CURRENT DEVELOPMENTS IN FEDERAL TRANSFER TAXES

ABA MEETING OF THE SECTION OF TAXATION
ESTATE AND GIFT TAXES COMMITTEE OF THE SECTION OF TAXATION
BOCA RATON, FL

January 31, 2020

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JANUARY 31, 2020

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TABLE OF CONTENTS

I. TREASURY MATTERS AND LEGISLATIVE UPDATE .................................................. 1
   B. Treasury Department Released Final Regulations Confirming No Clawback of Taxable Gifts Made Before January 1, 2026 ................................................................. 1
   C. SECURE Act Eliminates Stretch Treatment for Certain IRA Beneficiaries .......................... 2

II. STATE LAW .................................................................................................................. 3
   A. In the matter of Cleopatra Cameron Gift Trust dtd 6/26/1998 ............................................. 3

III. FEDERAL CASE LAW ................................................................................................ 5
    A. Kollsman v. Comm’r, ........................................................................................................ 5
    B. Cavallaro v. Comm’r, ...................................................................................................... 7
    C. Wilson v. United States, ................................................................................................ 8
    D. Estate of Skeba v. United States ................................................................................... 10

IV. PLRs ................................................................................................................................ 12
    A. PLR 201946009 ........................................................................................................... 12
    B. PLR 201942001 ........................................................................................................... 14
    C. PLR 201947007 ........................................................................................................... 15
I. TREASURY MATTERS AND LEGISLATIVE UPDATE


On November 6, 2019, the IRS released Revenue Procedure 2019-44, which provides the inflation adjustments for tax year 2020. The estate, gift, and generation-skipping transfer tax exemption amount increased to $11,580,000 and the annual exclusion amount remains $15,000.

B. Treasury Department Released Final Regulations Confirming No Clawback of Taxable Gifts Made Before January 1, 2026\(^2\)

1. **Summary**

The Tax Cuts and Jobs Act (TCJA), enacted in December 2017, doubled the basic exclusion amount from $5 million to $10 million per individual (indexed for inflation; $11.58 million in 2020) for individuals transferring property or dying between December 31, 2017 and January 1, 2026.

On November 26, 2019, the Treasury Department issued final regulations (T.D. 9884) and the Internal Revenue Service (“IRS”) issued IR-2019-189. The final regulations and the IRS notice specify that individuals who use their increased gift and estate tax exemptions will not lose the benefit of the increased exclusion amounts when the basic exclusion reverts to pre-2018 levels. Essentially, the IRS confirmed that the increased exclusion amount is a “use it or lose it” opportunity and will not later be subject to tax when the exclusion reverts to $5 million, adjusted for inflation.

The final regulations adopt the proposed regulations published in November 2018, address clawback concerns, and include examples illustrating the future sunsetting of the increased basic exclusion amount. The regulations confirm that individuals planning to make large gifts between 2018 and 2025 can do so without fear of losing the benefit of higher exclusion level once it decreases in 2026. Additionally, if any deceased spousal unused exemption (“DSUE”) is generated from 2018 to 2025, the DSUE will not revert to pre-2018 basic exclusion levels.

2. **Bottom Line**

For any decedent dying after December 31, 2025, the estate tax will be computed by using the greater of the basic exclusion applicable when the transfer occurred or at death. The same principle applies to computing DSUE. The DSUE amount will not be reduced after 2025. Rather, DSUE will be computed based on the exemption levels that existed in the year the spouse died.

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\(^1\) November 6, 2019

C. SECURE Act Eliminates Stretch Treatment for Certain IRA Beneficiaries.

1. **Summary**

   On December 20, 2019, President Trump signed into law the Setting Every Community Up for Retirement Enhancement Act (“SECURE Act”), which provides comprehensive retirement reform. For those individuals who attain age 70 ½ and die after December 31, 2019, the SECURE ACT makes significant changes that may require the individuals to revisit their estate plans.

   The SECURE Act made two significant changes that will affect individual retirement account owners during life. First, the SECURE Act allows individuals who are 70 ½ or older to make deductible contributions from their wages to traditional IRAs. Second, it increases the age for required minimum distributions (“RMDs”) from 70 ½ to 72. The RMD change only applies to those distributions required for individuals who attain 70 ½ after December 31, 2019. As a result of these changes, the account owner may contribute to his or her IRA for as long as he or she earns compensation. It also allows individuals to delay withdrawals until after age 72. Both changes provide people more opportunity to save for retirement.

   The SECURE Act made another change that will affect the treatment of IRAs once the account owner dies. Historically, non-spouse beneficiaries have been able to “stretch” the distribution of inherited IRAs based on the beneficiary’s life expectancy. The SECURE Act eliminates the “stretch” treatment for all non-spouse beneficiaries (except the decedent’s spouse or minor children, disabled persons, chronically ill persons, and persons born within 10 years of the decedent). Accordingly, for decedents dying after December 31, 2019, a non-spouse beneficiary inheriting an IRA will now be required to withdraw the entire account within 10 years of the decedent’s death.

