Current Developments Musings

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(A number of other summaries prepared by Steve Akers and other resource information for professional advisors is available at www.bessemer.com/advisor.)

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

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

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

- The IRS will issue, in order, (1) Form 8939, and shortly thereafter (2) instructions for Form 8939, followed by (3) Publication 4895, Treatment of Property Acquired From a Decedent Dying in 2010.
- The final Form 8939 will be posted at least 90 days before it is required to be filed.
- The Form 8939 *should not* be filed with the decedent's final income tax return (emphasis in original). (OBSERVATION: This is despite the literal wording of § 6075(a) providing that "[t]he return required by section 6018 with respect to a decedent shall be filed *with* the return of tax imposed by chapter 1 for the decedent's last taxable year" [(i.e., the decedent's final income tax return] (emphasis added).
- The carryover basis election under § 301(c) of TRA 2010 *should not* be made on the decedent's final income tax return (emphasis in original).
- Instructions on how to make the carryover basis elections under § 301(c) will be described on the Form 8939, in the instructions to Form 8939, and in Publication 4895. The March 2, 2011 Release says that "[t]he election is made by filing Form 8939."
- The March 2, 2011 Release says that Publication 4895 is only relevant for estates that file the Form 8939.
- The latest information on these issues can be found at www.irs.gov/form8939.

A summary of a conversation between Robert Chapman, of the IRS Tax Forms & Publications Desk, and Carol Cantrell on February 3, 2011 (in response to comments filed by the American Bar Association Tax and Real Property, Trust and Estates Law Sections on January 31, 2011) was published by Leimberg Information Services on Feb 8, 2011. Mr. Chapman's comments included the following:

- The Form 8939, Instructions to the Form 8939 and the Publication 4895 are expected to be released by May 2011.
- The IRS will issue guidance regarding whether appraisals are required and whether group and de minimis rules will be allowed.
- There is no place to report the surviving spouse's one-half of community property on the Form 8939 and the IRS will give guidance; he was asked to clarify that the surviving spouse's one-half would be eligible for the step-up and as well as a step-down in basis and he hinted that it is, by noting that the question of whether both halves of community property is adjusted is the same for both § 1014 and § 1022.
- The estate would be shown as the recipient of property not yet transferred by the time the Form 8939 is filed.
- An amendment would not be required to report subsequent transfers or distributions by the estate.
- Property that is sold by the estate cannot qualify for the $3.0 million spousal basis adjustment, even if the sale proceeds are distributed to the surviving spouse.
- The IRS may add Schedule R from Form 706 (for reporting generation-skipping transfers and exemption allocations) to the Form 8939 so that executors who need to report generation-skipping transfers or exemption allocations will not have to file both the Form 8939 and Form 706.
- The IRS prefers to make the mere act of filing the Form 8939 as the affirmative election under § 301(c) of the Tax Relief... Act of 2010 out of the estate tax regime and into carryover basis, rather than providing a box to check. He agrees that the Form 8939 should contain a statement to the effect that filing the form constitutes the election.
- The IRS is likely disinclined to allow a "protective election" out of the estate tax regime in the event an IRS audit adjustment makes the election more advantageous.

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

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

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

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

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

g. *Extended Time for Filing Estate Tax Return.* The act extends the time for filing estate tax returns of decedents dying before the date of enactment to nine months after that date (i.e., to September 19, 2011). Is a further extension available beyond that? We are not sure. The estate of the decedent who dies on December 17 can get an automatic 6-month extension beyond September 19. It would seem that automatic extension should also be available for the decedent died before December 17.

2. Administration's Fiscal Year 2012 Revenue Proposals

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

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

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

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

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

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

f. *Limit Duration of GST Exemption*. The proposal would limit the GST exemption to 90 years after a trust is created. At least 25 states have extended their perpetuities provisions far beyond the traditional lives in being plus 21 years. This would be accomplished by increasing the inclusion ratio of any trust to one on the 90th anniversary of the creation of the trust. Contributions to a trust by separate grantors are treated as separate trusts for GST purposes. For each such separate trust, the 90-year period would be measured from the date of the first contribution by the grantor of that separate trust. If an existing trust pours over or is decanted into another trust, the 90-year period would be based on the creation date of the initial trust unless the assets pass to a single beneficiary-"vested" trust (this exception permits an incapacitated beneficiary's distribution to continue to be held in trust without incurring GST tax on distributions to the beneficiary). The proposal would apply to trusts created after the date of enactment and to the portion of preexisting trusts attributable to additions after that date. (Estimated 10-year revenue impact: Negligible)

