ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

RPPT eREPORT

NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Probate and Trust Article

This Issue's Table of Contents

FRACTIONAL INTEREST DISCOUNT IN ARTWORK

by

Jim Roberts

Glast, Phillips & Murray, PC.

Dallas, Texas

Just in time for Thanksgiving, in the fall of 1993, Judge Whalen handed down the Tax Court Memo decision in *LeFrak* 1(cite) and cemented in the minds of many the idea of discounts in fractional interests in real property. In that case, he determined that the discounts were 20% for a minority interest and 10% for lack of marketability. To be sure, *LeFrak* was not the first case to recognize discounts. Earlier cases included *Propstra* 2(cite) (a 15% discount), *Youle* 3(cite) (a 12.5% discount) and *Pillsbury* 4(cite) (a 15% discount). But LeFrak got 30% - double the previous amounts. More cases would to follow 5(cite) . But could the concept work in personal property? If the reasoning of a recent case is followed, the answer is, in essence, "no."

The *Pillsbury* case cited above discussed the concept. No discount was given, and the Court in that case said that it could not give a discount based on a "bare assertion" where there was no evidence to support the claim. But in the recent case of *Stone v. United States*, No. 3:06-cv-00259, United States District Court for the Northern District of California (May 25, 2007), there was plenty of evidence.

In *Stone*, the decedent, Lois Stone, died on September 1, 1999. On her estate tax return, the executor valued the estate's 50% undivided interest in 19 works of art at $1,420,000, using a 44% fractional interest discount. The IRS took the position that the value should be simply the total value of the artwork, multiplied by the 50% undivided interest, or $2,766,250. The estate paid the tax and sued for a refund.

After going through the usual discussion of the definition of "fair market value," the Court tackled the argument by the IRS that no discount at all was warranted. The Court pointed out that the government's own expert said a 2% discount was warranted, so "no discount" was out of the question.

But the Court likewise found the estate's argument for a 51% discount (7% higher than the position taken on the return) unpersuasive. The Court found very credible the testimony of two experts for the government who laid out a history or art sales, and clearly testified that they were aware of fractional interests in artwork being traded, but that none of these had ever occurred at a discount. Even the estate's appraiser admitted he could find no data on discounts.

The Court reasoned that artwork in not fungible. From that, and the testimony of the experts (and commenting that unlike this case, sales of fractional interests in real estate sales had comparable sales evidence of discounts) the Court concluded, in general, that a hypothetical willing seller of an undivided interest in art would rather sell the whole piece and split the proceeds, then sell a fractional interest at a discount. Such a sale might be by agreement or might be by partition. But, because a partition could be sought, no hypothetical willing seller would accept anything less than full value.

Turning to specifics, after dissecting the testimony of estate's expert asserting a 51% discount, the Court said that "a small discount is appropriate to account for legal fees" (here, legal fees would have been about 1%) and a further discount of 2% for costs of sale should be added. No appraisals would be necessary. "Some discount" would be appropriate for the uncertainties involved in waiting to sell the art. The Court would give no discount for lack of control, lack of marketability, lack of liquidity, the time value of money or other discounts commonly discussed in such cases.

The Court stopped short of making a final determination of the appropriate discount. Instead, it ordered the parties to seek to reach an agreement on valuation. But the tone of the Court's opinion suggests that, if pushed to decide, the Court would "just say no" to big discounts.

1. *Samuel J. LeFrak and Ethel LeFrak v. Commissioner, T.C.* Memo 1993-526 (November 16, 1993)

2. *Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982)

3. *Estate of Youle v. Commissioner, T.C.* Memo 1989- 138 (March 30, 1989)

4. *Estate of Eleanor O. Pillsbury, deceased v. Commissioner*, T.C. Memo 1992-425 (July 27, 1992).

5. *Estate of Ellie Williams, deceased v. Commissioner, T.C.* 1998-59 (February 12, 1998)(20% for lack of marketability and 30% for lack of control for a total discount of 44%)*;* *Estate of Alto B. Cervin v. Commissioner, T.C*. Memo 1994-550 (October 31, 1994)(20% discount), *rev'd on other issues*, 111 F.3d 1252 (5 th Cir. 1997); *Estate of Bonnie I. Barge, deceased v. Commissioner, T.C.* Memo 1997-188 (April 23, 1997)(25% discount)

ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

RPPT eREPORT

NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Probate and Trust Article

[This Issue's Table of Contents](#)

INHERITED IRA NOT PROTECTED FROM CREDITORS

By

Jim Roberts

Glast, Phillips & Murray, P.C.

Dallas, Texas

Federal law provides protection for most qualified plans, including 401(k), pension and profit sharing plans.But protections for Individual Retirement Accounts ("IRAs") are a matter of state law. Most, if not all, states provide that IRAs are exempt. But there is a growing body of case law questioning the exemption of inherited IRAs.

A recent case highlights this growing trend. *In Re: Russell Jarboe d/b/a RJ's Brokerage & Plants* [1(cite)] was a case out of the United States Bankruptcy Court for the Southern District of Texas, Houston Division. It interpreted Texas law and, in particular, § 42.0021 of the *Texas Property Code*. In general, subsection (a) of that provision exempted from seizure by creditors those assets, whether vested or not, in "any stock bonus, pension, profit sharing, or similar plan, including a retirement plan for self-employed individuals, and under any annuity or similar contract purchased with assets distributed from that type of plan, and under any retirement annuity or account described in Section 403(b) or Section 408A of the Internal Revenue Code of 1986, and under any Individual Retirement Account or any Individual Retirement Annuity, including a simplified employee pension plan, and under any health savings account described in Section 223 of the Internal Revenue Code of 1986, is exempt from attachment, execution, and seizure for the satisfaction of debts unless the plan, contract or account does not qualify under the applicable provisions of the Internal Revenue Code of 1986."