   Eliminating the “stretch” treatment will also affect conduit trusts named as beneficiaries of IRAs and 401(k)s. The client’s beneficiary designations should be reviewed and adjusted to respond to the SECURE Act changes.

2. **Bottom Line**

   The new rules will significantly impact estates and trusts that incorporate retirement assets, specifically those that rely on stretch distribution treatment. Practitioners are encouraged to review their clients’ trusts and beneficiary designations to determine whether any adjustments are required. Additionally, certain clients may now be eligible for Roth conversions depending on when they attain age 70 1/2.
II. STATE LAW

A. In the matter of Cleopatra Cameron Gift Trust dtd 6/26/1998 - The South Dakota Supreme Court held that a California child support order was not entitled to full faith and credit because the enforcement of such order was a matter of South Dakota law and South Dakota trust law does not permit creditors to access trust funds.

1. Summary

The South Dakota Supreme Court evaluated a California child support order to determine whether it was entitled to full faith and credit under the U.S. Constitution after the California trust had changed its situs to South Dakota. The South Dakota Supreme Court determined that the order was entitled to full faith and credit, but the enforcement of the order turned on South Dakota law. Given that South Dakota trust law has strict spendthrift provisions, the court concluded that the order could not be enforced.

2. Facts

Cleopatra Cameron’s father established an irrevocable gift trust (“Gift Trust”) for Cleopatra’s primary benefit. He also established the Cameron Family Trust (“Family Trust” and with the Gift Trust, the “Trusts”) for his own benefit during his life. Upon his death, the Family Trust divided into shares. Cleopatra received a share that was subdivided between GST and non-GST assets. Cleopatra was the primary beneficiary of both trusts for her benefit and her children were permissible secondary beneficiaries. Both trusts were California trusts and featured spendthrift provisions.

In 2009, Cleopatra’s husband, Christopher, began divorce proceedings in California state court. During the divorce proceeding, Christopher sought spousal support to supplement his part-time employment income. He also sought child support as he was awarded sole custody of their two children. At the time, the Trusts distributed $40,000 to Cleopatra monthly. As such, the family court ordered Cleopatra to pay spousal and child support as well as Christopher’s legal fees of $50,000. In order to facilitate payment of Cleopatra’s support obligations, the family court joined the Trusts as parties in the divorce action under the theory that California trust law provides that a court may preempt spendthrift protection to force the trustee to make distributions for child and spousal support when it finds a trustee acts in bad faith.

The Trusts provided that the trustees had discretion to make distributions to Cleopatra. After the Trusts refused to pay the support obligations, the family court determined that the Trustees had acted in bad faith and abused their discretion. It ordered the Trustees to make the support payments. After initially refusing, Wells Fargo, as Co-Trustee of the Trusts, made the initial payments.

In parallel proceedings, Cleopatra and Wells Fargo obtained permission from a different California judge to resign as co-Trustees. The court appointed BNY Mellon as the sole successor.

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3 931 N.W. 2d 244 (S.D. 2019)
trustee after it agreed to be bound by the family court’s support order. Thereafter, the family court ordered Cleopatra or the Trusts to pay an additional $100,000 for Christopher’s legal fees.

Ultimately, the divorce was finalized in 2010 and the child support order was modified in 2012. Cleopatra was ordered to pay monthly child support. From 2010 to 2017, the Trusts paid child support to Christopher.

However, in 2012, Cleopatra invoked her authority to move the Trusts’ situs to South Dakota. In 2014, Cleopatra petitioned for court supervision of the Trusts to get court approval of the situs change and amendment of the Trusts. In November 2016, Trident Trust Company was appointed acting trustee and Empire Trust was appointed trust protector. Empire Trust determined that the child support obligations violated the Trusts’ spendthrift protections and ceased paying Christopher in January 2017. Empire Trust further determined any additional payments were imprudent due to the Trusts’ rapid depletion.

In May 2017, Cleopatra petitioned the South Dakota circuit court to determine whether the child support order violated the Trusts’ spendthrift provisions. The circuit court held that the order violated the spendthrift provision. Furthermore, while the California court had jurisdiction to order child support, South Dakota law determined how the order was enforced. Because South Dakota trust law does not allow creditors to pierce spendthrift provisions, the circuit court determined it was not required to enforce the California support order.

Christopher appealed. The question presented for consideration was whether the Trusts are prohibited from making child support payments to Christopher. However, the South Dakota Supreme Court considered the question whether the California child support order is entitled to full faith and credit under the U.S. Constitution.

3. Analysis

The issue before the South Dakota Supreme Court was whether the U.S. Constitution required the court to enforce a California child support order against former California trusts that had been recently relocated to South Dakota. Under the U.S. Constitution, judgments from all states are entitled to the same full faith and credit. However, full faith and credit does not require a state to enforce the judgments in the same matter as the issuing jurisdiction. Rather, the court noted that the local law of the enforcing jurisdiction governs so long as the enforcement method is “evenhanded”. 4

The South Dakota Supreme Court reviewed the California statute used to relied on in the child support order and determined that it was an enforcement statute under California law. Thus, the California enforcement statute did not provide sufficient grounds for full faith and credit. The South Dakota Supreme Court then analyzed South Dakota statutes and determined that South Dakota law precluded the support payments from the Trusts because the Trusts had spendthrift provisions.

