POST MORTEM PLANNING—IT'S NOT TOO LATE TO PLAN: A REVIEW OF INCOME, GIFT AND ESTATE TAX PLANNING ISSUES AND STRATEGIES

May 2, 2016

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(This outline is excerpted from a considerably longer outline. Send an email to the author if you would like to receive the longer outline.)

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March 28, 2016

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POST MORTEM PLANNING—IT'S NOT TOO LATE TO PLAN: A REVIEW OF INCOME, GIFT AND ESTATE TAX PLANNING ISSUES

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I. INTRODUCTION

This outline is intended as a summary some of the "hot topics" and items of particular current interest. It is not an overall discussion of post mortem planning strategies, but it focuses on selected topics. A more complete (and much lengthier) outline is available from the author (akers@bessemer.com).

II. INCOME TAX PLANNING

As a precursor to all of the various income tax issues, the fiduciary (the executor, if any, if not, the testamentary trustee, residuary legatees or distributees) should file Form 56 to advise the IRS of the fiduciary relationship. § 6903 (references to a "§" refer to a section of the Internal Revenue Code unless the context clearly indicates otherwise); Treas. Reg. §§ 601-503 & 301.6903. Written notice of the termination of the fiduciary relationship should also be filed (on Form 56) with the same office where the initial Form 56 was filed. Treas. Reg. § 301.6903-1(b).

A. Decedent's Final Return.

1. Partnership and S Corporation Income.

For partnership tax years ending after 1997, section 706(c)(2)(A) provides that the taxable year of a partnership closes with respect to a partner whose entire partnership interest terminates by reason of death. Accordingly, the final return of a deceased partner includes the flow through items for the short year ending on the date of death. Under the section 706 regulations, the allocation for the short year is made by an interim closing of the partnership's books or, if all of the partners agree, on a pro rata basis based on the number of days in each period. See Reg. §1.706-1(c)(2)(ii). (It is generally preferable to elect out of the exact method" in order to avoid the expensive accounting costs of preparing a mid-year closing.)

Similarly, an S corporation deceased shareholder must include on his or her final return a pro rata share of S corporation income for the corporation's tax year that ends within or with the decedent's tax year. The decedent's final return must include the decedent's pro rata share of the S corporation's income for the period from the beginning of the year to the date of death, on a number of days allocation basis. §1377(a)(1). If all the shareholders agree, the allocation for the short year is made by an interim closing of the books.§1377(a)(2).

Partnership or C corporations may earn proportionately more income after the date of death than before. In that case, if the income is allocated on a pro rata per day basis (rather than using an interim closing of the books), more income will be allocated to the deceased partner's or shareholder's final income tax return. The additional income tax can be deducted for estate tax purposes as an estate liability. In addition, allocating more income to the decedent's final return may facilitate using any carryovers that terminate with the decedent's final return.

2. Net Operating Losses, Charitable Deduction and Capital Loss Carryovers.

Net operating loss (NOL) carryovers, charitable deduction carryovers and capital loss carryovers from a prior year are deductible only on the decedent's final income tax return. Any unused losses are lost. E.g., ILM 201047021 (estate's beneficiaries could not use estate's unused capital loss carryover). If an NOL arises from a net business loss appearing on the decedent's final return, the NOL may be carried back to previous years. §172(b)(1)(A)(i); Rev. Rul. 74-175, 1974-1 C.B. 52.

3. Executor's Liability for Decedent's Unpaid Income (as well as Gift or Estate) Taxes.

The executor may have personal liability if the executor makes a distribution which results in insufficient funds to satisfy the decedent's federal tax obligations. 31 U.S.C.A. §3713. (A major reason for filing the Form 56 is so the executor will receive notice regarding the decedent's tax liabilities to avoid unwittingly distributing assets before the liabilities are paid.) Case law has interpreted this statute to require three elements to establish personal liability under the statute: (i) the personal representative distributed estate assets; (ii) the distribution rendered the estate insolvent; and (iii) the distribution occurred after the personal representative had "inquiry notice" of the claim. Allen v. Commissioner*,* T.C. Memo 19990385. The executor does not have to have actual knowledge of the tax liability before personal liability can be imposed. It is sufficient if the executor has knowledge of facts that would make a reasonably prudent person aware of the existence of the liability. See e.g., Little v. Comm'r, 113 T.C. 474 (1999) (executor received Forms W-2 and Forms 1099 for the decedent and the estate; executor took forms to estate's attorney who advised executor that no taxes would be due because of the size of the estate; held that executor is not personally liable for unpaid income tax deficiencies of the decedent and of the estate, reasoning that receipt of the forms put the executor on "inquiry" notice, but concluding that the executor acted in a prudent and reasonable manner in forwarding the forms to the attorney for advice); Leigh v. Comm'r, 72 T.C. 1105, 1110 (1979) ("notice of such facts as would put a reasonably prudent person on inquiry as to the existence of the unpaid claim of the United States"). There is no necessity that the unpaid taxes have been formally assessed. Viles v. Comm'r, 233 F.2d 276 (6th Cir. 1956). Despite the Little case, reliance on erroneous tax advice may not be sufficient to avoid personal liability. United States v. Marshall, 116 AFTR 2d 2015-5694 (5th Cir. August 19, 2015), *substituted opinion in place of prior opinion at* 771 F.3d 854 (5th Cir. 2014) (executors liable for amounts paid to charities and for payments of various expenses without preserving funds to pay the IRS in case its gift tax claim proved valid; executors had sufficient notice of gift tax claim to put a reasonably prudent person on notice because they were told the IRS might assert a claim for unpaid gift tax; erroneous legal advice about how to address the claim was not a valid defense to liability under §3713); United States v. Renda, 709 F.3d 472 282-85 (5th Cir. 2013) (erroneous legal advice as to the validity of a claim is not an excuse under the Federal Priority Statute, noting that 5th Circuit had previously declined to follow Little); New v. Comm'r, 48 T.C. 671, 679 (1967) ("If a fiduciary is put on inquiry, the fact that he inquires wrongly or haphazardly is not enough and is no defense. To absolve petitioner because his inquiry turned out to be inadequate would be to reward the careless fiduciary and to put a premium on rapid cursory investigations."). Another example that may arise unexpectedly is that the executor may have liability for failing to report foreign accounts that were not reported by the decedent once the executor is put on inquiry notice. See Kapiloff & Brackney, Stuck With the Bill? An Executor's Personal Liability for Unreported Foreign Accounts, 111 J.TAX'N 168 (Sept. 2009).

Determining What Returns Have Been Filed. The executor may file Form 4506-T to make a written request for a "Record of Account" (provided free of charge) with the

appropriate IRS region to determine what tax returns have been filed by the decedent. The executor's letters of appointment and a Form 2848 Power of Attorney should be included with the request. Call 1-800-829-1040 for details.

Determining Income Items. The executor may file a written request with the appropriate IRS region for "All Information Returns" (provided free of charge) to ascertain information regarding income items reported as being received by the decedent. The executor's letters of appointment and a Form 2848 Power of Attorney should be included with the request. Information is available after August 1 for the prior year. Typically, six years of information is maintained by the IRS. Call 1-800-829-1040.

Obtaining Copies of Filed Returns. To obtain copies of returns that have been filed with the IRS by the decedent, the executor may file Form 4506, Request for Copy or Transcript of Tax Form. Income as well as gift tax returns may be requested. The executor's letters of appointment and a Form 2848 Power of Attorney should be included with the request. Copies of the returns are provided for a set fee per return. Call 1-800-829-1040 for details.

Estate's Liability for Income and Gift Taxes (§ 6501(d)). The executor can make a request for prompt assessment of income and gift taxes with respect to any prior returns filed by the decedent or the executor by filing Form 4810. Doing so shortens the statute of limitations on a future assessment (or court proceeding without assessment for collection of tax) to 18 months from the date the request is filed. The request must specify the classes of tax and the taxable periods for which prompt assessment is requested. Treas. Reg. §301.6501(d)-1(b). The shorter statute of limitations will not apply to fraudulent returns or unfiled returns (§ 6501(c)), any returns with "substantial omissions" (§6501(e)), or certain other types of assessments described in section 6501(c). Observe that the shorter statute of limitations under this section protects not just the executor from personal liability but also the estate and its beneficiaries.

Executor's Personal Liability for Income or Gift Taxes (§ 6905). For an example of personal liability of an executor for the decedent's gift taxes, see U.S. v. Bartlett, 186 F. Supp.2d 875 (C.D. Ill. 2002) (executrix-surviving spouse was clearly aware of gift tax liability and made distribution to family trust, of which she was trustee and sole current beneficiary, rendering estate insolvent; trust beneficiaries also liable as transferees). The executor may file Form 5495 (filed after the relevant tax return has been filed) requesting release from personal liability for the decedent's income and gift taxes. The IRS then has 9 months to notify the executor of any amount due. After that date, the executor is discharged from personal liability for any deficiency thereafter found to be due. §6905; Reg. §301.6905-1. The request should be filed with the IRS office where the relevant return was filed. After the nine-month period has run, the executor can safely distribute estate assets to beneficiaries without danger of being held personally liable for additional income or gift tax that may be assessed in the future. Filing the request for discharge of personal liability does not shorten the statute of limitations for the IRS to proceed against the estate (or the estate's transferees under transferee liability principles.) If the executor is also the sole beneficiary of the estate, filing this request does no good—the IRS could still proceed against the estate and the beneficiary directly. If the executor is one of various beneficiaries, the request for prompt assessment only protects the executor from the personal liability of an executor (but not in his or her capacity as a beneficiary) and does not protect the other family members at all. (The request for discharge under §6905 for past income or gift taxes is only available to executors; the request for discharge under §2204 for estate taxes can be made by executors or trustees, and for trustees the time period is only six months rather than nine months.)

Executor's Personal Liability for Estate Taxes (§ 2204). The executor may have personal liability for the estate taxes of the estate. (Indeed, the personal liability may not be dischargeable in bankruptcy if the executor willfully evades payment of the estate tax debt. Carroll v. U.S. 2009-2 USTC ¶60,577 (N.D. Ala. 2009)(executors failed to make all deferred estate tax installment payments but distributed the estate to themselves).) The executor may request a discharge from personal liability of estate tax after nine months from making an application (or if the application is made before the return is filed, nine months after the due date of the return). §2204(a); Reg. §20.2204-1. The executor is discharged from personal liability with respect to any deficiency in the federal estate tax found to be due after the expiration of such nine-month period. If any estate tax is deferred under sections 6161, 6163, or 6166, the executor can be released from personal liability by providing a bond (or a special lien under §6324A in the case of tax deferred under section 6166.) The request for discharge from personal liability is made by attaching Form 5495 to the estate tax return, or by filing Form 5495 after the Form 706 has been filed. Filing the request for discharge of personal liability does not shorten the statute of limitations for the IRS to proceed against the estate (or the estate's transferees under transferee liability principles.)

Planning Strategies If Executor's Personal Liability Extends Past Termination of Estate. If the executor is ready to distribute the estate while the executor has potential outstanding personal liability for income, gift or estate taxes, one of the following strategies may allow the executor to feel comfortable with distributing the assets (and terminating the estate) before the potential personal liability has been finally resolved: (1) funded escrow agreement with executor holding reserved funds; (2) refunding agreement with appropriate indemnification provisions obligating beneficiaries to deliver funds to pay personal liability obligations of the executor; (3) creation of grantor trusts by beneficiaries with direction to deliver funds to executor to protect against personal liabilities; or (4) creation of limited liability company, with executor as sole manager with authority to distribute assets to executor to pay personal obligations for taxes.

B. Planning Considerations for Estate's Fiduciary Income Tax Return, Form 1041.

1. Consider Fiscal Year.

A decedent's estate may elect a non-calendar fiscal year as long as the first year does not exceed 12 months and the year ends on the last day of the calendar month. § 441(e); Reg. § 1.441-1T(b). The estate selects its fiscal year by filing the estate's initial Form 1041 with the selected year-end. Reg. §1.441-1(c)(1). (There is no requirement that the election be made on a timely filed return.) Considerations in the selection of a non-calendar fiscal year include (1) deferring payment of income tax by the estate, (2) deferring beneficiaries' income tax on distributions, by allowing them to report the income in a taxable year after when the distribution was received in certain circumstances, and (3) using an initial short year to split income into two separate years, (4) if death occurs near the end of a calendar year, to allow additional time to generate deductions (for example, payment of fees) and to minimize the number of estate income tax returns required to be filed.

2. Administrative Expense Deductions; Consider Whether to Deduct Administration Expenses on Income Tax or Estate Tax Return; "Hubert Regulations".

Administration and casualty losses are deductible in computing the taxable income of the estate, even if those expenses are chargeable to principal under state law. §§165, 212, 641. Section 642(g) provides that no income tax deduction can be allowed for such expenses unless a statement is filed in duplicate before the limitations period runs on the income tax return waiving the right to deduct those items on the estate tax return.

The IRS has issued final regulations in response to the Supreme Court discussion of the prior regulation in Hubert v. Commissioner, 520 U.S. 93(1997).) Treas. Reg. §§20.2013-4(b)(3), 20.2055-3, & 20.2056(b)-4(d). Fortunately, the new regulation recognizes that the payment of certain administration expenses will not require a dollar for dollar reduction of the marital or charitable deduction (as the IRS had argued under the prior regulation). However, the regulation has a variety of restrictions and limitations on when the payment of administration expenses will not require a reduction of the marital or charitable deduction. The regulation provides that "estate management expenses" may be deducted as an income tax deduction (but not as an administrative expense for estate tax purposes) without reducing the marital or charitable deduction. However, administration expenses that constitute "estate transmission expenses" will require a dollar for dollar reduction in the amount of marital or charitable deduction.

Estate management expenses are "expenses incurred in connection with the investment of the estate assets and their preservation and maintenance during a reasonable period of administration. Examples of these expenses include investment advisory fees, stock brokerage commissions, custodial fees and interest." Treas. Reg. §§20.2055-3(b)(1)(i) & 20.2056(b)-4(d)(1)(i).

Estate transmission expenses (which must reduce the amount of the marital or charitable deduction if they are paid out of assets that would otherwise pass to the surviving spouse or to charity) means all estate administration expenses that are not estate management expenses. Estate transmission expenses include expenses incurred as a result of the "consequent necessity of collecting the decedent's assets, paying the decedent's debts and death taxes, and distributing the decedent's property to those who are entitled to receive it." Treas. Reg. §§20.2055-3(b)(1)(ii) & 20.2056(b)-4(d)(1)(ii).

The marital or charitable deduction must be reduced by the amount of any estate management expenses that are "paid from the marital [or charitable] share but attributable to a property interest not included in the marital [or charitable] share." Treas. Reg. §20.2055-3(b)(4) [charitable share] & §20.2056(b)-4(d)(1)(iii)(4) [marital share].

The marital or charitable deduction must be reduced by the amount of any estate management expenses "that are deducted under section 2053 on the decedent's Federal estate tax return." Treas. Reg. §§ 20.2055-3(b)(3) & 20.2056(b)-4(d)(3).

In summary, for estates governed by the final regulations, **estate management expenses** should always be deducted on the income tax return if there is a substantial marital or charitable deduction. Taking an estate tax deduction would not result in any estate tax savings, and would forego getting any income tax savings. On the other hand, for **estate transmission expenses** there is no clear answer. Taking a current income tax deduction will usually increase the estate tax (or under a marital deduction formula clause, may operate to decrease the amount of assets passing to the non-marital share.) However, deducting estate transmission expenses on the income tax return may yield more savings if the marginal income tax bracket exceeds the marginal estate tax bracket or if the surviving spouse's estate is not subject to estate tax because of future law changes and increases in the estate tax exemption amount and reductions to the estate tax rates.

Many planners are now starting to take the position that at the first spouse's death, unless the income tax bracket is very low or unless the parties expect huge appreciation, the family is probably better off deducting transmission expenses on the income tax return rather than the estate tax return. That has the effect of reducing the bequest to the bypass trust. However, the idea is to take the "Bird in the hand" income tax savings in light of the uncertainty of the estate tax savings that may be achieved years later with the bypass trust.

Another exception might be if the surviving spouse is expected to die in the next several years, and there would not be much appreciation in the bypass trust assets. While many attorneys are tending to take the deduction on the 1041 now and give up on the bypass trust reduction, there is no one answer that fits all.

If the surviving spouse can pay the transmission expenses directly, doing so may give an optimal result. (The spouse would pay expenses under the rationale that much of the advice is to advise the surviving spouse.) That reduces the surviving spouse's taxable estate, but she would not get an immediate income tax deduction—unless it is an expense deductible under §212. (Furthermore, § 212 is not a perfect deduction; for example there is the 2% floor.) Similarly, it should be possible to allocate part of fee to the marital trust.

3. Effect of Two Percent Floor on Miscellaneous Itemized Deductions.

a. Issue. Does the "2% haircut rule" in §67(e) apply to investment advisor fees of trusts—i.e., can investment advisor fees be deducted only to the extent that "miscellaneous itemized deductions" of the trust exceed 2% of the trust's adjusted gross income?

b. Section 67. Under §67(a) miscellaneous itemized deductions may be deducted only to the extent that they exceed 2% of adjusted gross income. Under §67(e) the same rules apply to estates and trusts, except that "the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate" are allowed in full. This exception has been analyzed under a two prong test: (1) costs paid or incurred in connection with the administration of the estate or trust, and (2) which would not have been incurred if the property were not held in such trust or estate.

c. Overview Summary of Tests From Circuit Level Courts of Appeal to Meet the "Second Prong" Requirement. All agreed that the statute is clear and unambiguous. However, circuit level courts had reached differing conclusions as to the appropriate test for the second prong requirement. William J. O'Neill Jr. Irrevocable Trust v. Commissioner, 994 F.2d 302 (6th Cir. 1993), nonacq., 1994-2 C.B. 1. (costs are "incurred because of fiduciary duties"); Mellon Bank, N.A. v. United States, 265 F.3d 1275 (Fed. 2001) (costs are "not commonly incurred by individuals"); Scott v. United States, 186 F. Supp.2d 664 (E.D. Va. 2002) , aff'd, 328 F.3d 132 (4th Cir. 2003) (costs are "not commonly incurred by individuals"); Rudkin Testamentary Trust v. Commissioner, 467 F.3d 149 (2nd Cir. 2006) (costs that individuals "are incapable of incurring," giving as examples, trustee fees, judicial accountings, and fiduciary income tax returns). []

d. Supreme Court Approach. The Supreme Court considered the Rudkin appeal under the name Michael J. Knight, Trustee of the William L. Rudkin Testamentary Trust v. Commissioner, 552 U.S. 181 (2008). The Supreme Court held in favor of the government, but it did not agree with the Second Circuit's test. The Court adopts the "unusual or uncommon" test used by the Fourth and Federal Circuits and concludes generally that "§67(e)(1) excepts from the 2% floor only those costs that it would be *uncommon (or unusual, or unlikely*) for such a hypothetical individual to incur." (emphasis added) In applying this general test to investment advisory fees, the Court observes that a trust's investment advisory fees are often incurred to comply with the prudent investor standard, which is a standard based on "what a prudent investor with the same investment objectives handling his own affairs would do — *i.e.,* a prudent individual investor." In light of that "it is quite difficult to say that investment advisory fees 'would not have been incurred' — that is,

that it would be unusual or uncommon for such fees to have been incurred — if the property were held by an individual investor with the same objectives as the Trust in handling his own affairs." [Observation: That seems a real reach. Taxpayer's attorneys were unable to locate statistical data on how many individuals hire investment advisors — as opposed to investing through mutual funds or with a commission based broker (where the expenses are netted against income and are not subject to the §67 limitations in any event.)] In light of the Court's reasoning, it does not seem possible for trusts to argue that individuals in the same financial situation as the trust would not commonly hire an investment advisor.

The Court does acknowledge several exceptions. The Court recognizes, as the government conceded, that "some trust-related investment advisory fees may be fully deductible '*if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts.*'" (emphasis added). In addition, the court observed that "a trust may have an *unusual investment objective*, or may *require a specialized balancing of the interests of various parties*, such that a reasonable comparison with individual investors would be improper. In such a case, the incremental cost of expert advice beyond what would normally be required for the ordinary taxpayer would not be subject to the 2% floor." (emphasis added). In addition, the Court impliedly recognized that the IRS could provide regulatory guidance in stating "that the inquiry into what is common may not be as easy in other cases, particularly given the absence of regulatory guidance." Regulations could provide more practical guidance as to when investment advisory fees of trusts or estate are not subject to §67.

e. <u>Initial Proposed Regulations</u>. Proposed regulations were issued after the Supreme Court accepted certiorari in <u>Rudkin</u> but before the Supreme Court decided the case. They use a standard similar to the very strict test in <u>Rudkin</u>, and add that executor and trustee fees must be "unbundled" to identify the portion of the fee representing services that are unique to estates and trusts. Prop. Reg. §1.67-4. The proposed regulation provides that a cost incurred by an estate or non-grantor trust that is unique to the entity is not subject to the 2-percent floor, but costs that are not unique to estates or trusts are subject to the 2-percent floor. Prop. Reg. §1.67-4(a). Following the issuance of the *Knight* case, the IRS requested comments in Notice 2008-32 regarding the position that regulations should take regarding §67(e).

f. <u>Interim Guidance Regarding Unbundling Requirement for 2007-2011 Returns</u>. The unbundling requirement under the proposed regulations is not applied to returns for taxable years beginning before final regulations are issued. Notice 2008-32 (2007 returns), Notice 2008-116 (2008 returns)), Notice 2010-32 (2009 returns), and Notice 2011-37 (taxable years beginning before issuance of final regulations).

g. <u>2011 Proposed Regulations and 2014 Final Regulations</u>. The IRS issued a new set of proposed regulations on September 7, 2011. While the new proposed regulations change the semantics (no longer addressing expenses that are "unique" to estate and trust administration), but the effect is much the same as the prior proposed regulations. The IRS finalized the regulations on May 9, 2014, with very few changes from the proposed regulations. In particular, the unbundling requirement was retained. The final regulations apply to any taxable year of any trust or estate that begins on or after January 1, 2015.

Highlights of the final regulations include the following.

- The allocation of costs of a trust or estate that are subject to the two-percent floor is based not on whether the costs are "unique" to trusts or estates (as in the prior proposed regulations), but whether the costs "commonly or customarily would be incurred by a hypothetical individual holding the same property."
- In making the "commonly or customarily incurred" determination, the type of product or service actually rendered controls rather than the description of the cost.
- "Commonly or customarily" incurred expenses that are subject to the two-percent floor include costs in defense of a claim against the estate that are unrelated to the existence, validity, or administration of the estate or trust.
- "Ownership costs" that apply to any owner of a property (such as condominium fees, insurance premiums, maintenance and lawn services,etc. [other examples are listed]) are subject to the two-percent floor. Expenses that are deductible under §§62(a)(4), 162, or 164(a) may be fully deductible because they would not be miscellaneous itemized deductions subject to §67(e).
- A safe harbor is provided for tax return preparation costs. Costs of preparing estate and GST tax returns, fiduciary income tax returns, and the decedent's final income tax return are not subject to the two-percent floor. Costs of preparing all other returns are subject to the two-percent floor. (Interestingly, gift tax returns are not included. What if the estate has protracted litigation over gift tax issues—are all of those expenses subject to the 2% rule?)
- Investment advisory fees for trusts or estates are generally subject to the 2% floor except for certain incremental fees (above what is normally charged to individuals). Those incremental fees that are not subject to the 2% rule are (i) an "additional charge that is added solely because the investment advice is rendered to a trust or estate rather than to an individual," or (ii) an additional charge "attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen)." If an investment advisor charges an extra fee to a trust or estate because of the "usual" need to balance the varying interests of current beneficiaries and remaindermen, those extra charges *are* subject to the two-percent floor. The incremental portion of investment advisory fees not subject to the 2% floor "is limited to the amount of … fees, if any, that exceeds the fees normally charged to an individual investor. (Excepting only "specialized balancing" expenses but not "usual balancing" expenses from §67 seems unfair. Individuals have no need for balancing the interests of various parties, so it would seem that all additional expenses for balancing the interests of beneficiaries would be different than expenses "commonly" incurred by individuals.) Determining what types of expenses for balancing the interests of various trust beneficiaries is sufficiently "specialized" or "unusual" will require careful consideration by fiduciaries. *See* McGuire Woods, *IRS Publishes Final Regulations Under Section 67 on Deductibility of Fiduciary Expenses; Postpones Effective Date* (August 6, 2014).
- Bundled fees (such as a trustee or executor commissions, attorneys' fees, or accountants' fees) must be allocated between costs that are subject to the two-percent floor and those that are not.
- A safe harbor is provided in making the allocation of bundled fees. If a bundled fee is not computed on an hourly basis, only the portion of the fee that is attributable to investment advice is subject to the two-percent floor. All of the balance of the bundled fee is *not* subject to the two-percent floor (This exception may seem overly broad as applied to attorneys' and accountants' fees, but the exception is explicit. If attorneys or accountants charge on a project basis rather than on an hourly basis, there is no need to unbundling any of the fees if none of them relate to investment advisory expenses.)

- If the recipient of the bundled fee pays a third party or assesses separate fees for purposes that would be subject to the two-percent floor, that portion of the bundled fee will be subject to the 2% floor.
- Any reasonable method may be used to allocate the bundled fees. The Preamble to the proposed regulations provides that detailed time records are not necessarily required, and the IRS requested comments for the types of methods for making a reasonable allocation, including possible factors and related substantiation that will be needed. The IRS was particularly interested in comments regarding reasonable allocation methods for determining the portion of a bundled fee that is attributable to investment advice — other than numerical (such as trusts below a certain dollar value) or percentage (such as 50% of the trustee's fee) safe harbors, which the IRS suggests that it will not use.

The Service received only one comment about allocating bundled expenses- stating that no single standard could be applied to multiple trusts or even to the same trust in different years. The final regulations provide three facts that may be considered (among others) in making a "reasonable" allocation:

> Facts that may be considered in determining whether an allocation is reasonable include, but are not limited to, the percentage of the value of the corpus subject to investment advice, whether a third party advisor would have charged a comparable fee for similar advisory services, and the amount of the fiduciary's attention to the trust or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions.

Commentators observe that even if the percentage fee that is charged for investment advisory services and trustee fees is about the same, there are big differences between the services required for investment advisory and trustee services.

> There's a huge difference between acting as a trustee and acting as an investment advisor. A trustee has aggregate responsibilities that far transcend those of an investment advisor—including making mandatory and discretionary distributions to beneficiates, addressing the needs of disabled beneficiaries and those in difficult or special circumstances, engaging in tax planning, allocating receipts and disbursements between income and principal according to legal standards and assembling and rendering fiduciary accountings. Charles A. Redd, *Don't Forget to "Unbundle" for Winter!*, Trusts & Estates 14, 16 (Nov. 2014).

In the future, trustees may tend to make investments through mutual funds rather than through common trust funds or by direct investments, because the investment expense of administering a mutual fund is netted out before the taxable income from the fund is determined. Thus, there is not an issue of having a separate expense that is not fully deductible (or that is subject to the alternative minimum tax).

h. Unbundling Requirement. The Second, Fourth and Sixth Circuit level courts provided that trustee fees are deductible, without any suggestion that a portion of them would be nondeductible.

The Supreme Court did not discuss the unbundling requirement that had been suggested by the IRS in the proposed regulations, either in oral argument or in the *Knight* opinion. A concern with subjecting trustee fees or corporate trustees to the unbundling requirement is that many times there is very little difference between trustee fees and investment management fees that are charged by financial institutions, so most trustee fees

might arguably be nondeductible — which seems contrary to the dictum in three circuit level cases (and no case has suggested to the contrary). This is quite unfortunate because most families do not use investment advisors (as compared to using mutual funds or commission-based brokers) but any family needing a professional trustee to make sure that all of the fiduciary duties of trustees in protecting the interests of all beneficiaries are met will have to pay a trustee fee. As a practical matter, the trustee fee is incurred only because the assets are in trust. Furthermore, a significant portion of the fee paid to professional trustees represents time spent in communicating with beneficiaries and handling the many wide-ranging administrative and fiduciary duties of trustees. To the extent that corporate trustees charge about the same for investment management fees as for trustee fees means that they in effect are undercharging for the investment advice to trusts. This is widely understood, and planners have hoped that the IRS would take a "real world" approach of generally recognizing that trustee fees are, by their nature, expenses that would not have been incurred if the property were not held in trust. In light of the difficulty of unbundling fees, planners have hoped that the IRS will be sensitive to adopting an approach that is workable and practical in the real world.

Some commentators questioned the authority of the IRS to require unbundling of fiduciary commissions. Interestingly, the IRS used the Supreme Court's *exception* meant to favor taxpayers by allowing full deductibility of investment advisory fees in some circumstances as a rationale to support the requirement to unbundle all fiduciary fees. Many comments objected to unbundling because of the cost and administrative difficulty of doing so, perhaps requiring expensive software to track and measure the value of the various types of services provided. The IRS response is that the proposed regulations address reducing the administrative burden because they "limit the costs that are subject to allocations" under §67(e) and allow "any reasonable method to perform such allocations." [Observation: The limitations of costs subject to the §67 allocation in the proposed regulations are (i) that return preparation expenses for certain tax returns are excepted and (ii) for unbundled fees not computed on an hourly basis, the portion of the fee that is not attributable to investment advice is not subject to the two-percent floor [although there are exceptions to even that]. Of course, that sidesteps the difficult issue — which is determining the portion of the bundled fee that is attributable to investment advice, and no kind of safe harbor is offered for that critical issue.]

i. <u>AMT Effect of Being Type of Expense Subject to 2% Floor</u>. Section 63(d) defines "itemized deductions" to mean deductions other than (1) deductions allowed in arriving adjusted gross income and (2) the deduction for personal exemptions. Therefore, if an investment advisory expense "flunks" §67(e), it is an "itemized deduction." Section 67(b) says that "miscellaneous itemized deductions" includes all "itemized deductions" other than 12 specific deductions listed in §67(b), none of which covers investment advisory expenses. In computing alternative minimum taxable income, §56(b)(1)(A) provides (among many other adjustments) that "No deduction shall be allowed – (i) for any miscellaneous deduction (as defined in section 67(b)." Therefore, if an investment advisory expense does not come within the §67(e) exception for trusts and estates, all of the expense (not just the amount within 2% of adjusted gross income that cannot be deducted) is a tax preference item for alternative minimum tax purposes.

The AMT effect can be much larger than the effect of not being able to deduct expenses that do not exceed 2% of adjusted gross income. For example, assume a trust has $100,000 of investment advisory expenses, and $100,000 of adjusted gross income.

Despite the 2% rule, the trust can still deduct $98,000 for taxable income purposes, resulting in negligible "regular" income tax. However, for AMT purposes, no deduction would be allowed; after reduction for the $22,500 AMT exemption, the 26% tentative AMT tax is roughly $20,000.