While Texas law was at issue, many states have similar types of provisions. For example, New York law, in Article 52, § 5205(c)(2), exempts "all trusts, custodial accounts, annuities, insurance contracts, monies, assets or interests established as part of, and any payment from, either any trust or plan, which is qualified as an Individual Retirement Account under Section 408 or Section 408A of the United States Internal Code of 1986, as amended …". Florida law, in Title XV, Chapter 222, Section 222.21(2)(a)(2) exempts any money "maintained in accordance with a plan or governing instrument that has been determined by the Internal Revenue Service to be exempt from taxation under s.401(a), s.403(a), s.403(b), s.408, s.408A, s.409, s.414, s. 457(b), or s.501(a) of the Internal Revenue Code of 1986, as amended …".

In this Texas case, the Court noted that the statutes of the different states, while all having an apparently similar purpose, are different in their wording. And thus, while citing other cases from other jurisdictions, the Court concluded that none of those cases provided anything more than food for thought. In this case, the statute contained trailing language behind the primary operative provision, and referred to plans that are "qualified" under the Internal Revenue Code. The Court asked the question, "What does this mean?" The Court cited cases from other Bankruptcy courts, all of which have opened the door for creditors to seize inherited IRAs. One case was *In re Kirchen.* *2(cite)* The *Kirchen* court listed what it perceived to be the attributes of an IRA, concluding that if an IRA does not satisfy those requirements, it "will not qualify or comply with the Internal Revenue Code."3(cite) Using *Kirchen* as a guide, the Court in the Texas case focused on the following: (a) the IRA could not be rolled over into another IRA (as the original participant or a beneficiary-spouse might be able to do); (b) contributions could not be made to the inherited IRA; (c) most importantly, the owner of an inherited IRA could remove funds from the IRA at any time, for any reason, and without penalty; and (d) the person inheriting the IRA was required either to start taking lifespan-measured withdrawals from the IRA within one year or to take the entire amount within five years, regardless of the beneficiary's age. The one thing the Court conceded that inherited IRAs have in common with other IRAs is tax deferral.

As a result of these key differences, the Court concluded "… that an IRA inherited from someone other than a spouse may not be claimed as exempt …". And, as a result "… an inherited IRA does not 'qualify' under Texas Property Code § 42.0021. The mere fact of temporary tax deferral is insufficient." And, thus, the creditors were allowed to reach the assets inside the inherited IRA.

One of the trends advocated by some recently is that all people should have "inheritance trusts," and that such trusts should be the designated beneficiaries of their parents' and others' wills, life insurance and retirement accounts. Perhaps such a trust, with an IRA-sensitive tax provision, interposed between the decedent-participant and the beneficiary-debtor, could be a possible means to alleviate this growing problem. But, then, whether that will work when what otherwise appeared to be the plain language of a statute did not, is something that should be carefully considered and questioned.

1. 2007 Bankr. LEXIS 1147

2. 344 B.R. 908 (Bankr. E.D. Wisc. 2006)

3. 344 B.R. at 913.

ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW
RPPT eREPORT
NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Probate and Trust Article

This Issue's Table of Contents

Proposed Regulations Limiting Estate Tax Deductions for Uncertain Claims Against Decedents and Other Administration Expenses Under §2053

May 2007

Steve R. Akers
Bessemer Trust
Dallas, Texas 75201

Introduction

The IRS has issued proposed regulations dealing primarily with the deductibility of claims against a decedent's estate that are uncertain in amount at the date of death. The general approach for such contingent or uncertain claims is that a deduction is allowed only as payments are actually made by the estate, but there is an exception for estimated amounts that are ascertainable with reasonable certainty. Unless stated otherwise, all references to regulations in this summary refer to the newly issued proposed regulations.

I. Background.

There have been various cases in the last several years dealing with the deductibility of claims against the estate when the precise amount of the estate's liability is uncertain at the date of death. For example, there may be threatened or pending litigation against the decedent at the date of death. The trend of the recent cases has been to value the claim based on facts known at the date of death and not considering post-death facts including

settlement agreements. There is a split among the circuit courts of appeal on this issue. Aghdami, *Effect of Post-Mortem Facts On Claims Against the Estate,* TR. & EST. 18 (May 2004); Loeb, *Crossed Circuits on Estate Tax Deductibility of Disputed or Contingent Claims*, 12 CALIF. TR. & ESTS. Q. 6 (Summer 2006). The Preamble to the proposed regulations points out that there are two lines of cases dealing with this issue, going back to the 1920s.