4 Id. at 250 (citing Baker by Thomas v. Gen. Motors Corp., 522 U.S. 222, 235, 118 S. Ct. 657,665, 139 L. Ed. 2d 580 (1998); Adar v. Smith, 639 F.3d 146, 159 (5th Cir. 2011)).
The South Dakota Supreme Court then determined that even if Christopher had registered the order for enforcement, South Dakota law would preclude enforcement under both the Uniform Enforcement of Foreign Judgments Act and Uniform Interstate Family Support Act.

4. **Bottom Line**

While it may seem that this case provides an avenue for trusts to duck a beneficiary’s support obligations or other creditors, the South Dakota Supreme Court noted in a footnote that the case does not set a rule that trusts may be relocated to South Dakota and thereafter relieved of all obligations determined in sister states. However, this case demonstrates how robust the spendthrift provisions are in South Dakota and the instances in which South Dakota will interpret its laws to protect trusts from creditors.

III. **FEDERAL CASE LAW**

A. **Kollsman v. Comm’r**, 5

On June 21, 2019, the 9th Circuit Court of Appeals affirms the Tax Court’s determination of the value for two pieces of Old Master artwork.

1. **Summary**

The 9th Circuit affirmed the Tax Court’s valuation of two Old Master paintings and declined to reduce the interest on the tax deficiency to lack of jurisdiction. The Court of Appeals reviewed the Tax Court’s analysis and determined it had not erred in its findings of fact.

2. **Facts**

Eva Franzen Kollsman died on August 31, 2005 domiciled in New York. Her executor was domiciled in California and was the recipient of two 17th Century Old Master paintings: (1) *Village Kermesse, Dance Around the Maypole* (“Maypole”) by Pieter Brueghel the Younger and (2) *Orpheus Charming the Animals* (“Orpheus”) by Jan Brueghel the Elder or Jan Brueghel the Younger or a Brueghel studio.

At issue in the Tax Court was whether the Estate of Eva Franzen Kollsman (“the Estate”) had properly valued the two paintings at fair market value on the date of death. After considering the Estate’s appraisal and the IRS’s appraisal, the Tax Court concluded that the Estate’s appraisal lacked support for the value conclusion. To value the paintings for the estate tax return, the Estate relied on a letter from Sotheby’s concluding that the paintings were valued at $500,000 (Maypole) and $200,000 (Orpheus), without any explanation. The Estate reflected the letter values on the 706.

Concurrent with the valuation letter, Sotheby’s sent the Estate an auction agreement granting Sotheby’s the exclusive right to auction the paintings for five years. The auction agreement described Maypole’s value at $600,000 to $800,000 and Orpheus’ value at $100,000 to

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5 123 AFTR 2d 2019-2296 (9th Cir. 2019).
$150,000. Maypole later sold in 2009 for $2.1 million (pre-sale estimate of $1.5 million - 2 million). Orpheus remained in the Executor’s personal possession.

In contrast, the IRS’s expert relied on comparable sales, as well as evaluated the provenance and overall condition of the paintings. The IRS’s expert valued Maypole at $2.1 million and Orpheus at $500,000. However, the IRS’s expert did not discount the paintings for the significant dirt that had accumulated on the paintings as of the date of death. The Tax Court agreed a nominal discount to reflect the risk of cleaning was appropriate. With respect to Orpheus, the Tax Court also determined that the Estate established an attribution discount was appropriate for Orpheus as it the true authorship was disputed. It also found that the Estate established that Orpheus was bowed and thus was not in perfect condition and applied an additional discount.

The Tax Court considered the reports and both expert testimony and held that the IRS’s expert’s valuation more persuasive. However, the Tax Court reduced the valuation by 5% to reflect the risk of cleaning the paintings and an additional 20% for attribution and condition for Orpheus. Thus, the Tax Court held that Maypole was worth $1.995 million and Orpheus was worth $375,000.

Consequently, the Tax Court calculated a $585,836 estate tax deficiency. The Estate appealed the determination.

3. **Analysis**

   The issues before the Ninth Circuit Court of Appeals were (1) whether the Tax Court erred in its valuation of the paintings and (2) whether the Estate is entitled to a reduction of interest on the deficiency.