The AMT effect is carried through to beneficiaries who receive trust distributions in excess of the trust's taxable income. Although the beneficiary will not have any taxable income if the trust has $100,000 in gross income and $100,000 in deductions, the K-1 to the beneficiary will report the $100,000 as an adjustment that must be added back for AMT purposes on the beneficiary's tax return. Distributions carry out regular taxable income first to the beneficiaries, leaving tax preferences in the trust. If distributions are less than taxable income, the AMT tax preferences stay in the trust. Excess distributions carry out tax preferences to the beneficiaries. Carol Cantrell says that the ideal plan, for AMT purposes, is for the trust to distribute more than its taxable income but less than the AMTI, and to split the preferences between the trust and the beneficiaries (because each taxpayer has its own AMT exemption). "Distributions are a dynamite cure for both the 2% rule and the AMT."

j. Effect on Trust Beneficiaries. If the 2% limitation applies, the effect will be to increase DNI — so there will be a larger hit to beneficiaries of the DNI carryout. A trustee may take the position that the 2% rule does not apply to the payment of certain investment advisory fees because they represent an "incremental cost … beyond what would ordinarily be required for the ordinary taxpayer." If the IRS reverses that position on audit and if that has the effect of disallowing some deductions, the most significant concern is for beneficiaries who received distributions (and had trust income carried out to them up to the amount of the trust's DNI) and who may have to go back tax returns and pay penalties and interest.

k. Trust Distributions Reduce Trust AGI and Minimize the Impact of §67. The distribution deduction is subtracted in arriving at the adjusted gross income of the trust (and the 2% limit under §67 is based on the adjusted gross income). For example, if the trust distributes enough so that the adjusted gross income, after subtracting the distribution deduction, is $10,000 and if there are $10,000 of administration expenses, then there is only a $200 "hit" even if the 2% rule applies. If the trust distributed even more, the trust would get more distribution deduction and drive the AGI even lower, but then the trust would lose the benefit of the $10,000 of administration expenses.

l. Not Subject to Overall Limit on Itemized Deductions under §68. Unlike individuals, estates are not also subject to an overall limitation on itemized deductions under section 68, which (for individuals only) generally reduces the overall allowable itemized deductions (even after taking into account the two percent floor on "excess itemized deductions") by the lesser of (1) 3% (2% in 2006-2007 and 1% in 2008-2009) of the excess of adjusted gross income (AGI) over an indexed "applicable amount" or (2) 80% of the itemized deductions. §§68(a), 68(f)(2). The applicable amount was increased beginning in 2013 to $300,000 for a joint return, or $250,000 for a single individual, indexed from 2013. §68(b).

m. Planning Suggestion for Documenting Investment Adviser Fees and Trustee Fees. In light of the Knight decision, Carol Cantrell (an attorney and CPA in Houston, Texas) recommends preparing a separate fee agreement for investment advisers, spelling

out the special balancing requirements for trustees, the necessity of investing in accordance with the requirements of the Prudent Investor Act, the particular needs of the beneficiaries, etc. There was not any special fee agreement in the facts of the Knight case.

Carol Cantrell also recommends that institutional trustees document the unique things that the trustee does, such as closely reviewing the trust agreement, evaluating situs issues, complying with federal and state filing requirements, evaluating whether to exercise the power to adjust, evaluating requirements for distributions, determining whether to make distributions in cash or in kind, evaluating income tax planning for the trust, evaluating the GST implications of trust distributions, evaluating the tax impact of distributions, etc. (Those things are 98% of the value that the trustee brings; the "stock picking" is the last thing that the trustee does.)

n. Calculation of 2% Floor is Complicated. Calculating the 2% floor is an interrelated calculation if the trust pays the beneficiary more than its DNI. Carol Cantrell says: "The AGI depends on the distribution deduction, which is limited by DNI, which depends on the trust's allowable miscellaneous itemized deductions (AMID), which depend on its AGI. Thus we have a circular calculation that requires an algebraic formula found only in the IRS instructions to Form 1041, p. 17-18."

o. Legislative Proposals; Revenue Cost. There have been some considerations of a legislative proposal to delete the delete the second clause of §67(e)(1) ("and would not have been incurred if the property were not held in such trust or estate"). The AICPA Society has prepared an impressive letter supporting the proposal, listing 11 reasons why such repeal makes sense. The Joint Tax Committee released its score on the proposal, estimating a $3.6 billion cost over a 10-year budget window. However, "most everyone who has studied this issue believes that the JTC estimate is grossly overstated based on current IRS statistical data."

4. Election Under §645 to Treat Revocable Trust as Part of Grantor's Estate.

a. Overview. The Taxpayer Relief Act of 1997 permits the executor of an estate and the trustee of a "qualified revocable trust" to treat the trust as part of the estate (and not as a separate trust) for income tax purposes for all taxable years of the estate ending after the date of the decedent's death and before the "applicable date". This change was made as the culmination of a long term planning project generally to treat estates and revocable trusts in a similar manner for income tax purposes.

b. Maximum Election Period; Procedures for Making Election. The election period begins on the date of the decedent's death and terminates on the earlier of (1) the day on which both the electing trust and related estate, if any, have distributed all of their assets, or (2) the day before the "applicable date." Treas. Reg. § 1.645-1(f)(1). The term "applicable date" means (A) if no estate tax return is required to be filed, the date that is 2 years after the date of the decedent's death, and (B) if an estate tax return is required to be filed, the date that is 6 months after the date of the final determination of the estate tax liability. §645(b)(2). The final regulations provide that the of the liability is the date that is the earlier of six months after the date the closing letter is issued or various other events (none of which will apply to most estates).. See Treas. Reg. § 1.645-1(f)(2)(ii).

Therefore, the section 645 election generally will terminate twelve months after issuance of the closing letter. (This raises the specter of theoretically being able to keep the election period open indefinitely if the estate does not request to receive a closing letter in

light of the IRS announcement estate tax closing letters will be issued only upon request by the taxpayer. That will not keep the election period open indefinitely, however, because another of the limiting factors is when the period runs on additional IRS assessments.)

If an estate tax return is filed to make the portability election for an estate that is not otherwise required to file a return, is the return "required" for purposes of §645? The Preamble to the §1411 proposed regulations states that an estate tax return is treated as "required" in that circumstances for purposes of §645.

The election must be made not later than the time prescribed for filing the income tax return for the first taxable year of the estate (including extensions) and, once made, is irrevocable. § 645(c); Treas. Reg. § 1.645-1(e)(1).

The mechanical procedures for making the election are revised under the final regulations (which apply for decedents dying on or after December 24, 2002). If there is an executor, the executor and trustee of the QRT make the election by signing and filing Form 8855 (which was issued in March 2004). The election form must be filed by the due date (including extensions) for filing the Form 1041 for the first year of the estate (regardless of whether there is sufficient income to require the filing of that return.) Treas. Reg. § 1.645-1(c)(1)(i). If there is no executor, the trustee of the QRT (or trustees of multiple QRTs) must file the election form by the due date (including extensions) for the first taxable year of the electing trust. Treas. Reg. § 1.645-1(c)(2).

c. Obtaining TINs and Filing Short Year Return. The final regulations revise the approach of the proposed regulations by requiring that the QRT obtain a TIN after the death of the deceased owner (whether or not the election will be made and whether or not there is an executor for the estate). The trustee must furnish that number to payors to the trust after the decedent's death. Treas. Reg. § 1.645-1(d)(1). There is no requirement for the trust to file a short year return from the date of death to December 31 of that year if a section 645 election will be made. However, the final regulations retain the requirement that the Form 1041 be filed for the short taxable year from the date of death to December 31 if the section 645 election will not be made or if the trustee and executor are uncertain whether a section 645 election will be made (whether or not there is an executor). If the election is not made and if the trust has not filed a timely return, the QRT will be subject to penalties and interest. Treas. Reg. § 1.645-1(d)(2).

d. Various Tax Effects of Making Election to Treat Revocable Trust as Part of Grantor's Estate. Some of the income tax benefits that may result from electing to treat a revocable trust as part of the decedent's estate include the following:

- availability of a fiscal year under §644, Treas. Reg. § 1.645-1(e)(3)(i);
- no estimated tax obligation for 2 years after the decedent's death, Treas. Reg. § 1.645-1(e)(4);
- availability of the permanent set-aside charitable deduction under section 642(c)(2), Treas. Reg. § 1.645-1(e)(2)(iv) & (e)(3)(i);
- eligibility to hold S corporation stock without meeting special trust rules (which would permit the trust to hold S corporation stock for a somewhat extended period of time, because if a federal estate tax return is required the § 645 election applies until 6 months after the date of the final determination of the estate tax liability), Treas. Reg. § 1.645-1(e)(3)(i); see Rev. Rul. 76-23, 1976-1 C.B. 264 (estate exception applies for the reasonable period of estate administration and applies for entire section 6166 deferral period);
- waiver of the § 469 passive loss active participation requirement for rental real estate for 2 years after death, which allows using the estate's exemption under section

469(j)(4) to use up to $25,000 in losses from rental real estate activities, even if the losses exceed the estate's passive income, Treas. Reg. § 1.645-1(e)(3)(i);

- using the $600 personal exemption available to an estate rather than either a $300 or $100 exemption available to trusts (depending on whether the trust is a simple or a complex trust), Treas. Reg. § 1.645-1(e)(2)(ii)(A);

- allowing losses in funding pecuniary bequests under section 267(b)(13);

- simplifying the number of returns (and K-1s) if the trust meets the requirements to permit filing only an estate Form 1041 and not a separate trust Form 1041;

- deferral of payment of income tax on income earned after the date of death until the due date of the estate's fiduciary return (which could result in up to eleven additional months of deferral—which would apply if the grantor were to die in December); and

- tax items of one entity (such as passive activity losses, net operating losses, capital losses, or investment interest) that would otherwise be nondeductible may offset the other entity's corresponding items of income, thus reducing the aggregate current income tax (but complications may arise in allocating the tax benefits and tax amounts between the estate and revocable trust)

One disadvantage of making the section 645 election is that the revocable trust will have to give up the benefit of an additional personal exemption and use of the lower income tax brackets that would otherwise be available to the trust. In addition, there may be additional administrative costs. For example, an allocation will have to be made of the benefit or cost of various tax effects between the trust and the estate (because they remain separate legal entities even though merged for tax purposes).

5. Income in Respect of a Decedent Deduction.

Income in respect of a decedent (IRD) is, generally speaking, income that was earned before the decedent's death, but that was received after his death. In order to avoid allowing a cash basis taxpayer to avoid paying income tax on such items of income, the code provides that IRD is taxed upon receipt by the estate or other beneficiary. §691(a)(1). Furthermore, to avoid double estate and income taxation on the same amount, an income tax deduction is allowed against IRD income, when it is received by the estate or by a beneficiary for the federal estate tax attributable to the IRD income. §691(c). (The estate or beneficiary is entitled to the section 691(c) deduction for the year that the IRD income is received by the estate or beneficiary, even if the estate tax has not yet been paid. Field Service Advice 200011023.) This mitigates double taxation (estate tax and income tax) on the same IRD item. The §691(c) deduction achieves a result roughly comparable to the decedent having paid an income tax on the item and deducting that income tax from the gross estate for estate tax purposes, if the income tax bracket of the recipient is the same as that of decedent.

There is not a complete offset of the double tax because the §691(c) deduction is only allowed for the federal estate tax—but not the state inheritance taxes—attributable to the income in respect of decedent items. The fact that state estate taxes are deductible under §2058 does not remove the double tax with respect to state estate tax on income in respect of a decedent. (Indeed, the overall tax cost of IRD is even higher than before because the state estate tax on the IRD is merely a deduction rather than a credit for federal estate tax purposes, and the state tax is not considered in the §691 deduction.) In some cases, recognizing the IRD income before death will result in lower overall taxes. See Blattmachr

& Gans, Planning for IRD After Elimination of the State Death Tax Credit, 33 EST. PL. 3 (March 2006).

The estate tax is computed on the net value of the IRD (IRD amount minus deductions in respect of decedent.) The estate tax attributable to the IRD is calculated using an incremental and not an average tax approach (this is done by recomputing the estate tax as though the net value of the IRD had not been included in the gross estate.) Reg. §1.691(c)-1(a). The person who receives the IRD is the person entitled to the §691(c) deduction, whether (1) that person receives a distribution of the right to the IRD from the estate prior to its receipt, or (2) the estate receives the IRD payment, which is then distributed to a beneficiary carrying out DNI including the IRD amount. Reg. §1.691(c)-2.

DNI and the distributions deductions are calculated without regard to the §691(c) deduction, and the §691(c) deduction is then apportioned between the estate and the beneficiaries. Reg. §1.691(c)-2. The beneficiaries deduct the §691(c) deduction allocable to them on their separate returns. The part, if any, of the §691(c) deduction apportioned to the estate is deducted by the estate in computing its taxable income (even though it does not reduce DNI).

If the estate or beneficiary transfers the right to receive the IRD item before receipt, the estate or beneficiary is treated as having received the fair market value of the right at the time of the transfer. §691(a)(2).)

If an item of IRD is distributed by an estate to a beneficiary, the distribution likely does not carry out DNI to the beneficiary. Several cases have held that a distribution of IRD (before recognized by the estate) "is treated as a neutral event, and is not subject to the distribution rules of Secs. 661 and 662." Dean Estate v. Comm'r, T.C. Memo 1983-276. See also Rollert Residuary Trust v. Comm'r, 752 F.2d 1128 (6th Cir. 1985). (However, in those cases the IRD asset had a zero basis, so its distribution would not carry out DNI absent an election under section 643(e)(3).) A distribution of an IRD item with basis, such as an installment note, probably would carry out DNI to the extent of the basis. Cf. Rev. Rul. 68-195, 1968-1 C.B. 305 (distribution of right to receive future payments under section 736(a) of the Internal Revenue Code of 1954, is not property distributed in kind for purposes of the deduction provisions of section 661(a)). When the actual IRD amount is received by the beneficiary, it will be taxed to him or her at that time.

6. New Higher Income Tax Brackets Under ATRA.

The American Taxpayer Relief Act of 2012 (ATRA) extended the income tax provisions of the 2001 Act except that the top income tax bracket for individuals is increased to 39.6% for *taxable income* in excess of indexed threshold amounts, which, for 2013, were $450,000 for married individuals filing joint returns, $425,000 for heads of households, $400,000 for unmarried individuals (other than surviving spouses and heads of households), and $11,950 for estates and trusts. These numbers for 2014 are $457,600, $433,200, $406,750, and $12,150, respectively. Rev. Proc. 2013-35, 2013-47 I.R.B. 537. The numbers for 2015 are $464,850, $439,000, $413,200, and $12,300, respectively. Rev. Proc. 2014-61, 2014-47. The numbers for 2016 are $466,950, $441,000, $415,050, and $12,400 respectively. Rev. Proc. 2015-53, 2015-44 I.R.B.

The 2003 Act reduced the maximum rate on most long-term capital gains to 15% and applied the same 15% rate to "qualified dividends." Under ATRA, the rates on qualified

dividends and long-term capital gains are adjusted by adding new 15% and 20% brackets (i.e., the top "general" rate is increased to 20% for high income taxpayers to which the 39.6% rates apply).

7. 3.8% Tax on Net Investment Income.

a. Basic Statutory Structure. The tax on "net investment income" was technically part of the Health Care and Education Reconciliation Act of 2010, which was passed one week after the Patient Protection and Affordable Care Act, but the two statutes are collectively called the Affordable Care Act.

Section 1411 imposes a surtax (in addition to federal income taxes) of 3.8% on the unearned income of individuals, estates, and trusts for taxable years beginning after December 31, 2012. For individuals, the tax is 3.8% of the lesser of —

(i) the individual's modified adjusted gross income in excess of a threshold amount ($200,000 for individuals and $250,000 for couples), or

(ii) the individual's net investment income for the year.

For estates and trusts, §1411(a)(2) imposes a tax equal to 3.8% times the lesser of —

(i) the estate's or trust's adjusted gross income (as defined in §67(e)) in excess of the highest income tax bracket threshold ($11,950 for 2013, $12,150 for 2014, $12,300 for 2015, $12,400 for 2016), or

(ii) the estate's or trust's undistributed net investment income.

The threshold for individuals is not indexed. The threshold for estates and trusts is the dollar value for the highest income tax bracket for estates and trusts, which is indexed, but which is a very low number. Multiple estates and trusts cannot be used to avoid the net investment income tax (because all of Chapter 1 of the Code is intended to apply and §643 is in Chapter 1).

The net investment income tax is a complement to the payroll taxes on wages. Payroll taxes on wages consist of 6.2% for Old-Age, Survivors and Disability Insurance (subject to a wage base limit) and 1.45% for Hospital Insurance Tax that is not subject to a cap. The employer also pays a 1.45% Hospital Insurance Tax, so the total Hospital Insurance Tax for employees is 2.9%. Beginning in 2013, the employee's portion of the Hospital Insurance Tax increases by 0.9% for wages (or self-employment income) in excess of the same threshold amounts that apply to the NII tax. ($250,000/$200,000). Therefore, the total combined Hospital Insurance Tax for taxpayers above the threshold is 1.45%+1.45%+0.9%=3.8%. Self-employed individuals are subject to a 3.8% Hospital Insurance Tax. Therefore, the 3.8% tax, in effect, applies whether the taxpayer receives income by wages or by investment income.

Some types of income, however, escape the 3.8% tax totally. For example, executor fees paid to an individual fiduciary may escape the wage, self-employment and net investment income tax. *See* New York State Bar Association Tax Section Report on the Proposed Regulations Under Section 1411, Report 1284, May 15, 2013.

b. Regulations Overview**.** Proposed regulations were published on December 5, 2012 (with corrections on January 31, 2013). The IRS received numerous comments and released final regulations on November 26, 2013 (scheduled for official publication on December 2, 2013). In addition, the IRS released a new set of proposed regulations regarding various topics that are not covered in the final regulations. Among other issues in the final regulations:

- No "fresh start" for making the election to consistently treat distributions as including realized capital gains is permitted (in order to satisfy one of the methods of including capital gains in DNI);

- There is no guidance regarding how a trust or estate "materially participates" in a trade or business, but the IRS is studying the issue and has sought comments as to whether it should give additional guidance regarding that topic for purposes of §469 as well as §1411;

- Under the final regulations, charitable remainder trusts ("CRTs") must track net investment income within each class of the trust's income to determine the amount of undistributed net investment income, but the newly proposed regulations still permit CRTs to use the "simplified method" of tracking net investment income as described in the December 2012 proposed regulations (with a few modifications);

- New proposed regulations provide additional detail regarding the determination of the amount of net investment income arising as a result of dispositions of certain interests in partnerships of S corporations; and

- New proposed regulations take the position that if a QSST sells its S stock, the determination of whether or not there is material participation in the S corporation's business (so that the resulting gain would qualify for the non-passive trade or business income exception) is made at the trust level, and not based on the activity of the trust beneficiary (even though the trust beneficiary is generally treated as the section 678 owner with respect to S corporation stock held by a QSST. Some professional groups will be filing comments with the IRS urging a revision of the proposed regulation so that the material participation would be determined at the beneficiary level in that circumstance).

c. Grantor Trusts***.*** The §1411 tax is not imposed on grantor trusts, but items of income, deduction or credit are treated as if they had been received or paid directly by the grantor for purposes of calculating that person's individual net investment income. Reg. §1.1411-3(b)(1)(v). The net investment income from the trust is treated as owned by the grantor, and will be taxed based on the grantor's individual threshold ($250,000/$200,000)). Material participation (for purposes of the active business income exception, discussed below) is tested based on participation by the grantor. See General Explanation of the Tax Reform Act of 1986 by the Staff of the Joint Committee on Taxation, at 242, n.33. Spousal attribution of material participation, allowed generally under §469(h)(5), should be applicable.

d. Net Investment Income***.*** There are three major categories of income, which are offset by various allowed deductions, to determine NII. A common theme of all three

categories is that if an item of income is not treated as income for regular tax purposes, it will not be NII for surtax purposes. The income items are--

- Category 1. Gross income from interest, dividends, annuities, royalties, and rent (but not including those items that are income derived in the ordinary course of a non-passive business [such as rents, discussed below]). Any of these items that are not in regular income are not in NII—for example, municipal bond interest income is not included in NII.

- Rents are generally passive for purposes of the §1411 tax. There is an exception for real estate professionals that devote 500 hours annually to working in the real estate business. Reg. § 1.1411-4(g)(7). Otherwise, taxpayers must meet two tests to be for rent to be excepted from being net investment income: (i) material participation and (ii) the rental income activity is a trade or business.

- Category 2. Gross income that is from (1) a passive activity or (2) a trade or business of trading in financial instruments or commodities is NII. (Rents would generally be considered passive income, but they are included in Category 1.) To determine whether an activity is "passive," the passive activity loss rules of §469 apply. This category includes business income if the taxpayer does not materially participate in the business. Passive loss carryovers apply for NII purposes to offset passive NII (even passive loss carryover from years prior to 2013 can offset passive NII income).

  - Under the § 469 passive loss rules, activities may be "grouped"; an individual's activities in several businesses that are grouped may rise to the level of being material participation, even though the individual would not meet the material participation for any separate activity. Regrouping is generally not permitted under § 469, but a one-time regrouping is allowed (which will apply for both regular and surtax purposes) on the return for the first year the individual would be subject to the surtax. Reg. §1.469-11(b)(3)(iv).

  - Working interests in oil and gas property are treated as active, not passive activities. This applies whether the taxpayer owns the working interest directly or in an entity—except that if the interest is owned in an entity that limits the liability of the taxpayer, the interest will be deemed to be a passive activity. §469(c)(3)(A).

- Category 3. Net gain that is included in taxable income (this would include capital gains). Examples of gains that are not included in taxable income (and therefore are not NII) include gain that is excluded from gross income on the sale of a principal residence, Qualified Small Business Stock, ESOP stock, build-up in value of life insurance policies, and tax-free like-kind exchanges and tax-free exchanges of life insurance policies. Gain on the sale of business assets used in an active business is not included in NII. Gains attributable to goodwill in the sale of an active business's are not NII. (The 2012 proposed regulations include this statement about goodwill, Prop. Reg. § 1.1411-7(c)(5)(ii)(B); the final regulations do not specifically address goodwill;) Net gain includes "recapture" income that is often recognized on

the sale of investment real estate. Reg. § 1.1411-4(d), Ex. 2. Capital losses can offset gains (indeed, "net gain" is what is included as NII in Category 3), but capital losses can offset income in Categories 1 or 2 only up to $3,000 per year.

- Gain from the sale of S corporation or partnership interests is subject to special rules designed to be taxpayer friendly. The seller can exclude from NII the amount of gain that would have been excluded from NII (*i.e.*, the gain attributable to active trade or business assets) if the entity had sold its assets immediately before the taxpayer's sale of its interest in the entity. §1411(c)(4). The 2012 proposed regulations had a complicated 4-step process, but the final regulations withdrew the 2012 prior regulations and new proposed regulations were issued adopting commentators' suggestions to simplify the reporting process. Prop. Reg. §1.
1411-7.

- Excluded Income Items. Several types of income are specifically excluded from NII, including (i) distributions from IRAs and qualified plans, (ii) non-passive trade or business income, (iii) tax-exempt income and tax-exempt annuities, and (iv) income subject to self-employment tax. As discussed above, certain gains from the disposition of interests in partnerships and S corporations are excluded. The final regulations specifically address various other exclusions covered by non-recognition provisions (such as §§1031), income covered by various exclusion provisions (such as §§ 103, or 121), wages, compensation, unemployment compensation, Social Security benefits, and alimony.

The final regulations added a wide variety of deductions "properly allocable to such gross income or gain" that can be subtracted in determining the "net" investment income. Reg. §1.1411-4(f). For trusts, the final regulations added that trustee fees can be deducted for purposes of the surtax, and planning opportunities are available in allocating trustee fees against certain types of income. See Item 9.k below.

e. Exception for Non-Passive Business Income; Material Participation. The non-passive trade or business income exception requires that (1) there be an activity that involves a trade or business (within the meaning of §162) and (2) is a non-passive activity within the meaning of §469, which requires material participation by the taxpayer. Reg. §1.1411-5(a-b). (There is no exception for business income from trading financial instruments or commodities, whether or not the activity is passive.) Thus, generally there must be *both* (1) a trade or business and (2) material participation by the taxpayer. As an example, if real estate that is used in a business is held in a separate entity from the operating company, such rental income will not be trade or business income (unless the real estate company is in the trade or business of leasing multiple similar real properties). Also, generally any interest, dividends, capital gains, etc. earned on investment assets held by the business will constitute NII, no matter how strong the business purpose is for holding the investment assets and no matter if there is material participation so that the business is an active activity. Reg. §1.1411-6.

The material participation requirements under the §469 passive loss rules are used for determining whether an activity is passive for purposes of the exception from the surtax for business income. §1411(c)(2)(A). Section 469(h)(1) defines material participation

as an activity in which the taxpayer participates on a "regular, continuous, and substantial basis."

Individuals can use one of seven tests (one of them being the 500-hour rule) to establish material participation to avoid passive income treatment. Reg. §1.469-5T(a). In addition, there is a separate exception for real estate professionals (if the taxpayer performs more than 750 hours in real property trades or businesses). §469(c)(7)(B). The section 1411 regulations indicate (in an extremely round-about way) that a **100-hour test** may generally apply, with some exceptions, for purposes of the active business interest exception. Reg. §1.1411-5(b)(2). *See* Richard Dees & Jeffrey Ekeberg, *Participation of 100 Hours May Be Sufficient to Generate Active Income Exempt from the 3.8 Percent Health Care Tax on Net Investment Income*, McDermott Will & Emory Website, On the Subject Newsletter (April 14, 2014). (If the 100-hour test applies, there may be complications if the business has associated tax credits; they may be suspended until the company has passive income at some point (i.e., a year in which the taxpayer flunks the 100-hour test). *See* Steve Gorin, *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications* (2015) (available from author). For a detailed discussion of the 100-hour test, See Item 9.f of the Hot Topics and Current Developments Summary (December 2014) available at www.Bessemer.com/Advisor.

f. Material Participation by Trusts or Estates. There is no guidance regarding how a trust or estate "materially participates" in a trade or business, under either the §469 or §1411 regulations. The IRS is considering regulations to address this issue; the Treasury Priority Guidance Plan for 2014-2015 issued August 26, 2014 includes the following new item: "Guidance regarding material participation by trusts and estates for purposes of §469." Various groups have submitted comments to the IRS regarding material participation by trusts and estates. ACTEC filed comments on September 24, 2015. (Among other things, the ACTEC comments suggest that (i) work done by fiduciaries should count as work of the trust or estate even if done in another capacity as long as the person is bound by fiduciary duties, (ii) activities of fiduciaries whose responsibilities for the trust or estate are solely ministerial (e.g., transmitting information concerning claims) or unrelated (e.g., management of a trust's non-business assets) would not count as material participation of the trust or estate, (iii) the fiduciary's power with respect to the business need not be a controlling power, (iv) the activities of multiple fiduciaries would generally be aggregated, (v) whether the fiduciary is an individual or an entity is generally not relevant in determining the trust or estate's material participation, (vi) work done by independent contractors generally would not count but work done by employees would count as work of the trust if the fiduciary-employer is responsible to the beneficiaries for the employees' work under the same fiduciary obligations that apply to work performed directly by the fiduciary, (vii) for grantor trusts, ignore the trust and look to whether the grantor materially participates, and (viii) characterization of the trust as materially participating or not generally carries through to the beneficiary level, but if the trust or estate does not materially participate but makes a distribution to a beneficiary who is active, "fairness requires that the beneficiary's participation in the business count and serve to recharacterize the income as nonpassive.")

For a considerably more detailed discussion of the issues regarding material participation by trusts, including the *Aragona Trust* case, See Item 9.g-h of the Hot Topics and Current Developments Summary (December 2014) and available at www.Bessemer.com/Advisor.

For a detailed discussion of the application of the non-passive trade or business income exception from the §1411 tax to trusts, see Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 1,* Tax Notes 683, at 688-700 (Aug. 12, 2013) and Richard Dees, *20 Questions (and 20 Answers!) On the New 3.8 Percent Tax, Part 2,* Tax Notes 785 (Aug. 19, 2013). Another excellent resource including planning strategies with respect to the trust material participation issue is Steve Gorin, *Structuring Ownership of Privately-Owned Business: Tax and Estate Planning Implications* (2014) (a 500+ page article addressing a variety of tax and estate planning issues for businesses available from the author at sgorin@thompsoncoburn.com).

The IRS position is that the trustee must be involved directly in the operations of the business on a "regular, continuous, and substantial" basis. The IRS points to the legislative history of §469, which states very simply:

> Special rules apply in the case of taxable entities that are subject to the passive loss rule. An estate or trust is treated as materially participating in an activity if an executor or fiduciary, in his capacity as such, is so participating. S. Rep. No. 99-313, at 735.

The IRS lost the only prior reported case that has addressed material participation by trusts. (The *Mattie K. Carter Trust* v. U.S., 256 F. Supp.2d 536 (N.D. Tex. 2003). Since then, the IRS has issued several informal ruling positions, generally taking a strict approach toward trust material participation.

Letter Ruling 200733023 disagreed with the *Carter Trust* decision and said that activities of "Special Trustees" would not be considered in determining the trust's material participation if they did not have the authority to commit the trust to any course of action without approval of the trustees.

Letter Ruling 201029014 was taxpayer friendly in recognizing that a trust could materially participate in the activities of a multi-tiered subsidiary through the activities of its trustee even though the trustee had no direct authority to act with respect to the business in its capacity as trustee (because of the remote relationship of the trust to the subsidiary).

Technical Advice Memorandum 201317010 takes a very hard-nosed approach, refusing to recognize the activities of a co-trustee who was also the president of a subsidiary of an S corporation in which the trust owned an interest, reasoning in part that the activities were largely in the individual's capacity as employee and not as trustee. The *Aragona Trust* case (discussed below) in particular seems to undermine the IRS's strict approach in that TAM.

The final regulations say that the character of an item of trust income as NII (or not) is determined at the trust level (for trusts that are not deemed to be owned by the grantor or a third party for income tax purposes under the grantor trust rules including §678), and that determination does not change when the income item is distributed to a beneficiary. Reg. §1.1411-3(e)(3)(ii). Presumably, the reverse would be true as well—active business income that is not NII to the trust would not be NII to the beneficiaries. (The IRS has indicated informally that is the case.) Accordingly, even if a beneficiary is clearly materially participating in a business, a distribution of business income from the trust to the beneficiary will not qualify for the "active business income" exception if the trust did not materially participate in the business to qualify for the exception at the trust level.

g. Frank Aragona Trust v. Commissioner. The Frank Aragona Trust qualified for the "real estate professional exception" under §469(c)(7) so that rental losses were not disallowed as passive activities for purposes of the passive activity loss rules of §469. The IRS raised and the court addressed two major issues. *Frank Aragona Trust v. Commissioner*, 142 T.C. No. 9 (March 27, 2014) (Judge Morrison).

First, the court rejected the IRS's contention that a trust can never qualify for the real estate professional exception even though the regulations refer to personal services "performed by an individual." The court concluded that if the trustees are individuals, their work can be considered "work performed by an individual" and that a trust is capable of performing personal services and therefore can satisfy the §469(c)(7) exception.

Second, the court ruled that the trust materially participated in the real estate business, which is one of the requirements to satisfy the §469(c)(7) real estate professional exception. Three of the six co-trustees were full time employees of an LLC that managed the rental properties. The IRS argued that the activities of the three co-trustees as full-time employees of the LLC should not be considered because (1) they performed their activities as employees, and (2) it is impossible to disaggregate the activities they performed as employees and as trustees. [This is consistent with the IRS's reasoning in TAM 201317010.] The court concluded that the activities of the trustees, including their activities as employees, should be considered in determining whether the trust materially participated in real-estate operations. The court reasoned that state law requires trustees to look out solely for the interests of trust beneficiaries, and that trustees are not relieved of their duties of loyalty by conducting activities through an entity controlled by the trust.