The "date of death" line of cases follows Ithaca *Trust v. Commissione*r, 279 U.S. 151 (1929), which held that the estate tax charitable deduction for a charitable remainder interest was determined as of the date of death. These cases generally do not allow courts to consider post-death events (such as settlement agreements) in valuing a claim. However, even the courts that follow this line have recognized some exceptions, such as when a claim is not presented for payment or when a claim is contested, contingent, unenforceable, or becomes unenforceable after the decedent's death. *E.g., Propstra v. U.S.*, 680 F.2d 1248 (9th Cir. 1982) ("The law is clear that post-death events are relevant when computing the deduction to be taken for disputed or contingent claims."); *Estate of Van Horne v. Comm'r*, 78 T.C. 728, 734 (1982), *aff'd,* 720 F.2d 1114 (9th Cir. 1983), *cert. denied*, 466 U.S. 980 (1984) (dicta that post-death events are relevant in cases where the claims are potential, unmatured, contingent, or contested at the date of death). Several of the recent cases following the *Ithaca Trust* line have even held that the amount actually paid pursuant to a settlement agreement (sometimes for pennies on the dollar) is not even admissible into evidence in the tax proceeding to determine the date of death value of the claim. *Estate of Smith v. Comm'r,* 198 F.3d 515 (5th Cir. 1999), *nonacq*. 2000-19 IRB; *Estate of McMorris v. Comm'r*, 243 F.3d 1254 (10th Cir. 2001); *Estate of O'Neal v. U.S.*, 258 F.3d 1265 (11th Cir. 2001).

The "actual payment" line of cases follows *Jacobs v. Commissioner*, 34 F.2d 233 (8th Cir. 1929), *cert. denied*, 280 U.S. 603 (1929). Jacobs distinguished the valuation of claims from the determination of the amount of charitable deductions (that were addressed by the Supreme Court in *Ithaca Trust*), stating that "... the claims which Congress intended to be deducted were actual claims, not theoretical ones." Older cases in the First, Second, Fifth, and Eighth Circuits have considered post-death events in valuing uncertain claims. *Estate of Sachs v. Comm'r*, 856 F.2d 1158 (8th Cir. 1988); Comm'r v. Shively's Estate, 276 F.2d 372 (2d Cir. 1960); *Comm'r v. State Street Trust Co.*, 128 F.2d 618 (1st Cir. 1942). The Fifth Circuit had held similarly in a per curiam opinion in *Estate of Hagmann v. Comm'r*, 492 F.2d 796 (5th Cir. 1974), but the Fifth Circuit later distinguished the holding in that case based on its specific unusual facts.

The lack of consistency in the lines of cases results in disparate treatment of similarly situated estates, and the IRS determined that a consistent rule is needed. The IRS states that the date of death approach often requires a "re-trial" of the valuation of the claim on the date of death in a tax proceeding even though the underlying claim has been resolved by a settlement or court proceeding. The IRS concludes that the date of death approach is inefficient, expensive (appraisal and litigation costs), often results in a deduction different than the amount actually paid, and forces the taxpayer to take contradictory positions in the tax proceeding and the court proceeding on the underlying claim.

The Preamble states that it reaches this decision in light of (1) its review of court cases, (b) legislative history to §2053, and (c) furtherance of the "effective and fair administration of the tax laws." (The Preamble does not discuss the legislative history that supports its "actual payment" approach.)

The Preamble justifies taking a different position for valuing §2053 deductions (using amounts actually paid) versus the valuation of assets in the gross estate (which is based on the date of death values) based on statutory differences. It observes that §2031(a)

specifically refers to "the value at the time of his death" whereas §2053 does not refer to value at the date of death.

II. General Rules Applicable to All of §2053, §20.2053-1.

A. <u>Applies to All of §2053.</u> Proposed Regulation §20.2053-1 applies to all deductions under §2053, not just claims against the estate.

B. <u>Limit to Amounts Actually Paid (and Not Reimbursed), §20.2053-1(b)(1).</u> A sentence is added to this regulation limiting all deductions under §2053 (including funeral expenses, executor commissions, attorney fees, administration expenses, and mortgages) to "the total amount actually paid." A corollary of this requirement is that no deduction is allowed if the amount "is or could be compensated for by insurance or otherwise." §20.2053-1(b)(5).

C. <u>Court Decree, §20.2053-1(b)(2).</u> The proposed regulations restate the discussion in the current regulations regarding the effects of court decrees. The mere payment of funeral expenses, administration expenses, claims or mortgages is not, by itself, sufficient to assure the deductibility of the amount paid. While a court decree is not required to support a deduction, the proposed regulation adds that a court decree may be relied on if four requirements are met: (a) the expenditures are otherwise deductible under §2053 and its regulations; (b) the expenditures have been paid by the estate or meet the requirements for estimated expenses; (c) the court reviewed the facts relating to the expenditures; and (d) the court's decision is consistent with local law. For example, a decree allowing an executor's commission "in excess of the amount or limit prescribed by statute" may not be relied on.

If the court decree is based on consent of the parties, the consent must be "a bona fide [deleting the following parenthetical in the current regulations—"(and not a mere cloak for a gift)"] recognition of the validity of the claim and [must be] accepted by the court as satisfactory evidence upon the merits." The proposed regulation restates the provision in the existing regulation that "[c]onsent given by all parties having interests adverse to that of the claimant will be presumed to be recognition of the claim's validity."

D. <u>Settlements, §20.2053-1(b)(3).</u> A settlement may be relied on to support the deduction of an amount paid (or meeting the requirements for estimated expenses described below) if five requirements are met: (a) the settlement resolves a bona fide issue in an active and genuine contest; (b) the settlement is the product of arm's length negotiations by parties having adverse interests with respect to the claim; (c) the settlement is within the range of reasonable outcomes under applicable state law governing the issues resolved by the settlement; (d) the settlement is consistent with local law; and (e) the underlying claim is not unenforceable. The "reasonable outcomes" condition is met if the settlement "results in a compromise between the positions of such adverse parties and reflects the parties' assessments of the relative strengths of their respective positions."