First, as to whether the Tax Court erred, the appellate court had to determine whether there was a clear error in the Tax Court’s factual finding of the paintings value. The Court of Appeals concluded that the Tax Court applied the appropriate fair market value standard as defined in Tres. Reg. 20.2031-1(b). Furthermore, the Tax Court appropriately applied the standard to the facts when it determined the Estate’s expert failed to support his value conclusion with comparable or any recognized methodology. Rather, the Estate’s expert based his judgment on his opinion and failed to explain why the value of the paintings increased dramatically in both the auction agreement and later at auction. Finally, the Court of Appeals concluded that the Tax Court correctly identified the Estate’s expert had a conflict of interest in the valuation that was not appropriately mitigated in the valuation. Consequently, the Court of Appeals held that the Tax Court did not err in its factual finding of the paintings values.

Second, the Court of Appeals declined to adjust the interest because it lacked jurisdiction under 26 U.S.C. §6601(a) and 26 U.S.C. §7482(a)(1).

4. **Bottom Line**

   This case illustrates the importance of a neutral and qualified appraiser. It also demonstrates how courts analyze valuations of hard to value property, like artwork. Furthermore, it is a reminder to determine whether the relief requested is relief the court may grant.
B. **Cavallaro v. Comm’r,** 6 - The Tax Court evaluated the Commissioner’s valuation expert’s report of two companies involved in a disguised gift transaction and determined that the taxpayers had made a disguised gift of $22.8 million rather than $29.7 million.

1. **Summary**

In the latest installment of the Cavallaro gift tax case, the Tax Court considered the magnitude of the disguised gift the Cavallaros made to their sons after the First Circuit Court of Appeals remanded the case for reconsideration of the valuation expert’s report.

On remand, the Tax Court determined that the valuation expert had made a $6.9 million error when he assumed both companies had similar profit margins in the 90th percentile. This assumption was not statistically reliable and resulted in overstating the value of the gift.

2. **Facts**

Patricia and William Cavallaro owned Knight Tool Co., Inc. (“Knight”). Patricia owned 51% and William owned 49%. Their sons, Ken, Paul, and James were involved in Knight’s business from time to time. The sons independently formed Camelot Systems, Inc. ("Camelot") after Ken and William developed a liquid adhesive dispensing machine prototype called the CAM/A LOT. Knight manufactured the CAM/A LOT machines and Camelot sold the machines. There was no written licensing agreement between the two companies. There were no other documents supporting the assertion that Camelot owned significant intangibles.

At some point in 1994, Patricia and William contacted their accountants at Ernst & Young ("E&Y") and their attorneys at Hale & Dorr to discuss a possible transaction. The accountants recommended merging Knight and Camelot but determined that Patricia and William would receive 85% of the shares after the transaction because Knight owned significant intangible assets (namely, the prototype design for CAM/A LOT). E&Y valued the resulting company at $70-75 million. However, the lawyers disagreed with the analysis and persuaded the Cavallaros that Camelot owned the intangible assets and therefore, the Cavallaros would receive 19% of the merged company and their sons would receive 81%. The practical result of attributing the intangible assets to Camelot meant that the Cavallaros transferred value to their sons in the merger. E&Y eventually acquiesced to the treatment.

The merger occurred on December 31, 1995. The IRS conducted a gift tax examination and issued notices of deficiency on November 18, 2010 for the 1995 tax year. The IRS contended each parent had made a $23 million gift to their sons.

In Cavallaro II, after considering various expert reports, the Tax Court concluded that Knight owned the intangible assets and as such, the Cavallaros had made a taxable gift. On appeal, the First Circuit upheld the Tax Court’s determination that Knight owned the intangible

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6 TC Memo 2019-144
assets and that the Cavallaros had made a disguised gift but remanded for further consideration of the gift’s value.\(^7\)

The issues before the Tax Court were (1) was the Commissioner’s valuation expert’s report arbitrary and excessive due to methodological flaws and if so, (2) what is the proper amount of tax liability.

3. **Analysis**

For the first issue, the Tax Court considered the Commissioner’s expert’s report and underlying assumptions. When calculating normalized profits for both companies, the Commissioner’s expert used a value for Camelot’s profit margin that was statistically unreliable. The Tax Court determined that because the value used was erroneous and made a substantial difference in the valuation, the valuation was arbitrary and excessive.

Given that the expert’s error resulted in an arbitrary and excessive value, the Tax Court analyzed the second question. It reviewed the various expert reports, underlying data and trial record to make its own determination. Furthermore, it performed a series of reliability checks to double check its conclusion. The Tax Court also consider various arguments that the Cavallaros raised for the first time and dismissed them due to timeliness and on merit. Further, the Tax Court revisited previous arguments and determined that the erroneous assumption was the only meritorious claim.

Both parties agreed that if the expert had used the correct 90\(^{th}\) percentile figure, the gift declines by $6.9 million. Therefore, the Tax Court concluded that the appropriate value is $22.8 million.

4. **Bottom Line**

This case reminds practitioners that transactions must be based in fact. It is not enough to paper a transaction and allow the blanks to be filled in later. It also underlines the importance of reviewing appraisals prepared for a transaction to make sure the underlying methodology supports the conclusion.

C. **Wilson v. United States.**\(^8\) The U.S. District Court for the Eastern District of New York determined that the sole owner of a foreign trust may not be penalized as both grantor and beneficiary for a late filed foreign trust informational return under IRC §§6048 and 6677.