> The trustees were required by Michigan statutory law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the properly of another, i.e., a beneficiary. Mich. Comp. Laws sec. 700.7302 (2001) (before amendment by 2009 Mich. Pub. Acts No. 46); see also In re Estate of Butterfield, 341 N.W.2d 453, 459 (Mich. 1983) (construing Mich. Comp. Laws sec. 700.813 (1979), a statute in effect from 1979 to 2000 that was a similarly-worded predecessor to Mich. Comp. Laws sec. 700.7302).
>
> Trustees are not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. Cf. In re Estate of Butterfield, 341 N.W.2d at 457 ("Trustees who also happen to be directors of the corporation which is owned or controlled by the trust cannot insulate themselves from probate scrutiny [i.e., duties imposed on trustees by Michigan courts] under the guise of calling themselves corporate directors who are exercising their business judgment concerning matters of corporate policy.") Therefore their activities as employees of Holiday Enterprises, LLC, should be considered in determining whether the trust materially participated in its real-estate operations.

Also, the court rejected the IRS argument that two of the co-trustees owned minority interests in some of the entities that conducted the rental operations and that some of their activities were attributable to their personal portions of the businesses. The court gave several reasons, including that their interests as individual owners were generally compatible with the trust's goals for the jointly held enterprises to succeed.

The *Aragona* court specifically noted that it was not faced with deciding whether the activities of non-trustee agents or employees should be disregarded. (Footnote 15).

h. Capital Gains in DNI. Capital gains are an item of net investment income. While distributions reduce both AGI and net investment income, distributions will not include capital gains unless they are included in distributable net income. If steps are taken so that capital gains are in DNI (see Section II. C.1.a.(i) below) distributions to beneficiaries who are below the net investment income tax threshold may avoid paying the 3.8% tax on trust capital gains. For an excellent discussion of various alternatives see Morrow, Avoid the 3.8 Percent Medicare Surtax, TR. & ESTS. 32, 35-37 (Dec. 2012).

i. Funding Pecuniary Bequests. If a pecuniary bequest is funded with appreciated property, the post-death appreciation will be taxed as capital gain to the estate or trust, subject to the 3.8% net investment income tax as well as the 20% capital gains tax (assuming the estate or trust has taxable income in excess of $12,300 in 2015).

C. Funding and Distribution Planning.

1. General Rules Regarding Income Tax Effects of Distributions.

a. General Rules and Capital Gains. Any distribution from an estate, whether of income or principal, will generally carry out the income of the estate to the beneficiary to the extent of the estate's "distributable net income" (DNI). §661 (deduction to estate); §662 (income to beneficiary). DNI is the taxable income of the estate with certain modifications. §643(a). If the distributions exceed the amount of DNI, the DNI is carried out proportionately to the beneficiaries, and the various characters of income in DNI (ordinary dividends, qualified dividends, tax exempt income, etc.) are also carried out proportionately. Merely allowing a beneficiary to use trust assets, even if the trust pays property taxes or maintains the asset, is not a distribution that carries out DNI to the beneficiary. DuPont Testamentary Trust v. Comm'r, 66 T.C. 761 (1976), aff'd 574 F.2d 1332 (5th Cir. 1978); Comm'r v. Plant, 76 F.2d 8 (2d Cir. 1935), acq. 1976-1 C.B. 1; Ltr. Rul. 8341005.

(i) Capital Gains in DNI. One of the main exceptions from the general rule that DNI is the taxable income of the estate is that capital gains and losses are usually excluded from DNI since they are typically allocated to corpus and are not distributed to beneficiaries currently. §643(a)(3). That section provides that gains from the sale or exchange of capital assets are excluded from distributable net income to the extent that these gains are allocated to corpus and they are not either paid, credited, or required to be distributed, to a beneficiary during the year, or paid, permanently set aside, or to be used for a charitable purpose. However, the regulations provide the capital gains will be included in DNI if they are, (1) "pursuant to the terms of the governing instrument and applicable law" or (2) "pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)"

> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));

(2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or

(3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary. Reg. §1.643(a)-3(b).

Planning possibilities using each of these three exceptions are summarized below.

Exception (1)—Capital Gains Allocated to Income.

- Consider providing in the trust instrument that capital gains are allocated to income (but do not do this for mandatory income trusts—so that the capital gains would not necessarily have to be distributed annually).
- Consider providing in the trust instrument that the trustee has the *discretion* to allocate capital gains to income; **there is no consistency requirement in Reg. §1.643(a)-3(a)(1) regarding allocating capital gains to income,** so the trustee could exercise its discretion each year whether to allocate capital gains to income. *See* Reg. §1.643(b)-1 ("an allocation to income of all or a part of the gains from the sale or exchange of trust assets will generally be respected if the allocation is made either pursuant to the terms of the governing instrument and applicable local law, or pursuant to a reasonable and impartial exercise of a discretionary power granted to the fiduciary by applicable local law or by the governing instrument, if not prohibited by applicable local law.").
- Distributions from flow-through entities are typically treated as fiduciary accounting income rather than principal unless the distribution is part of a liquidating distribution. Under UPAIA cash distributions from a flow-through entity with capital gains that are taxed to the trust are treated as being allocated to income and therefore meet exception (1) so that the capital gain from the entity would be included in DNI. (If the entity distributes less than all of its taxable income, the result may not be clear as to whether the capital gain is distributed.) Capital gain that is distributed in the ordinary course of partnership operations and that is allocated to the trust on the Schedule K-1 of a partnership or LLC is permitted to pass through to the beneficiaries. Crisp v. United States*,* 34 Fed. Cl. 112 (1995). *See* Carol Cantrell, *Income Tax Problems When the Estate of Trust is a Partner,* ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 1375, 1446-47 (April 2013).
- There is an interesting argument that Schedule K-1 capital gains allocated to a trust from a partnership but that is not distributed is still included in the trust's DNI. Section 643(a) starts with taxable income in defining DNI and then describes several modifications. Section (a)(3) says that capital gains are excluded from DNI to the extent they are allocated to corpus and are not paid or required to be distributed to a beneficiary or for charitable purposes. If the capital gains are not allocated to corpus, there are no provisions in the statute removing them from DNI. If the partnership does not make distributions of the capital gain, the trust has no receipts that are characterized as either income or corpus. As long as the K-1 capital gains are not allocable to corpus, they are not excluded from DNI.
- Net short term capital gain from a mutual fund is treated as fiduciary income under the Uniform Principal and Income Act. Comments to Section 401 of the Act include the following:

> Capital gain dividends. Under the Internal Revenue Code and the Income Tax Regulations, a "capital gain dividend" from a mutual fund or real estate investment trust is the excess of the fund's or trust's net long-term capital gain over its net short-term capital loss. As a result, a capital gain dividend does not include any net short-term capital gain, and cash received by a trust because of a net short-term capital gain is income under this Act.

Exception (2)—Capital Gains Allocated to Corpus and Consistently Treated as Part of Distributions.

- Give the trustee the authority to treat principal distributions as consisting of capital gains realized during the year. This is sometimes referred to as a "deeming" rule. Reg. §1.643(a)-3(e) Exs. 2-3. Example (1) of Reg. §1.643(a)-3(e) refers to a trust in which the trustee "is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year." In that example, "Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gains tax to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains." In Example (2) the trustee elects "to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year," and in Example (3) the trustee "intends to follow a regular practice of treating discretionary distributions of principal is being paid from any net capital gains realized by Trust during the year from the sale of certain specified assets or a particular class of assets." In each example, this treatment of capital gains is "a reasonable exercise of Trustee's discretion." In Examples (2) and (3) capital gains are included in DNI.
- Trust agreements may specifically grant the trustee the discretion to allocate all or part of realized gains from the sale or exchange of trust assets to income or to principal (within the meaning of Reg. §1.643-3(b)), or to deem any discretionary distribution of principal as being made from capital gains realized during the year (within the meaning of Reg. §1.643(a)-3(e)). See generally Blattmachr & Gans, *The Final "Income" Regulations: Their Meaning and Importance,* 103 TAX NOTES 891 (2004).
- The "treated consistently" requirement applies to exception (2) (*i.e.*, capital gain that is allocated to corpus but treated as part of a distribution). This is easy to meet if the issue arises in the trust's first year that a distribution is made when the trust has capital gains. How a trust changes its position to start deeming that capital gains are included in distributions is not clear. (Historically, capital gains typically have not been treated by trustees as being included in distributions to cause them to be included in DNI.)

Exception (3)—Capital Gains Allocated to Corpus But Actually Distributed or Considered in Determining Amount to be Distributed.

- There is no requirement in the regulation that this be exercised consistently. *See* Frederick Sembler, *Including Capital Gains in Trust or Estate Distributions After ATRA,* TRUSTS & ESTATES 23 (March 2013)(suggesting that the trustee "make a record, before the distribution if possible, of the decision to do so") .

- As an example, a trustee may study the trust income and income tax brackets of the trust and beneficiaries in making a decision about what distributions to make, and the trustee might specifically acknowledge that in determining the amount of distributions it has considered the trust income tax situation and the capital gains of the trust. Arguably the capital gains have been “utilized by the fiduciary in determining the amount that is distributed” thus satisfying exception (3).
- However, the examples in the regulations for Exception (3) are rather narrow and do not include an example with that rationale. Those examples include: (i) a trust that is directed to hold an assets for 10 years and then sell it and distribute the proceeds (Ex.6); (ii) amounts distributed in a year the trust terminates when all income and principal is required to be distributed (Ex.7), and (iii) a trust requiring that one-half of the principal be distributed at a particular age, at which time the trustee sells one-half the securities and distributes the proceeds (Ex.9). However, the suggested scenario seems to meet the literal requirements stated in exception (3) because the capital gains have been “utilized by the fiduciary in determining the amount that is distributed.”

***Example Clause.* An example clause giving the trustee discretion to utilize the flexibilities afforded by the regulation to cause capital gains to be in DNI is as follows**:

> The Trustee may allocate realized short term capital gains and/or realized long term capital gains to either trust income or trust principal, and such gains shall be includable in distributable net income, (1) to the extent that such gains are allocated to income; or (2) if such gains are allocated to principal, to the extent they are distributed to the trust beneficiary, or used by the Trustee in determining the amount distributable to the trust beneficiary, or treated consistently on the trust’s books, record, and tax returns as part of a distribution to the trust beneficiary.

Gregory Gadarian, *Including Capital Gains in DNI,* ACTEC 2014 Fall Meeting of Fiduciary Income Tax Committee.

(ii) Termination; Distribution of Sales Proceeds. At the termination of the trust, all trust assets including capital gains will actually be distributed, so capital gains are included in DNI. Treas. Reg. §1.643(a)-3(e)(Ex.7). If the only cash in the trust is represented by sales proceeds and they are all distributed, the capital gains are actually distributed and are therefore included in DNI. Treas. Reg. §1.643(a)-3(e)(Ex.9). If the only cash in the trust is represented by sales proceeds and only some of them are distributed, the Trustee may determine to what extent the capital gains are distributed, but in the absence of an exercise of such discretion, the capital gains that are deemed distributed and therefore included in DNI will be determined on a proportional basis. Treas. Reg. §1.643(a)-3(e)(Ex.10).

(iii) Impact on Distribution Decisions. Distributions from an estate or trust may reduce the income subject to the top 39.6%/20% rates on ordinary and capital gains income, respectively, as well as reducing the income subject to the 3.8% tax on net investment income. See Morrow, *Avoid the 3.8 Percent Medicare Surtax*, TR. & ESTS. 32 (Dec. 2012). Thus, distributions to beneficiaries can save 4.6% or 5% of income tax, depending on whether the income is ordinary income or capital gain, if the individual beneficiary is not in the top tax bracket ($450,000/$400,000 in 2013, $457,600/$406,750 in

2014, $464,850/$413,200 in 2015). In addition, distributions can save the 3.8% tax on net investment income if the beneficiary does not have AGI exceeding the $250,000/$200,000 threshold. The total tax savings could be 8.4%-8.8%, and the savings may be even greater if there are state income taxes.

This issue is especially important for estates, because the entire estate assets may well be distributed within several years in any event. Make interim distributions sufficient to keep the estate from paying income taxes at the top rate brackets.

In making decisions about the tax impact of distributions, keep in mind that if the trust is in a state that does not have a state income tax on the trust, making the distribution to a beneficiary who lives in a state with a state income tax may generate enough state income tax to the beneficiary to more than offset the federal income tax savings to the trust by making the distribution.

This may present additional pressure on fiduciaries to make distributions. Of course, the fiduciary must look to the distribution standards in the trust agreement to determine the extent to which these tax considerations come into play. If the distribution is based solely on the health, education, support, and maintenance of the beneficiary, the trustee may not have the authority to take into consideration tax effects of distributions. *Drafting Tip:* Giving a non-beneficiary trustee the authority to consider tax implications may broaden the ability of the fiduciary to consider these tax implications of distributions. Even so, the fiduciary would generally treat taxes as merely one factor to be considered in the overall factors that the fiduciary considers in determining the appropriateness of distributions.

These additional income tax implications may also factor into the trustee's investment decisions—for example, whether to include allocation to tax-exempt investments.

b. Exceptions: Specific Bequest Exception and Separate Share Rule; Treatment of Interest on Pecuniary Formula Bequests.

Specific Bequest Exception. Payments of specific bequests are excluded from the general rule that distributions carry out estate income to beneficiaries. This exception applies to a bequest of a specific sum of money or specific property and which is paid or credited all at once or in not more than 3 installments. §663(a)(1). In order to qualify for this exception, the amount of money or the identity of specific property must be ascertainable under the terms of the will as of the date of death. Reg. §1.663(a)-1(b). For example, a marital deduction formula pecuniary bequest is not covered by this exception (because the amount of the bequest depends upon the amount of administration expenses and elections made by the executor.) Observe that tax advantage may be possible by failing to satisfy the specific bequest exception, to facilitate "carrying out" the estate income to the beneficiaries rather than having the income taxed in the estate at high income tax brackets.

Separate Share Rule. The separate share rule is now mandatory for estates. The general purpose is to provide a more equitable result for estate beneficiaries, by limiting the amount of distributable net income (or DNI) that is "carried out" as taxable income for a particular beneficiary to that beneficiary's pro rata share of such income that the beneficiary is entitled to receive from the estate. § 663(c). While this purpose is laudable, the application of the rule can be difficult, especially in estates with difficult-to-value assets.

The general effect of the separate share rule is to limit the amount of DNI that is carried out to each beneficiary (which is taxable to the beneficiary, § 662(a), and deductible to the estate, § 661(a)) to the DNI that is allocable to each beneficiary's separate share. The rule only limits the amount of DNI carried out with distributions that are made. It does not create a "flow-through" system to allocate taxable income to beneficiaries who do not receive distributions. For example, if an estate makes distributions to only one of two equal beneficiaries in year one, the separate share rule would limit the DNI carried out to that one beneficiary to his or her share of the estate's income. The remaining income would be taxed to the estate. State laws (not the separate share rules) would then determine if the income tax paid by the estate would be charged solely against the remaining beneficiary's share of the income, or whether it would be charged against the estate generally—which would be inequitable to the beneficiary who received the distribution and had to pay income tax with respect to his or her share of the income.

Interest on Funding Pecuniary Bequests. The IRS maintains that interest on funding pecuniary bequests is not included in the estate's DNI that is carried out to the beneficiary, and is not deductible by the estate as a distribution deduction under section 661 or other sections. However, it is interest income to the beneficiary. The overall effect is to create taxable income to the family. As a result, there may be an emerging trend for estate planning instruments to allocate estate income to pecuniary bequests, rather than paying interest on pecuniary bequests. Some state statutes adopt that position; the Pennsylvania principal and income statute provides that the pecuniary beneficiary is entitled to income at the rate of 5%, thus providing an argument that the payment is entitled to a DNI distribution deduction.

The preamble to the separate share final regulations makes clear that interest on pecuniary bequests is not subject to the 661-662 rules (i.e., it does not carry out DNI to the beneficiary and is not deductible by the estate.) This confirms the analogous position taken in the proposed regulations and retained in the final regulations with respect to elective shares that do not share in estate income but receive interest. Treas. Reg. 1.663(c)-5 Ex. 7.

One district court case has held that interest paid on specific bequests was not deductible. Schwan v. United States, 91 AFTR2d 2003-1658 (D. S.D. 2003). The court reasoned that the interest expense was not deductible under section 212 because it was not necessary for the estate to incur the interest charges. An investment interest deduction under section 163 was not allowed because the interest was not tied to debt incurred for an investment:

> Here, there is no investment expenditure and no debt proceeds to trace. The legacies, upon which the interest at issue was incurred, did not arise in connection with the acquisition or maintenance of property held for investment purposes. This is not a situation in which the estate incurred a debt such as a loan to maintain investment property already in the estate. Here, the purported debt at issue was not incurred as an expenditure of the estate but rather was created as an obligation of the estate by the testator in the form of a legacy. As such it has no connection to property held for investment and a deduction under § 163 is inappropriate.

Although cases have not allowed an income tax deduction for interest on pecuniary bequests, an estate tax deduction was allowed in Turner v. U.S., 93 AFTR2d 2004-686 (N.D. Tex. 2004). The court reasoned that the delay in funding the bequest was necessary to the administration because the pecuniary bequest was to an entity and the bequest was conditioned on it being a qualified charity under §2055. The entity ("Juliette Fowler Homes, Inc.") was a subordinate organization that claims exempt status by its affiliation with a church, but it had not directly requested a determination letter that it was an exempt entity. The court reasoned that the executor had to take steps to assure that bequest to the entity qualified for an estate tax charitable deduction, and was reasonable in waiting until an estate tax closing letter was received, particularly in this case. The case also discusses the wisdom generally of delaying the funding of bequests until after an estate tax closing letter is received. However, in its conclusion, the court says that "a closing letter was particularly important in this case" because the Will required that the bequest be made only to an exempt entity. Whether the court would have allowed the interest deduction without that special situation is unclear.

c. Distribution of Appreciated Property in Satisfaction of Pecuniary Bequest. Distributions of property in kind from trusts or estates that are in satisfaction of pecuniary bequests or pecuniary amounts are treated as taxable sales or exchanges, and gains or losses may result. A pecuniary bequest or amount is one that has a fixed or definite dollar amount. Reg. §1.661(a)-2(f)(1); Kenan v. Commissioner, 114 F.2d 217 (2nd Cir. 1940). This general concept applies to funding pecuniary marital deduction bequests (Rev. Rul. 60-87, 1960-1 C.B. 286 [bequest of fixed percentage of adjusted taxable estate is a fixed fraction times a constant, which is treated as a fixed dollar amount]; Rev. Rul. 56-270, 1956-1 C.B. 325), or in satisfaction of a debt (Rev. Rul. 74-178, 1974-1 C.B. 196).

The Taxpayer Relief Act of 1997 extended the loss disallowance rule of §267 (which disallows any deduction for loss on a sale or exchange of property between certain related parties including a trust and a beneficiary of the trust) and the ordinary income rule under §1239 (which treats gain as ordinary income rather than capital gain for sales or exchanges of depreciable property between a trust and a beneficiary of a trust) to sales or exchanges between an executor and a beneficiary of the estate. However, the extension of §§267 and 1239 does not extend to a sale or exchange that is in satisfaction of a pecuniary bequest §267(b) (13). Therefore, a distribution of a depreciated asset to a beneficiary in satisfaction of a pecuniary bequest can still qualify for a loss deduction. In funding pecuniary bequests, keep in mind the possibility of generating a loss deduction to the estate by funding the bequest with assets that have depreciated in value since the date of the decedent's death. This exception from the loss disallowance rule for funding pecuniary bequests is available to estates, but not trusts.

d. Distribution of IRD to Satisfy Pecuniary Bequest Accelerates Recognition of IRD. A distribution of a right to receive IRD in satisfaction of a fixed sum of money bequest will likely cause tax on the IRD accelerated. Treas. Reg. § 1.691(a)-4(b)(2) says that if the right to receive IRD is transferred to a specific or residuary legatee, only the legatee includes the IRD in income. An implied connotation is that transferring IRD in satisfaction of a pecuniary bequest does not carry out the income tax burden to the legatee; if not, the distribution would seem to be treated as a transfer or sale of an IRD item under Reg. § 1.691(a)-4(a), which would trigger the income. See Reg. §1.661(a)-2(f)(1) & 1.1014-4(a)(3).

The acceleration problem does not occur if IRD is distributed in satisfaction of a percentage bequest where the executor had the right to make distributions in cash or in kind and to allocate assets to a particular beneficiary. Letter Rul. 200234019. Furthermore,

allocating an item of IRD in satisfaction of a portion of a residuary bequest does not trigger acceleration. E.g., Ltr. Ruls.201444024; 201013033 (no listed beneficiary so estate was default beneficiary; IRA transferred to one of charities entitled to residuary estate under revocable trust agreement); 200652028 (trustee's exercise of discretion under non pro rata funding authority to distribute IRA in satisfaction of residuary distribution of trust not a deemed transfer under §691(a)(1)).

e. Distribution of IRA In Satisfaction of Pecuniary Bequest. A different result may apply in the situation of satisfying a pecuniary bequest with an IRA. For example, the IRS has issued several letter rulings that addressed the availability of a spousal rollover when a pecuniary marital deduction bequest was funded with an IRA without also addressing whether funding the pecuniary bequest with the IRA triggered immediate income recognition. Ltr. Ruls. 9808043, 9623056, 9608036, & 9524020. Some commentators believe that the taxation of distributions from qualified plans and IRAs is governed exclusively by sections 672, 402(a), and 408(d)(1), and that no income recognition occurs until there is an actual distribution or some other transaction expressly made taxable under those sections. See Ice, Hot Topics and Recent Developments in the IRA/Qualified Plan Distribution Arena From the Sublime to the Ridiculous, Texas Tax Lawyer 37 (Oct. 2000)(describing positions of Marjorie Hoffman and Merv Wilf). The issue is whether section 402(a) and 408(d)(1) are exclusive and, in effect, override section 691. An argument can also be made under §691 itself that satisfying a pecuniary bequest with an IRA would not trigger acceleration. See Choate, Life and Death Planning for Retirement Benefits 103-08 (5th ed. 2003).

In CCM 2006-44020, a trust made a pecuniary bequest of $100,000 to charities. The trustee directed the IRA provider to put $100,000 of the IRA into the names of the charities (hoping to get the $100,000 IRA to the charity without anyone ever having to pay income tax on the $100,000 because of the charity's tax exempt status.) The IRS said that the distribution would trigger ordinary income to the trust, reasoning that a transfer of an IRA to a pecuniary fixed dollar legatee accelerates income recognition under §691(a)(2). There is a split among planners as to whether this is correct. For example, Professor Christopher Hoyt believes that the qualified plan rules should trump §691, and that there should not be gain recognition when an IRA is used to fund a pecuniary bequest. Leimberg Information Services Charitable Planning Newsletter #110 (Nov. 7, 2006). Natalie Choate thinks the IRS may have been right. Leimberg Information Services Employee Benefits and Retirement Planning Newsletters #395 & 396 (Dec. 26 & 28, 2006). Natalie reasons that the trustee had a choice of assets to use to fund the bequest, and because the trustee chose to use the IRA, that could be an assignment of income under §691(a)(2). Section 691(a)(2) says that after death of an owner of an "income in respect of a decedent" asset, a transfer of the IRD to someone else triggers immediate realization of income UNLESS the person is entitled to the asset under the decedent's will or trust. The ruling reasoned that the charity was not entitled to that particular asset. (The CCM went too far, though, in citing a 60 year old case that does not even mention §691(a)(2) as support for its conclusion.) See also Ltr. Rul. 201438014 (income recognized on funding pecuniary bequest from IRA).

Planning Pointer: Natalie Choate points out that this ruling should not apply if the trust document says the trustee MUST satisfy the bequest with the IRA—even if it is a pecuniary bequest. Also, the ruling does not apply if the beneficiary designation itself contains the pecuniary gift. Id.

2. Consider Planning Considerations in Distribution of Installment Note.

a. If Decedent Made Sale Before Death, Distribution of Note to Beneficiaries Does Not Trigger Gain. An installment note held by a decedent may be distributed by the estate without causing the immediate recognition of gain (as long as it is not distributed to the obligor on the note and is not distributed in satisfaction of a pecuniary bequest). §453B(c). See generally LeDuc, Avoiding Unintended Dispositions of Installment Obligations, 31 EST. PL. 211 (2004). Cf. §453(e)(6)(C) (disposition of property by related person rule does not apply after death).

b. If Estate Made the Sale, Distribution Triggers Gain. A transfer of an installment obligation would generally cause the transferor immediately to recognize any remaining gain which has been deferred by the installment reporting method. §453B(a). (The exception under §435B(c) for the disposition of an installment obligation at death does not help because it applies only to installment obligations passing from a decedent, rather than installment notes arising after the decedent's death.) Rev. Rul. 55-159, 1955-1 C.B. 391. Of course, in many situations in which the estate sells an asset for an installment note, there should be little gain to recognize upon a disposition of the installment obligation due to the step-up in basis of the asset at death.

c. Distribute Asset to Beneficiary and Allow Beneficiary to Sell. If an estate asset is to be sold that has substantial appreciation above its stepped-up basis, consider distributing the asset to a beneficiary and allowing the beneficiary to make the installment sale.

d. Distribute Installment Note to Person Other Than Obligor. While §453B(c) contains a general exception for distributing a decedent's installment note to beneficiaries of the estate, that section applies "except as provided in section 691." Section 691(a)(5)(A)(i) provides that a transfer by the estate of a decedent's installment note to the obligor of the note will trigger recognition of gain on the note. If the obligor is related to the decedent, within the meaning of §453(f)(1), the amount of gain triggered by the disposition will be based on the full face amount of the note instead of just the fair market value of the note, if the fair market value is lower. §691(a)(5)(B). In addition, any cancellation of such a note is treated as a transfer that triggers immediate gain on the note. If the decedent's will specifically bequeaths the note to someone other than the obligor of the note, the gain should not be triggered to the estate. If the estate elects to make a non-pro rata distribution of the assets pursuant to authority in the will or state law, and if the executor elects to distribute an installment note to someone other than the obligor, it is not clear whether recognition of the gain to the estate will be avoided. The IRS might conceivably take the position that there has been an indirect distribution of the note to the obligor. See Ltr. Rul. 8806048. See generally Hesch, Dispositions of Installment Obligations by Gift or Bequest, 16 Tax Management-Estates, Gifts and Trusts Journal 137 (1991).

e. Consider Delaying Cancellation of Installment Note Owed by Beneficiary or Distribution of Installment Note Owed by Beneficiary. A cancellation of a note at death, or a bequest of an installment note to the obligor will trigger recognition of inherent gain on the note to the estate. However, the triggering transfer and the related reporting of gain does not occur until the earliest of (1) the executor's assent to the distribution of the note under state law, (2) the actual cancellation of the note by the executor, (3) upon the note becoming unenforceable due to the applicable statute of limitations or other state law, or (4) upon termination of the estate. Ltr. Rul. 8552007. For example, if an installment note passes by the residuary clause to the decedent's child, the accelerated gain is reported by the estate in the year in which the note is actually distributed to the child. Ltr. Rul. 8806048.

3. Consider Whether Making In-Kind Distribution Will be Treated as a Taxable Transaction.

If a will leaves bequests to multiple beneficiaries, and if the beneficiaries agree to take specific assets of equal value rather than receiving pro rata distributions of a fractional interest in every asset, the IRS takes the position that this results in a taxable sale or exchange between the estate beneficiaries. Rev. Rul. 69-486, 1969-2 C.B. 159.

Rev. Rul. 69-486 indicates, however, that if the executor has the authority to make a non-pro rata distribution, no taxable event occurs when a non-pro rata distribution is made.

4. Basis Issues; Basis Consistency and Information Reporting Requirements.

a. General Rule and Background of Legislative Proposals. Property includible in a decedent's gross estate (other than income in respect of a decedent assets) includible in a decedent's gross estate for estate tax purposes generally takes a new basis equal to the fair market value at date of death (unless the alternate valuation date is elected, in which event the value on six months after the date of death or the date of a prior disposition of property by the estate controls.) This rule can either "step up" or "step down" the basis of property. §1014. For community property, both halves receive a changed basis—not just the decedent's half. §1014(c). An important exception to the changed basis rule applies for income in respect of a decedent items (which generally are items earned before death but received after the date of death.)

(1) Prior Law (and Continuing Law For Many Estates) Allowing Inconsistent Valuation Positions Under §1014(a). For purposes of determining the basis of assets received from a decedent, the value of the property as determined for federal estate tax purposes generally is deemed to be its fair market value. Treas. Reg. §1.1014-3(a). The estate tax value is not conclusive, however, but is merely a presumptive value that may be rebutted by clear and convincing evidence except where the taxpayer is estopped by the taxpayer's previous actions or statements (such as by filing estate tax returns as the fiduciary for the estate). Rev. Rul. 54-97, 1954-1 C.B. 113; *see Augustus v. Commissioner*, 40 B.T.A. 1201 (1939). In Technical Advice Memorandum 199933001, the IRS ruled that an individual beneficiary who was not the executor of the estate and took no other inconsistent actions or statements was not estopped from trying to establish that the date of death value (and the basis) was higher than the value reported on the estate tax return. Duty of consistency and estoppel principles have resulted in the estate tax value applying for basis valuation purposes in several cases. *Janis v. Commissioner*, 461 F.3d 1080 (9th Cir. 2006), *aff'g* T.C. Memo 2004-117; *Van Alen v. Commissioner*, T.C. Memo 2013-235.

(2) Legislative Proposals. The President's Budget proposal for fiscal year 2010, published on May 11, 2009 proposed various "loophole closers" to help fund a reserve for health care reform, including a consistency of basis provision. It proposed that gift transferees would be required to use the donor's basis (except that the basis in the hands of the recipient could be no greater than the value of the property for gift tax purposes). The basis of property received by death of an individual would be the value for estate tax purposes. Regulations would address implementation details, such as rules for situations in which no estate or gift tax return is required, when recipients may have better information than the executor, and when adjustments are made to the reported value after the filing of an estate or gift tax return.

The "Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal" issued by the Staff of the Joint Committee on Taxation on September 8, 2009 provided further insight. As to the estoppel issue, the report stated that a beneficiary "should not be estopped from claiming a basis different from the value

determined by an executor for estate tax purposes where the taxpayer did not participate in the executor's determination." In addition, the report took the position that the basis would be the value "r*eported* for transfer tax purposes" (i.e., the value placed on the gift or estate tax return) and not the value ultimately determined in an estate or gift tax audit. The report says that would have "the salutary effect of encouraging a more realistic value determination in the first instance." The report adds that the salutary effect would be lost if a relief mechanism existed in case the basis used by transferees differed from the fair market value "ultimately determined for transfer tax purposes." In contrast, the Greenbook says that the basis would be "the value of that property for estate tax purposes" and that regulations would address "the timing of the required reporting in the event of adjustments to the reported value subsequent to the filing of an estate or gift tax return." Finally, the report clarified that under the proposal, the basis of the recipient can be no *greater than* the value determined for estate and gift tax purposes, but the recipient could claim a lower value to avoid accuracy-related penalties under §6662 if the transferor overstated the value for transfer tax purposes.