Observe, if all family members agree with the validity of a claim by another family member, they may have difficulty establishing the arm's length requirement for settlements. That requirement does not exist for the court decree provision (even a court decree based on consent), so the parties may wish to go through a court proceeding rather than just relying on a settlement agreement.

E. <u>Estimated Amounts, §20.2053-1(b)(4).</u> The current regulation allows the deduction of estimated amounts that are ascertainable with reasonable certainty (as opposed to vague and uncertain estimates) and will be paid, even if the exact amount is unknown. The

proposed regulation adds that the executor has the duty to notify the IRS if the payment is waived or left unpaid, and must pay the resulting additional estate tax (with interest). (Observe: that requirement is in the current regulation dealing with executor commissions, §20.2053-3(b)(1).)

If an amount cannot be ascertained with reasonable certainty, no deduction is allowed until the amount is paid (or presumably when it later becomes ascertainable with reasonable certainty, thus satisfying the "estimated amounts" exception; this is stated explicitly in proposed regulation §20.2053-4(b)(1) regarding potential and unmatured claims.) However, the estate can file a protective claim for refund before the statute of limitations runs on refund claims. The proposed regulation states two requirements for the protective claim for refund: (a) it must identify the outstanding liability or claim that it would have been deductible under §2053(a) had it already been paid; and (b) it must describe the reasons and contingencies delaying the determination of the liability or the actual payment of the claim.

III. Executor Commissions and Attorney Fees, §20.2053-3(b-d).

A. <u>Protective Claims for Refund, §20.2053-3(b)(2-3) & §20.2053-3(c)(1)</u>. The proposed regulation adds that a protective claim for refund may be filed if the requirements for deductibility in the current regulation are not satisfied before the statute of limitations for refunds has expired.

B. <u>Omission of Paragraph Regarding Attorney Fees of Beneficiaries; Expenses in Defending Against Claims, §20.2053-3(d)(3).</u> The proposed regulation omits a paragraph in the current regulation that allowed attorneys fees incurred by beneficiaries regarding their respective interests in the estate. A paragraph is substituted regarding expenses incurred in defending the estate against claims. These expenses are deductible even if the estate is not ultimately victorious. Deductible expenses include costs relating to arbitration, mediation, costs and depending claims (even if the claim is unenforceable), and costs in reaching a settlement. However, expenses incurred merely to extend the time of payment or not in good faith are not deductible.

IV. Claims Against the Estate, §20.2053-4. The one short paragraph in the current regulations has been expanded to 5 pages of detailed provisions regarding the deductibility of claims against the estate.

A. <u>General Requirements.</u> Deductible claims are limited to “legitimate and bona fide claims that—

(i) Represent personal obligations of the decedent existing at the time of the decedent’s death;

(ii) Are enforceable against the decedent’s estate at the time of payment; and

(iii) Are actually paid by the estate in settlement of the claim.”

B. <u>Potential and Unmatured Claims; Contested Claims, §20.2053-4(b)(1-2)</u>. Unmatured claims that later mature and are paid are deductible. No deduction may be taken on an estate tax return for a potential or unmatured claim or for a contested claim, but the estate can file a protective claim for refund. (For potential and unmatured claims, the regulation restates the protective claim for refund provisions in the "Estimated Amounts" clause of §20.2053-1(b)(4). For "contested claims," the proposed regulation just references §20.2053-1(b)(4) relating to estimated amounts.)

C. <u>Multiple Parties; Reimbursement, §20.2053-4(b)(3).</u> If the claim is asserted against the estate and one or more other parties, only the portion "due from and paid by the estate" may be deducted. The deductible portion must be reduced by any reimbursement received from any other party or the amount the estate could collect from another party or insurer even if the estate declines or fails to attempt to collect (unless the cost of collecting from others "would have outweighed the benefit from those efforts").

D. <u>Claims by Family Members, Related Entities, or Beneficiaries, §20.2053-4(b)(4).</u> There is "a rebuttable presumption that claims by a family member of the decedent, a related entity, or a beneficiary of the decedent's estate or revocable trust are not legitimate and bona fide and therefore are not deductible. Evidence sufficient to rebut the presumption may include evidence that the claim arises from circumstances that would reasonably support a similar claim by unrelated persons or non-beneficiaries." A settlement of such a claim similarly is presumed "not to be deductible absent evidence of the legitimacy and bona fide nature of the client." There is a definition of family members, including the decedent's spouse, grandparents, parents, siblings, and spouses and lineal descendents of grandparents, parents and siblings. [Observe: Spouses of such lineal descendents are not included.] A related entity is an entity in which the decedent, either directly or indirectly, had a beneficial interest at the date of death or in the preceding three years, other than a publicly-traded entity or a closely held entity in which the interests of the decedent and family members is less than 30% (whether voting or nonvoting).

E. <u>Unenforceable Claims, §20.2053-4(b)(5).</u> Claims that are unenforceable prior to death or before they are actually paid are not deductible, even though the estate pays the claim.

F. <u>Claims Founded on a Promise, §20.2053-4(b)(6).</u> The current regulation says that claims founded on a promise or agreement or deductible only if the promise or agreement was "bona fide and in exchange for adequate and full consideration." The proposed regulation also requires that "the promise or agreement must have been made in good faith, and that the price must have been an adequate and full equivalent reducible to money value."