1. **Summary**

The central issue *Wilson v. United States* involves whether the IRS could assess both the 35% penalty (applicable to beneficiaries of trusts) and the 5% penalty (applicable to owners) under IRC §6677 for a late filed informational foreign trust return when the owner and the sole

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\(^7\) *Cavallaro III*, 842 F.3d 16 (1st Cir. 2016).

\(^8\) 2019 WL 6118013 (E.D. N.Y. Nov. 18, 2019) (slip copy).
beneficiary are the same person. IRC §6048 requires certain foreign trusts to file informational returns. Failure to file the required returns will result in penalties under IRC §6677. If a beneficiary fails to report a distribution from a trust on Form 3520, the penalty to the beneficiary is equal to 35% of the distribution amount. If the owner of a trust fails to file a report, IRC §6677(b) imposes a 5% penalty on the balance of the trust at the end of the year in which the report was not filed.

Ultimately, the court found that the sole owner and beneficiary of a trust could only be assessed the 5% penalty under IRC §6677 as the owner. The Court denied the IRS’s attempt to impose the 35% penalty under §6677 for distributions received because the 35% penalty applies to beneficiaries.

2. Facts

In 2003, Joseph Wilson established a foreign trust and named himself grantor, sole owner, and beneficiary. The trust’s purpose was to remove assets from his spouse’s reach prior to divorce. Mr. Wilson funded the trust with approximately $9 million in U.S. Treasury bills, which had been previously subject to U.S. taxes. His wife subsequently filed for divorce.

From 2003-2007, Mr. Wilson filed Form 3520 and other informational returns with the IRS, reporting the trust's assets and accrued interest. When his divorce concluded in 2007, Mr. Wilson terminated the trust and transferred approximately $9 million of assets to his U.S. accounts. However, Mr. Wilson filed his 2007 Form 3520 late. The IRS assessed a 35% late penalty of $3,221,183 against Mr. Wilson as the beneficiary of the trust.

Mr. Wilson paid the assessed penalty but filed a Claim for Refund and later a suit in the Court of Federal Claims. He asserted he had reasonable cause for his untimely filing of Form 3520 and that, since he owned the trust, the proper penalty was the 5% penalty for failing to report the trust rather than the 35% penalty on unreported distributions. The IRS agreed that the 5% penalty would apply to Mr. Wilson, as the owner, but asserted that the two penalties can be applied independently.

3. Analysis

Under IRC §§ 6048 and 6677, a taxpayer is not liable for any two combined penalties if their aggregate assessment would exceed more than the gross reportable amount for any one violation.

IRC § 6677 codifies the penalties for violating the reporting requirements under IRC § 6048. IRC §6677(a) provides that the “person required to file such notice or return shall pay . . . 35 percent of the gross reportable amount. . . . At such time as the gross reportable amount with respect to any failure can be determined by the Secretary, any subsequent penalty imposed under this sub§ with respect to such failure shall be reduced as necessary to assure that the aggregate amount of such penalties do not exceed the gross reportable amount (and to the extent that such aggregate amount already exceeds the gross reportable amount the Secretary shall refund such excess to the taxpayer).”
IRC §6677(b) provides that the penalty is 5% “for returns required to be filed by the owner of a foreign trust.”

The court analyzed how the penalties should apply when Mr. Wilson is both a beneficiary and the owner of the trust. The Court clarified that “[a]t the outset, it is imperative to understand that a person in Wilson’s situation — i.e. a sole grantor/owner and sole beneficiary of a foreign trust — would have only been required to file a single Form 3520 for fiscal year 2007. So the question then becomes, whether 26 U.S.C. § 6677 permits a single person untimely filing a single IRS form to be penalized as two different people — as an owner and as a beneficiary.”

The court rejected the IRS’s view that both penalties could apply in this situation because applying both penalties contravenes the statute’s plain language and would result in an irreconcilable textual conflict. Given that the statute requires a taxpayer’s penalties under §6677 must not exceed “the gross reportable amount” (i.e., the gross value of the portion of the trust’s assets at the close of the year), all penalties for a violation are limited by the gross reportable amount. Therefore, the court held a taxpayer cannot be liable for both penalties when the combined assessed amount would exceed the gross reportable amount for any one violation.

Mr. Wilson’s gross reportable amount was $0 because the trust account balance was $0 at year end. Accordingly, additional penalty resulting from the same failure would violate the statute. Therefore, the court concluded the amount that the IRS sought, $3,221,183 violated the statute and the IRS could only assess the 5% penalty related to Mr. Wilson’s ownership of the trust.

4. **Bottom Line**

If the taxpayer is both owner and beneficiary of a foreign trust, the owner will be liable for failure to file timely as the owner and only the 5% penalty applies.

D. **Estate of Skeba v. United States** - The U.S. District Court for the District of New Jersey determined the estate was entitled to a refund of late filing penalties assessed because the estate was justified for its delayed payment and the entire tax was paid before the filing extension expired.