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

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

> "…the loophole arose because the drafters of the original GST exemption presupposed that the long-established state-law rule against perpetuities would limit the revenue loss. Congress had no reason to foresee a few lawyers and financial-services vendors would set off a race among some of the states to repeal the rule against perpetuities for the purpose of attracting trust business. The result has been that the GST exemption has now become a lure for the creation in such states of dynasty trusts, trusts that are designed to shelter wealth from GST taxation for centuries. In May of this year, the American Law Institute voted to urge Congress to plug the loophole, a decision that I think is indicative of the policy consensus on this matter in the bar and in legal academia.

> It is a rare occurrence that plugging a tax loophole can have such totally benign consequences: raising revenue within the spirit of the law, while preventing any evasion of the core policy of the estate tax, which is to prevent the untaxed accumulation of dynastic wealth."
>
> Several years ago the Staff of the Joint Committee on Taxation proposed a rule that would prohibit allocating GST exemption to a "perpetual dynasty trust," which would include trusts permitting distributions to beneficiaries in the generations below the transferor's grandchildren's generation. (There was no discussion of how existing trusts would be treated.) The approach proposed by the Staff of the Joint Committee on Taxation might be referred to an "invalidation approach" — invalidating the allocation of any GST exemption to trusts that might last beyond the prescribed term. The Administration's 2012 Fiscal Year Budget uses another approach, which merely causes the exemption to expire at the end of the prescribed period.

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

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

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

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

This provision applies to any patent pending and any patent issued after the date of enactment. Therefore, for example, it would not invalidate the SO-GRAT patent.

A floor statement by Sen. Grassley specifically noted a letter sent from a coalition of 15 groups describing why tax strategy patents are bad for taxpayers.

4. Deference to Regulations: Mayo Foundation Supreme Court Case

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

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

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

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

   > The Government... contends that the *National Muffler* standard has been superseded by *Chevron…*
   >
   > *. . .*
   >
   > Under *National Muffler*, for example, a court may view an agency's interpretation of a statute with heightened skepticism when it has not been consistent over time, when it was promulgated years after the relevant statute was enacted, or because of the way in which the regulation evolved…
   >
   > Under *Chevron*, in contrast, deference to an agency's interpretation of an ambiguous statute does not turn on such considerations…
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   > Aside from our past citation of *National Muffler,* Mayo has not advanced any justification for applying a less deferential standard of review to

> Treasury Department regulations than we apply to the rules of any other agency. In the absence of such justification, we are not inclined to carve out an approach to administrative review good for tax law only.
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> . . .
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> The principles underlying our decision in *Chevron* apply with full force in the tax context. . . . Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes. [citation omitted] We see no reason why our review of tax regulations should not be guided by agency expertise pursuant to *Chevron* to the same extent as our review of other regulations.

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

> [B]oth the full-time employee rule and the rule at issue in *National Muffler* were promulgated pursuant to the Treasury Department's general authority under 26 U.S.C. §7805(a) to "prescribe all needful rules and regulations for the enforcement" of the Internal Revenue Code…. In two decisions predating *Chevron*, this Court stated the "we owe the [Treasury Department's] interpretation less deference" when it is contained in a rule adopted under that "general authority" than when it is "issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision." [citing *Rowan Cos.* and *Vogel Fertilizer* cases]
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> Since *Rowan* and *Vogel* were decided, however, the administrative landscape has changed significantly. We have held that *Chevron* deference is appropriate "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority. [citation omitted] Our inquiry in that regard does not turn on whether Congress's delegation of authority was general or specific.

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

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

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

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

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

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

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

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

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

However, the court reiterates that on remand the court will apply the timing test issues that have been raised by *Holman* and *Gross*:

> To obtain favorable tax treatment, the Lintons needed to transfer assets to the LLC and then wait at least some amount of time before they gifted the LLC interest to their children. The waiting period would subject the gifted assets to some risk of changed valuation before they were transferred, through the LLC, to the children's trusts. That would make the two transactions distinct for tax purposes. (The government has not challenged that the nine days between January 22 and January 31 is a sufficiently long to make the transactions distinct, notwithstanding that some of the value transferred to the LLC was cash.)

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

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

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

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

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

The underlying premise of the reasoning is that § 2036 is not triggered if a donor must pay fair market rent for continued use of the property. Interestingly, that underlying premise was never discussed, and it seemed well enough established that the court assumed § 2036 would not apply if the donor intended to pay rent following the end of the QPRT term.