G. <u>Recurring Payments, §20.2053-4(b)(7).</u> If recurring payments on an enforceable non-contingent obligation will likely extend beyond the final determination of the estate tax liability, the estate may deduct the present value of the payments on the date of the decedent's death as an estimated amount (under the exception described in §20.2053-1(b)(4).) §20.2053-4(b)(7)(i). However, if the recurring payments are for a contingent obligation (including one for which there is a reasonable likelihood that full satisfaction of the liability will not be made) or for any other situation not described by the preceding sentence, the deduction is limited to amounts actually paid. §20.2053-4(b)(7)(ii). If a commercial annuity is purchased to satisfy a recurring obligation on an enforceable and certain claim (whether or not contingent), the estate can deduct the sum of (a) the amount paid for the commercial annuity, and (b) any amount actually paid prior to the purchase of the commercial annuity.

Observation: The substantive regulation states the present value limitation only for recurring payments on non-contingent obligations that will likely continue beyond the final determination of the estate tax liability, §20.2053-4(b)(7)(i). All other situations involving recurring payments are governed by §20.2053-4(b)(7)(ii), which allows a deductions for amounts actually paid, and does *not* have the present value limitation. For this purpose, the estate may be able to take a larger deduction if the limiting conditions in subparagraph (i) do not apply. An example in the proposed regulations raises an interesting interpretation issue on this point. Under the example, the estate owes 7 non-contingent annual payments under a divorce decree after the date of death, and one of the annual payments is made before the estate tax return is filed. The example concludes that "[t]he estate may take a deduction for the present value of these payments." Apparently, that

means that only the present value of the payment made before the filing date is allowed, not the full amount of such payment. (If a contingency applied [such as a provision to cease the payments on the spouse's remarriage or death], apparently the full amount of the payments would be deductible as made, not just the present value of the payments.)

H. Interest on Claims, §20.2053-4(c). The interest accrued up to the date of death and actually paid on a claim is deductible as a claim. (The date of death amount applies even if the estate elects the alternate valuation date for purposes of valuing assets.)

"Post-death accrued interest may be deductible in appropriate circumstances either as an estate tax administration expense under section 2053 or as an income tax deduction."

V. Taxes, §20.2053-6, 20.2053-9, 20.2053-10. The regulations are updated to refer to the deductibility of state estate taxes for decedents dying after 2004 under §2058. The regulations also add a provision clarifying that a deduction is allowed for any post-death adjustments increasing a tax [such as gift or income tax] (and allowing a protective claim for refund to keep the statue of limitations open to make such a claim.) §20.2053-6(g). Similarly, any refund subsequently determined and paid after the date of death must be reported to the IRS and the resulting additional estate tax must be paid (with interest). See §20.2053-6(g)Ex. 2.

VI. Effective Date. The new provisions will apply to decedents dying on or after the adoption of final regulations

VII. Observations.

A. Approach Favors IRS But Seems a Reasonable Approach Except For Different Treatment of Claims and Counterclaims. The IRS has argued for the actual payment approach in the recent litigated cases and in its informal notices. See Field Service Advice 200217022. The actual payment approach generally favors the IRS, preventing estates from arguing for a high date of death value of a claim against the estate despite an actual settlement and payment of a much lower amount. In this respect, the position of the proposed regulation is self-serving in reversing the trend of recent cases that favors the date of death approach. (Of course, the opposite can also occur. For example, much more serious environmental liability facts may become known after the date of death, resulting in a higher deduction under the actual payment approach.) Despite the self-serving result, using an actual payment approach seems to be a reasonable approach for efficient administration of the tax system—except that the system would seem more complicated than ever if there are claims and counterclaims involved. (See paragraph C below.) In light of those complications, perhaps the approach is not sound.

B. Contrast With Valuation of Claim Owned By Estate Against Another Party. The flip side is the valuation of claims owned by the estate (rather than claims against the estate.) Claims owned by the estate are assets of the estate and are governed under the general valuation principles based on date of death values. These two different types of claims will be treated differently in the future.

The issue is even more acute with a claim owned by the estate—because it is not possible to just wait until after the claim has been resolved. The IRS will want to make a determination of the amount of the claim as an asset of the gross estate to determine the amount of the estate tax. This exacerbates the problem of the contradictory positions dilemma, discussed in Paragraph J below, because the executor will have to take a position on the estate tax return as to the value of the claim owned by the estate.

C. <u>Effect of Counterclaims.</u> What if there is a claim against the estate, but the estate makes a counterclaim, or the reverse situation in which the estate has a claim against another party but that party makes a counterclaim against the estate? (This is a very real problem because it is very typical in many, if not most, lawsuits to have counterclaims.) The claim against the estate would be governed by one set of rules (possibly deferring any deduction until the claim is paid, allowing a deduction only for the amount actually paid) and the claim by the estate against the other party would be governed by a different set of rules (deferring the value of the estate's claim presumably would not be delayed until the time of actual payment, and the value of the claim would be based on the date of death value rather than the actual amount of the payment). The goal of the IRS's position in the proposed regulations is largely based on administrative convenience and efficiency, but this very common situation will result in even more complexity in light of the different approaches that will apply to the claim and counterclaim.

D. <u>Attorneys Fees of Beneficiaries.</u> The Preamble did not discuss the reason for deleting the paragraph dealing with attorneys fees paid by beneficiaries of the estate regarding their respective interests in the estate. §20.2053(c)(3). It is not clear whether this signals a change of position by the IRS regarding the deductibility of such attorney fees incurred by estate beneficiaries.