1. **Summary**

In Estate of Skeba, the U.S. District Court in New Jersey rejected late filing penalties when the executor paid the full estate tax due before the extended return filing date and the executor had reasonable cause for not paying within nine months of the date of death. The court concluded the IRS’s summary rejection of the estate’s reasonable cause explanation was arbitrary and capricious.

2. **Facts**

The decedent died on June 10, 2013 and the estate was valued at approximately $13.1 million. However, $10.2 million of the $13.1 million gross estate was real estate.

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Additionally, the estate was embroiled in ongoing estate litigation in New Jersey. The initial
deadline to file and pay U.S. federal taxes was March 10, 2014.

Given that the estate was mostly illiquid, on March 6, 2014 the executor filed for a
six-month extension to file and pay the estate taxes. In the application, the executor explained the
estate’s liquidity issues, detailed how he was using the $1.475 liquid assets to pay federal, New
Jersey, and Pennsylvania estate taxes, and provided that the estate was in negotiations to satisfy
the balance of taxes owed but needed more time. A partial payment of $725,000 accompanied the
application. On March 18, 2014, the estate made a second tax payment of $2.745 million. Thus,
the estate was only 8 days late in fully paying the estate taxes owed.

On June 25, 2014, the IRS approved the estate’s application for an extension of time to
file the estate tax return, granting a six-month extension until September 10, 2014. On July 8,
2014, the IRS extended the estate’s deadline to pay the taxes to September 10, 2014. However,
the estate had already paid the full tax owed.

As there was an ongoing will contest that questioned the executor’s authority to act for the
estate, among other issues, the estate did not file the estate tax return for another year. IRS officials
repeatedly told the executor that there would be no penalty for failure to file if the tax was paid.
The estate eventually filed the estate tax return on June 30, 2015 requesting a refund of $941,000.

The IRS accepted the overpayment but assessed $451,000 for failure to file timely. The
IRS credited the estate for the $725,000 timely-made initial payment but did consider that the
second payment was made within the extended deadline. The executor requested an abatement
for reasonable cause. The basis for the reasonable cause request was that the pending will contest
had experience delays in litigation due first to the executor’s health, then due to their counsel
receiving a cancer diagnosis (prompting the estate to change counsel), and that the executor had
received assurances from IRS representatives in multiple conversations that no penalty would be
assessed because the estate had paid all the tax by the extended deadline.

The IRS denied the estate’s abatement request. The estate appealed the IRS’s determination
but never received a response.

3. **Analysis**

On a summary judgment motion, the issues before the court were whether the IRS’s
assessment of a penalty under IRC §6651 and subsequent dismissal of the estate’s abatement
request was arbitrary and capricious.

IRC §6651(a) provides that a late filed return is subject to penalty unless the failure
to file timely is due to reasonable cause and not to willful neglect. Similarly, IRC §6651(b)
provides that the failure to timely pay is subject to penalty unless the failure is due to reasonable
cause and not to willful neglect.

After determining there were no genuine issues of material fact, the court analyzed
whether the executor’s failure to timely file was due to reasonable cause and not willful neglect.
The court first noted that the IRS must first consider the extended deadlines before assessing a penalty. Thus, the IRS may not assess a penalty under IRC §6651(b) because the full amount was paid before the extended deadline elapsed.

Additionally, even though the estate filed the return well after the extended deadline, the court concluded the estate had reasonable cause and no penalty should be assessed under IRC §6651(a). The court concluded that the IRS’s dismissal was arbitrary and capricious because the IRS failed to consider the entire record and to independently investigate the executor’s explanations. The IRS disregarded the extensions, the representations made by its representatives to the executor, and the executor’s explanations for the delay. Furthermore, the court faulted the IRS for failure to hold a hearing or otherwise investigate the executor’s explanation before dismissing the abatement request. Accordingly, the court held that the IRS’s abatement denial was arbitrary and capricious.

4. **Bottom Line**

This case illustrates the importance of developing a record of communication with the IRS in the event an estate is unable to timely file or pay tax. Although mere reliance on an attorney or accountant does not form the basis of reasonable cause, attorneys and accountants will be well served to follow up with the IRS and document all conversations. Moreover, this case demonstrates how courts evaluate abatement requests and the standards of inquiry they apply to the IRS.

IV. **PLRs**

A. **PLR 201946009** - A spouse was permitted to make a non-qualified disclaimer of QTIP property without jeopardizing the QTIP election for the remaining trust property.

1. **Summary**

A Marital Trust was severed without losing its QTIP election and the spouse was permitted to make a non-qualified disclaimer of a partial interest in a Marital Trust without losing the QTIP election or causing inclusion under IRC §2044.

2. **Facts**

Upon his death, decedent’s revocable trust split into two irrevocable shares: (1) Family Share and (2) Marital Share. His executor elected to QTIP the Marital Share, which was further divided into a GST Exempt Marital Share and a Non-Exempt Marital Share.

