clock is not properly started, the government had three years from the date of Albert’s death to file its proof of claim. The government filed its proof of claim within the three-year window. Given that the flush language of Section 6502 provides that so long as the government timely institutes a proceeding for the collection of tax, it may pursue the tax by levy beyond the ten year period, the court concluded that as long as the government files the proof of claim on time, the time to collect the tax by proceeding or by levy is extended beyond ten years. In concluding that all the government has to do to toll the statute of limitations is start a proceeding on time, the court’s decision attempts to harmonize the statute of limitations period with the statutory flush language. As a result, the government merely instituting any proceeding in court is enough to toll the statute of limitations.

4. **Bottom Line**

Given that the government merely needs to institute any court proceeding to toll the statute of limitations, careful attention must be paid to making sure the government is notified of the proof of claim window. Failure to start the clock running on the claims period could allow for the government to extend the statute of limitations beyond the ten-year period. Furthermore, practitioners should review what constitutes a proceeding in their respective jurisdiction as this decision makes clear that filing a proof of claim can rise to the level of “any proceeding” under Section 6502.

**F. Estate of Clyde v. Comm’r**

Inclusion of Section 2036 assets in the gross estate does not reduce the marital deduction and post-death income received by the surviving spouse does not increase the marital deduction.

1. **Summary**

The two issues before the court were (1) whether the estate is required to reduce the marital deduction by the amount of estate tax owed on gifts included in the gross estate under Section 2036 and (2) whether the estate is entitled to an increased marital deduction to account for post-death income reported on the Form 1041 and paid to the surviving spouse. The court reviewed the statutory scheme and held that the phantom Section 2036 assets included in the gross estate did not result in a reduced marital deduction. The estate may recover the amount of estate taxes attributable to the phantom assets from the recipients under Section 2207B. Second, the court held that post-death income does not increase the marital deduction because it was not initially included in the determination of the gross estate.

2. **Facts**

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11 151 T.C. No. 10
Clyde Turner, Sr. established a family limited partnership with his wife Jewell in 2002. In 2003, Clyde donated 21.7466% interest in the family limited partnership to family members. Clyde died in 2004. In previous litigation, it was determined that the value of the assets donated in 2004 was includable in his estate under Section 2036. Clyde’s will did not provide for estate tax apportionment but did state an intention to receive the “maximum marital deduction”. To the extent Clyde had remaining credit, a credit shelter trust was created under his will. Otherwise, the balance of his property passed to his wife, Jewell.

As a result of the phantom 2036 assets being included in his estate, Clyde did not have any remaining exemption. Thus, no credit shelter trust was created. However, the phantom assets generated an estate tax liability, but there were no assets available to pay the estate taxes other than those qualifying for the marital deduction. To the extent the assets are used to pay the estate tax, the marital deduction would be reduced.

The Commissioner contends that the marital deduction must be reduced by the amount used to satisfy the estate taxes. The estate contends that Section 2207B allows the executor to recover the estate taxes attributable to the Section 2036 property from the recipients. Accordingly, no marital deduction reduction is required.

Furthermore, the estate contends that the marital deduction shall be increased by the amount of post-death income paid to the surviving spouse as transmission expenses.

3. Analysis

First, the Tax Court considered whether the marital deduction must be reduced by the amount of property used to satisfy the estate tax liability created by the inclusion of the Section 2036 assets. The Tax Court considered Section 2207B, which provides that the executor may recover the tax amounts attributable to 2036 property when the will and state law permit. Given that Clyde’s will did not include an apportionment clause and Georgia law did not limit reimbursement rights for Federal estate taxes, the court concluded that the executor had a right to recover.

Furthermore, because Clyde’s will expressly stated an intent that the estate receiving the “maximum marital deduction”, the court inferred that Clyde would want his executor to take all steps necessary to make sure the property passing to his spouse qualified for the marital deduction. Thus, the court concluded that the executor must seek reimbursement from the recipients of the Section 2036 property in order to make sure that all the property qualifying for the marital deduction actually passes to Jewell free from the estate tax burdens created by the phantom assets.