E. <u>Claims of Family Members and Related Parties.</u> Claims by family members or related parties may be deducted only if the estate overcomes the presumption that such claims are not legitimate and bona fide. §20.2053-4(b)(4). This documents the IRS's long term hesitancy to allow a deduction for "trumped up" intra-family claims.

F. <u>Unenforceable Claims.</u> The executor will have to be careful not to pay claims after they have become unenforceable, because such amounts will not be deductible even though actually paid. §20.2053-4(b)(5). (Of course, the payment of unenforceable claims raises fiduciary liability concerns as well.) This may be particularly important with claims by family members, where the executor and family members agree that a valid claim of a family member should be paid by the estate. The parties will need to be careful to pay the claim within the applicable statute of limitations period.

G. <u>Settlements.</u> One of the requirements for relying on settlements to recognize the deductibility of expenses under all of §2053 is that the settlement is based on arm's length negotiations of parties who are adverse to each other. §20.2053-1(b)(3). That may be difficult to establish in a harmonious family situation. The parties may wish to obtain a court decree regarding the claim, because that requirement does not exist in the provision dealing with court decrees. (Even court decrees based on consent do not have a stated arm's length negotiations requirement, but the parties must establish the bona fides of the claims). §20.2053-1(b)(2).

H. <u>Recurring Payments.</u> As discussed in Item IV.G above, the estate may be entitled to a larger deduction if the underlying claim has some contingency or if payments will not likely extend beyond the final determination of the estate tax. In that case, a deduction is allowed only as payments are made, but the full amount of the payments would be deductible, not just the present value of the payments discounted back to the date of death.

I. <u>Protective Claim for Refund; Later Actual Claim for Refund.</u> If there is any uncertainty at all regarding the ultimate amount of a claim against the estate or if a claim is not paid, the executor must be careful to file a protective claim for refund before the statute of limitations runs on refund actions. Once the amount of the uncertainty is resolved, the executor should then file an actual claim for refund to get a refund attributable to the additional administration expense.

J. <u>Contradictory Positions; Practical Dilemma.</u> The Preamble observes that the estate may take contradictory positions in the tax proceeding and the underlying proceeding to determine the amount of the claim against the estate. A practical problem is how to balance estate tax reporting with the defense of the actual litigation. The plaintiff suing the estate may depose the executor the day after the estate tax return is due and subpoena a copy of the return. If the claim against the estate is reported at a high value on the estate tax return (to support a large deduction), the plaintiff will use that as "Plaintiff's Exhibit 1" to argue that even the estate thinks the claim is valid and large. The best approach seems to report the claim against the estate on the Form 706 and list its value as "Undetermined."

The problem is even worse if the estate owns a claim against another party. The executor will have to take a position on the estate tax return as to the value of the asset. Even if the executor lists the value as "uncertain" on the estate tax return, the issue will be addressed in the audit, and it is more likely that the attorney defending the claim will be able to discover the negotiated value than in the case of a claim against the estate, for which a deduction can just be delayed until after the underlying claim is resolved.

K. <u>*Graegin* Loans.</u> The proposed regulations do not seem to impact *Graegin* loans at all. While §20.2053-1(b)(1) limits §2053 deductions to amounts actually paid, §20.2053-1(b)(4) allows the deduction of estimated amounts that are ascertainable with reasonable certainty, with a requirement to contact the IRS if the actual amount that is later paid differs from the estimate. The current and proposed regulations both allow a deduction of estimated amounts of administration expenses that may be ascertained with reasonable certainty and will be paid. Current Reg. §20.2053-1(b)(3); Proposed Reg. §20.2053-1(b)(4).

In *Estate of Graegin v. Comm'r*, T.C. Memo, 1988-477, the Tax Court in a memorandum decision allowed an estate to deduct projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation. The estate borrowed $204,218 from a corporation, 97% of whose stock was owned by the decedent or the decedent's son. The $204,218 unsecured note provided a fixed 15% interest rate for the entire 15 year term and the note provided for a substantial prepayment penalty. Even though the estate could have made some annual payments on the note (because it anticipated receiving dividends on its preferred stock in the corporation of $70,000 per year), the note was structured to require payment of all principal and interest in a single balloon payment at the end of the 15 year term. The 15 year term and the balloon payment were utilized because the decedent's wife had a 15 year life expectancy, and a trust for the wife that would terminate when she died contained liquid funds which could be used to pay off part of the note. The court reasoned that the amount of the interest was sufficiently ascertainable to be currently deductible because of the fixed term of the note and because of the substantial prepayment penalty provisions in the note. The court observed that it was "disturbed by the fact that the note requires only a single payment of principal and interest", but determined that such a repayment term was not unreasonable given the decedent's post-mortem asset arrangement. The court observed that it was "mindful of the potential for abuse presented by the facts in this case", but found the executor's testimony regarding his intention with respect to repayment of the note credible. ¶88,477 PH Memo TC at 2446-88. The court specifically pointed to the fact that there was an outside shareholder who would complain if the loan was not timely paid.

L. <u>Post-Death Interest Expenses.</u> Similarly, the proposed regulations do not appear to impact the deductibility of post-death interest expenses. If the interest expense cannot be estimated with reasonably certainty it would only be deducted as actually paid, particularly in light of the additional sentence added to Reg. §20.2053-1 limiting deductions under §2053 to amounts actually paid unless the estimated amounts provision applies. (The cases have been pretty lenient in allowing an estate tax deduction for post-death interest.)