The Trustee proposes to further sever the Non-Exempt Marital Share into two trusts: Trust A and Trust B. Trust A will hold cash and Trust B will contain the remaining GST Non-Exempt Trust property. After the Non-Exempt Marital Share is divided, the spouse will make a

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10 November 15, 2019
non-qualified disclaimer of her interest in Trust A and Trust A will continue in trust for
decedent’s issue.

Rulings Requested:

1) Severing the Non-Exempt Marital Share will not affect the QTIP election for the GST Exempt Marital Share and the Non-Exempt Marital Share or Trust A and B as QTIP Trusts.
2) Terminating Trust A and distributing the cash will not invalidate the QTIP election as to Trust B and the GST Exempt Marital Share.
3) Spouse’s non-qualified disclaimer will be treated as a transfer under IRC §2519 of her interest in Trust A’s principal and under IRC §2511 of her qualifying income interest in Trust A.
4) Spouse’s non-qualified disclaimer will not be treated as though she made a transfer of her interest in Trust B or in the GST Exempt Marital Share under either IRC §2511 and §2519.
5) Spouse’s non-qualified disclaimer will not result in her interest in Trust B or the GST Exempt Marital Share being valued at zero under IRC §2702.
6) Spouse’s non-qualified disclaimer will not cause Trust A’s property to be included in her estate under IRC §2044 if she survives for three years after the transfer date.

3. **Rulings**

1) Rulings 1 and 2: The severance will not disrupt the QTIP status of either share of the Marital Trust or Trust A and B and the disclaimer will not disrupt the QTIP status of the GST Exempt Marital Share or Trust B.

The IRS analyzed IRC §2001 (imposing a tax on each citizen’s estate) and §2056 (providing a marital deduction for certain qualified terminable interest property that passes to a spouse for her life) and determined that severing the Non-Exempt Marital Share did not disqualify the share for the marital deduction because post-severance, the spouse retains her lifetime qualifying income interest. After the Non-Exempt Marital Share is severed, the beneficiaries’ interests are not materially impaired. Thus, because the spouse retains her qualifying interest and the beneficiaries’ interests are not impaired, the IRS concluded the severance will not affect the QTIP election for the either share of the Marital Trust and Trusts A or B. The IRS also concluded the nonqualified disclaimer of Trust A will not affect the QTIP election for Trust B or the GST Exempt Marital Share.

2) Rulings 3 and 4: The spouse’s non-qualified disclaimer will be treated only as a transfer of her interest in Trust A under IRC §2511 and 2519.

The IRS analyzed IRC §2501 (taxing gifts), §2511 (applying gift tax to trust transfers) and §2519 (treating the spouse as transferor for transfers of QTIP property) and state law to
determine that the spouse would be the transferor for gift tax purposes of the Trust A property but would not be deemed to have made a gift of Trust B or the GST Exempt Marital Share.

3) Ruling 5: The spouse’s interest in Trust B and the GST Exempt Marital Share will not be valued at zero under IRC §2702 despite her non-qualified disclaimer of Trust A.

The IRS analyzed IRC §2702 (valuation of retained interests in trust) and determined that the spouse’s disclaimer of Trust A will not cause a deemed transfer of Trust B. As such, her retained interest in Trust B and the GST Exempt Trust will not be valued at zero for purposes of determining the value of the Trust A transfer.

4) Ruling 6: If spouse lives for three years after the non-qualified disclaimer, her interest in Trust A will not be included in her estate under IRC §2044.

The IRS analyzed IRC §2044 and determined that because spouse’s non-qualified disclaimer was treated as a gift under IRC §2519, IRC §2044(b) precluded the property from being included in the spouse’s gross estate even though a marital deduction had been taken. So long as the spouse lives for three years after the transfer, the property will be omitted from her gross estate.

4. **Bottom Line**

Severing a marital trust and a non-qualified disclaimer of marital property did not disrupt the QTIP election.

**B. **PLR 201942001**

An executor requested an extension of time to allocate GST exemption to 4 years of prior transfers due to the failure of a qualified tax professional to make the appropriate election.

1. **Summary**

An executor requested an extension of time to allocate GST exemption under §2642(g) after discovering that the tax adviser failed to make the proper allocation. The IRS granted a 120-day extension to make the election on a supplemental gift tax return for four years of gifts.

2. **Facts**

Decedent established an irrevocable exempt Trust for the benefit of his three children. The Trust was immediately divided into a trust for each child but remained administered together. Each trust has generation-skipping transfer tax potential. Prior to December 31, 2000, the donor made gifts to the trust over the course of four years and retained a tax adviser to advise and prepare his gift tax return. However, the tax adviser failed prepare and file gift tax returns for the four years. The tax adviser had previously prepared and filed gift tax returns timely and had properly filed

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11 October 18, 2019
returns after. Decedent’s attorney discovered the error when he reviewed Decedent’s estate. Decedent died with enough GST exemption to allocate to the four years of transfers.