This proposal was repeated in the Administration's Revenue Proposals for Fiscal Years 2011-2016 but the Proposals made clear that the value as finally determined for estate tax purposes would apply, not just the reported value. A legislative proposal of that approach was contained in section 6 of the Responsible Estate Tax Act in 2010 (S. 3533 and H.R. 5764), in the December 2010 "Baucus Bill," and in section 5 of "The Sensible Estate Tax Act of 2011" legislative proposal (H.R. 3467).

b. Legislative Provision in Surface Transportation and Veterans Health Care Choice Improvement Act*.* The basis consistency provisions for property received from a decedent (but not the consistency proposals for gifts) were enacted as Section 2004 of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, which extends funding of the "Highway Trust Fund" through October 29, 2015 (but this revenue provision is permanent), and which was signed into law July 31, 2015 (the "Act").

c. New Section 1014(f).

Value Limit*.* Section 2004 of the Act adds new §1014(f), which provides that the basis of property to which §1014(a) applies (i.e., property acquired from a decedent) shall not exceed the final value determined for estate tax purposes (and detailed provisions govern when the tax is finally determined), or if the final value has not been determined, the value provided in a statement to the decedent's recipients. Observe that the "shall not exceed" wording leaves open the possibility that the IRS could take the position that the date of death value for purposes of §1041(a) is lower than the finally determined estate tax value or that legatees could claim a lower value than the estate tax value to avoid penalties if the executor overstated the value of property on the Form 706.

Exception If Property Does Not Increase Estate Taxes*.* This provision applies only to property "whose inclusion in the decedent's estate increased the liability for the tax imposed by chapter 11… on such estate." Observe that if no estate tax is imposed because of the marital or charitable deduction and therefore inclusion of the asset in the estate does not increase the liability for the estate tax imposed on such estate—because the estate tax liability "on such estate" remains at zero—the basis consistency provision of §1014(f) does not apply. Instructions to Form 8971 make clear that this exception applies to estates that have no estate tax by reason of the marital or charitable deductions in addition to estates that are below the exemption amount. Unfortunately, however, no similar exception is included in the information reporting requirements in new §6035, discussed below; all estates required to file estate tax returns will have to provide reporting information

to beneficiaries even if the estate is paying no estate tax. The exception would apply to the penalty under new §6662(k), because it references §1014(f), but no similar exception arises to the penalties under §§6721 and 6722. (See below for a discussion of the penalties.) The 2017 Fiscal Year President's Budget Plan proposes expanding the basis consistency requirement to include estates that pay no estate tax because of the marital deduction.

d. New §6035; Information Reporting Requirements.

What Estates Must Report? If the estate is required to file an estate tax return under §6018(a), the executor is required to report valuation information reports to the persons described below. The Instructions to Form 8971 state that estates that file returns "for the sole purpose of making an allocation or election respecting the generation-skipping transfer tax" are not subject to reporting requirements. The Instructions do not address estates that are under the exemption amount but merely file estate tax returns to make the portability election, but he proposed regulations makes clear that the basis consistency and reporting requirements do not apply to those estates. Prop. Reg. §1.6035-1(a)(2).

Who Receives Reports? Estates that are required to file estate tax returns must give reports to both the recipients (i.e., "each person acquiring any interest in property included in the decedent's gross estate") and the IRS. §6035(a)(1). For amounts passing to trusts, must the report be given to each potential trust beneficiary or just to the trustee of the trust? The Instructions to Form 8971 and proposed regulations indicate that the report would be given just to the trustee. Prop. Reg. §1.6035-1(c)(2).

Presumably, the only point of providing a statement to the IRS would be to give the IRS information about assets passing to particular beneficiaries in case the IRS will track the basis information that may be reported by those beneficiaries on their future income tax returns. Giving the information to the IRS would permit the IRS to use matching programs, much like with Form 1099s, to match the basis reporting on individual beneficiaries' income tax returns when they report sales of assets received from estates. Catherine Hughes, with the Treasury Department, has confirmed that the IRS is revising its computer systems in light of the basis consistency statute.

When Are Reports Due? Under the statute and proposed regulations, such statements must be furnished at the time prescribed in regulations, but no later than 30 days after the return's due date, including extensions (or 30 days after the return is filed, if earlier). §6035(a)(3)(A). The Form 8971 Instructions relax this to say that if the Form 706 is filed after the "due date," the Form 8971 and Schedule(s) A to beneficiaries are due 30 days after the "filing date" (apparently referring to the actual date the Form 706 is filed late). If valuation or other adjustments are made after the statements are furnished, supplemental statements must be furnished within 30 days of the date of the adjustment. §6035(a)(3)(B).

Extensions of Due Date for Information Reports. Notice 2015-57 extended the due date for filing information reports under new §6035 to February 29, 2016. "This delay is to allow the Treasury Department and IRS to issue guidance implementing the reporting requirements of section 6035." The Notice provided that information reports should not be filed "until the issuance of forms or further guidance."

Notice 2016-19 extends the due date further until March 31, 2016. Notice 2016-19 provides that basis consistency statements under section 6035 need not be filed with the IRS or furnished to beneficiaries until March 31, 2016, rather than the current February 29, 2016 deadline. The Notice further recommends that executors and other persons who are required to file an estate tax return wait to prepare statements required under section 6035 "until the issuance of proposed regulations by the Treasury Department and the IRS addressing the requirements of section 6035. The Treasury Department and the IRS expect

to issue proposed regulations under sections 1014(f) and 6035 very shortly." Temporary and proposed regulations were published in the Federal Register on March 4, 2016. The temporary regulations provide that are reports due before March 31, 2016 need not be filed until March 31.

Regulatory Authority. Regulatory authority is granted to provide implementation details, including rules for situations in which no estate tax returns are required, or if the surviving joint tenant or other recipient has better information than the executor.

e. Penalties.

(1) Penalties for Inconsistent Reporting. Section 2004(c) of the Act amends §6662 to provide that the accuracy-related penalties on underpayments under §6662 apply if a taxpayer reports a higher basis than the estate tax value basis that applies under new §1014(f).

(2) Penalties for Failure to Provide Information Returns and Statements. Penalties for the failure to file correct "information returns" or "payee statements" are provided in §§6721 and 6722, respectively. The penalty is generally $250, with a maximum penalty for all failures during a calendar year of $3,000,000 (the maximum penalty is lower for taxpayers with average annual receipts of $5 million or less). The penalty is lowered to $50 per failure, with a maximum penalty of $500,000 per year if the information return is filed within 30 days of the due date. (These amounts are inflation adjusted.) These penalty provisions are recited in the Instructions to Form 8971 (and the Instructions provide indexed numbers for 2016); separate penalties apply to the Form 8971 to be filed with the IRS and to each Schedule A that is required to be filed with beneficiaries. The Instructions make clear that only one penalty applies for all failures relating to a single filing of a Form 8971 (even if multiple problems with the Form exist) and one penalty applies for all failures related to each Schedule A. If the failure to furnish the required information return or statement is "due to intentional disregard" of the requirement to furnish the return or statement, the statute provides for a penalty of $500.00 (inflation adjusted) or if greater, "10 percent of the aggregate amount of the items required to be reported correctly." §§6721(e) and 6722(e). ***Thus, the penalty under the statute could be quite large for intentionally disregarding the requirement to file the information returns or statements.*** Interestingly, the Instructions to Form 8971 do not refer to a possible penalty of 10% of the estate, but merely state that if the failure to file Form 8971 or a Schedule is due to intentional disregard, "the penalty is at least $530 per Form 8971 and the Schedule(s) A required to be filed along with it, with no maximum penalty."

Section 6724(a) provides a waiver of the penalties imposed by §§6721-6723 if the "failure is due to reasonable cause and not … willful neglect." The Instructions to Form 8971 provide that an inconsequential error or omission is not considered a failure to provide correct information, but errors "related to a TIN, a beneficiary's surname, and the value of the asset the beneficiary is receiving from the estate" are never considered inconsequential.

The §§6721 and 6722 penalties are extended to information returns and statements to estate recipients required under new §6035. §2004(b)(2) of the Act.

f. Effective Date. The amendments to §§1014(f), 6035 and 6724(d) described above "shall apply to property with respect to which an estate tax return is ***filed after*** the date of the enactment of this Act." §2004(d) of the Act. This applies not only to returns required after but also to any returns actually filed after the date of enactment (July 31, 2015). For example, the executor may have delayed filing the estate tax return for an estate in which sufficient assets pass to the surviving spouse or charity or to a QTIP trust

(the QTIP election can be made on the first return that is filed, even if it is filed late, Treas. Reg. §20.2056(b)-7(b)(4)) so that no estate tax is due for the decedent's estate.

g. Form 8971. Form 8971 and its Instructions were released on January 29, 2016.

- Part I of Form 8971 lists general information about the decedent and executor.
- Part II lists information about beneficiaries (including TIN, address, and the date that Schedules A are "provided" to each beneficiary).
- A Schedule A is attached to provide information to each estate beneficiary. The Schedule A includes the Form 706 Item number and description of property that the beneficiary has acquired from the decedent. For each asset listed, the executor indicates whether the asset increases estate tax liability and provides the valuation date and value. Schedule A contains a "Notice to Beneficiaries" directing the beneficiary to retain the schedule for tax reporting purposes and informing the beneficiary that if the property increased the estate tax liability, the Code requires consistent reporting of basis. [Observe: As discussed below regarding the ACTEC Comments, that notice could be confusing and even extremely misleading to some beneficiaries (for example, those receiving income in respect of a decedent). The executor may want to send the Schedule A with a letter providing more information to the beneficiary about the importance of the information reported on the Schedule A.]
- Some planners have questioned whether the executor could give a beneficiary whose bequest has not been funded at the time the Form 8971 is filed with all of the Schedules attached to the estate tax return rather than having to transfer all of that detailed information onto a Schedule A (combined with a general statement describing the valuation date and stating that the assets increased the estate tax liability. In that manner, all of the information required by Schedule A would be supplied to the beneficiary without having to draft voluminous descriptions on the Schedule A. (Individual government staff persons have disagreed as to whether that is permissible.)
- If the executor is also a beneficiary, the executor will have to send a Schedule A to himself or herself. (The Instructions say that if the executor is also a beneficiary, "the executor is a beneficiary for purposes of the Form 8971 and Schedule A.")
- The executor is directed to "[s]ubmit Form 8971 with a copy of each completed Schedule A to the IRS." The Instructions direct the executor to file the Form 8971 with all Schedules A to the IRS within 30 days after the due date (but if the return is filed late, within 30 days of the filing date) of the estate tax return. The Form 8971 and attached Schedules A are not to be filed with the Form 706, but must be filed separately. If values are adjusted, a Supplemental Form 8971 and Schedules A must be filed with the IRS within 30 days after the adjustment.
- Beneficiaries only receive Schedules A and not the Form 8971 itself. The Schedules A must be "provided" (in person or by email, U.S. mail or private

delivery service) within 30 days of the due date of the estate tax return (or within 30 days of the filing date if the return is filed late). If adjustments are made to assets listed on the estate tax return (such as values or the inclusion of additional assets), an updated Supplemental Schedule A must be given to each affected beneficiary within 30 days of the adjustment.

h. Undistributed Assets. A big question has been what to report 30 days after the Form 706 is filed if distributions have not been made at that time (which is typically the case). The Instructions say:

> the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A. (This means that the same property may be reflected on more than one Schedule A.) A supplemental Form 8971 and corresponding Schedule(s) A should be filed once the distribution to each such beneficiary has been made.

Therefore, when the Form 8971 is filed 30 days after the Form 706 has been filed (and before most of the assets have been distributed), each beneficiary will receive a Schedule A reporting all items in the gross estate that "could be used" to fund the bequest to that beneficiary, "in whole or in part" (which presumably would be pretty well all of the assets in the gross estate that have not previously been distributed or sold).

When distributions are later made, the Instructions provide that a revised Schedule A will be sent to the beneficiary and a supplemental Form 8971 will be sent to the IRS. The Instructions do not provide a due date for when the Supplemental Form 8971 is due to the IRS or when the updated supplemental Schedules A are due to affected beneficiaries. (This is important because penalties apply if reports are not filed or "provided" timely.)

The proposed regulations make some revisions to this procedure. They say that if the executor has not "determined" what assets will be distributed to a beneficiary, all assets (other than the types of assets that the proposed regulations except from the reporting requirements) that could be used to fund the bequest to that beneficiary must be reported. After the executor determined what assets will be distributed, the executor may but is not required to deliver a supplemental report to the beneficiary and IRS. Prop. Reg. §1.6035-1(c)(3).

This process cause real heartburn for some estates. Executors may be reluctant to provide full information about all estate assets to beneficiaries who are only entitled to receive a general bequest that may represent a fairly small portion of the estate. Furthermore, it will be burdensome. In effect, *each* beneficiary who has not already been funded by the 30 day due date will receive a report that may be about as long as the Form 706–including a list of all assets listed on the return that have not yet been sold or distributed and that could be distributed to the beneficiary.

i. Temporary and Proposed Regulations.

(1) Synopsis. Temporary and proposed regulations provide additional guidance regarding the basis consistency and information reporting requirements of new §§1014(f) and 6035. Some of the highlights and surprises include the following:

- The final value for estate tax purposes sets the *initial* basis; normal post-death basis adjustments are still applicable;

- For property subject to non-recourse debt, the basis is the gross value of the property, not just the net value reported on the estate return;
- The reporting requirement does not apply to estates that are not required to file estate tax returns but do so merely to make the portability election;
- Property that qualifies for the marital or charitable deduction is not subject to the basis consistency requirement, but is subject to the reporting requirements;
- Tangible personal property that does not have a marked artistic or intrinsic value over $3,000 is not subject to the basis consistency or reporting requirements;
- After-discovered or omitted property gets a basis of zero if the property is not reported on an estate tax return before the period of limitations on assessments has expired;
- The Form 8971 and Schedules A to beneficiaries can omit cash, IRD, tangible personal property (as described above), and property sold before the information reports are due;
- For bequests to a trust, estate or entity the Schedules A are given to the trustee, executor or entity (not the trust beneficiaries);
- For life estates, Schedules A must be sent to the life tenant and presumptive remainderman (and if the initial remainderman dies before the life tenant, the executor apparently must send supplemental reports to the IRS and to the new remainderman);
- If the executor has not determined what property will be distributed to a beneficiary when the information report is due, all property that could be used to satisfy the bequest must be included on the Schedule A to that beneficiary (and the executor does not have to send supplemental reports to the IRS and to that beneficiary after the bequest is funded);
- The executor must file a supplemental Form 8971 with the IRS and send supplemental Schedules A to beneficiaries if any previously reported information is incorrect or incomplete (such as if the final estate tax value is changed), but a supplement is not needed for inconsequential errors or omissions;
- If a recipient of an asset in the gross estate makes a subsequent gift or distribution to a "related transferee" (which, for some strange reason, includes a grantor trust but not a non-grantor trust for a related party) the recipient must file a Schedule A with the IRS and transferee reporting the change in ownership and final estate tax value of the property; and
- The Form 8971 and Schedules A to each beneficiary are due 30 days after the earlier of the due date or the date the estate tax return is actually filed (as required by the statute); the proposed regulations do not adopt the relaxation of the due date in the Instructions to Form 8971 saying that if the

estate tax return is filed late, the information reports are not due until 30 days after the date the return is actually filed.

(2) Transitional Relief Regarding Initial Time for Filing; Effective Date.

Temporary regulations provide that persons required to file an information statement under §6035(a)(1) or (a)(2) before March 31, 2016 "need not do so" until March 31, 2016. Temp. Reg. §1.6035-2T(a). Notice 2015-57 extended the due date to February 29, 2016, and Notice 2016-19 provided that persons require to give reports "need not do so" until March 31, 2016. Notice 2016-27 (issued March 23—a mere 8 days before the March 31 due date) further extends the "needs not do so" date to June 30, 2016.

Section 6081 authorizes the IRS to grant a reasonable extension for filing any "return, declaration, statement, or other document" required under the Internal Revenue Code for up to 6 months. There appears to be no statutory authority for granting a further due date extension. The Notices do not extend the formal time for filing, but merely say that persons required to file basis consistency returns and statements "need not do so" until the specified extended dates.

Effective Date of Regulations. The regulations will be effective when finalized, but persons may rely on the proposed regulations before the publication of final regulations. Prop. Reg. §§1.1014-10(f) & 1.6035-1(i). This is particular important for these regulations because they are sometimes at variance with the Instructions to the Form 8971, so planner may rely on following the requirements in the proposed regulations.

Effective Date of Statute*.* The basis consistency rules and reporting rules under §§1014(f) and 6035 apply to "property with respect to which an estate tax return is filed after the date of enactment" [i.e., July 31, 2015]. What if the estate filed an initial estate tax return before July 31, 2015, but files a supplemental return after July 31 to report an after-discovered asset or to report a different value? Is property passing from that decedent subject to the basis consistency and reporting rules? The answer is not clear. The Code nowhere recognizes the concept of an "amended estate tax return." Is a supplemental estate tax return really a "return"? What if the supplemental return is not a complete Form 706 but merely additional information provided to supplement information on an existing schedule (or perhaps a supplemental schedule) together with revised first two pages of Form 706 reflecting the revised estate tax calculation? That limited supplemental information clearly would not constitute a complete "return" for purposes for commencing the period of assessment if a complete return had not previously been filed.

(3) Post Death Adjustments. Section 1014(f) states that the basis of property acquired from a decedent "shall not exceed" the finally determined estate tax value of the property. Post-death adjustments to a property's basis under other Code provisions are still made—the estate tax value of property merely becomes the upper limit on the *initial* basis of the property after the decedent's death. Prop. Reg. §1.1014-10(a)(2).

Property Encumbered by Debt*.* Post-death payments on debt secured by property in the gross estate do not result in an adjustment to the property's basis because "[t]he existence of recourse or non-recourse debt secured by property at the time of the decedent's death does not affect the property's basis, whether the gross value of the property and the outstanding debt are reported separately on the estate tax return or the net value of the property is reported." Prop. Reg. §§1.1014-10(a)(2), 1.1014-10(e) Ex. 4.

[Treas. Reg. §20.2053-7 provides that if the decedent's estate is not liable for the debt (i.e., if it is non-recourse debt), "only the value of the equity of redemption (or the value of the property, less the mortgage or indebtedness) need be returned as part of the value of the gross estate." In light of that regulation, planners have been uncertain as to whether basis would be allowed for the full gross value of estate property that is subject to non-recourse indebtedness. The proposed regulation clarifies this issue.]

[Schedule A will be confusing for assets subject to non-recourse debt if the net value is reported on the estate tax return. Column E on Schedule A entitled "Estate Tax Value" might suggest that the net value reported on the estate tax return should be listed (the Form 8971 Instructions say to "list the value reported on the Form 706" in this column), but the proposed regulations indicate that the beneficiary's basis will be the gross value of the asset not reduced by the non-recourse debt.]

(4) Property Subject to Consistency Requirement. The basis consistency requirement applies to property includable in a decedent's gross estate under §§2031 and 2106 that generates federal estate tax in excess of allowable credits (other than a credit for a prepayment of the tax). Prop. Reg. §1.1014-10(b)(1).

Marital or Charitable Deduction Property. Section 1014(f)(2) states that the basis consistency rule only applies to property whose inclusion in the gross estate increased the liability for estate tax (reduced by allowable credits). (This exception for property that does not increase the estate tax liability only applies for the basis consistency rule; this exception does not extend to the information reporting requirements.) Proposed regulations clarify that property that qualifies for an estate tax charitable or marital deduction under §§2055, 2056, or 2056A "does not generate a tax liability under chapter 11 and therefore is excluded from the property subject to the consistency requirement." Therefore, even if the estate pays estate tax, any property passing to a surviving spouse or charity that qualifies for a marital or charitable deduction is excluded from the basis consistency requirement. Prop. Reg. §1.1014-10(b)(2).

Certain Tangible Personal Property. The proposed regulations add an exclusion (not included in the statute) for tangible personal property for which an appraisal is not required under Regulation §20.2031-6(b), which requires an appraisal for "household and personal effects articles having marked artistic or intrinsic value of a total value in excess of $3,000 (e.g., jewelry, furs, silverware, paintings, etchings, engravings, antiques, books, statuary vases, oriental rugs, coin or stamp collections)" Prop. Reg. §1.1014-10(b)(2).

By way of background, §20.2031-6(a) indicates that a room by room itemization of household and personal effects is desirable; all articles should be named and valued specifically except that items in the same room may be grouped as long as none of them exceed $100. Alternatively, in lieu of an itemized list, an aggregate value appraised by a competent appraiser (or dealer in the class of items involved) may be used. Reg. §20.2031-6(b) has a special rule that applies, notwithstanding paragraph (a), that applies for articles with marked artistic or intrinsic value of $3,000 or more. Interestingly, the $3,000 amount has not been adjusted since this regulation was adopted in 1958.)

An example in the proposed regulations of an analogous exception under the information reporting rules hints that this exception applies for any *individual* asset that is

under $3,000. Prop. Reg. §1.6035-1(b)(2)Ex.1. However, Reg. §20.2031-6(b) applies if the *"total value*" of articles "having marked artistic or intrinsic value" exceeds $3,000. The Instructions to Form 706 relax this appraisal requirement somewhat, though, by requiring an appraisal for "works of art or items with collectible value (for example, jewelry, furs, silverware, books, statuary, vases, oriental rugs, coin or stamp collections) … [i]f any item or collection of *similar items* is valued at more than $3,000." (emphasis added). This suggests, for example, that jewelry and furs would not be aggregated for purposes of the $3,000 test amount.

All Property Other Than Exceptions. If the estate must pay any estate tax, all property in the gross estate, other than marital or charitable deduction property or tangible personal property for which an appraisal is not required, is subject to the basis consistency requirement. (Observe that while the proposed regulations list other property that is not subject to the reporting requirements [i.e., cash, IRD and assets sold], only marital or charitable deduction property or the specified tangible personal property is excepted by the basis consistency requirement of §1014(f).) If the estate pays no federal estate tax, none of the estate property is subject to basis consistency. Prop. Reg. §1.1014-10(b)(3).

(5) Final Value. The proposed regulations address how the "final" estate tax value is determined. Prop. Reg. §1.1014-10(c)(1). The "final value" is the value reported on the estate tax return once the period of limitations on assessment has expired, or the amount determined by the IRS once it can no longer be contested, or the amount determined in an agreement binding on all parties, or the value determined by a court once the court's determination is final. Until the final value of property is determined, the recipient of the property may not claim a basis for that property in excess of the value reported on the information statement (i.e., the Schedule A) given to the recipient. If the final value, once it is determined, is less than the reported value, the recipient may not rely on the value listed in the initial statement and may have a deficiency and underpayment attributable to the difference. Prop. Reg. §1.1014-10(c)(2).

(6) After-Discovered or Omitted Property. If property is discovered after the estate tax return has been filed or is otherwise omitted from that return, special rules apply. If the property is later reported on a supplemental estate tax return before the period of limitation on assessment of tax expires, the normal "final value" rules apply. Prop. Reg. §1.1014-10(c)(3)(i)(A). In an extension of the basis consistency statute, however, if the after-discovered or omitted property is not reported on a supplemental estate tax return before the limitation period expires (generally three years from the filing date, §6501(a)), the basis of such property is *zero*. Prop. Reg. §1.1014-10(c)(3)(i)(B). [Planners generally believe that no duty exists to report after-discovered property if the estate tax return was filed in good faith. *See* David Pratt & George Karibjanian, *Filing a Supplemental Estate Tax Return After Probate Litigation*, Est. Pl. (Sept. 2009). If a supplemental estate tax return is not filed reporting the additional asset, however, the recipient may not take the position that the basis is the fair market value at the date of death even though the property was acquired from a decedent (despite the language of §1014(a) which says that property "acquired from a decedent" has a basis equal to the fair market value of the property at the date of death). Accordingly, if a preparer determines that no obligation to amend a return exists to report omitted property, the failure to report the property may result in a 40% estate tax savings, but that savings may be offset by a 23.8% federal capital gains tax (plus any state capital gains tax) or an even higher income tax attributable to the inability to

depreciate the property. If the recipient of the after-discovered asset is not the party responsible for paying estate tax with respect to that asset, the executor may be put in an inherent conflict situation; the party who bears estate taxes will not want the property reported but the party who receives the asset will want it reported to have a basis equal to the date of death value of the asset.

If the after-discovered or omitted property passes to the surviving spouse, the zero basis rule would not apply—because assets passing in a manner that qualifies for the marital deduction is not subject to §1014(f).

The effect of this "zero basis rule" is that if the estate has filed an estate tax return and the assessment period has run, there is no way to avoid the deemed basis of zero. Apparently, this would be the case even for after-discovered or omitted cash, life insurance proceeds, or a bank account–which raises interesting issues regarding the effect of cash having a zero basis—is the use of the cash to buy something treated as a "sale or exchange" of the cash, thus generating capital gain? On the other hand, if a return had never been filed, the executor could file a late return and secure a fair market value basis for the assets. Filing a supplemental estate tax return may not even result in any additional estate tax (if debt or administrative expense deductions can reduce the taxable estate below the exemption amount). In this respect, an estate that is close to the filing limit but arguably below the limit may be better off by not filing an estate tax return by the initial due date. This rule may also impact how aggressive a return preparer may be in omitting assets that are arguably in the gross estate (such as under a §2036 "implied agreement" of retained enjoyment argument)–if the questionable assets are not listed but the IRS later (perhaps many years later) determines that they should have been included in the gross estate, the articles may have a zero basis.

(7) Executor. For purposes of knowing who must file information reports under §6035, the term "executor" is defined broadly to mean the appointed executor, or if none is appointed, any person in possession of property (incorporating §2203), or any other beneficiary required to file a return under §6018(b). Prop. Reg. §§1.1014-10(d), 1.6035-1(g)(1).

(8) Requirement to Provide Information Statement. The "executor" (see immediately above) who is required to file an estate tax return under §6018(a) (i.e., if the size of the gross estate plus adjusted taxable gifts exceeds the basic exclusion amount), must provide information statements to the IRS (on Form 8971) and the recipients of property that was included in the gross estate (with several exceptions described below). Prop. Reg. §1.6035-1(g)(2)-(3). The preamble says this means that Form 8971 and all Schedules A must be provided to the IRS and Schedules A must be provided to recipients.

Portability Returns and Other Returns Filed But Not Required. The reporting requirement does not apply if the executor is not required to file an estate tax return but does so anyway (such as to make a GST exemption allocation or portability election, or to file a protective return in case an asset value is later determined to cause a return to be required). Prop. Reg. §1.6035-1(a)(2).

(9) What Property Must be Reported? The reporting requirement generally applies to all property on the estate tax return (or property with basis determined in whole or in part with reference to property in the gross estate, such as like-kind exchange property).

For a non-resident alien, this includes only property subject to the U.S. estate tax. Only the decedent's one-half of community property is subject to the reporting requirement (even though both community halves get a basis adjustment under §1014(b)(6)).

The proposed regulations provide four exceptions: (i) cash other than coins or paper bills with a numismatic; (ii) income in respect of a decedent assets; (iii) tangible personal property for which an appraisal is not required under Reg. §20.2031-6(b); and (iv) property in the gross estate that has been sold, exchanged or otherwise disposed of by the estate (and therefore not distributed to the beneficiary) in a transaction in which capital gain or loss is recognized. Prop. Reg. §1.6035-1(b)(1). These exceptions are very important. The executor does not have to give reports to the IRS or recipients about any of those four types of assets that are distributed to estate recipients.

Cash. Does "cash" include amounts in checking accounts, bank accounts, money market funds, certificates of deposit, or life insurance proceeds? Does cash included accounts denominated in a foreign currency (those accounts could result in currency gains or losses)? ACTEC Comments had asked whether the basis reporting rules apply to life insurance proceeds but the proposed regulations do not address insurance proceeds]

IRD. The executor should not assume that any amounts in IRAs or retirement plans are not reportable. Non-deductible contributions may have been made to the IRA or plan, and a portion of the IRA or plan may not be income in respect of a decedent.

Sold Assets. Commentators have questioned why the exception applies only if "capital" gain or loss is recognized. What if property is disposed in a transaction in which ordinary income is recognized (such as the sale or trade or business assets)? What if property is sold in a transaction for an amount exactly equal to the basis so that neither gain nor loss is recognized? Because of this exception, some planners have suggested liquidating (and diversifying) the estate assets soon after date of death, so that no reporting would be required under §6035. (However, if the executor repurchases the same assets within 30 days, the wash sales rules would apply, and the assets may no longer be excepted from the reporting requirement.)

Assets may be actively traded in a brokerage account. If so, the executor will need to decide what cut-off date to use in deciding what assets to list that have not been sold by that date for listing on Schedule(s) A passing to beneficiaries of undistributed assets.

The "sold assets" exception raises the issue of whether assets used to fund a pecuniary bequest will ever be reportable? Satisfaction of the pecuniary assets with assets in-kind will necessarily result in a gain or loss (e.g., Kenan v. Commissioner, 114 F.2d 217 (2nd Cir. 1940)). Perhaps nothing needs to be reported to the pecuniary legatee, even if the bequest has not been funded by the time the Form 8971 is filed (because gain or loss will be recognized when it is funded), [Query whether the IRS might still want some reporting? A preparer's mantra will likely be: When in doubt, report.]

No exception exists for property includable in the gross estate under the "string" statutes of §§ 2035-2042 (including assets in a funded revocable trust). The executor is required to provide information to the IRS and recipients of assets included in the gross estate under those sections even though the executor may not have any control over those assets. (If a trust holds those assets, the information would be given to the

trustee.) However, adjustments to the gross estate under §2035(b) for gift tax on gifts made within three years of the date of death do not reflect assets passing to a beneficiary and therefore would not seem to be reportable to the IRS or any beneficiary.

(10) Who Are "Beneficiaries" Who Must Receive Reports With Respect to Reportable Property? Beneficiaries generally include any person receiving reportable property, including the executor who is also a beneficiary. Prop. Reg. §1.6035-1(c)(1). (No exception applies for beneficiaries who are surviving spouses or charities to whom bequests qualify for the marital or charitable deduction. Even though they are not subject to the basis consistency limitation, as discussed above, they must still receive the required information under the reporting requirements.)

Life Estates. A special complicating rule applies for life estates. Beneficiaries who receive reports include the life tenant and the remainderman(men) who would receive property if the life tenant were to die immediately after the decedent. If a "contingent beneficiary" changes (presumably because a presumptive remainderman dies before the life tenant), the executor must do a supplemental reporting to the IRS and new remainderman. Prop. Reg. §1.6035-1(c)(1). This could create a continuing duty of the executor to give reports years in the future. What if the estate has been closed and the executor is discharged—does the life tenant become the "executor" for reporting purposes? (The word "not" appears to have been inadvertently omitted from the proposed regulation; the regulation apparently should say the beneficiary of a contingent interest is "not" a beneficiary unless the contingency occurs before the Form 8971 is filed.)

Trusts or Estates. If the beneficiary is a trust or another estate, the executor gives the information to the trustee or executor—not to the beneficiaries of that trust or estate. Prop. Reg. §1.6035-1(c)(2). (See below as to whether additional reporting requirements may apply when that trust or estate distributes the property.)