Various cases have permitted the deduction of post-death interest with respect to loans obtained by an executor for general estate purposes, where the loans were necessary for the administration of the estate. E.g., *Estate of Huntington v. Comm'r.*, 36 B.T.A. 698 (1937); *Estate of Todd v. Comm'r,* 57 T.C. 288 (1971); *Hipp v. U.S.*, 72-1 U.S.T.C. ¶ 12,824 (D. S.C. 1971). However, an interest deduction will not be permitted where the estate administration is unduly prolonged or where the estate could have sold assets other than at distress prices instead of borrowing funds. *See Hibernia Bank v. U.S.*, 75-2 U.S.T.C. ¶13,102 (N.D. Calif. 1975), *aff'd*, 581 F.2d 741 (9th Cir. 1978).

The IRS position is to allow a deduction for post death interest on amounts borrowed to pay estate taxes in order to avoid a "forced sale of assets." Rev. Rul. 84-75, 1984-1 C.B. 193. Some of the cases cited above also involved borrowings to pay estate taxes. The cases have even allowed post-death interest deductions for amount borrowed from family entities to pay estate taxes. *Estate of Thompson v. Comm'r*, T.C. Memo 1998-325; *McKee v. Comm'r*, T.C. Memo. 1996-362; *Estate of Graegin*, T.C. Memo. 1988-477.

ABA SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

RPPT eREPORT

NEWS, PRACTICE UPDATES AND MEMBER BENEFITS

Probate and Trust Article

This Issue's Table of Contents

Erickson Extends §2036 to Using Partnership Funds to Pay Decedent's Estate Taxes

Summary prepared by: Steve R. Akers, Bessemer Trust

May 2007

Estate of Erickson v. Commissioner , T.C. Memo 2007-107 is another §2036 victory for the IRS in a "terrible facts" case. The case is particularly interesting in that the retained enjoyment of the partnership was the use of partnership funds to pay estate taxes (albeit through the purchase of an estate asset and a redemption of part of the estate's interest). However, the case was surrounded with other facts that made readily apparent that the only purpose of the partnership was to try to secure an estate tax discount.

Key Facts

1. The decedent was an Alzheimer's patient in poor health in her 80s when the partnership was created.

2. There was a delay in funding, including scurrying to fund interests in several condos on the decedent's deathbed.

3. The decedent had two daughters, one of whom managed the decedent's affairs under a power of attorney and acted under the power of attorney to create and fund the partnership and (on the decedent's deathbed) to make gifts of partnership interests.

4. The other daughter (who was also a partner) testified that she did not understand anything about the particulars of the partnership except that it saved taxes.

5. The partnership was funded with almost all of the decedent's liquid assets (including $2,000,000 of marketable securities) and interests in several condominiums; the decedent initially acquired an 86% limited partnership interest.

6. There was also a $1.0 million credit shelter trust for the decedent that had been created at her husband's prior death.

7. Two days before the decedent died, the daughter (acting under the power of attorney) scrambled to convey the various interests in condominiums to the partnership and to make gifts to the decedent's grandchildren, reducing the decedent's percentage of the partnership from 86% to 24%.

8. The partnership assets had the same managers of the investment portfolio and the same management company managing the condominiums as before the partnership was created.

9. Post-death, partnership funds were used to pay part of the decedent's estate and gift taxes. The estate sold the decedent’s home to the partnership for $123,500 and the partnership redeemed some of her partnership interests for $104,000. This is the money from the partnership that the estate used to pay part of the estate and gift taxes.

Bona Fide Sale for Full Consideration Exception to §2036

(The court analyzed the section 2036(a)(1) application before addressing whether the bona fide sale exception applied. Instead, I will first summarize the bona fide sale exception discussion.)

The court first gave the obligatory regurgitation of general factors bearing on whether a legitimate and significant nontax reason existed for the partnership. The court listed the following factors: (1) “Standing on both sides of the transaction” (one daughter did everything regarding creation and funding of the partnership); (2) Financial dependence on distributions from the partnership; (3) Commingling of partnership and personal funds; (4) Failure to transfer assets to the partnership; and (5) Just serving as a vehicle to change the form of the investments, a "mere asset container." [That last factor is a throwback to the Tax Court’s “recycling of value” theory of the full consideration requirement before Bongard, but now called the “mere asset container” theory and now applying to the bona fide requirement rather than to the full consideration requirement.]

The court next rejected the estate’s purported non-tax reasons for the partnership. (1) Centralized management – the management of the investment portfolio and condominiums did not change after the assets were contributed to the partnership. (2) Creditor protection – the court’s one sentence response reflects that the court does not at all understand (or refuses to understand) the potential asset protection advantages of a limited partnership: “A creditor who sought funds from the partnership, however, would have a significant asset base from which to recover from the partnership, over $2 million.” [That’s beside the point. The point is that a limited partner’s creditors generally cannot reach inside the partnership and get access to partnership assets.] However, the facts of the case do not reflect any particular creditor concerns. (3) Facilitating gift giving – which the court says is not a significant nontax purpose.