The issue before the IRS was whether the Decedent’s estate was entitled to Treas. Reg. § 301.9100 relief due to the tax adviser’s failure file returns properly allocating Decedent’s GST Exemption.

3. **Analysis**

The IRS evaluated the requirements under IRC §9100 to grant relief, namely that (1) the time to make an automatic allocation election is not prescribed by statute, (2) the taxpayer acted reasonably and in good faith, and (3) granting the extension will not prejudice the Government’s interests. The IRS found that the first element was met because Notice 2001-50 expressly provides that taxpayers can seek an extension of time to make the election under Treas. Reg. §301.9100-3. Additionally, the IRS found Decedent’s estate met the second element because a taxpayer is deemed to have met the element if the taxpayer relies on a “qualified tax professional”. Thus, the Decedent’s estate was granted additional time to allocate GST exemption.

4. **Bottom Line**

The IRS will grant additional time to allocate GST exemption if the taxpayer relied on a qualified tax professional to make the appropriate elections even if the election to opt out relates to transfers occurring more than three years ago.

C. **PLR 201947007**

   - The IRS permitted an estate to qualify a reformed trust for the charitable deduction when the trust was reformed into a CRUT.

1. **Summary**

The IRS permitted the retroactive reformation of a trust to create a charitable remainder unitrust for the benefit of the decedent's descendants and a Foundation, recognizing the validity of the trust after it was reformed to: (a) make a 5 percent unitrust payment (rather than the original 3.5 percent payment) to be divided among the noncharitable beneficiaries; (b) require that all of the shares be paid for the shorter of the lives of the primary beneficiaries or 20 years; and (c) to name Child 1’s estate as the remainder beneficiary of the special needs trust.

2. **Facts**

Decedent had six living children and one pre-deceased child who left issue. One of Decedent’s children was a special needs individual for whom a special needs trust had been established. Decedent’s revocable trust became an irrevocable unitrust at her death. Upon Decedent’s death, the residue splits into seven shares: one for each surviving child and one for the predeceased child’s issue. Each share is entitled to receive 3.5% of the trust’s aggregate fair market value during their life (“unitrust amount”). However, the special needs beneficiary’s unitrust amount is paid directly to the special needs trust for that beneficiary. At a beneficiary’s death, their

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portion of the unitrust amount is paid to a foundation. The issue of the seventh child are not entitled to receive unitrust amounts beyond a certain date. At the last surviving beneficiary’s death, the entire trust is distributed outright to the foundation.

When Decedent died, the trust did not qualify for a charitable estate tax deduction because it was not a charitable remainder unitrust (“CRUT”) as defined in IRC §664(d)(2). Consequently, the trustee of the trust petitioned the state court to reform the trust into a CRUT. However, despite modifying the trust to provide a 5% unitrust amount, the first reformation failed to limit the term to 20 years for the predeceased child’s share and failed to limit the payments to the special needs trust by a term or life expectancy.

Therefore, the trustees petitioned the state court for a second reformation to correct the omissions. After the state court reformed the trust, the trustees requested the following rulings:

1) The charitable interests are “reformable interests” within the meaning of IRC §2055(e)(3)(C).
2) The second reformation is a qualified reformation of trust under IRC §2055(e)(3)(C).
3) The estate is permitted a charitable deduction for the present value of the reformed trust.
4) The estate is permitted a charitable deduction for the present value of the Foundation’s portion of the unitrust interest.

3. **Rulings**

1) Ruling 1: The charitable interests are “reformable interests” within the meaning of IRC §2055(e)(3)(C).

The IRS analyzed IRC §664 and Rev. Rul 2002-20 to determine the requirements for a CRUT. The IRS also analyzed IRC §2055 to determine whether the reformed trust had qualified “reformable interests”. IRC §2055 defines a reformable interest as any interest that qualifies for a charitable deduction except that it originally passed to a non-charitable beneficiary unless that interest is in a CRUT or charitable remainder annuity trust. After evaluating the facts, the IRS determined that the trust was a “reformable interest” because a charitable deduction would have been allowed for its remainder (passing to the foundation) but for §2055(e)(2) and the noncharitable payments were originally expressed as a fixed percentage.

2) Ruling 2: The second reformation is a qualified reformation of trust under IRC §2055(e)(3)(C).

The IRS determined that the second reformation was qualified because the difference between the qualified interests and the reformable interest is less than 5% of the actuarial value of the reformable interest, the interests terminate at the same time, and the reformation was made effective Decedent’s date of death.
3) Ruling 3 and 4: The estate is permitted a charitable deduction for the present value of the reformed trust and the Foundation’s unitrust amount.

The IRS determined the estate could take a charitable deduction because the deduction does not exceed the amount which would have been allowed for the reformable interest but for IRC §2055(e)(2).

4. **Bottom Line**

The IRS permitted Decedent’s estate to reform a trust to qualify it as a CRUT because the reformation satisfied the basic CRUT requirements. As such, Decedent’s estate was entitled to a charitable deduction.