Funded Revocable Trusts; Other Trusts Includable in Gross Estate. For a funded revocable trust or other trust whose assets are included in the gross estate, does the executor give the Schedule A reports to the trustee of the trust or to the recipients of the trust? What about a pour over to an unfunded revocable trust? The answer is not clear, but many planners think that the executor would report assets to be distributed to an unfunded revocable trust to the trustee, but would report assets in a funded trust includible in the gross estate to the recipients of the trust (and for a revocable trust, that might be the trustee of a credit shelter trust or marital trust or other trust created under the revocable trust at the decedent's death). For example, Howard Zaritsky's view is as follows:

> Unfunded revocable trust. The beneficiary of the assets of the estate that are poured-over to the rev trust is the trustee of the trust, and the Schedule A is sent only to the trustee.
>
> Funded revocable trust. The beneficiaries of the rev trust are the beneficiaries with respect to assets already in the rev trust, and the executor files Form 8971 and Schedule A with respect to those transfers, because the rev trust is not a beneficiary as to those assets.
>
> I believe that the distribution of assets from the rev trust to the marital trust may or may not get its own reporting, depending upon whether the assets were in the rev trust on the date of death. If they were, then the marital trust is a beneficiary and the trustee of the marital trust gets a Schedule A from the executor of the estate. [Quoted with Howard's permission]

Undistributed Property (Undetermined Beneficiary). If the executor has not decided what property will be distributed to each beneficiary by the due date of the information statement (30 days after the estate tax return due date, as discussed below), "the executor must report on the Statement for each such beneficiary all of the property that the executor could use to satisfy that beneficiary's interest." Prop. Reg. §1.6035-1(c)(3). In effect, "mini-706s" will have to be given to each such beneficiary listing all remaining property in the gross estate, other than cash, IRD, or certain tangible personal property. The preamble acknowledges that this will result in duplicate reporting of assets on multiple Schedules A. If the executor has "determined" what property will be distributed to a beneficiary but has simply not made the distribution when the information statement is due, this special provision would not literally apply, and presumably the executor would list the property that the executor has determined will be used to satisfy that beneficiary. *See* Prop. Reg. §1.6035-1(e)(3)(ii)Ex.1. After the executor later determines what property will be used to satisfy a particular beneficiary's interest, "the executor may, but is not required" to file a supplemental return with the IRS and a supplemental statement with the beneficiary. [Presumably the beneficiary would not need a supplemental statement because the beneficiary would know what property was actually received and can find the property listed on the initial statement.]

When the Form 8971 is filed 30 days after the Form 706 has been filed (and before most of the assets have been distributed), each beneficiary will receive a Schedule A reporting all items in the gross estate that "could be used" to fund the bequest to that beneficiary, "in whole or in part" (which presumably would be pretty well all of the assets in the gross estate that have not previously been distributed or sold).

The proposed regulations state that "all of the property that the executor could use to satisfy that beneficiary's interest" must be listed. It does not refer merely to remaining "reportable" property in the estate, but an example suggests that only reportable property must be listed. Prop. Reg. §1.6035-1(e)(3)(ii)Ex. 2 (the initial Schedule A for an unfunded bequest did not list tangible personal property for which no appraisal was required in the list of property that could be used to satisfy the bequest). Accordingly cash, IRD, tangible personal property for which an appraisal is not required, or the proceeds of liquidated assets would not have to be included in this list because those assets are not property "for which reporting is required" under Prop. Reg. §1.6035-1(b). [One way to avoid advising beneficiaries whose bequests cannot be funded prior to the reporting date about most of the assets in the gross estate would be to liquidate the estate soon after the date of death (unless the same assets are re-purchased within 30 days, triggering the wash sales rules).]

[This reporting requirement for undistributed property may cause real heartburn for some estates. Executors may be reluctant to provide full information about all estate assets to beneficiaries who are only entitled to receive a general bequest that may represent a fairly small portion of the estate. Furthermore, it will be burdensome. In effect, *each* beneficiary who has not already been funded by the 30 day due date will receive a report that may be about as long as the Form 706 without attachments–including a list of all assets listed on the return that have not yet been sold or distributed and that could be distributed to the beneficiary.]

The ACTEC Comments took the position that a beneficiary who has not received his or her distribution when the Form 8971 is filed should receive a Schedule A that merely lists the value f the bequest, and that when the bequest is subsequently funded, the executor should file a supplemental Form 8971 and Schedule A. The Comments point that listing all assets that could be used to fund the bequest can be very misleading:

> Providing Schedule A to a beneficiary listing all items of property that could be used to fund the beneficiary's distribution, when the beneficiary will not, in fact, receive all of such assets (even when the listing states that the beneficiary's distribution will be funded in whole or in part with the listed assets), can result in a beneficiary believing he or she will be entitled to all of such assets. Schedule A does not provide a place for the executor to notify such a beneficiary that the assets reported on the Schedule as property in which the beneficiary has acquired an interest includes assets (and potentially a significant number of assets) that the beneficiary will not receive. Moreover, we believe that the confusion will be increased by the portion of Schedule A titled "Notice to Beneficiaries" which states "[y]ou have received this schedule to inform you of the value of property you received from the estate of the decedent named above" (emphasis added).

Ron Aucutt agrees with this suggestion, and believes that the IRS has the authority to take this approach by regulation:

> I still think that the interchangeable use of "received" and "acquired" in the regulations and instructions to Form 8971 suggests that the writers of these rules are already open (even if subconsciously) to providing in regulations that a Schedule A need not be given with respect to any asset until 30 days after distribution of that asset to the beneficiary. No extensions of time would be needed. For property passing at death without the need for a distribution and property distributed before the values are determined and reported on the 706, the Schedule A, under the statute and regulations, would not be due until 30 days after the 706 is filed. Not only would that be much simpler and (in my view) would not need congressional action, but it would most clearly serve the purpose of the statute by providing basis information to those who need it. [Quoted with Ron's permission]

Beneficiary Cannot Be Located. If a beneficiary cannot be located by the time the report is due, the executor must still file the information report, explaining the efforts to locate the beneficiary, and a supplemental report must be filed within 30 days of later locating the beneficiary. Prop. Reg. §1.6035-1(c)(4).

(11) Due Dates of Reports. The information reports to the IRS and recipients of reportable property (as described above) are due the earlier of 30 days after the due date of the estate tax return or the date it is actually filed. Prop. Reg. §1.6035-1(d). This reiterates the due date as provided in §6035(a)(3)(A). The Instructions to Form 8971 revise this due date—stating the reports are due within 30 days of the *filing* date if the estate tax return is not filed until after the due date. [This makes sense because the information on the Schedules A is based on information in the estate tax return and the Schedules A could not be completed if the estate tax return has not been filed. The statute is flawed and the Instructions adopt the only reasonable approach—even though that results in an extension of the statutory due date.]

(12) Supplemental Information. Supplemental information returns (Form 8971) and statements (Schedules A) generally must be provided if any change occurs that causes the reported information to be incorrect. Examples include the discovery of additional property, a change in value of property pursuant to an examination of litigation, or the executor's disposition of property in a transaction in which basis is determined in whole or in part with reference to property in the gross estate, such as a like-kind exchange. Prop. Reg. §1.6035-1(a)(1)-(2). Two exceptions apply: (1) inconsequential errors or omissions; and (2) the actual distribution of property previously reported as being available to satisfy unfunded bequests described above. Prop. Reg. §1.6035-1(a)(3).

Inconsequential Error or Omission. No further guidance is in the proposed regulations as to what constitutes an "inconsequently error or omission, but the Instructions to Form 8971 give further guidance as to inconsequential errors or omissions that would qualify for the reasonable cause exception from penalties. Errors on Form 8971 "that are **never** inconsequential are those related to a TIN, a beneficiary's surname, and the value of the asset the beneficiary is receiving from the estate." (emphasis included in original). Errors on a Schedule A "that are **never** inconsequential are those related to (a) the value of the asset the beneficiary is receiving from the estate, and (b) a significant item in a beneficiary's address." (emphasis in original).

Due Date. The due date of supplemental returns and statements is 30 days after (1) the final value is determined, (2) incorrect or incomplete information is discovered by the executor, or (3) a supplemental estate tax return is filed reporting additional assets. Prop. Reg. §1.6035-1(a)(4)(i). An exception to the due date applies for undistributed property from a probate estate or revocable trust—if one of the three events listed in the preceding sentence occurs before the property is distributed to a beneficiary from the probate estate or revocable trust, the due date of the information return and statement is 30 days after the property is distributed to the beneficiary. Prop. Reg. §1.6035-1(a)(4)(ii).

(13) Subsequent Transfers. A surprise in the proposed regulations is the requirement for recipients of a decedent's property to provide a "supplemental Statement" with the IRS and a transferee upon making subsequent distributions or transfers to a "related transferee" in which the basis is determined, in whole or in part, by reference to the recipient/transferor's basis (for example, a gift). Prop. Reg. §1.6035-1(f). If the subsequent transfer occurs before the final value is determined, the recipient/transferor must also give the executor a copy of the information Statement that is provided to the IRS and transferee, so that if the executor subsequently provides any information Statements, they can be given to the new transferee.

These requirements regarding subsequent transfers can impose a significant reporting burden on estate recipients for possibly many years in the future (and penalties can apply if the reports are not given). Some planners have even suggested that executors might consider liquidating many of the estate assets so that estate beneficiaries would not receive assets that were in the gross estate; the assets would not have to be reported to the initial recipient on a Schedule A, and the initial recipient would not be burdened with having to provide reports on making any future gifts of those assets to related parties.]

Purpose. The preamble to the proposed regulations gives the following reason for imposing this requirement: "The Treasury Department and the IRS are concerned, however, that opportunities may exist in some circumstances for the recipient of

such reporting to circumvent the purposes of the statute (for example, by making a gift of the property to a complex trust for the benefit of the transferor's family)." Some planners have questioned why this reporting is needed in light of the fact that the basis of gifted assets must be listed on the gift tax return. However, a gift tax return may not be filed (for example, if all gifts are covered by the annual exclusion) and the beneficiary typically does not receive a copy of the gift tax return. One planner suggests that if a subsequent gift will be reported on a gift tax return, the regulations should be modified to provide that Schedule A reporting the value of the asset in the decedent's gross estate would not have to be given to the donee and IRS until 30 days after the gift tax return is filed. In any event, the Schedule A to the donee may be misleading because the basis of the asset at that time may be far different than the estate tax value in the decedent's gross estate (perhaps many years earlier).

Related Transferee. The proposed regulation has an objective definition of who constitutes a "related transferee" of a subsequent transfer that will require supplemental Statements.

For purposes of this provision, a related transferee means any member of the transferor's family as defined in section 2704(c)(2), any controlled entity (a corporation or any other entity in which the transferor and members of the transferor's family (as defined in section 2704(c)(2)), whether directly or indirectly, have control within the meaning of section 2701(b)(2)(A) or (B)), and any trust of which the transferor is a deemed owner for income tax purposes. Prop. Reg. §1.6035-1(f).

Section 2704(c)(2) defines a "member of the family" with respect to any individual as meaning (1) the individual's spouse, (2) any ancestor or descendant of such individual or such individual's spouse, (3) any sibling of the individual, and (4) any spouse of an individual described in items (2) or (3). For example, if the estate distributes an asset to the decedent's surviving wife, who later gives the asset to a daughter, the subsequent transfer would require the surviving wife to give an information Statement to the IRS and her daughter (even if that subsequent gift occurs many years later).

Subsequent Distribution From Trust Recipient. What about a transfer from a decedent's estate to a trust and later distribution from the trust to a beneficiary? The trust clearly is a recipient and is making a subsequent transfer in which the basis is determined, at least in part, by the trust's basis (assuming the distribution is not made in satisfaction of a pecuniary distribution (which is a gain recognition event) and assuming the trustee does not make the election to recognize gain under §643(e)(3)). However, it is not clear that the beneficiary who receives the distribution from the trust is a "related transferee" of the trust (which is the "recipient/transferor"). Section 2704(c)(2) describes who is a member of the family "with respect to any *individual*," and the trust is not an individual. However, if the attribution rule of §2704(c)(3) were to be applied to determine the interests held by any individual, the individuals who are beneficiaries of the trust would likely be treated as indirectly owning the trust assets, and a distribution to another beneficiary may be treated as a transfer to a "related transferee." The definition of related transferee in the proposed regulation, makes reference to §2704(c)(2), and does not specifically make reference to §2704(c)(3) (but is §2704(c)(3) necessarily applicable in applying §2704(c)(2)?).

Thus, if a trust that receives estate property (and receives a Schedule A from the executor) makes a later distribution to a beneficiary, the distribution would not appear to

require the trustee (or other trust beneficiaries who might be deemed transferors under §2704(c)(3) if it applied) to file an information Statement with the IRS and trust beneficiary about the finally determined estate tax value of the property. . Howard Zaritsky's agrees, in this summary of whether a distribution from an unfunded revocable trust to trust beneficiaries must be reported (after the initial transfer has been reported to the trustee of the revocable trust):

> If the rev trust was entirely unfunded on the date of death, however, then the only Schedule A is filed by the executor to the trustee of the rev trust. The redistribution from the rev trust to the marital trust of assets that were in the probate estate on the date of death should not require a supplemental Schedule A, because the marital trust is not a related party to the rev trust. The regs do not address it directly, but I feel strongly that the trustee of the rev trust is viewed only in his/her/its fiduciary capacity, and not as an individual. The mere fact that he or she may be related to the trust beneficiaries (or those of the marital trust) should be immaterial. Obviously, the IRS may disagree and the final regs may take a different position, but I feel quite strongly that this is the right view. [Quoted with Howard's permission]

Subsequent Distribution From Individual Recipient to a Grantor Trust. If the recipient/transferor who is an individual who makes a transfer to a grantor trust, the individual would have to provide information Statements to the IRS and the trustee of the grantor trust. On the other hand, if the individual gives the property received from an estate to a non-grantor trust, apparently, no such information Statements are required. [This makes no sense. Indeed, giving information Statements for gifts to a non-grantor trust would make more sense because the distribution from an individual to a grantor trust is generally treated as a non-event for income tax purposes and the person would in effect be giving notice to herself. For example, if a surviving wife who receives assets from her husband's estate makes a subsequent gift of such an asset outright to her daughter or to a GRAT that is a grantor trust or to another type of grantor trust for her daughter, the gift would be reportable; if the gift is made to a non-grantor trust for her daughter, the gift would not be reportable.]

Due Date. The supplemental Statement must be given to the IRS and the transferee within 30 days of the date of the distribution or other transfer.

Information Statement. The term "Statement" is defined to be Schedule A of the Form 8971 (or any successor schedule issued by the IRS). Prop. Reg. §1.6035-1(g)(3). Therefore, information regarding subsequent transfers will be described on a Schedule A (both to the transferee and the IRS). This is different from the way that basis consistency information is given to the IRS in all other circumstances; in other situations the IRS is advised with an "information return" (which is Form 8971), but in this situation both the IRS and recipient are advised using a Schedule A.

How Will Recipient Know About Requirement To Report Subsequent Transfers? Perhaps the Notice on Schedule A should be revised by the IRS, or perhaps the transmittal letter sending a Schedule A to a beneficiary should notify the beneficiary that reporting requirements may exist with respect to certain subsequent transfers of property reported on the Schedule A.

(14) "Information Return" and "Statement". The proposed regulations use the terms "Information Return" and "Statement" throughout the regulations. "Information

Return" is defined as Form 8971 and "Statement" is defined as Schedule A (or any successor form issued by the IRS). Prop. Reg. §1.6035-1(g))(2)-(3).

(15) No New Process for Beneficiaries to Contest Estate Tax Values. This basis consistency limitation can lead to unfair results because the beneficiary may have had no input in the values reported on an estate tax return or in audit negotiations. In an audit, the executor may have "traded off" on the valuation of various assets. With this provision, the executor will have to consider the effect of audit negotiations on the basis of assets received by the various individual beneficiaries. Furthermore, the executor will have to consider the values that are reported on the Form 706 with respect to the impact upon beneficiaries for basis purposes. Some planners have questioned whether Wills should be revised to more protection to the executor with respect to the valuation of assets on the Form 706 and the negotiation of values in the estate tax audit.

The preamble to the proposed regulations says that one commenter asked the IRS to provide a process by which a beneficiary could challenge a value reported by the executor on an estate tax return. The IRS responded that "[t]he beneficiary's rights with regard to the estate tax valuation of property are governed by applicable state law"—meaning that the beneficiary can pursue state law remedies with the executor.

j. Proposal in 2017 Fiscal Year President's Budget Plan. The 2017 Fiscal Year Budget Plan proposes that the basis consistently requirement be expanded to apply to "(1) property qualifying for the estate tax marital deduction, provided a return is required to be filed under section 6018, even though that property does not increase the estate's federal estate tax liability, and (2) property transferred by gift, provided that the gift is required to be reported on a federal gift tax return." The proposal would be effective "for transfers after the year of enactment." The estimated 10-year revenue impact of this expansion of the basis consistency requirement is $1.693 billion.

k. Revenue Impact; "Cracking Nuts With a Sledgehammer." Most planners are unaware of any situations in which beneficiaries have taken the position that the basis adjustment under §1014 is different than the value listed on the estate tax return. Many wonder if the revenue estimates (the Joint Committee on Taxation estimated a ten-year revenue impact of $1.542 billion, and the 2016 Fiscal Year Plan estimated a $3.237 billion revenue impact between 2016-2015) are realistic. (Perhaps the estimates assume there is substantial intentional cheating and that having basis numbers reported to the IRS will discourage cheaters.) Furthermore, will the additional actual revenue be less than the additional expense that will be incurred by estates in complying with the information reporting measures within 30 days after estate tax returns are filed?. For large estates having various beneficiaries who cannot be funded by the due date of the reports, imagine the volume of reports that will be required when issuing "mini-Form 706's" to each beneficiary. Most planners believe the revenue estimate is wildly overblown; one planner has referred to this basis consistency and reporting concept as "cracking nuts with a sledgehammer."

5. Equitable Recoupment.

An unfair result may occur in a situation in which an estate asset is sold after the decedent's death, the gain is reported using the value date of death value as reported on the estate tax return, the time period for claiming an income tax refund expires, and afterward the estate tax value of the asset is finally determined and is increased. In that situation, equitable recoupment may provide relief for the taxpayer. The equitable recoupment doctrine is a well-established equitable remedy when the same transaction,

item or taxable event is subject to two inconsistent taxes. United States v. Dalm, 494 U.S. 596, 608 n.5 (1990). The doctrine permits a party to a tax dispute to raise a time barred claim in order to reduce or eliminate the money owed on the timely claim. Rothensies v. Elec. Storage Battery Co., 329 U.S. 296, 300 (1946). (The doctrine may also be raised by the IRS as a defense to a claim for refund. E.g., Estates of Buder v. United States, 372 F. Supp.2d 1145 (E.D. Mo. 2005), aff'd, 436 F.3d 935 (8th Cir. 2006).

The required elements of an equitable recoupment offset are as follows. (1) The "same transaction, item or taxable event" must be subject to two taxes; (2) The taxes must be inconsistent; (3) The tax sought to be recouped must be time barred; (4) There must be an "identity of interest" between the parties paying the duplicative tax; and (5) The court in which the recoupment claim is brought must independently have jurisdiction to adjudicate the claim. E.g. Estate of Branson v. Comm'r, 264 F.3d 904 (9th Cir. 2001), cert. denied 535 U.S. 927 (2002); Estate of Jorgensen, T.C. Memo. 2009-66 (equitable recoupment allowed to adjust for prior income tax overpayments in light of increase in basis attributable to increased gross estate value after §2036 applied to include assets contributed to family limited partnership in gross estate).

From a planning perspective filing a protective claim for refund of the initial tax should be filed, if possible, rather than having to rely on an equitable recoupment argument. This is a fairly common situation, where the IRS claims that estate assets are undervalued for estate tax purposes, and typically that allegation would arise before the statute of limitations has run on any post-death sales of assets by the estate or estate beneficiaries, thus leaving time to file a protective claim for refund of the excess income tax paid by the estate or estate beneficiary.

D. Executor's Commissions.

1. Consider Tax Effects of Payment of Executor's Commissions.

If an executor's commission is paid, the executor will receive the fee as ordinary income, and the fees will be deductible by the estate for estate tax or fiduciary income tax purposes. If the executor does not accept a fee, there will be no deduction on the estate tax return or fiduciary income tax return, but the executor will not realize ordinary income. Therefore, the executor should consider the relative marginal brackets of the executor's personal income tax, the estate tax, and the fiduciary income tax. In addition, if younger generation family members are also beneficiaries, the executor may effectively shift value from the older generation to the younger generation without any additional transfer tax costs by waiving commissions.

In comparing the bracket of the individual fiduciary in receiving the income versus the bracket of the estate for deductions, consider whether the executor's commission will be treated as self-employment income subject to the self-employment tax. Rev. Rul. 58-5, 1958-1 C.B. 322 (executor commissions of nonprofessional fiduciaries generally not treated as earnings from self-employment), *distinguished in* Rev. Rul. 72-86, 1972-1 C.B. 273. Executor commissions are also not subject to the net investment income tax. See Item II.B.7.a above.

2. Comply with Requirements for Valid Waiver of Commissions.

Two issues arise with respect to whether a waiver of executor commissions will be recognized: (1) whether the income will be includible in income even though not received, under the constructive receipt doctrine, and (2) whether the waiver will be treated as a gift to residuary beneficiaries. The primary factor is whether the commissions are waived early in the estate administration. Rev. Rul. 64-225, 1964-2 C.B. 15. A waiver should be

formalized within six months of appointment. If commissions are not waived within the first six months, an intention to serve on a gratuitous basis may still be shown if the fiduciary fails to claim fees "and if all of the other attendant facts and circumstances are consistent with a fixed and continuing intention to serve gratuitously." Rev. Rul. 66-167, 1966-1 C.B. 20; Breidert v Commissioner, 50 T.C. 844 (1968), acq., 1969-2 C.B. xxiv.

III. GIFT TAX PLANNING.

Any taxable gifts made by the decedent during life must be reported on timely filed federal gift tax returns. If the executor is aware of taxable gifts by the decedent for which returns have not been filed, the executor should file returns as soon as possible. Reg. §25.6019-1(c) (executor required to file gift tax return for deceased donor). If the donor dies during the calendar year in which a gift is made, the Form 709 must be filed and the gift tax must be paid no later than the earlier of (i) the date (including extensions) the decedent's estate tax return is due or (ii) April 15 of the year following the calendar year in which the gifts were made. §6075(b)(3); Treas. Reg. §25.6075-1(b)(2)(filing); §25.6151-1 (payment). If no estate tax return is required to be filed, the gift tax return is due on April 15 of the following calendar year. Treas. Reg. §25.6075-1(b)(2).

IV. ESTATE TAX PLANNING

A. Alternate Valuation Date.

1. General Rule.

The economy of the last several years has left many situations in which the estate assets decline in value during the first six months following the decedent's death. The alternate valuation election in that situation *may* produce substantial estate tax savings, but careful planning is required. See generally Blattmachr & Lo, Alternative Valuation—Now, Perhaps, More Important Than Ever, 111 J. TAX'N 90 (Aug. 2009).

An executor may elect to have the estate assets valued as of a date six months after the decedent's death. There are two requirements to qualify for the alternate valuation date election; the gross estate must decline as a result of making the election and the combined estate and GST taxes must decline as a result of making the election. If the alternate valuation date is selected, any assets sold or distributed during this six-month period would be valued as of the date of sale or distribution. §2032(a). The actual sales price of a publicly traded security, not the median between the high and low on the date of sale, is used. Rev. Rul. 70-512, 1970-2 C.B. 192. For estates of decedents dying after July 18, 1984, the election may be made only if it will decrease the value of the gross estate and the combined amount of federal estate tax (reduced by allowable credits) and federal generation-skipping transfer tax. §2032(c). Treas. Reg. § 20.2032-1(b)(1).

The regulations describe in detail what property is "included" and "excluded" in the alternate valuation date value. For example, income earned or accrued after the date of death is generally excluded. Treas. Reg. §20.2032-1(d).

While income earned or accrued after the date of death are generally treated as "excluded property", Regulation § 20.2032-1(d)(4) states that dividends declared to stockholders of record on or before the date of death are included property. "On the other hand, ordinary dividends out of earnings and profits declared to shareholders of record after the date of decedent's death are 'excluded property' and are not to be valued under the alternate valuation method." Treas. Reg. § 20.2032-1(d)(4). The IRS ruled privately that

amounts earned by a decedent's wholly owned corporation during the six-month period after her death that were not distributed to her estate during that period were not excluded property for purposes of determining the value of the stock on the alternate valuation date. Letter Rul. 200343002. (The estate could avoid this result and reduce the alternate value by simply declaring all of the corporation's earnings as dividends during the six-month period after the date of death.)

2. Mechanics for Making Election; Protective Elections

Once made, the election is irrevocable. §2032(d)(1). The election cannot be made if the federal estate tax return is filed more than one year after the expiration of the time for filing the return (including extensions). §2032(d)(2). The election must be made on "the last estate tax return filed by the executor on or before the due date of the return (including extensions of time to file actually granted) or, if a timely return is not filed, the first estate tax return filed by the executor after the due date, provided the return is filed no later than 1 year after the due date (including extensions of time to file actually granted)." Reg. § 20.2031-1(b)(1).

The regulation also removes Reg. §301.9100-6T(b), so that estates that fail to make the alternate valuation election on the last estate tax return filed before the due date or the first return filed after the due date could request an extension of time to make the alternate valuation election or a protective election under Reg. § 301.9100-1 and §301.9100-3. There is no limit on the time for making a request for extension of time to make the election or protective election (subject to the requirements under the 9100 regulations), as long as the return was filed no later than 1 year after its due date (including extensions of time actually granted.) Reg. § 20.2032-1(b)(3). E.g., Ltr. Ruls. 201109014 (revoking Ltr. Rul. 201033023); 200452030. Before the regulation was finalized, the IRS maintained that 9100 relief had to be requested within one year of the due date of the return. E.g., Ltr. Rul. 211419005.

If the election is made, it applies to all property in the gross estate and cannot be applied to only a portion of the property. Reg. §20.2032-1(b)(1).

The regulations provide guidance on making a protective election in cases where, based on the return as filed, alternate valuation would not result in a decrease in transfer tax but it is later determined that such a decrease would occur. Reg. § 20.2032-1(b)(2). While a protective election generally would be irrevocable, it could be revoked on a subsequent return filed by the due date (including extensions actually granted). Absent a revocation, when it is determined that the election would result in a decrease of estate and GST tax payable by reason of the decedent's death, alternate valuation would apply and could not later be changed. Reg. § 20.2032-1(b)(2). Various types of protective elections have been approved. E.g., Estate of Mapes v. Comm'r, 99 T.C. 511 (1992); Tech. Adv. Memo. 9846002; Ltr. Rul. 199942015.

3. Make Alternate Valuation Election if it Produces Lower Estate Tax.

If the aggregate value of assets in the estate has decreased by the time of the alternate valuation date, and if the estate is in the position of having to pay an estate tax, making the alternate valuation election would generally produce a favorable result. The effect is that the estate receives 100% of appreciation during the six-month period, but only bears 65% of depreciation during that period (with a 35% estate tax). Some planners suggest using a collar (buying a "put" on the value of the stock on the date of death and selling a "call" to completely offset the price of the put). The effect is that the estate is assured of receiving at least the value of the stock on the date of death, but can also receive some of the appreciation (i.e., up to the "strike price" on the call option) if there is

appreciation during the six-month period. The estate would pay estate taxes based on the lower of the date of death or alternate value. Any additional value received by the estate would be subject to capital gains taxes. A potential issue is whether entering into the put obligation constitutes a disposition for purposes of the alternative valuation date election. See Gordon & Hoopingarner, The Estate Collar, TRUSTS & ESTATES 45 (Dec. 2008).

4. Consider Making Sufficient Disclaimers to Cause a Small Amount of Tax to be Payable.

Making the alternate valuation election in an estate that depreciates during the six month period after the date of death may be helpful if the will has a marital deduction formula clause to charge the entire loss against the marital share (for example, if a pecuniary amount marital deduction/credit shelter residuary disposition is used). For decedents dying after July 18, 1984, the election may be made only if it will decrease the value of the gross estate and the amount of the federal estate tax (reduced by allowable credits). If the estate will not pay an estate tax because of the marital deduction, consider having the spouse disclaim a sufficient amount so that a small federal estate tax would be produced. Alternatively, the trustee of a QTIP could make a partial QTIP election to generate a small federal estate tax. However, consider that this may generate a substantial state inheritance or estate tax for decedents dying before 2005. For example, for a decedent dying in 2003, if the state death tax is based on the federal state death tax credit amount, the spouse would need to disclaim $43,458, which would produce a state death tax of $17,817, in order to result in the payment of a federal estate tax—which would be reduced by making the alternate valuation date election. However, if the state has "decoupled," and imposes a state death tax based on the prior level of the state death tax credit and based on lower "applicable exclusion amounts," the added state death tax from the disclaimer may be much lower. For example, a disclaimer of $43,458 for a New Jersey decedent dying in 2003 may result in additional state tax of only $2,434 while producing a federal estate tax of $1. *See* Fox, Pomeroy & Abbott, "Ramification for Estate Planners of the Phase-Out of the Federal State Death Tax Credit: Boom, Bust or Unknown?" 29 ACTEC J. 26, 30 (Summer 2003).

For decedents dying after 2004, there is no state death credit, but there is an unlimited federal estate tax deduction for state death taxes under §2058. Under that regime, if the state has an exemption equal to the federal applicable exclusion amount, a disclaimer or "unelected QTIP" of slightly more than the applicable exclusion amount would result in a taxable estate that would produce a small federal estate tax. Because a deduction rather than a credit is allowed for state taxes, a small federal tax would be produced for any amount of taxable estate in excess of the applicable exclusion amount (even after considering the state death tax deduction under §2058) as long as the state tax rate is less than 100%. However, if the state imposes death taxes based on a lower exemption, specific calculations will be needed to determine how much must be disclaimed before a federal estate tax is generated, taking into consideration that a substantial amount of state death taxes may be imposed on the federal applicable exclusion amount.

Some planners prefer using the "unelected QTIP" approach because (1) it is administratively simpler than dealing with the technical disclaimer requirements, (2) there are 15 months (if the return is extended) rather than just 9 months with a disclaimer to make the decision, and (3) the spouse can have a testamentary limited power of appointment with the QTIP approach but not with a disclaimer.

An alternative approach would be to utilize the "decreased GST tax" leg of the decreased tax rule. For example, if a portion of the residue passes to grandchildren, the

GST tax may be reduced if using the alternate valuation date values reduce the size of the estate.

The disadvantage of using the alternate valuation date to lower the values in order to be able to fully fund the bypass trust is that the income tax basis of the estate assets in the hands of estate beneficiaries will be lower. The planner must weigh the estate tax savings years later (from a larger bypass trust) vs. the current tax basis decrease.

5. Consider Effects of Sales and Distributions on Alternate Values.

A sale or distribution of an asset within the six-month alternate valuation period fixes the alternate valuation of that particular asset as of the date of the sale or distribution. If assets that have depreciated in value since the date of death will have to be sold in order to generate sufficient liquidity for paying estate taxes, consider selling those assets within the six-month alternate valuation period. If sales are made after the six-month alternate valuation period, any additional subsequent drop in the market value may result in reduced proceeds of sale without any reduction of estate tax values. If the alternate valuation is to be selected, distributions should be made during the six-month period only if the executor anticipates that the value of an asset has reached a low, and that the value may increase prior to the end of the six-month period.