The court emphasized that all facts and circumstances must be reviewed to determine whether the transaction is bona fide. The Court pointed to the following factors, among others, to conclude that the bona fide test is not satisfied:

- **Partnership consisted mainly of passive assets (including marketable securities and rental properties)**
- **Same managers as before the partnership was created.**
- **Making loans to family members of the partnership on favorable terms.**
- **Partnership was planned unilaterally by one daughter.**
- **Same law firm represented all partners in the creation and funding of the partnership.**
- **Delay in funding – the key seemed to be scurrying around on the decedent's death bed to complete the funding (suggesting testamentary motivations).**
- **Financial dependence – $227,000 of partnership assets were used to pay estate taxes; the disposition of cash from the partnership was characterized partly as a purchase of the decedent's residence and partly as a redemption, but the form is not controlling.**

Section 2036(a)(1) Application

The court mentioned many of the same factors as in the bona fide test analysis. It gave the following list of general factors that courts have previously considered in determining whether a decedent impliedly retained the right to possession and enjoyment of transferred assets: "co-mingling of funds, a history of disproportionate distributions, testamentary characteristics of the arrangement, the extent to which the decedent transferred nearly all of his or her assets, the unilateral formation of the partnership, the type of assets transferred, and the personal situation of the decedent."

The court noted the delay in funding the partnership (suggesting a failure to respect formalities of the partnership) and then the scurry to complete the funding of the decedent's and other family members' contributions on the decedent's deathbed: There was "no hurry to alter their relationship to their assets until decedent's death was imminent."

The court emphasized particularly that the partnership provided funds for payment of the estate tax liabilities. (The only liabilities mentioned in the case were gift and estate tax liabilities.) The court viewed that as tantamount to making funds available to the decedent. Although the disbursement was implemented as a purchase of assets from the estate and as a redemption, "the estate received disbursements at a time that no other partners did. These disbursements provide strong support that Mrs. Ericsson (or the estate) could use the assets if needed."

The partnership had little practical effect during the decedent's life and was mainly an alternative method to provide for the decedent's heirs.

The court concluded that no one factor is determinative, but the court must consider all facts and circumstances. The court's summary seems to emphasize its "smell test" problem with the partnership: "The transaction represents decedent's daughters' last-minute efforts to reduce their mother's estate's tax liability while retaining for decedent the ability to use the assets if she needed them."

Key Planning Points from *Erickson*

1. The partnership involves a transfer of all liquid assets from an Alzheimer's patient in her 80s and in poor health by her daughter acting under a power of attorney, with some transfers and gifts being made on her deathbed. Expect the IRS to try to grab the low hanging fruit.

2. This is the first case to focus on the post-mortem use of partnership assets to pay estate tax liabilities. (The Fifth Circuit *Strangi* case addressed post-mortem use of partnership assets to pay estate liabilities, but did not focus on the payment of estate and gift tax liabilities.) Apparently, there were no distributions from the partnership to the decedent during her lifetime, and indeed there was $1 million in a credit shelter trust for her support. This suggests keeping assets outside the partnership to pay for living expenses *and* anticipated post-death expenses, including estate taxes (or at least a substantial part of them). Query whether future cases will similarly focus on the use of partnership assets to pay estate taxes, even when the payment occurs in a sale and redemption transaction.

3. This raises an interesting question—what if the estate had retained enough assets to pay the gift and estate taxes? Would the transfer of substantial assets to the partnership, even on the decedent's deathbed, have avoided the application of §2036 when there was no other evidence of an implied agreement for retained enjoyment of the assets (i.e., because the $1.0 million in the bypass trust was enough to provide all of her living expenses for her life)? The estate could not have satisfied the bona fide sale exception (for the same reasons described above), but arguably there is no retained enjoyment of the partnership assets (express or implied) that would trigger the application of §2036(a)(1).

4. The IRS in prior cases has tried to argue that the partnership's payment of estate taxes could constitute §2036(a)(1) retained enjoyment. For example, the *Estate of Bassler* case (U.S. Tax Court, Docket 003532-02 (filed February 14, 2002)) was tried before Judge Thornton. The decedent contributed about $35 million to the FLP and kept about $6 million for living expenses. The IRS argued that she needed to retain assets to live on AND to pay estate taxes in order to avoid §2036(a)(1). The IRS wanted to introduce into evidence a cash flow summary including estate taxes (which the court did not allow to be introduced into evidence). (The case was settled after trial.) While the IRS has tried to make this argument previously, *Erickson* is the first case that explicitly focused on the payment of estate and gift taxes as the §2036(a)(1) trigger.

5. The question often arises as to how best to pay estate taxes if the estate does not have sufficient liquidity without using partnership assets. In this case, structuring the transaction as a purchase of an estate asset and as the redemption of the estate's interest in the partnership did not avoid the §2036(a)(1) taint. Using a loan, purchase, or redemption would still seem far preferable to merely having the partnership make a large distribution to the decedent's estate to get cash to the estate for paying estate taxes. If possible, it would be preferable for the estate to borrow the needed funds from a third party or from the beneficiaries. Another alternative would be to have third parties (perhaps family members or related entities) purchase limited partnership interests in the FLP from the estate to generate estate liquidity.

6. Management activities for some assets contributed to the partnership should change if centralized management is a nontax purpose of the partnership.

7. This is yet another case mentioning a lack of negotiations, the fact that one partner planned the entire transaction, and that the same law firm represented all parties.

8. This is also another case mentioning disproportionate distributions, but the court particularly focused on the fact that distributions were made only to the decedent (really the decedent's estate).

9. Finally, this is yet another case (reminiscent of *Rosen*) in which the court failed (or refused) to understand the potential asset protection advantages of owning limited partnership interests rather than owning assets directly.

American Bar Association | 321 N. Clark St. | Chicago, IL 60610 | 800.285.2221