Second, the Tax Court considered whether the marital deduction should be increased by the amount of post-death income received by the surviving spouse. Given that the tax imposed under Section 2001(a) is on the value of all property owned by the decedent on the date of death, the Tax Court concluded that the marital deduction should not be increased by the amount of post-death income received because that income was not included in the gross estate.
4. **Bottom Line**

Although assets may be included in the gross estate under Section 2036, Section 2207B provides a method to recover the taxes attributable to the increased tax liability when there are no assets available in the estate to pay the taxes. The marital deduction is not diminished by the amount of tax liability attributable to the phantom assets.

IV. **PLRs**

A. **PLR 201848002/201848009**\(^\text{12}\) - IRS ruled on the tax implications of ING trusts.

1. **Summary**

In two similar rulings, the IRS ruled on the gift and estate tax implications of ING trusts. The INGs were considered incomplete gifts for gift tax purposes and any distribution from the ING to the grantor was merely a return of property. Accordingly, any distribution of property from the ING to the grantor was not a completed gift even if made by related members of the Distribution Committee. Finally, at the grantor’s death, the fair market value of the property in the ING is includible in the grantor’s gross estate for federal estate tax purposes.

2. **Facts**

A grantor established an incomplete gift non-grantor trust (ING) and will be the sole contributor to the trust. The ING’s beneficiaries include the grantor and his four children. A private fiduciary is the sole trustee of the ING. Under the terms of the ING, a Distribution Committee is established and is given the ability to make certain distributions. The grantor retained a power to consent to the distributions of income and principal as proposed by the Distribution Committee and retained the power to direct the Trustee to make distributions to any beneficiary other than himself for health, education, maintenance and support. Additionally, the Distribution Committee can make distributions as determined by the unanimous consent of the Distribution Committee.

The Distribution Committee is comprised of the grantor, and two of his children. At the grantor’s death, the ING terminates and all property passes according to the grantor’s testamentary limited power of appointment. In default of the exercise, the grantor’s descendants receive the balance, per stirpes.

3. **Rulings**

a. Ruling #1: Is the ING a grantor trust under Section 671?

The IRS concluded that as long as the Distributions Committee exists, no part of the ING will result in the grantor being treated as the grantor for income tax purposes under Section 673, 674, 676 or 677 because the grantor does not have the power to make distributions without the consent of an adverse party. Additionally, because none of the Distribution Committee members possess the power to unilaterally vest the ING income or corpus in himself, none of the Distribution

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\(^\text{12}\) August 20, 2018.
Committee members are treated as the grantor under Section 678. The IRS deferred the determination of whether the grantor would be treated as a grantor under Section 675 due to the factual nature of the determination but concluded that none of the circumstances that would cause administrative controls to be considered exercisable in favor of the grantor were present.

b. Rulings #2 & 3: Is the transfer to the ING a completed gift and are distributions from the ING to the grantor a completed gift if made by any member of the Distribution Committee?

Given that the grantor retained the power to consent to distributions of income and trust principal and the Distribution Committee members are not adverse for purposes of Treas. Reg. §25.2511-2(e), the IRS concluded that the grantor is considered to possess the power to distribute income and principal to any beneficiary. As such, the distributions are not considered completed gifts. Similarly, the grantor’s retention of the power to solely change the interests of the beneficiaries means that the distributions are incomplete gifts. Even though the grantor’s power is limited by an ascertainable standard, because he can change the enjoyment, the power is not a fiduciary power.

Moreover, the grantor’s retained limited power of appointment means that the entire transfer is not completed for estate and gift portions because the grantor retained dominion and control over the distribution of the property. Finally, even though the Distribution Members are required to have unanimous consent over distributions to beneficiaries other than the grantor, the power is not a condition precedent to the grantor’s other powers. Therefore, because the grantor retains control over the property until the Distributions Committee exercises their powers, the transfer is not complete for gift and estate tax purposes.

c. Ruling #4: Are distributions from the ING by the Distribution Committee to any beneficiary other than the grantor a completed gift for gift tax purposes?

The IRS concluded that because the Distributions Committee members must exercise their powers in conjunction with the grantor, none of the members had a general power of appointment under Section 2514. Therefore, any distributions made by the Distribution Committee are gifts by the grantor to any beneficiary other than himself and are not completed gifts made by the Distribution Committee members.

4. **Bottom Line**

The ING is not a completed gift during the life of the grantor. As such the fair market value of the ING will be included in the grantor’s estate for estate tax purposes. Any distributions made to beneficiaries other than the grantor count as completed transfers for gift tax purposes.