Another possible advantage of sales and distributions would be to prevent the increasing value of a few assets from "cannibalizing" the reduction in value of other estate assets. If the estate assets are generally declining in value but several assets are expected to increase in value, selling or distributing those assets would cap the value used for alternate valuation purposes at the value on the date of such sale or disposition. A very easy way to accomplish that for pourover will estates is to distribute the asset from the estate to the revocable trust. Even if the same person is the executor and trustee, retitling the asset in a book entry is deemed to be a disposition for purposes of the acceleration rule. Query, what if the estate sells an asset to cap the value for alternate valuation purposes, and then immediately repurchases the same number of shares of stock in that same company? There are no direct "wash sales" rules under §2032 or its regulations and many planner presume none would apply for alternate valuation date purposes.

In Kohler v. Comm'r, T.C. Memo 2006-152, *nonacq.* AOD 2008-001, the company did a tax-free reorganization during the first six months of the estate administration. Is that a disposition that accelerates the alternate valuation date — so the estate would value the old Kohler stock on the reorganization date — or is it a mere change in form so the estate values the new stock on the alternate valuation date? The court said it was a close question, but ruled it was tax free event, a mere change in form, so it was not treated as a disposition and the new stock was valued on the alternate valuation date. The IRS filed a non-acquiescence in the Kohler case. The Treasury's nonacquiescence makes clear that changes in value because of a change in the character of the property should not be permitted on the alternate valuation date.

Proposed regulations were issued in 2008, in response to Kohler, providing that the election to use the alternate valuation method is available to estates that experience a reduction in the value of the gross estate following the date of the decedent's death due to market conditions, but not due to other post-death events. "Market conditions" is defined as "events outside the control of the decedent (or the decedent's executor or trustee) or other person whose property is being valued that affect the fair market value of the property being valued." The regulation goes on to provide that "[c]hanges in value due to mere lapse or time or to other post-death events other than market conditions will be ignored…under the alternate valuation method." Prop. Treas. Reg. §20.2032-1(f)(1). The 2008 proposed

regulation was to be effective, when the regulation was finalized, for estate of decedents dying on or after April 25, 2008.

The IRS received comments to the 2008 proposed regulations raising enough concerns that the IRS withdrew those proposed regulations and issued new proposed regulations on November 17, 2011. The new proposed regulations take the approach of describing events that constitute an acceleration event. For those events, the valuation is determined the moment before the acceleration event and the triggering event itself is not reflected in the value that is included in the gross estate. The result is similar to the prior proposed regulations, but the new proposed regulations are more expansive in the events that are addressed. Jeff Pennell concludes that these regulations will not impact most estates and that they will minimal effect. Leimberg Estate Planning Newsletter #1898 (Nov. 29, 2011). Highlights of the new proposed regulations are briefly summarized. See generally Nathan Honson, The 2011 Proposed Alternate Valuation Date Regulations, WILLAMETTE MNGT ASSOCIATES INSIGHTS 3 (Summer 2012).

- There is a general rule describing very broadly transactions that constitute distributions, sales, exchanges, or dispositions that trigger valuation on the "transaction date" rather than on the 6-month date). Prop. Reg. § 20.2032-1(c)(1)(i).There is a nonexclusive long list of events including investing in other property, contributions to an entity (whether nor not gain is recognized on the contribution, an exchange of an interest in an entity for a different interest in that entity or in another entity (unless the fair market values of the exchanged interests are within 5% of each other, Prop. Reg. § 20.2032-1(c)(1)(ii)).
- Also included in the general rule list of accelerating transactions is a change in the ownership structure or interest in or assets in an entity such that the interests after the change does not reasonably represent the property at the date of death, including the dilution of the decedent's ownership interest, the redemption of a different owner which increases the decedent's ownership interest, a reinvestment of the entity's assets, and a distribution or disbursement of property by the entity other than earnings or expenses paid in the ordinary course of business (but see the exception below that applies to distributions or disbursements) . Prop. Reg. § 20.2032-1(c)(1)(i)(I).
- There is an exception for a distribution or disbursement from an entity or from other assets if the distribution/disbursement does not reduce the combined value of the payment plus the entity value after the distribution/disbursement. In that case the alternate value is the value of the payment on the payment date and the value of the remaining interest in the entity on the 6-month date. Prop. Reg. § 20.2032-1(c)(1)(iii)(A).
- A special aggregation rule when *part* of an interest owned by the decedent is "distributed, sold, exchanged or otherwise dispose of" during the initial 6 months. The special aggregation rule eliminates the application of fractionalization discounts in determining the value of the interest or interests that are distributed and of any interest remaining in the estate at the end of the 6-month period (if any). For example, if the estate distributes 70% of Blackacre to beneficiary A after one month and distributes the remaining 30% to beneficiary B after two months, the value of each distribution is determined on the respective distribution date without any fractionalization discount. Prop. Reg. § 20.2032-1(c)(1)(iv).

- Property that is distributed by beneficiary designation or by operation of law is not treated as a disposition. Those various distributed interests are valued on the 6-month date.
- There are a number of examples illustrating these rules. As examples, a contribution of assets to a limited partnership or the dilution of a decedent's interest in an entity to a noncontrolling interest are treated as accelerating transactions. Also, multiple distributions or sales of interests during the 6-month period are treated as proportionate distributions without applying an fractionalization discount attributable to the fractionalized interests thereby created.
- The new proposed regulation will be effective for estates of decedent dying on or after the date the regulations are finalized.

B. Special Use Valuation.

1. General Effect of Special Use Valuation.

Certain real estate used in a farm or in a trade or business may be valued at its use in that enterprise rather than at its fair market value measured by its "highest and best use." For persons dying after 1982, the maximum reduction in value is $750,000. §2032A(a)(2). The Revenue Act of 1997 provides that the $750,000 is increased for cost of living increases beginning in 1999, with any increase being rounded down to the next lowest multiple of $10,000. § 2032A(a)(3). The $750,000 amount has increased as follows for persons dying in the respective years: $760,000 in 1999, $770,000 in 2000, $800,000 in 2001, $820,000 in 2002, $840,000 in 2003, $850,000 in 2004, $870,000 in 2005, $900,000 in 2006, $940,000 in 2007, $960,000 in 2008, $1,000,000 in 2009 and 2010, $1,020,000 in 2011, $1,040,000 in 2012, $1,070,000 in 2013, $1,090,000 in 2014, $1,100,000 in 2015, and $1,110,000 in 2016. Rev. Proc. 2015-53, 2015-44 I.R.B.; Rev. Proc. 2014-61, 2014-47 I.R.B. 860; Rev. Proc. 2013-35, 2013-47 I.R.B. 537; Rev. Proc. 2012-41, 2012-45 I.R.B. 539; Rev. Proc. 2011-52, 2011-45 IRB.

The special use value applies for generation-skipping transfer tax purposes as well as for estate tax purposes. §§ 2624(b) (direct skips of property in gross estate), 2642(b)(2)(A) (for transfers at death use estate tax values in determining inclusion ratios).

2. Qualification Requirements.

A number of detailed requirements must be satisfied before special use valuation is available. These include a 50% test and a 25% test.

Fifty percent or more of the "adjusted value" of the gross estate must consist of real or personal property that was (1) used for a "qualified use" by the decedent or "member of the decedent's family" on the date of death, and (2) "acquired from or passed from" the decedent to a "qualified heir." §2032A(b)(1)(a).

Twenty-five percent or more of the "adjusted value" of the gross estate must consist of real property that was (1) "acquired from or passed from" the decedent to a "qualified heir," (2) during five or more years of the eight year period prior to retirement, disability or death, there was "material participation" by the decedent or a member of the decedent's family, and (3) for five or more years of the eight year period prior to death there was a "qualified use" with respect to the real property by the decedent or a "member of the decedent's family." §2032A(b)(1)(B)

The interest in the qualifying real property may be owned indirectly through a corporation, partnership, trust, or limited liability company. §2032A(g); *see generally* Kasner, Strauss & Strauss, POST MORTEM TAX PLANNING (WG&L) ¶7.02[2][a].

An excellent summary of these requirements is included in the instructions for Schedule A on the Form 706.

A regulation requiring that a partial election of qualifying property is available only if the partial election covers property comprising at least 25% of the adjusted value of the gross estate was declared invalid as being contrary to the unambiguously expressed intent of Congress in §2032A in Finfrock v. U.S., 109 AFTR 2d ¶2012-596 (D. Ill. March 20, 2012).

3. Special Use Value.

If the special use valuation election is made, the property may be valued based on a capitalization of rents method (if it is farm or ranch land) under §2032A(e)(7) or a five-factor method under §2032A(e)(8). The capitalization of rents method is most commonly used. This method values the property by dividing the average annual gross cash rental (after payment of state and local real estate taxes) for comparable land for the five most recent full calendar years ending prior to death, by the average annual effective interest rate for all new Farm Credit Bank Loans in the district where the property is located for the year of death. The rates for each year are described in a Revenue Ruling. Rev. Rul. 2015-18, 2015-34 I.R.B. (2015 rates range from 4.17% to 5.21%); Rev. Rul. 2014-21, 2014-34 I.R.B. (2014 rates range from 4.31% to 5.29%); Rev. Rul. 2013-19, 2013-39 I.R.B. (2013 rates range from 4.56% to 5.49%); Rev. Rul. 2012-26, 2012-39 I.R.B. 358 (2012 rates range from 5.15% to 6.19%); Rev. Rul. 2011-17, 2011-33 IRB 160 (2011 rates range from 5.78% to 6.97%). Therefore, comparable lease information must be obtained in order to determine the special use value. Cash rentals from the decedent's land cannot be used; only cash rentals from the comparable land that are the result of arms' length bargaining may be used. Courts generally have been strict in requiring the identification of comparable land and of five years of actual cash rents from those comparable properties. For an excellent analysis of the alternative valuation methods, see Rogers v. Comm'r, T.C. Memo. 2000-133.

Some attorneys report that they have been successful (on multiple occasions) in getting IRS agents to approve using the "Agricultural Value" on property tax statements as the special use value. This is one of the factors listed under the "five factor method." §2032A(e)(8)(C) ("assessed land values in a State which provides a differential or use value assessment law for farmland or closely held business").

4. Minority Interest Discount With Special Use Valuation.

Various cases and rulings previously held that a minority interest discount could not be applied to the special use value (where the real estate is held in an entity). Maddox v. Comm'r, 93 T.C. 228 (1989), Technical Advice Memorandum 9119008 and Field Service Advice 1999-1081 (April 2, 1993). A subsequent 10th Circuit case, however, has held that for purposes of determining the limit based on the $750,000 (indexed) maximum reduction in value attributable to §2032A valuation, the estate could determine the highest and best use value taking into consideration a minority interest discount. (The §2032A value could be as low as such discounted highest best use value minus $750,000 indexed amount.) Estate of Hoover v. Comm'r., 69 F.3d 1044 (10th Cir. 1995), rev'g, 102 T.C. 777 (1994). The IRS has announced its acquiescence in part in the Hoover case, 1999-1 I.R.B.5, and has followed that approach in private rulings. Ltr. Rul. 200448006. The IRS has confirmed that the same approach of applying minority interest discounts to special use values also applies for GST purposes. Ltr. Rul. 200448006.

C. General Valuation Considerations.

1. Penalty Considerations.

a. Substantial and Gross Valuation Penalty Tests. The Pension Protection Act of 2006 toughened the valuation penalty rules. These tougher rules apply to any returns filed after August 17, 2006. Income tax: Substantial valuation misstatement--If there is an underpayment of income tax by more than $5,000 and if the value claimed on the return is from 150% to 200% (down from 200% to 400%) of the "correct" value, there is a penalty of 20% of the underpayment of income tax attributable to the overvaluation. Gross valuation misstatement--The penalty is 40% if the valuation claimed is 200% (down from 400%) of the "correct" value. § 6662(a & e).

Estate and gift tax: Substantial valuation misstatement--If there is an underpayment of estate or gift tax by more than $5,000 and if the value claimed on the return is from 65% to 40% (up from 50% to 25%), there is a penalty of 20% of the underpayment of estate or gift tax attributable to the undervaluation. Gross valuation misstatement--The penalty is 40% if the valuation claimed is 40% (up from 25%) or less of the "correct" value. §6662 (g-h). For example, the 20% substantial valuation misstatement penalty could apply if an estate or gift tax return claims a 35% discount that is disallowed totally.

There is also a separate fraud penalty that is separate from the substantial and gross valuation penalty. There is a 75% penalty for the portion of underpayment that is attributable to fraud. §6663. The fraud penalty can be applied based on fraud in intentionally undervaluing properties. See Gaughen v. U.S., 109 AFTR 2d 2012-752 (M.D. Pa. 2012).

b. Reasonable Cause Exception. A "reasonable cause" exception applies if the underpayment was due to "reasonable cause" and the taxpayer "acted in good faith". §6664(c). (However, reasonable cause is no longer a defense to a gross overvaluation misstatement penalty for charitable deduction income tax purposes for returns filed after August 17, 2006 unless there is a qualified appraisal and a good faith investigation of the value of the contributed property. §6664(c)(3).) As an example, this exception might apply if the valuation is supported by an appraisal by an independent qualified appraiser. See Estate of Berg v. Commissioner, 976 F.2d 1163 (8th Cir. 1992) (reliance on experienced and respected CPA constituted reasonable cause); Litman/Diener v. United States and Hotels.com v. United States, 78 Fed. Cl. 90 (2007); Estate of Jung, 101 T.C. 412 (1993) (reasonable basis for valuation used on return even though court criticized appraiser's report); Estate of Giovacchini, T.C. Memo. 2013-27 (estate relied upon professional advisors who were provided the information they needed to accurately appraise the property; estate demonstrated good faith reliance and never directed the appraiser to take any particular tax positions that might have been favorable; understatement arose from the evaluation of a unique property and in a unique location that was very difficult to value); Bernard Mandelbaum, 69 T.C.M. 2852 (1995) (reliance on advice of company's outside counsel and outside accountant)..

Reliance on professional advice is not necessarily sufficient to avoid the undervaluation penalty. In Estate of Josephine Thompson v. Comm'r, T.C. Memo 2004-174, the Tax Court reasoned that merely having an independent appraisal did not necessarily satisfy the good faith exception, but found that the exception applied based on various factors including that the valuation was particularly difficult and unique and involved a number of difficult judgment calls. The Tax Court specifically observed that while the appraisers for both the estate and the IRS were aggressive, the court's determination of value was closer to the estate's valuation than the IRS's valuation. The Second Circuit

determined that the Tax Court did not apply the correct legal test, and remanded to the Tax Court to make factual findings based on the legal test announced by the Second Circuit. 499 F.3d 129 (2nd Cir. 2007). The court said that "reliance on … an appraiser does not necessarily demonstrate reasonable cause and good faith,", but reliance on an appraiser does satisfy the reasonable cause exception if "under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith." The court noted that reliance on an expert's opinion "may not be reasonable or in good faith if the taxpayer knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of federal tax law." On remand, the Tax Court concluded that although the estate's experts were "not sophisticated valuation experts," they were "sufficiently credible and sufficiently qualified … to have their opinions considered by the Court," and that reliance on them was reasonable cause and good faith. The IRS appealed that determination as well, and the Second Circuit concluded that the Tax Court had complied with the Second Circuit's mandate. It had made an explicit finding based on the evidence that the reliance on the experts "was reasonable and in good faith." Even though there was hesitation about the experts' qualifications, "the Tax Court specifically clarified that the experts were, in fact, sufficiently credible and qualified to form the basis of the Estate's good faith reliance." 105 AFTR 2d ¶2010-1413 (2010).

The Tax Court refused to apply the reasonable cause exception in Estate of Richmond v. Comm'r, T.C. Memo. 2014-26. The executors engaged an accountant to value the decedent's interest in a closely-held investment holding company. The accountant had prepared 10-20 valuation reports and had testified in court, but did not have any appraiser certifications. The accountant delivered an unsigned draft of his valuation report. He was never asked to finalize the report and without further consultation, the estate reported the decedent's interest in the stock at the amount in the unsigned draft. The court cited several reasons for its conclusion that the accountant's activities did not support a reasonable cause and good faith position by the estate. (1) The accountant had some appraisal expertise but did not have any appraisal certifications. (2) The accountant testified at trial but "[t]he estate did not proffer him as an expert witness and did not demonstrate that he is qualified as an expert in valuation." (3) The estate merely used the number on the unsigned draft report. (4) The estate never discussed how the accountant arrived at the value used other than that two prior transactions used the capitalization of dividends approach. (5) The estate did not explain what defects in the accountant's valuation resulted in the initial $3.1 million value being abandoned at trial in favor of the higher $5 million value, so the value on the Form 706 "is essentially unexplained."

The court in particular emphasized the fact that the estate did not rely on a certified appraiser: "In order to be able to invoke "reasonable cause" in a case of this difficulty and magnitude, the estate needed to have the decedent's interest in PHC appraised by a certified appraiser. It did not."

c. Penalty Imposed On Appraisers. Rather than the aiding and abetting penalty under §6701 (generally limited to $1,000), appraisers are now subject to a penalty equal to the greater of $1,000 or 10% of the underpayment attributable to the valuation misstatement, up to a maximum of 125% of the gross income received for preparing the appraisal, in certain circumstances. The appraiser penalty applies if the appraiser knew or should have known that the appraisal would be used in connection with a return or refund and if the appraised value results in a substantial valuation misstatement or a gross valuation misstatement. No penalty is imposed on the appraiser if the appraiser establishes that the appraised value was "more likely than not" the correct value. The appraiser penalty applies for appraisals prepared for returns or submissions filed after August 17, 2006.

Query whether this provision will have a "chilling" effect on appraisers and significantly affect appraisals for tax purposes. Appraisers may be more conservative in giving tax appraisals than when giving appraisals for "real life" transactions.

d. Tax Return Preparer Penalties Broadened.

(1) Overview of Standard. Section 6694 was amended in the Small Business and Work Opportunity Act of 2007 to strengthen the return preparer penalties. Section 6694 was amended to elevate the general rule from a realistic possibility of success standard to a "more likely than not" (greater than 50%) likelihood of success to avoid penalties. §6694(a)(2)(B). The Emergency Economic Stabilization Act of 2008 changed the "more likely than not" standard to "substantial authority." If adequate disclosure of the issue is made on the return (or for a non-signing practitioner, if advice about disclosure is given), the non-frivolous standard is elevated to a reasonable basis standard. §6694(a)(2)(B). There is a further exception from preparer penalties if the preparer had reasonable cause and acted in good faith. § 6694(a)(3). In 2009, the IRS finalized §6694 regulations.

(2) Overview of Comparison to Taxpayer Penalty Standards. Very briefly, the major taxpayer penalty provision is for the substantial understatement of *income tax*, if the understatement is the greater of (1) 10% of the tax shown on the return, or (2) $5,000. § 6662(d)(1)(A). Unless the issue involves a tax shelter (in which event more onerous standards apply), the general standard for avoiding taxpayer penalty is substantial authority. However, if the issue is adequately disclosed there is no taxpayer penalty if there is a reasonable basis for the position. § 6662(d)(2)(B). There is an exception from taxpayer penalties if the taxpayer had reasonable cause and acted in good faith. § 6664(c). Therefore, for this taxpayer penalty for income taxes, the standard to avoid penalties is the same for taxpayers and for preparers.

For other taxpayer penalties (including penalties related to estate and gift taxes) taxpayer penalties can be avoided if there is reasonable cause and good faith (§ 6664(c)) or if the taxpayer is not negligent (§ 6662(b)(1)), which requires that there is a reasonable basis for the position. Reg. § 1.6662-3(b)(1).

(3) Definition of Return Preparer. Section 6694 applies to both signing and nonsigning tax return preparers. Reg. §1.6694-1(b). In either case, a preparer refers only to someone who prepares or gives advice as to "all or a substantial portion" of the return. §7701(a)(36)(A); Reg. §301.7701-15(a).

Position by Position Approach; Primary Responsibility. A very important change in the regulations is to adopt a "position by position" approach, recognizing that different preparers can be responsible for different positions on a return. If an advisor is responsible for a particular position on a return, that person is the preparer with respect to that position, not the person who signs the return.

Only One Preparer For a Position In Same Firm. "There is only one individual with a firm who is primarily responsible for each position on the return or claim for refund giving rise to an understatement." Reg. §1.6694-1(b)(1).

Substantial Portion. "Whether a schedule, entry or other portion of a return or claim for refund is a substantial portion is determined based upon whether the person knows or reasonably should know that the tax attributable to the schedule, entry or other portion of a return or claim for refund is a substantial portion of the tax required to be shown on the return or claim for refund." Reg. §301.7701-15(b)(3)(i). A single tax entry may constitute a substantial portion of the tax required. Factors to consider include but are not limited to: "(A) the size and complexity of the item relative to the taxpayer's gross income;

and (B) the size of the understatement attributable to the item compared to the to the taxpayer's reported tax liability." Id. There is a de minimis safe harbor for certain nonsigning income tax return preparers.

(4) Reasonable Basis. The reasonable basis standard will be interpreted in accordance with the current regulations (Reg. §1.6662-3(b)(3)). Reg. §1.6694-2(d)(2).

33%? A proposed amendment to Circular 230 removed the statement that a reasonable basis means a one in three chance of success, but gives a more subjective description.

25%? Some within the IRS says this means a one in four likelihood.

20%? An analogous provision in the taxpayer penalty provisions suggests a 20% likelihood of success standard. (Taxpayers are only subject to a "substantial authority" standard [which the Joint Committee on Taxation says is approximately a 40% likelihood of success on the merits] for undisclosed positions and a "reasonable basis" standard [which the Joint Committee on Taxation says is approximately a 20% likelihood of success on the merits] for disclosed positions in order to avoid penalties under §6662.)

(5) Disclosure Methods to Reduce Standard to Reasonable Basis Standard — Signing Preparers. Notice 2008-13 and the final regulations include significant lenient alternatives for satisfying the disclosure requirement. Three permissible disclosure methods are described for signing preparers. (i) Disclosure with return. File a Form 8275 or Form 8275-R with the return. Reg. §1.6694-2(d)(3)(i)(A). (ii) Preparer prepares disclosure but taxpayer removes it. Deliver the return to the taxpayer with a disclosure attached. Reg. §1.6694-2(d)(3)(i)(B). (iii) For returns other than income tax returns. The third method applies for returns other than income tax returns. (The regulation refers to returns subject to penalties pursuant to §6662 "other than the substantial understatement penalty under §6662(b)(2) and (d)." Section 6662(b)(2) and (d) refer to income tax returns.) Under this method that applies to estate and gift tax returns, the preparer must advise the taxpayer of the penalty standards applicable to the taxpayer under §6662, and must contemporaneously document the advice. Reg. §1.6694-2(d)(3)(i)(C). Therefore, the preparer can always reduce the reporting standard from a substantial authority standard to a mere reasonable basis standard (for returns other than income tax returns) by merely advising the taxpayer of the taxpayer penalty standards under §6662 and contemporaneously documenting the advice.

Guidance in Regulations-Generally. The regulations provide guidance about how to provide adequate disclosure — generally using Form 8275 (or Form 8275-R for a position that is contrary to a regulation). Reg. §1.6694-2(d)(3), incorporating Reg. § 1.6662-4(f). The regulations also give detailed guidance as to the requirements for giving sufficient advice about penalties in order to use the more lenient disclosure standards. Reg. §1.6694-2(d)(3)(iii).

Each Position That May Not Meet Substantial Authority Standard. The preparer must address each position for which there is a reasonable basis but not a substantial authority basis for the position.

Tailored to Taxpayer. "The advice to the taxpayer with respect to each position… must be particular to the taxpayer and tailored to the taxpayer's facts and circumstances." Id. The preparer must contemporaneously document the advice.

Boilerplate Not Sufficient. "There is no general pro forma language or special format required for a tax return preparer to comply with these rules. A general disclaimer will not satisfy the requirement …" Id.

May Use Form or Template. "Tax return preparers, however, may rely on established forms or templates in advising clients regarding the operation of the penalty provisions of the Internal Revenue Code." Id. The Preamble to the final regulations states that "Tax return preparers, and their firms, may use standard language to describe applicable law and may adopt a standard approach to disclosure issues."

Single or Separate Documents. The advice may be given in a single document covering all positions, or in separate documents for each position. Id.

While a boilerplate notice is not sufficient, the penalty standards under §6662 (or for a nonsigning preparer, advice to the taxpayer of the opportunity to avoid penalties under §6662 or advice to another return preparer of his or her disclosure requirements) would seem to be a very similar notice for many situations, as long as there is listing of each position for which the substantial authority standard may not be satisfied. Preparers may develop a format that will generally be used for giving the requisite advice, and list the particular positions on the return that may have inherent uncertainty as to satisfying the substantial authority standard.

(6) Disclosure Methods — Nonsigning Preparers. For advice to a taxpayer, the disclosure requirement (to reduce the standard from substantial authority to reasonable basis) is met either (1) by giving disclosure on Form 8275 or Form 8275-R, or (2) by the preparer advising the taxpayer of any opportunity to avoid penalties under § 6662 that could apply to the position and of the standards for disclosure to the extent applicable. The preparer must contemporaneously document the advice. Reg. §1.6694-2(d)(3)(ii)(A). For advice to another return preparer, the preparer must advise the other return preparer that disclosure under § 6694(a) may be required, and must contemporaneously document the advice. Reg. §1.6694-2(d)(3)(ii)(B).

(7) Exception for Advice Given Before Transaction. Pre-transaction advice may be subject to preparer penalties under § 6694 if (1) the position causing an understatement is primarily attributable to the pre-transaction advice, (2) the advice was substantially given prior to the transaction primarily to avoid the § 6694 penalty, and (3) there was some post-transaction confirmation of the advice. Advisors giving pre-transaction advice can avoid penalties by avoiding giving *any* post-transaction advice.

In describing who constitutes non-signing return preparers, the regulations provide that if an advisor gives advice both before and after the transaction, if the amount of time afterward is less than 5% of total time both before and after, then the person is not a preparer. Reg. §301.7701-15(b)(2)(i). Planners suggested that advisors in planning transactions who anticipated having to advise another signing return preparer about reporting the transaction could avoid being treated as a preparer by giving all advice before the transaction and preparing a lengthy memo of how to report the transaction —so the planner would not have to spend any time afterward. However, the final regulations add an anti-abuse rule saying that time spent on advice before the transaction will be taken into account if the facts and circumstances show that the advice was given before the transaction primarily to avoid being treated as a return preparer. Reg. §301.7701-15(b)(2)(i). Many attorneys believe that in typical planning situations, such as a sale to a grantor trust, preparing a memo describing the tax effects of the transaction would be satisfactory to satisfy this exception.

(8) Reliance on Information From Others and Legal Conclusions. For purposes of determining if there is a reasonable belief to satisfy the substantial authority or reasonable basis standards or for purposes of meeting the reasonable cause and good faith exception, the regulations address when the preparer can rely on information provided

by the taxpayer or another party. Reg. §1.6694-1(e)(1). The preparer may rely on such information without auditing, examining or reviewing "books and records, business operations, or documents or other evidence to verify independently" the information. However, the preparer cannot ignore the implications of information furnished to or actually known by the preparer. For purposes of the reasonable cause and good faith exception, there are further conditions described in the regulations. Reg. §1.6694-2(e)(5).

The proposed regulations stated that the preparer cannot rely on legal conclusions offered by the taxpayer. However, many issues involve both fact and legal issues. For example, if the taxpayer says "I'm married to my wife," isn't that a mixed fact and law conclusion? Also corporations have in-house counsel who offer conclusions that the preparer should reasonably be able to rely on. The final regulations dropped the statement that the preparer cannot rely on legal conclusions offered by the taxpayer.

(9) Reasonable Cause Exception. Unless the understatement is due to willful or reckless conduct, there is a reasonable cause exception to the penalty if the practitioner acted in good faith. §6694(a)(3). (That same exception applied under prior law as well, although the formatting of the section has been revised.) Factors that are considered in applying the reasonable cause and good faith exception are detailed in Reg. § 1.6694-2(e).

(10) What Is "Substantial Authority" — Notice 2009-5. Notice 2009-5 gives guidance as to what constitutes "substantial authority." Commentary from secondary authorities is not substantial authority. (Articles written by authors who we think of as the top national experts do not count.) The authority in favor of a position must be significant compared to authority against the position. Private letter rulings and technical advice memoranda can be considered but field service advice cannot (Brown v. Commissioner, T.C. Memo 2011-83). In addition, the § 6662 regulations have a detailed description of the types of authorities and weighting of authorities that may be considered. Reg. § 1.6662-4(d)(3)(ii-iii). The § 6694 preparer penalty regulations refer to and incorporate those provisions for purposes of determining the meaning of "more likely than not," "substantial authority," and "reasonable basis for a position." Reg. §§ 1.6694-2(b)(1) & 1.6694-2(d)(2).

2. Make Appropriate Valuation Adjustments.

a. Undivided Interests in Real Estate and Art. The IRS scrutinizes valuation adjustments for undivided real estate interests, in large part based on the state law right of co-tenants to partition real property interests. Tech. Adv. Memo. 9336002 (only discount is for cost of partition action). Cases have allowed substantial discounts and generally reject the IRS position limiting the discount to partition costs. Samuel J. LeFrak v. Commissioner, T.C. Memo. 1993-526 (20% minority discount and a 10% marketability discount for gifts to children of interests [under 10% to each child] in a number of apartment and office buildings); Estate of Barge v. Comm'r, T.C. Memo 1997-188 (26% discount in valuing a 25% undivided interest in timberland); Estate of Ellie Williams, T.C. Memo 1998-59 (44% discount for an undivided interest in timberland); Estate of Brocato v. Comm'r, T.C. Memo. 1999-424 (20% discount for decedent's 50 percent interest in various multiple dwelling properties; consider factors other than just cost of partition, such as the historical difficulty in selling fractional interests and lack of control); Wineman v. Comm'r, TCM 2000-193 (15%); Stevens v. Comm'r, TCM 2000-53 (25%); Estate of Busch v. Comm'r, T.C. Memo 2000-3 (10% discount); Estate of Forbes, 81 T.C.M. 1399 (2001) (allowed 30% discount suggested by the estate's appraiser); Estate of Baird, T.C. Memo. 2001-258 (60% undivided interest discount for timberland). See generally John Ramsbacher & Annika Reinemann, Co-Tenancy Interests: Current Thinking on the Valuation and Use in Estate

Planning, TR. & ESTS. 57 (Oct. 2012)(describing various approaches to valuing fractional interests in real property and emphasizing that a number of variables must be considered).

The Baird case is most interesting in light of the Fifth Circuit's recent determination that the estate was entitled to an award of administrative and litigation costs because the IRS was not substantially justified in taking the position that the only discount allowable when valuing fractional undivided interests in timberland was the cost of partitioning the property. Estate of Baird v. Comm'r, 416 F.3d 442 (5th Cir. 2005), rev'g, T.C. Memo 2002-299.

A recent case continued the approach of considering illiquidity and marketability issues in addition to the cost of partition in determining that a 17.2% discount was allowed for 50% interests in a Hawaiian vacation home that were contributed to QPRTs. Ludwick v. Comm'r, T.C. Memo. 2010-104. Judge Halpern determined the value assuming a two-year partition action would be required (resulting in a 26.5% discount) and assuming that the property could be sold in one year without a partition action (resulting in a 16.2% discount). The judge weighted those outcomes, concluding that there was a 90% likelihood that no partition action would be needed (based partly on the taxpayer having the burden of proof). The resulting weighted discount was about 17.2%.