The court allowed a debt deduction for the amount of rent determined up to the date of death, but refused to allow and administrative expense deduction for the post-death rent, reasoning that the estate "did not require a roof over its head" and had no need to rent the house following the decedent's death.

7. Transfers With § 2036 Retained Interests, *Adler* and *Van* Cases. Aggregation of Various Undivided Interests Included in Estate Under § 2036; Adler v. Comm'r, T.C. Memo. 2011-28

a. *Transfer of Residence With Continued Occupancy by Donor Without Paying Rent Resulted in § 2036 Inclusion; Van v. Comm'r*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Analysis. Under § 6324(a)(1) there is an absolute 10-year limit on the special automatic estate tax lien, without extensions or tolling. However, the court said that the IRS was not proceeding under that section but under the transferee liability provision of §6324(a)(2), which does not contain the absolute 10-year limitation by its terms. Because transferee liability is derivative of the transferor's liability, courts addressing the limitations applicable to § 6324(a)(2) have looked at the generally applicable statutes of limitations created under §§ 6501-6502.

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

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

(2) There is no indication in this case that the IRS ever made an assessment against the defendants personally under the transferee liability provision, despite the fact that § 6901(c) provides that the period of limitations for assessment of transferee liability against an initial transferee is one year after the expiration of the period of limitation for assessment against the transferor. The IRS must assess tax against the estate within three years of filing the estate tax return (§ 6501(a)), so § 6901(c) requires assessment against the transferee within four years after the return was filed. The case did not discuss whether the IRS made an assessment against the recipients of the retirement accounts and life insurance policy within four years (which would be unusual), and did not address the effect of a failure to make such an assessment. Again, this raises the concern that transferees may conceivably first get notice of an unpaid estate tax liability when a Complaint is filed many years (in this case 17 years) after the date of death. (In this case, presumably the defendants had notice that an estate tax liability was unpaid, because they were the decedent's daughters, although the case did not indicate whether they were also the executors of the estate.) The potential injustice of this possibility, without prior assessment against the transferees, was raised in the recent *Mangiardi* case, discussed immediately below.

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

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

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

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

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

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

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

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

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

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

(2) This concern is exacerbated with respect to IRA beneficiaries or beneficiaries of other retirement accounts. For example, in *Kulhanek* the IRS concluded that a reasonable offer-in-compromise "was at least $3 million given that the beneficiaries received $3,433,007 in IRA distributions." That simple conclusion ignores that the IRA beneficiaries will owe income taxes at ordinary income tax rates on the IRA receipts. For example, using the *Kulhanek* facts assume that beneficiaries of the $3,433,0 IRA were in the 35% income tax bracket when they received their distributions years earlier. They would have paid income taxes of $1,201,552, leaving them net proceeds of $2,231,454. That does not matter; they are still personally liable under § 6324(a)(2) for the full $3,433,007 that they received from the decedent. Even assuming they still have the $2,231,454 net

proceeds many years later, they would still have to cough up the additional $1,201,552 out of their other assets. Yes, there is a § 691(c) deduction against the income tax for estate tax attributable to the IRD asset, but the statute of limitations for getting a refund of those income taxes has long passed. Hello bankruptcy!

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

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

An unmarried couple lived together 22 years in Nevada. "After learning that Shapiro was involved with another woman," the cohabitant brought a palimony claim, which was outstanding when the decedent died. His estate claimed a §2053 deduction for the value of the palimony claim, and estimated the claim at $8 million. The palimony case settled the next year for $1 million. The IRS denied any deduction. The lower court granted summary judgment disallowing a deduction for the palimony claim, because the woman paid no consideration that was valid to support a contract under Nevada law. In a 2-1 decision, the Ninth Circuit reversed the summary judgment that disallowed the palimony deduction, saying that "twenty-two years of cooking, cleaning and other homemaking services" does in fact constitute consideration that is good enough to support a contract under Nevada law. It noted that the lower court never reached the issue of whether those services constituted "adequate and full consideration in money or money's worth," which is necessary to support a deduction under § 2053. It remanded the case for the lower court to consider that question, and if it determined that it did meet that standard, to determine the value of the claim as of the date of death. *Estate of Shapiro v. Comm'r*, 107 AFTR 2d 2011-942 (9th Cir. February 2, 2011)

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

respect to the accuracy or completeness of such information. Views expressed herein are current opinions only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in law, regulation, interest rates, and inflation.