In Estate of Mitchell, T.C. Memo. 2011-94, large fractional interest discounts were created for fractional interest transfers made on the eve of death (both the fractional interests transferred and the fractional interests retained in the estate of the donor). The case does not discuss the "eve of death" issue but the parties stipulated to the discounts. The opinion reflects that the estate and IRS stipulated to the following significant undivided interest discounts in the Beachfront and Ranch properties:

> Beachfront property: 32% discount for 5% gifted interest; 19% discount for 95% interest owned at death
>
> Ranch property: 40% discount for 5% gifted interest; 35% discount for 95% interest owned at death

The opinion does not reflect any of the factors that entered into the amounts of those discounts. The taxpayer's valuation expert has indicated that the IRS initially argued for very low undivided interest discounts on the 95% interests owned at death, by basing discounts just on the costs of partition, in reliance on the Ludwick decision. Hoffman, *Estate of Mitchell* Scores Lopsided Victory for Taxpayer, FMC Valuation Alert (May 5, 2011). Taxpayer's counsel distinguished the Ludwick case, because that article indicates a joint tenancy agreement governing the property in that case gave each owner a put right for their interest at a non discounted value. Based on that distinction and the taxpayer's expert reports (from FMV Opinions, Inc.), the parties ultimately agreed on the stipulated undivided interest discounts.

Many practitioners indicate that they often claim fractional interest discounts on the estate tax return without the benefit of an appraisal specifically addressing the fractional discount. Some practitioners indicate that the IRS audit groups in their locales are "comfortable" with a 20-25% discount, but an unsubstantiated claim for more than 25% will draw an objection on audit. One appraiser (Jeffrey Wolpin in California) who appraises about 10-20 undivided interests each year maintains a proprietary database of over a hundred undivided interest sales comparables that indicate discounts in the 30% range, which he believes has a relatively low margin for error. He indicates that their appraisals of undivided interests have not been audited to date, despite the large number of such appraisals that they have done.

Undivided Interests in Art. Cases generally have allowed only minimal undivided interest discounts for tangible personal property. A mere 5% discount for owning 50% of an art collection was allowed in Stone v. U.S., 103 AFTR 2d 2009-1379 (9th Cir. 2009) and in Estate of Scull v. Commissioner, (T.C. Memo 1994-211). A recent case, *Elkins v. Commissioner*, allowed a much greater discount, grounded in large part on the lack of evidence by the IRS.

The Tax Court recently allowed only a 10% discount in valuing the decedent's 73% and 50% fractional interests in items of art having an undiscounted value of about $35 million. In determining an appropriate discount for the undivided interests in this case, the court noted that the three children had strong sentimental and emotional ties to each of the works of art so that they treated the art as "part of the family." The estate argued that a hypothetical purchaser of the estate's fractional interest would apply a discount, knowing that the children were unlikely to sell their fractional interests in light of their strong sentimental attachment to the art. The court turned this argument on its head — reasoning that a hypothetical third-party purchaser of the estate's fractional interest "would be in an excellent position to persuade the Elkins children, who, together, have the financial wherewithal to do so, to buy the buyer's interest in any or all of the works, thereby enabling them to continue to maintain absolute ownership and possession of the art." The court concluded that the Elkins children would be anxious to acquire the decedent's fractional interest to preserve for themselves 100% ownership and possession of the art, and that a hypothetical willing buyer and seller of decedent's interest in the art would agree upon a price at or fairly close to the pro rata fair market value of those interests. It allowed a nominal 10% discount because a hypothetical purchaser could not be certain that the Elkins children would agree to pay the full pro rata fair market value for those interests. Estate of Elkins v. Comm'r, 140 T.C. No. 5 (March 11, 2013, opinion by Judge Halpern, not a "reviewed" opinion by the Tax Court).

The Fifth Circuit reversed and rendered, reasoning that the IRS offered *no* evidence of appropriate discounts and accepting the undisputed testimony of the estate's experts at trial. The Fifth Circuit noted that the Elkins family members should not be viewed as hypothetical willing buyers under the willing buyer/willing standard. A hypothetical willing buyer would know that the family members owned the other undivided interests and that they might be interested in purchasing interests owned by others, but the court pointed to testimony by a family member that the family would only be willing to buy a third party's undivided interest at a "fair price." The average discount allowed was 67%. 767 F.3d 443 (5th Cir. September 15, 2014).

The Fifth Circuit agreed with the Tax Court's rejection of the IRS's "*no* discount" position. The court emphasized that the IRS offered NO evidence of the proper amount of discount if any discount is allowed. The estate attached an appraisal to the Form 706 and offered even more evidence of discounts (larger than on the Form 706) at trial.

The court noted that the taxpayer had the burden of proof, but the burden shifted to the IRS when the estate offered credible evidence. Because the IRS offered no evidence of the appropriate discount amount, the court observed that the estate should have prevailed under the burden of proof, but the court did not rely on that issue.

The court stated that there was no factual support for the Tax Court's own nominal 10% discount. The court believed that the estate's experts considered all the characteristics of the Elkins heirs, who testified that they would purchase a third party's undivided interest, but only at a "fair price."

The Fifth Circuit rejected the Tax Court's assumption that a hypothetical buyer would know the family would buy any undivided interest with no (or little discount).

> It is principally within the last few pages of its opinion that the Tax Court's reversible error lies. While continuing to advocate the willing buyer/willing seller test that controls this case, the Tax Court inexplicably veers off course, focusing almost exclusively on its perception of the role of 'the Elkins children' as owners of the remaining fractional interests in the works of art and giving short shrift to the time and expense that a successful willing buyer would face in litigating the restraints on alienation and possession and otherwise outwaiting those particular co-owners. Moreover the Elkins heirs are neither *hypothetical* willing buyers nor *hypothetical* willing sellers, any more than the Estate is deemed to be the hypothetical willing seller.
>
> We acknowledge, of course—as did the Estate's experts—that a hypothetical willing buyer would be aware of and take into account *all* aspects of the remaining fractional interests in the art that the Elkins heirs owned, not just the likelihood of their hypothetical desire to acquire the Decedent's fractional interests in the art from any successful hypothetical buyer thereof. [The court reviewed various characteristics about the heirs, including their testimony that they would be willing to purchase interests only "after first determining from experts that any price was fair and reasonable."]

The court allowed discounts based on the only evidence at trial about the amount of discounts (i.e., the estate's experts). The court did not raise whether the estate's position on the Form 706 (44.75% discount) was an admission against interest that was binding absent "cogent proof" of why the valuation should be different.

Estate's expert at trial opined that the discounts varied among the 64 works of art. The aggregate fractional interest discount was 67%.

The Fifth Circuit did not mention §2703 at all. It is not clear whether the discount allowed by the court was based in part on the co-tenants agreement that the art could be sold only with unanimous consent of the undivided interest owners.

b. Interests in Closely Held Businesses.

Generally; Actual Sales. In the typical situation, there are no actual sale prices or bona fide bid and asked prices for closely held businesses. In that case, the regulations provide that shares of stock are to be valued taking into account the company's net worth, prospective earning power, dividend-paying capacity, and "other relevant factors". Reg. §20.2031-2(f).

An example of a case giving primary importance to earnings and the dividend paying capacity of the company is Kohler v. Comm'r, T.C. Memo. 2006-152,*nonacq.*, AOD 2008-001. The IRS and the taxpayer were about $100 million apart on valuation issues involving both estate and gift tax deficiencies. One of errors cited was that the IRS appraiser did not use a dividend method of determining value. Because this was minority block of stock, and because there were historically payments of dividends, and because there was no other prospect of realizing value as a practical matter, the company should be valued using a dividend based methodology. Failure to use that was error—and part of the reason the IRS expert was rejected. (Contrast this case with Estate of Richmond v. Comm'r, in which the court reasoned that the dividend capitalization approach "may be entirely appropriate where a company's assets are difficult to value." However, the capitalization of dividends method "is based entirely on estimates about the future," and the result is extremely sensitive to variations in the assumptions that are made. The court concluded that the net asset valuation approach should be used to value an interest in a corporation that predominantly held a portfolio of publicly traded securities.)

Actual sales within a reasonable period before and after the valuation date are given substantial weight in determining the value. In Huber v. Comm'r, T.C. Memo 2006-96, the court approved valuing gifts of closely held stock on an appraisal based on publicly

traded company comparables with a 50% discount, where over 90 sale transactions had occurred with family and non-family members using that same appraisal approach. For example, in Estate of Branson v. Comm'r, T.C. Memo 1999-231, the court rejected valuing stock on the basis of "market method" appraisals by two nationally reputed appraisers. Instead, the court based the valuation primarily on sales that were made sporadically but in significant ratios just prior to and soon after death. In Morrissey v. Comm'r, 243 F.3d 1145 (9th Cir. 2001), the Court found "no good reason" for disregarding the prior sales because the sales occurred close to the valuation date, the sellers sold the stock under their free will, and the sellers were not really closely related to the buyer.

Nonmarketability Adjustment. Some of the factors examined by courts and in IRS rulings to determine the amount of an appropriate lack of marketability discount are: (1) The cost of a similar corporation's public and private stock; (2) an analysis on the corporation's financial statements; (3) the corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends; (4) the nature of the corporation, its history, its position in the industry, and its economic outlook; (5) the corporation's management; (6) the degree of control transferred with the block of stock to be valued; (7) any restriction on the transferability of the corporation's stock; (8) the period of time for which an investor must hold the stock to realize a sufficient profit; (9) the corporation's redemption policy; and (10) the cost of effectuating a public offering of the stock to be valued. See Rev. Rul. 77-287, 1977-2 C.B. 319, 320-21; Estate of Gilford v. Comm'r, 88 T.C. 38, 60; Estate of Desmond v. Comm'r, T.C. Memo. 1999-76; Mandelbaum v. Comm'r, T.C. Memo. 1995-255 (30% marketability discount; detailed analysis of 10 factors for determining amount of marketability discount). An interesting summary about marketability discounts is "Discounts for Lack of Marketability Job Aid for IRS Valuation Professionals." For an analysis taking the position that the courts have generally underestimated the "magnitude of discounts for lack of marketability in the real world," see Pratt, Defending Discounts for Lack of Marketability, 29 ACTEC J. 276 (2004).

A wide variety of cases have allowed substantial marketability discounts in valuing interests in non-publicly traded corporations that own investment assets or that constitute operating entities. E.g. Estate of Josephine Thompson v. Comm'r, T.C. Memo 2004-174, rev'd on other grounds, 499 F.3d 129 (2nd Cir. 2007) (30% marketability discount and 15% minority interest discount [seriatim discount of 32%] for valuing 27% stock ownership of publishing company [compared to 45% and 40% discounts for marketability and minority claimed by the estate]; Second Circuit reversed as to reasonable cause exception to accuracy related penalty); Estate of Jelke, T.C. Memo 2005-131 (15% nonmarketability discount and 10% lack of control discount for corporation that owned mostly marketable securities, observing that the facts suggest a lower-than-average nonmarketability discount based on the factors outlined in the Mandelbaum case), rev'd and remanded on other grounds, 507 F.3d 1317 (11th Cir. 2007), cert. denied; Anderson et al v. U.S., 97 AFTR2d 2006-649 (W.D. La. 2005) (estate owned minority interests in LLCs that owned mineral interests; 40% marketability discount applied for both market and net asset value approaches and 10% liquidation discount and 10% minority discount applied for the net asset approach); Huber v. Comm'r, T.C. Memo 2006-96 (valued gifts of closely held stock on the basis of an appraisal that was based on publicly traded company comparables with a 50% discount, where over 90 transactions had occurred with family and non-family members using that same appraisal approach); Dallas v. Comm'r, T.C. Memo 2006-212 (closely held stock valued for gift tax purposes with a 20% nonmarketability discount based on restricted stock studies [the court pointed out that the taxpayer's expert should have used studies in the time frame of when the gifts were made], and minority interest discounts

of 15% for the portion attributable to nonoperating assets and 20% for the portion attributable to operating assets, with no additional discount for lack of voting rights); Langer v. Commissioner, T.C. Memo 2006-232 (parties stipulated a 47.5% discount "for all applicable discounts" in valuing decedent's 29.19% interest in an LLC holding various commercial real estate development properties); Robertson, Trustee v. U.S., 97 AFTR2d 2006-371 (N.D. Tex. 2006)(magistrate's finding of fact of value of 19.6686% limited partnership interests held by four charitable lead trusts at their termination; 19% discount for lack of control interests [8% based on world equity closed-end fund data and 11% for the fact such funds were significantly different than a partnership interest] and 12.5% marketability discount [accepting IRS's appraisal and rejecting taxpayer's appraiser's 25% discount because IRS appraisal reflected actual data and academic research and taxpayer's appraisal was based solely on the appraiser's judgment and was not supported by empirical evidence], for a combined seriatim discount of 29.125%); Holman v. Comm'r, 130 T.C. 170, aff'd, 601 F.3d 763 (8th Cir. 2010) (limited partnership holding Dell stock; lack of marketability discount of 12.5%, in part based on reasoning that partnership would have incentive to purchase gifted interests if donee wished to sell; lack of control discounts for 1999, 2000 and 2001 of 11.32%, 14.34% and 4.63%, respectively); Estate of Litchfield, T.C. Memo 2009-21 (25% marketability discount for 43% interest in corporation that owned farmland, marketable securities and a closely held subsidiary; 20% marketability discount for 23% interest in corporation that owned marketable securities and other equities; case also addressed lack of control and built-in gains discount); Estate of Koons v. Comm'r, T.C. Memo. 2013-94 (7.5% marketability discount for LLC that owned primarily liquid securities; estate had 70.42% vote and could remove a limitation on discretionary distributions to 30% of "distributable cash"; court accepted IRS's expert's 7.5% discount); Estate of Richmond v. Comm'r, T.C. Memo. 2014-26 (32.1% lack of marketability discount, based on restricted stock/pre-IPO studies); Estate of Giustina v. Comm'r, 586 Fed. Appx. 417 (9th Cir. 2014), rev'g T.C. Memo 2011-141 (41.1% interest in FLP with timberland forestry operations; Tax Court valuation based 75% on cash flow method [for which a 25% marketability discount applied] and based 25% on asset method [for which no marketability discount applied because a 40% absorption discount had been allowed in valuing the large tract of timberland and court viewed an additional marketability discount in valuing the limited partnership interest as a "double discount"]; 9th Circuit rejected Tax Court's approach of giving a 25% weight to the net asset value of timberland; Tax Court concluded there was a 25% likelihood of liquidation of the partnership even though the decedent could not unilaterally force liquidation, reasoning that the owner of that 41% interest could form a two-thirds voting-bloc with other limited partners to do so; 9th Circuit said that conclusion was contrary to the evidence; for a liquidation to occur, (1) a hypothetical buyer would somehow have to obtain admission as a limited partners from the general partners, who have repeatedly emphasized the importance upon continued operation of the partnership, (2) the buyer would seek dissolution of the partnership or the removal of the general partners who just approved his admission; and (3) the buyer would manage to convince at least two (or possibly more) other limited partners to go along, despite the fact that "no limited partner ever asked or ever discussed the sale of an interest").

Minority, Non-Controlling Interest Adjustment. Cases have also consistently allowed discounts for interests in closely held businesses that are nonvoting or that do not represent control of the business. There has been a trend in recent cases to apply a blended minority discount, with different discounts for different classes of assets in a partnership. E.g., McCord v. Comm'r, 120 T.C. 358 (2003)(minority discounts of 10% for equities and bonds, 23.3% for real estate partnerships, 40% for directly owned real estate, 33.5% for oil and gas; blended overall weighted minority discount of 15%; marketability

discount of 20% [not weighted for different classes]);Lappo v. Comm'r, T.C. Memo 2003-258 (minority discounts of 8.5% for securities and 19% for real estate; overall weighted minority discount of 15%; marketability discount of 24% [not weighted for different classes of assets]); Perracchio v. Comm'r, T.C. Memo 2003-820 (minority discount factors for five different classes of assets ranging from a low of 2.0% for cash/money market funds to a high of 13.8% for foreign equities; overall weighted minority discount of 6% and 25% marketability discount [not weighted for different classes of assets]); Dallas v. Comm'r, T.C. Memo 2006-212 (closely held stock valued for gift tax purposes with a 20% nonmarketability discount based on restricted stock studies [the court pointed out that the taxpayer's expert should have used studies in the time frame of when the gifts were made], and minority interest discounts of 15% for the portion attributable to nonoperating assets and 20% for the portion attributable to operating assets, with no additional discount for lack of voting rights); Holman v. Comm'r, 130 T.C. 170, aff'd, 601 F.3d 763 (8th Cir. 2010) (limited partnership holding Dell stock; lack of marketability discount of 12.5%, in part based on reasoning that partnership would have incentive to purchase gifted interests if donee wished to sell; lack of control discounts for 1999, 2000 and 2001 of 11.32%, 14.34% and 4.63%, respectively); Estate of Litchfield, T.C. Memo 2009-21 (14.8% lack of control discount for 43% interest in corporation that owned farmland, marketable securities and a closely held subsidiary; 11.9% lack of control discount for 23% interest in corporation that owned marketable securities and other equities; case also addressed marketability and built-in gains discount); Estate of Richmond v. Comm'r, T.C. Memo. 2014-26 (7.75% lack of control discount for decedent's 23.44% interest in investment holding company that predominantly held a portfolio of publicly traded securities, based on closed-end fund studies).

Strategic Buyer. Various cases have emphasized that courts cannot use the price that a strategic buyer would pay, but must consider what a hypothetical willing buyer would pay. Estate of Jung v. Comm'r, 101 T.C. 412, 437-438 (1993) (assumption that closely held entity will redeem interests to maintain family harmony violates hypothetical willing buyer/willing seller test); Estate of Andrews v. Comm'r, 79 T.C. 938, 956 (1982) (Commissioner cannot "tailor 'hypothetical' so that the willing seller and willing buyer were seen as the particular persons who would most likely undertake the transaction"). Court of appeals cases from the 5th and 9th Circuits have reiterated this approach. Estate of Jameson v. Comm'r, 267 F.3d 366 (5th Cir. 2001) (reversing Tax Court because "the court should not have assumed the existence of a strategic buyer… Fair market value analysis depends instead on a hypothetical rather than an actual buyer"); Morrissey v. Comm'r, 243 F.3d 1145 (9th Cir. 2001)("[t]he law is clear that assuming that a family-owned corporation will redeem stock to keep ownership in the family violates the rule that the willing buyer and willing seller cannot be made particular"); Estate of Simplot v. Comm'r, 249 F.3d 1191, 1195 (9th Cir. 2001)(Tax Court assumed buyer "would probably be well-financed, with a long-term investment horizon and no expectations of near-term benefits;" reversed, holding that "[t]he facts supplied by the Tax Court were imaginary scenarios as to who a purchaser might be… [A]ll of these imagined facts are what the Tax Court based its 3% premium upon. In violation of the law the Tax Court constructed particular possible purchasers").

These cases all have strong language saying not to assume particular purchasers, and in particular, not to assume that the entity will redeem interests of a prospective seller of an interest in the entity.

In contrast to those cases, Estate of Elkins v. Comm'r, 140 T.C. No. 5 (2013) allowed only a small discount in valuing a decedent's fractional interest in art. The court reasoned that the Elkins children would be anxious to acquire the decedent's fractional

interest to preserve for themselves 100% ownership and possession of the art, and that a hypothetical willing buyer and seller of decedent's interest in the art would agree upon a price at or fairly close to the pro rata fair market value of those interests. It allowed a nominal 10% discount because a hypothetical purchaser could not be certain that the Elkins children would agree to pay the full pro rata fair market value for those interests. That seems very close to basing the value on what a strategic buyer would pay. If it is inappropriate to consider the price that a strategic buyer would pay, it would also seem inappropriate to consider that a hypothetical purchaser would assume that he or she could sell to a strategic buyer at close to pro rata fair market value. The Fifth Circuit reversed and rendered, and specifically rejected the strategic buyer approach of assuming that a purchaser will have a particular attitude towards sales.

The Elkins Tax Court opinion was consistent with the reasoning in Holman v. Comm'r, 130 T.C. 170, aff'd, 601 F.3d 763 (8th Cir. 2010). (Interestingly, Judge Halpern wrote the Tax Court opinions in both Elkins and Holman.) Holman allowed only a 12.5% marketability discount for limited partnership interests in a family limited partnership, partly based on a consideration that the remaining partners would have an economic interest to purchase an interest for a value somewhere between the discounted price that a third party was willing to pay and a pro rata share of net asset value, thus placing a floor on the marketability discount. The 8th Circuit affirmed that approach and held that it did not violate the hypothetical willing buyer/willing seller valuation standard.

Family Limited Partnerships. John Porter, an attorney in Houston, Texas who has litigated many of the family limited partnership cases, summarizes discounts that have been allowed by the courts in these cases as follows:

Case	Assets	Court	Discount from NAV/Proportionate Entity Value
Strangi I	securities	Tax	31%
Knight	securities/real estate	Tax	15%
Jones	real estate	Tax	8%; 44%
Dailey	securities	Tax	40%
Adams	securities/real estate/minerals	Fed. Dist.	54%
Church	securities/real estate	Fed. Dist.	63%
McCord	securities/real estate	Tax	32%
Lappo	securities/real estate	Tax	35.4%
Peracchio	securities	Tax	29.5%
Deputy	boat company	Tax	30%
Green	bank stock	Tax	46%
Thompson	publishing company	Tax	40.5%
Kelley	cash	Tax	32%

Temple	marketable securities	Fed. Dist.	21.25%
Temple	ranch	Fed. Dist.	38%
Temple	winery	Fed. Dist.	60%
Astleford	real estate	Tax	30% (GP); 36% (LP)
Holman	dell stock	Tax	22.5%
Keller	securities	Fed. Dist.	47.5%
Murphy	securities/real estate	Fed. Dist.	41%
Pierre II	securities	Tax	35.6%
Levy	undeveloped real estate	Fed. Dist. (jury)	0 (valued at actual sales proceeds with no discount)
Giustina	timberland; forestry	Tax	25% with respect to cash flow valuation (75% weighting to cash flow factor and 25% weighting to asset method); BUT reversed by 9th Circuit and remanded to reconsider without giving 25% weight to asset value
Koons	securities	Tax	7.5%; Estate owned 70.42% of vote and could remove limitation on distributions
Gallagher	publishing company	Tax	47%

John Porter, *The 30,000 Foot View from the Trenches: A Potpourri of Issues on the IRS's Radar Screen*, 49TH ANN. HECKERLING INST. ON EST. PL. ¶511 (2015).

Discount of Corporate Stock for Built-In Gains Tax. The Tax Reform Act of 1986 repealed the General Utilities doctrine, so that a liquidation of a corporation will generally generate gain at the corporate level on the corporate assets. Taxpayers have argued that such tax, which will be incurred whenever the corporation is liquidated, should be taken into account in valuing the stock. Cases have differed in their approach to this issue. See generally Fady Bebawy, Considerations of the Built-In Gain (BIG) Tax Liability Discount During the S Corporation Conversion Recognition Period, WILLAMETTE MNGT ASSOCIATES INSIGHTS 58 (Spring 2013); Robert P. Schweihs, Valuation Adjustment for Built-in Capital Gains in a C Corporation, WILLAMETTE MNGT ASSOCIATES INSIGHTS 25 (Summer 2012).

The Fifth and Eleventh Circuits allow dollar-for-dollar discounts in cases where an interest in a corporation is being determined on a net asset value approach. Estate of Dunn v. Comm'r, 301 F.3d 339 (5th Cir. 2002); Estate of Jelke, 507 F.3d 1317 (11th Cir. 2007), cert. denied. The Second and Sixth Circuits instructed the Tax Court to consider the built-in gains tax liability in valuing a corporation, but suggested that it would not be appropriate to use a dollar-for-dollar discount. Eisenberg v. Comm'r, 155 F.3d 50 (2d Cir.1998) acq. 1999-

4 IRB 4; Estate of Welch v. Comm'r, T.C. Memo. 1998-167, 208 F.3d 213 (2000) (unpublished opinion).

The latest of these Circuit level cases is Estate of Jelke, 507 F.3d 1317 (11th Cir. 2007), cert. denied. The court gave a detailed history of the prior case law. The case concluded this review with a determination that the assumed liquidation and 100% offset approach avoided having to prophesy as when assets would be sold, observing that the IRS's approach "requires us to either gaze into a crystal ball, flip a coin, or, at the very least, split the difference between the present value calculation projections of the taxpayers on the one hand, and the present value calculation projections of the Commissioner, on the other." The court found support in the underlying nature of the estate tax as being based "upon a 'snap shot of valuation' frozen on the date of Jelke's death." Using a liquidation assumption "eliminates the crystal ball and the coin flip and provides certainty and finality to valuation as best it can, already a vague and shadowy undertaking. It is a welcome road map for those in the judiciary, not formally trained in the art of valuation." In addition, the approach "bypasses the unnecessary expenditure of judicial resources being used to wade through a myriad of divergent expert witness testimony, based upon subjective conjecture, and divergent opinions." The court pointed to the Fifth Circuit's reasoning, observing that while some say that this approach is an oversimplification, the other end of that spectrum is over-engineering. The court also thought this approach better reflects economic reality because a hypothetical buyer "will not pay the same price for identical blocks of stock, one purchased outright in the marketplace with no tax consequences, and one acquired through the purchase of shares in a close-held corporation, with significant, built-in tax consequences." The Eleventh Circuit remanded the case to the Tax Court, for it to recalculate the net asset value of the corporation "using a dollar-for-dollar reduction of the entire $51 million in built-in gains tax liability, under the assumption that CCC is liquidated on the date of death and all assets sold." (The Eleventh Circuit did not change the Tax Court's finding of a 10% lack of control discount and a 15% lack of marketability discount.) The Supreme Court denied the government's petition for certiorari.

Estate of Litchfield, T.C. Memo. 2009-21, involved the valuation of a decedent's stock in a C corporation and in an S corporation that had converted from a C corporation about 22 months before the valuation date, and the corporate-level capital gains tax would be imposed on the sale of assets within 10 years of the S election. The taxpayer's expert calculated the built-in gains discount by projecting holding periods and estimated sale dates (after discussions with the officers and board of directors of the corporation), estimated appreciation of the assets up to the anticipated sale dates, calculated the estimated capital gains taxes on those sales dates (taking into account appreciation before the date of death as well as anticipated appreciation after the date of death up to the sale date for anticipated sale dates that were within ten years of the S conversion), and discounted the tax amounts to present values. The court agreed with the estate's appraiser as to the built-in gains discount. The court specifically criticized the IRS's expert for not taking into account appreciation after the valuation date to the anticipated sale dates "that also likely will occur and that will be subject to taxes at the corporate level—what one expert has described as the tax-inefficient entity drag." (If the asset were not in the corporation, future appreciation would not be subject to the double tax, so the analysis assumes that a hypothetical buyer would take this extra corporate level tax burden into account in negotiating a sales price. The court specifically observed in footnote 10 that the expert did not apply a dollar-for-dollar discount and that the court did not need to decide if that approach would have been appropriate in this case.)

The Tax Court applied its own present value analysis in allowing an adjustment to the net asset value of a C corporation for the built-in gains tax in Estate of Richmond v. Comm'r, T.C. Memo. 2014-26. A C corporation holding a $52 million portfolio had unrealized appreciation of about $45.58 million, which the parties agreed would produce a BIG tax of about $18.1 million, assuming a 39.74% combined federal and state tax rate. The Notice of Deficiency allowed *no* discount for the BIG tax, "a position that the Commissioner does not defend, and for good reason." The court summarized why taking into account the BIG tax in some manner is required:

> An investor could have easily replicated PHC in December 2005 by contributing $52 million to his own new holding company and then having it purchase the very same types of securities that were in PHC's portfolio. No investor interested in owning such a company would have been indifferent to the fact that acquiring PHC meant acquiring an eventual liability of $18.1 million. An investor would therefore have insisted on paying less than $52 million to acquire PHC; if PHC had offered no discount, an investor would simply buy the stocks and be better off. That is, the market would have required a discount, and any fair market valuation must reflect a discount.

The court noted that the case would be appealable to the 3rd Circuit and rejected the dollar-for-dollar approach that has been adopted by the 5th Circuit and the 11th Circuits. (*Estate of Jelke*). The court rejected the IRS's expert's approach of merely including the BIG tax reduction as a part of the lack of marketability discount, reasoning that the marketability discount is applied at the individual level. The BIG tax liability, on the other hand "is a liability of the entity, which affects its net asset value [and] we find it appropriate to determine the BICG tax liability at the entity level." The court rejected the IRS expert's method of arriving at a 15% BIG tax discount, but made present value calculations assuming the portfolio would be sold over 20 or 30 years periods (based on the IRS expert's testimony that a potential investor would expect the portfolio to be turned over within a period of 20 to 30 years) and ultimately allowed an adjustment to the value of $7.8 million (which was the IRS conceded amount). The court made no mention at all of whether the BIG tax liability should take into account future assumed appreciation in the portfolio (which was allowed in Litchfield), requiring a greater tax liability in the future as opposed to an investor who could simply acquire the same pro rata portfolio and would not incur the corporate "double tax" on the subsequent appreciation.

Tax Affecting S Corporation Earnings in Valuing S Corporation Stock. Cases have generally not allowed "tax affecting" the earnings of S corpaorations that are valued based on earnings in light of the fact that the earnings are taxed to the shareholders. The seminal case was Gross v. Comm'r, 272 F.3d 333 (6th Cir. 2001), aff'g, T.C. Memo 1999-254 (court concluded that the IRS's expert used a "preshareholder-tax discount rate," so there was not necessity of "tax affecting" the earnings). Various cases have followed the Gross reasoning. E.g., ; Estate of Giustina v. Comm'r, T.C. Memo 2011-141, rev'd on other grounds, 114 AFTR 2d 2014-6848 (9th Cir. 2014) (estate expert's analysis was adjusted because it had reduced each year's predicted cash flows by 25% to account for income taxes even though it used a discount rate based on pretax rates of return); Estate of Gallagher v. Comm'r, T.C. Memo. 2011-148, modified by T.C. Memo. 2011-244 (limited liability company taxed as S corporation; "we will not impose an unjustified fictitious corporate rate burden on PMG's future earnings"); Dallas v. Comm'r, T.C. Memo 2006-212 (court concluded that there was "insufficient evidence to establish that a hypothetical buyer and seller would tax-affect DGA's earnings and that tax-affecting DGA's earnings is not appropriate") ; Estate of Adams v. Comm'r, T.C. Memo 2002-80 (capitalization rates of S

corporations need not be adjusted to be compared with capitalization rates of C corporations); Heck v. Comm'r, T.C. Memo 2002-34 (court did not address issue by one appraiser applied a 10% discount for additional risks associated with S corporations, including "the potential loss of S corporation status and shareholder liability for income taxes on S corporation income").

Commentators have generally been critical of the refusal to allow any adjustment to reflect that an S corporation's income is subject to shareholder taxes. E.g., Nancy Fannon & Keith Sellers, Taxes, Value, and the S Corp Valuation Puzzle, 18 Valuation Strategies No. 6, at 20 (July/August 2015); Tinkelman, Viswanath & Vogel, Sub S Valuation: To Effect, or Not to Tax Effect, Is Not Really the Question, 65 TAX LAWYER 555 (SPRING 2012); Dorman, Lau & Adasiak, Failure to Tax-Adjust S Corp.'s Income Results in Valuation Premium, 31 Est. Pl. 82 (Feb. 2004). See Zach Oehlman, Valuing S Corporations in Family Law Engagements, WILLAMETTE MNGT ASSOCIATES INSIGHTS 50 (Spring 2013).

Mineral Interests. Special rules are applied in valuing mineral interests. See generally Alan Harp, Oil and Gas Minerals: How They and Their Holding Entities Are Valued, TR. & ESTS. 49 (Oct. 2012).

3. No Necessity of Aggregating With QTIP Assets for Valuation Purposes.

If fractional interests in an asset are included in a decedent's estate under §2033 and §2044, the IRS previously took the position that the interests must be aggregated for purposes of determining whether a minority discount is available. Various courts rejected the IRS approach and the IRS has acquiesced. Estate of Mellinger v. Comm'r, 112 T.C 26 (1999), acq. in result only 1999-2 C.B. 763. However, interests that are transferred to multiple donees in which the donor retains a life estate and that are included in the donor's gross estate under § 2036 must be aggregated for valuation purposes. Estate of Adler v. Comm'r, T.C. Memo. 2011-28.

An important consideration in structuring estate plans prior to the first spouse's death is whether to use a bequest to a QTIP trust rather than outright to a surviving spouse in order to take advantage of the possibility of discounting values in the surviving spouse's estate for estate tax purposes if a QTIP trust is utilized. Apparently, the advantages can be achieved even if the spouse is named as a co-trustee (perhaps even as sole trustee) and is given a testamentary limited power of appointment.

These developments may cause the IRS to be even more sensitive to the values placed on assets at the first spouse's death, making sure that the estate reports based on the values of fractional interests passing at the first spouse's death, to eliminate any excess step up in basis due to overvaluation. Alternatively, some commentators have hinted that the IRS might choose to raise no objections about inclusion of assets at the first spouse's death without any fractional ownership discounts, and claim at the surviving spouse's death that a "duty of consistency" would require that the same valuation approach (i.e., no discounts) be used. (The IRS has prevailed in its duty of consistency argument in a different context in various cases. See Section IV.E.1.b of this outline.)

4. Effect of Post-Transfer Events.

The effect that should be given to post-transfer events was summarized in Polack v. Comm'r, 366 F.3d 608 (8th Cir. 2004).

> Whether evidence relating to subsequent events is admissible in determining the fair market value of property on an earlier date is an issue of relevance. Most

> subsequent events are not relevant because "the measure of the tax must be determined according to the situation as it existed on the date [in question], and not according to subsequent events." Morris v. Commissioner, 761 F.2d 1195, 1201 [56 AFTR 2d 85- 6485] (6th Cir. 1985), quoting Walter v. United States, 341 F.2d 182, 185 [15 AFTR 2d 1306] (6th Cir. 1965). "Information that the hypothetical willing buyer could not have known is obviously irrelevant to this calculation." First Nat'l Bank of Kenosha v. United States, 763 F.2d 891, 894 [56 AFTR 2d 85-6492] (7th Cir. 1985); accord Saltzman v. Commissioner, 131 F.3d 87, 93 [80 AFTR 2d 97-8365] (2d Cir. 1997). But subsequent events that shed light on what a willing buyer would have paid on the date in question are admissible, such as "evidence of actual sales prices received for property after the date [in question], so long as the sale occurred within a reasonable time ... and no intervening events drastically changed the value of the property." First Nat'l Bank of Kenosha, 763 F.2d at 894; see Trout Ranch, LLC v. Comm'r, T.C. Memo. 2010-283 (lot sales within a reasonable period after valuation date tends to make a given estimate of the lot prices more or less likely and is relevant).Schnorbach v. Kavanagh, 102 F. Supp. 828, 834 [41 AFTR 808] (W.D. Mich. 1951).

In Polack, the court refused to allow an appraiser to consider unaudited financial statements in the two years after the date of death, or to consider post-transaction earnings, because those items of information would not have been known to prospective purchasers on the valuation date.

Okerlund v. United States, 365 F. 3d 1044 (Fed. Cir. 2004) was a gift tax case where post-gift sales prices were lower than the values asserted by the IRS on the date of the gift. The Federal Circuit affirmed the Federal Claims Court decision to approve the IRS's position to exclude post-gift sales where there were changed circumstances. The changed circumstances in that case included specific instances of food contamination, which resulted in the death of a customer, and which resulted in a decline of sales and income.

In Estate of Noble v. Comm'r, TC Memo 2005-2, the decedent owned 11.6 % of a private bank. The estate reported the shares at $8,000/share (with a 45% minority interest discount) on the estate tax return. There was a prior sale of 1% of the stock 15 months before the date of death for $1,000 per share, and a sale of 0.7% of the stock 2 months before the date of death for $1,500 per share. The owner of the balance of the shares (a bank holding company that was owned by the family of an individual who was unrelated to the decedent) offered to buy the estate's shares for $7,569 per share (based on a book value appraisal, with a 29% minority discount and a 35% marketability discount). The estate declined that offer. The estate later sold all of its shares to the remaining shareholder for $9,483 per share about 13 months after the date of death. The court examined whether the buyer was a "strategic buyer" that would pay more than a hypothetical purchaser. The court held that the buyer was not a strategic buyer. The court also addressed whether the post-death event of the actual sale of the stock would be considered in determining the date of death value. The court held that it would because there was no evidence of changed circumstances that would affect the value of the property. The court discounted the actual purchase price (assuming a 3% inflation factor) to discount back to the date of death value.

In U.S. v. Davenport, 97 AFTR2d 2006-825 (S.D. Tex 2006) the issue involved the value of stock that was given on July 2, 1980. The IRS offered, as evidence of value, various settlements in other cases, and a subsequent sale of the stock about a year later. The court said the subsequent sale "is a post-event transaction which is inadmissible under existing Fifth Circuit authority. See Estate of Smith v. Comm'r, 198 F.2d 515 (5th Cir.

1999)."

In Estate of Gimbel v. Comm'r, T.C. Memo. 2006-270, the court determined the effect of a redemption agreement and actual purchases of stock under the agreement after the decedent's death. The actual redemption of 63% of the shares at a lower discount did not control as to the valuation of that 63% block. The court gave the standard reasoning: "Post death events are generally disregarded…However, subsequent events which are reasonably foreseeable as of the valuation date may be considered." The appraisal attached to the Form 706 did not consider the redemption agreement and the company's history of prior repurchases at all—in spite of the fact that the Company in fact purchased 63% of the estate's stock at a price that reflected only a 7.0% discount. Perhaps that was the primary red flag that triggered the audit and the lawsuit.

In Levy v. U.S.,106 AFTR2d 2010-7205 (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. 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.") 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).

In Estate of Giovacchini*,* T.C. Memo. 2013-27, a unique 2500 acre tract was sold two years and seven months after the date that a 50% interest was sold to an LLC owned by family members and 16 months after the decedent's date of death. The court noted that subsequent events are generally irrelevant and inadmissible in determining the fair market value of property as of a prior valuation date. However, that guideline is inapplicable if the subsequent event is a sale of the property itself within a reasonable time unless there have been "material changes in circumstances … between the valuation date and the date of sale." The court determined that the sale within these time frames was reasonably close

and that the sale price was the best evidence of value. The property was sold for $29.5 million. The court determined that the value on the sale date was determined to be $18.5 million, and the value on the date of death was $21.3 million. The court refused to impose §6662 penalties for valuation understatements. (See Section IV.C.1.b of this outline.)

For an excellent review of the authorities regarding the effect of post-death events, see Soskin, Estate Tax Valuation of Property Sold After Death, 30 ACTEC J. 198 (2004). The estate must always balance selling estate assets before the estate tax audit is completed. The IRS will scrutinize sales at prices higher than the value reported on the estate tax return. That factor must be balanced against the possibility of losing a sale at an outstanding price that might not be offered after the estate tax audit is completed.

D. Administration Expense and Debt Deductions.

Administration expenses and debts of the decedent may be deducted under § 2053. (Most administration expenses can be deducted either for income or for estate tax purposes, but not both. See Section II.B.2 of this outline.) Administration expenses are deductible for estate tax purposes only if they are actually or necessarily incurred in the administration of a decedent's estate, such as for the collection of assets, payment of debts, and distribution of property to the persons entitled to it. Reg. §20.2053-3(a). Expenditures that are not essential to the proper settlement of the estate, but that are for the benefit of beneficiaries are not deductible. See Estate of Bates, T.C. Memo. 2012-314.

An issue that arises in many estates is how long expenses for maintaining the decedent's residence may be deducted as an administrative expense. See Estate of Marguerite S. Millikin, T.C. Memo. 1998-456, on remand from 125 F.3d 339 (6th Cir. 1997) (maintenance expenses could be deducted up to the date that the estate filed for and paid its estate taxes nine months after the decedent's death, but that maintenance and selling expenses incurred after that date could not be deducted; court reasoned that if marital trust, which owned the residence, had not distributed its income and dividends, it would have had sufficient liquid reserves to pay any potential taxes and did not need to sell the residence for estate purposes; principal reason for selling the residence was not to pay taxes but to accommodate distributing the value of the residence to 28 beneficiaries).

See generally Berall, Limitations on Deductibility of Legal Fees and Fiduciary Commissions, 33 EST. PL. No. 9, 19 and No. 10, 20 (Sept & Oct. 2006); Deduction of Administration Expenses Updated, 16 REAL PROP., PROB. & TR. J. 382, 385 (1981).

1. Allocating Between Income Tax Return and Estate Tax Return; "Hubert Regulations". See Section II.B.2 of this outline.

2. Deductibility of Post-Death Interest Expenses.

Section 2053 does not refer to the deduction of interest as such. To be deductible, interest must qualify as an administration expense. For an outstanding article addressing the deductibility of interest, see Lindquist, Making Lemonade from Lemons—Deducting Interest on the From 706, 14 Probate & Property 21-26 (May/June 2000). See generally Harmon, & Kulsrud, When is Interest Deductible as an Estate Administration Expense?, 77 PRACTICAL TAX STRATEGIES 166 (Sept. 2006). Deducting interest as an estate tax deduction is not as attractive as at one time, because the interest would be recognized as income when received and the decrease in the estate tax rates reduces the amount of arbitrage on the rate differential between the estate tax savings and the income tax cost. Even so, substantial savings may be achieved. The estate tax rates are still higher than the income tax rates, and the estate tax reduction occurs nine months after date of death whereas the interest income may not be recognized until later years.

a. Interest on Pre-Death Indebtedness.

Interest Accrued Before Date of Death. Interest accrued before the date of the decedent's death is deductible as a claim against the estate. §2053(a)(3).

Interest Accrued After Date of Death. Interest that accrues after the date of death is not deductible as a claim, even if the debt is payable in installments which mature after death. Rev. Rul. 77-461, 1977-2 C.B. 324. Some courts have held that interest accruing after the date of death on pre-death debts is deductible where the executor does not pay the decedent's debt immediately in order to avoid selling estate assets at sacrifice prices, and where the interest is treated as an allowable expense of administration under local law. Ballance v. United States, 347 F.2d 419 (7th Cir. 1965); Estate of Wheless v. Comm'r, 72 T.C. 470 (1979), *nonacq.* 1982-2 C.B. 3. The Tax Court has permitted a deduction of post-death interest on a loan used to purchase "flower bonds". Estate of Webster v. Comm'r, 65 T.C. 968 (1976), *acq. in result in part,* 1977-2 C.B. 2, *nonacq. in part* ,1977-2 C.B. 3.

Interest Accrued After Date of Death on Pre-Death Debt Extended By Executor. A distinction in treatment may apply after the executor has renewed the pre-death loan. In Rev. Rul. 77-461, 1977-2 C.B. 324, the ruling stated that if the executor had obtained an extension of the decedent's obligations, in order to avoid a sacrifice sale of assets, "any *additional* interest could be deductible as an administration expense." 1977-2 C.B. at 325 (emphasis in ruling).

b. Post-Death Interest on Income and Gift Tax, State and Foreign Tax, and Funds Borrowed for General Estate Purposes.

Post-death interest on income tax is a deductible administration expense. Maehlling v. United States, 1967-2 U.S.T.C. ¶12,486 (S.D. Ind. 1967); Rev. Rul. 69-402, 1969-2 C.B. 176 (post-death interest on federal and state income tax is deductible). Similarly post-death interest expenses on gift tax deficiencies are recognized as deductible administration expenses for estate tax purposes. Estate of Webster v. Comm'r, 65 T.C. 968 (1976). The IRS acquiesced in the Webster case with respect to this issue.

Interest paid to a state in connection with state death taxes is deductible. Rev. Rul. 81-256, 1981-2 C.B. 183; Ltr. Rul. 9106005. Similarly, interest paid to a foreign tax authority for death taxes is deductible if it is an allowable expense under local law. Rev. Rul. 83-24, 1983-1 C.B. 229.

Various cases have permitted the deduction of post-death interest with respect to loans obtained by an executor, 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); 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).

c. Post-Death Interest on Federal Estate Tax.

(1) Interest on Deferred Payment of Estate Tax to IRS. It is now clear that interest payable to the IRS on a federal estate tax deficiency is deductible as an administration expense to the extent the expense is allowable under local law; Estate of O'Neal v. Comm'r, 258 F.3d 1265 (11th Cir. 2001).

The Taxpayer Relief Act of 1997 provides that interest paid on estate taxes deferred under Section 6166 is not deductible for estate or income tax purposes. §§2053(c)(1)(D), 163(k). (Instead a lower rate is used for Section 6166 deferrals.) However, that imitation does not apply to estate tax deferrals under sections 6161 (discretionary extensions) or 6163 (extensions for estate taxes on reversionary or remainder interests).

Estate of Buchholtz v. Comm'r, 70 T.C. 814 (1978); Rev. Rul. 79-252, 1979-2 C.B. 333 (interest on estate tax deficiency); Rev. Rul. 78-125, 1978-1 C.B. 292 (interest on section 6166 extension).

The interest expense is deductible even if the interest accrues as a result of the estate's willful delay in filing the estate tax return and in paying the estate tax. Rev. Rul. 81-154, 1981-1 C.B. 470.

(2) Timing of Deduction for Interest on Deferred Payment of Estate Tax to IRS. In Rev. Rul. 80-250, the IRS gave two reasons for refusing to allow an "up-front deduction" for the interest accrued on a section 6166 pay out. First, an estate can accelerate payment of the deferred tax. Second, the interest rate of the deferred amount fluctuates, which makes it impossible to accurately estimate the projected interest expense.

Various courts agreed with the IRS's concerns, and refused to allow an upfront deduction of the estimated interest because of the fluctuating interest rate and the possibility of prepayment (or forced acceleration) of the deferred payments. Estate of Bailly v. Comm'r, 81 T.C. 246, modified, 81 T.C. 949 (1983); Estate of Spillar v. Comm'r, 50 T.C.M. 1285 (1985); Estate of Harrison, 52 T.C.M. 1306 (1987).

(3) Interest on Amounts Borrowed By Executor to Pay Federal Estate Tax--Generally. Unlike interest payable to the IRS on deferred estate tax payments, interest on private loans used to pay estate taxes is not automatically deductible. The IRS recognizes that interest is deductible on amounts borrowed to pay the federal estate tax where the borrowing is necessary in order to avoid a forced sale of assets. Rev. Rul. 84-75, 1984-1 C.B. 193 (interest on private loan obtained to pay federal estate taxes deductible because loan was obtained to avoid a forced sale of assets).

Various cases have permitted deduction of interest on amounts borrowed to pay federal estate tax, in situations where the loan was necessary to avoid a forced sale of assets. E.g., Estate of Duncan v. Comm'r, T.C. Memo. 2011-255; Estate of Todd v. Comm'r, 57 T.C. 288 (1971), *acq.* 1973-2 C.B. 4; Estate of Sturgis v. Comm'r, T.C. Memo 1987-415; Hipp v. United States, 1972-1 U.S.T.C. ¶12824 (D. S.C. 1971); Estate of Webster v. Comm'r, 65 T.C. 968 (1976); Estate of Graegin v. Comm'r, T.C. Memo 1988-477; Estate of Huntington v. Comm'r, 36 B.T.A. 698, 726 (1937).

Other cases have not allowed an interest deduction on amounts borrowed to pay estate taxes. A 1999 case refused to allow the estate to deduct interest on borrowing to pay estate tax. Estate of Lasarzig v. Comm'r, T.C. Memo. 1999-307 (beneficiaries rather than the estate borrowed the funds after an extended period of time; court observed that the IRS allowed deferral of payment of the estate tax for 5 years, "which seems to be a sufficient time to raise the funds to pay an agreed tax obligation"); Estate of Stick v. Comm'r, T.C. Memo. 2010-192 (residuary beneficiary of the estate (a trust) borrowed $1.5 million from the Stick Foundation to satisfy the estate's federal and state estate tax liabilities when the estate had nearly $2 million of liquid assets).

An unpublished district court case addressed the evidence required to establish the necessity of borrowing to pay estate taxes in a request for summary judgment by the estate. Dorothy Rupert, Executor of Estate of Knepp v. U.S., CV-03-0421 (M.D. Pa. 2004). The total gross estate was $6.97 million, of which $5.56 was the present value of lottery payments. The estate had to borrow $1.715 million to pay the estate taxes. The IRS argued that the estate did not prove a necessity for the borrowing, because it could have sold the right to receive the lottery payments. The estate had the burden of showing that the interest expense was necessary, which required the estate to show that the loan avoided some harm to the estate. There was no such evidence in the record, so summary

judgment could not be granted. However, the court observed that "such evidence could be supplied by showing that the sale of the lottery payments would be the equivalent of a forced sale of stock" [in light of the "forced sale of assets" standard described in Revenue Ruling 84-754, 1984-1 C.B. 193].

(4) Interest on Amounts Borrowed by Executor From Family-Owned Entity to Pay Federal Estate Tax. Several cases have permitted an interest deduction where the funds were borrowed from a family-owned entity rather than being borrowed from a bank. Estate of Kahanic. T.C. Memo. 2012-81; Estate of Duncan v. Comm'r, T.C. Memo. 2011-255; Beat v. United States, 107 AFTR 2d 2011-1804 (D. Kan 2011); Estate of Murphy v. U.S., 104 AFTR 2d 2009-7703 (W.D. Ark. October 2, 2009); Keller v. U.S., 104 AFTR 2d 2009-6015 (S.D. Tex. August 20, 2009)($114 million borrowed after death from FLP on a 9-year note); Estate of Thompson v. Comm'r, T.C. Memo 1998-325 (estate borrowed $2 million from irrevocable life insurance trust; court observed that regulations "do not require that an estate totally deplete its liquid assets before an interest expense can be considered necessary"); McKee v. Comm'r, T.C. Memo. 1996-362 (court refused to disallow interest deduction even though estate could have qualified for § 6166 election to defer payment of estate tax, concluding that it would not "second guess the business judgments of the executors"); Estate of Graegin, T.C. Memo. 1988-477.

(i) TAM 200513028. Technical Advice Memorandum 200513028 refused to allow any interest deduction for amounts borrowed from a family limited partnership to pay estate taxes. In that situation, the decedent created a family limited partnership with 90% of his assets, and died 5 ½ years later. The estate borrowed funds from the FLP to pay federal and state estate taxes under a 10-year note with principal and all interest payable on maturity, with a prohibition against any prepayments. The stated interest rate was 1% over the prime rate and 3% more than the 15-year mortgage rate on the date of the note. The estate's 99% interest in the FLP was pledged as security for the note. The ruling gave various reasons for denying a deduction for the interest expenses. (The IRS did not refer to the creation of the FLP as a self-imposed illiquidity as one of the reasons.) First, the IRS reasoned that the loan was not necessary to the administration of the estate because one of the decedent's sons who was a co-executor of the estate was the remaining general partner of the FLP, the FLP was not engaged in any active business that would necessitate retention of liquid assets, and there was no fiduciary restraint on the co-executor's ability to access the funds. The IRS rejected the notion that the estate could not require a distribution from the partnership since the estate possessed only a 99% assignee interest:

> "It seems clear that the same parties (closely related family members whose proportionate interests in the Estate are virtually identical to their proportionate interests in the partnership) stood on all sides of this transaction. Thus, the assets held in Partnership were readily available for the purposes of paying the federal estate tax. Rather, we believe that in view of the availability of the liquid assets to the Estate and its beneficiaries, and in view of the structure of the loan (10-year term with prepayment prohibited), the only reason the loan transaction was entered into was to obtain an 'upfront' estate tax deduction for the interest expense (an expense, which, as discussed below, is largely illusory.)"

Second, the IRS reasoned that the interest may not be repaid, and even if it is, the repayment has no economic impact on the parties. The limitation of the deduction for amounts actually paid "ensures that the expense has a real economic impact on the amount ultimately passing to the estate beneficiaries." In this case the interest payments have no economic effect on the beneficiaries. If the estate has any funds for making

payments, the estate would make the payments to the FLP to pay the interest, which would proportionately increase the value of the beneficiaries' interests in the FLP. More likely, the FLP will distribute assets to the estate, which will then repay those assets back to the FLP in payment of the loan. "Since the parties have virtually identical interests in the Estate and the partnership, there is no change in the relative net worth of these parties as a result of the loan transaction. Rather, other than the favorable tax treatment resulting from the transaction, it is difficult to see what benefit will be derived from this circular transfer of funds." The IRS attempted to further support this argument by analogizing to income tax cases, where the courts declined to allow an income tax deduction for interest under similar circumstances involving circular transfers for making payments on purported loan transactions.

(ii) Estate of Murphy. In Estate of Murphy, 104 AFTR 2d 2009-7703 (W.D. Ark. October 2, 2009), the estate borrowed $11,040,000 from the FLP on a 9-year "Graegin" note (i.e., which had a fixed term and interest rate and which prohibited prepayment). The estate also borrowed an additional $41.8 million from a prior trust on a "regular" note (i.e., that had a floating interest rate and that permitted prepayment). The IRS argued that the interest should not be deductible for two reasons. (1) The interest was not necessarily incurred "because it was the result of an unnecessary estate-tax avoidance transfer" that drained decedent's estate of liquid assets. The court rejects this reasoning, because the FLP was created "in good faith and for legitimate and significant non-tax purposes," and because decedent retained sufficient assets ($130 million) at the time the FLP was created to pay his living expenses and anticipated estate taxes. (2) The FLP could have sold some of its assets and made a distribution of cash to the estate to pay taxes. The court also rejects this argument, reasoning that "[i]f the executor acted in the best interest of the estate, the courts will not second guess the executor's business judgment. *McKee*, 72 T.C.M. at 333."

(iii) Estate of Keller. In Keller v. U.S., 104 AFTR 2d 2009-6015 (S.D. Tex. August 20, 2009), the decedent signed a partnership agreement and expressed the intent to fund the partnership with a specifically identified bond portfolio and cash, but the funding did not formally occur before her death. The decedent died unexpectedly, so the planner put the formal funding on hold for about a year until one of the planners heard about the Church case, which had recognized a partnership that similarly had not been formally funded at the decedent's death. In the meantime, the estate had paid the estate tax, not realizing that the assets legally already belonged to the partnership. The estate then documented the payment as an advance from the partnership to the estate, and deducted the interest on the loan from the partnership. The initial case allowed the interest deduction because the "estate lacked sufficient liquid assets to pay its necessary taxes and obligations without forcing the sale of its illiquid properties." In a subsequent opinion (106 AFTR2d 2010-6309, Sept. 14, 2010), the district court again addressed the validity of interest deductions on the deemed borrowing by the estate from the partnership. The IRS argued that the loan lacked economic substance. The Family Trust had paid $148 million to the IRS in February 2001, so the IRS argued that no borrowing was necessary and that the loan "was a complete sham." The court found that the loan satisfied the economic substance test and that it was entered into to preserve the liquidity of the estate. "While it is true that Mrs. Williams' advisors, at first, did not believe the Partnership was established, and drew a check from Family Trust accounts to pay taxes, the trust [apparently the court meant the Partnership] *did* exist and there in fact *was* a liquidity problem for the Estate." In addition, the IRS argued that the interest payments should not be deductible because they were paid from "property not subject to claims" (because the Family Trust and the trusts

that it funded [Trust A and Trust M] were not part of the probate estate) and that interest payments made after the statute of limitations for assessing additional taxes could not be deducted because of the limitation in § 2053(b). However, the court reasoned that § 2053(c)(2) defines "property subject to claims" as property includible in the gross estate that is burdened with the payment of the deducted expenses and it does not matter whether the property passes outside of probate. Under the decedent's will, administration expenses would to be paid from the Family Trust or residuary estate (which passed to the Family Trust), and therefore the Family Trust assets were subject to claims, and interest payments on the loan could be deducted in full, even after the statute of limitations on additional assessments had run. The court allowed a deduction for $52,018,200 of interest on the loan as requested by the Plaintiffs—calculated up to five days before the loan was due.

(iv) Estate of Black. The court rejected an interest deduction for amounts loaned from an FLP to the estate in Estate of Black v. Commissioner, 133 T.C. 340 (2009). See generally Liss, Estate of Black: When Is It 'Necessary' to Pay Estate Taxes With Borrowed Funds?, 112 J. TAX'N (June 2010). An FLP sold about one-third of its very large block of stock in a public company in a secondary offering, generating about $98 million to the FLP, and the FLP loaned $71 million to the estate to pay various taxes, expenses, and a charitable bequest. The estate argued four reasons for allowing an interest deduction. (1) The executor exercised reasonable business judgment when he borrowed funds, (2) the FLP was not required to make a distribution or redeem a partnership interest from the estate, (3) the son was the managing partner and executor and owed fiduciary duties to both the estate and the partnership, and (4) the loan itself was a bona fide loan. The IRS argued that the loan was (1) unnecessary and (2) not bona fide (because the transaction had no economic effect other than to generate an estate tax deduction). The court found that the loan was not necessary, basing its analysis primarily on the "no economic effect" rationale that the IRS gave in its "no bona fide loan" argument. The court noted that the partnership agreement allowed modifications, and a modification permitting a distribution of stock to the partners or a partial redemption of the estate's interest would not have violated the son's fiduciary duties, as managing partner, to any of the partners. The court reasoned further that the estate had no way to repay the loan other than actually receiving a distribution from or having its partnership interest redeemed by the partnership in return for the stock, which it would then use to discharge the debt. Instead, the partnerships sold the stock and loaned the sale proceeds to the estate. Under the court's analysis, the key factor in denying any deduction for loans obtained to pay debts and expenses seems to be that the loan was not necessary to avoid selling assets. The other cases cited by the taxpayer in which an interest deduction was allowed involved situations where the estate avoided a forced sale of illiquid assets or company stock. In this case, the company stock that was owned by the FLP was in fact sold by the FLP. That seems to be the key distinguishing factor from the prior cases that have allowed interest deductions for Graegin loans. John Porter (the attorney representing the estate) points out a business judgment problem with the redemption argument. The estate's interest would be redeemed at market value, with a discount. A redemption in that fashion enhances the value of the other partners, and the executor often makes a business decision not to do that. John Porter's view is that the court in Black substituted its business judgment for that of the executor.

(v) Estate of Stick. In Estate of Stick v. Comm'r, T.C. Memo. 2010-192, the estate reported liquid assets of nearly $2 million and additional illiquid assets of over $1,000,000. The residuary beneficiary of the estate (a trust) borrowed $1.5 million from the Stick Foundation to satisfy the estate's federal and state estate tax liabilities. The court concluded that the estate had sufficient liquid assets to pay the estate taxes and

administration expenses without borrowing, and denied a deduction of over $650,000 on interest on the loan. (This was despite the fact that the liquid assets of the estate appeared to have exceeded its obligations at the time of the borrowing by only about $220,000. That seems like a rather narrow "cushion" for an estate that owed over $1.7 million of liabilities, and other courts have been reluctant the second guess the executor's business judgment in somewhat similar situations.)

(vi) Beat v. U.S. In Beat v. United States, 107 AFTR 2d 2011-1804 (D. Kan 2011), the estate owned largely illiquid farmland. The estate distributed the assets to the beneficiary subject to a refunding agreement, and the estate borrowed money from the beneficiary to pay estate taxes. The estate had not paid interest to the plaintiff; it was bankrupt and could not pay the interest. The court reasoned that even if the asset had not been distributed there would have had to be borrowing to pay the estate tax and that the borrowing was "necessary and beneficial to the Estate."

(vii) Estate of Duncan. An interest deduction was allowed on a Graegin loan in Estate of Duncan v. Comm'r, T.C. Memo. 2011-255. In that case, the decedent had transferred a substantial part of his estate, including oil and gas businesses to a revocable trust. The decedent at his death exercised a power of appointment over an irrevocable trust that had been created by decedent's father to appoint the assets into trusts almost identical to trusts created under the revocable trust. The irrevocable trust and the revocable trust had the same trustees and beneficiaries. Following decedent's death in January 2006, the revocable trust borrowed about $6.5 million from the irrevocable trust to cover the estate's shortfall in being able to pay federal and state estate taxes and various administration expenses and debts. The loan was evidenced by a 6.7% 15-year balloon note that prohibited prepayment. A 15-year term was used because the volatility of oil and gas prices made income from the oil and gas businesses difficult to predict. The 6.7% interest rate was the rate quoted by the banking department of one of the corporate co-trustee for a 15-year bullet loan. (At the time of the loan, the long term AFR was 5.02% and the prime rate was 8.25%.) In fact, the revocable trust ended up being able to generate to over $16 million in cash within the first three years, but the note prohibited prepayment. The revocable trust did not expect to generate sufficient cash to repay the loan within three years.

In Duncan, the estate claimed a deduction under § 2053 of about $10.7 million for interest that would be payable at the end of the 15-year term of the loan. The IRS denied any deduction for the interest (although at trial it was willing to allow a deduction for three years of interest). The court (Judge Kroupa) determined that the interest was fully deductible. (1) The loan was bona fide debt. Even though the lender and borrower trusts had the same trustees and beneficiaries, the loan still had economic substance because the parties were separate entities that had to be respected under state law. (2) The loan was actually and reasonably necessary. The revocable trust could not meet its obligations without selling its illiquid assets at reduced prices. Because of the trustee's fiduciary duty, the irrevocable trust could not merely purchase assets from the revocable trust without requiring a discount that third parties would apply. The terms of the loan were reasonable and the court refused to second guess the business judgments of the fiduciary acting in the best interests of the trust. The 15-year term was reasonable because of the volatile nature of the anticipated income. The interest rate was reasonable; using the AFR as the interest rate would have been unfair to the irrevocable trust because the AFR represents the appropriate interest rate for extremely low risk U.S. government obligations. The IRS complained that there were no negotiations over the rate, but the court said that the trustees had made a good-faith effort to select a reasonable interest rate and that "formal negotiations would have amounted to nothing more than playacting." (3) The amount of the

interest was ascertainable with reasonable certainty. The IRS argued that the loan might be prepaid and that there is no economic interest to enforce the clause prohibiting prepayment. The court found that prepayment would not occur because the two trusts had to look out for their own respective economic interests. If a prepayment benefited one trust it would be a financial detriment to the other. See generally Stephen Liss, In *Estate of Duncan*, the Tax Court Returns to Traditional *Graegin* Loan Principles, 116 J. TAX'N 193 (April 2012).

(viii) Estate of Kahanic. A deduction was allowed in Estate of Kahanic. T.C. Memo. 2012-81. This case did not involve a "Graegin" loan because the loan could be repaid at any time. Accordingly, the estate did not claim a deduction on the estate tax return for the interest that would accrue over the life of the loan. The issue was merely whether the interest that had accrued up to the time of trial could be deducted under §2053.

The estate was trying to sell the decedent's medical practice when the estate taxes were due, and did not have the liquid funds to pay the estate taxes without a forced sale of the medical practice. Immediately before paying the estate taxes, the estate had about $400,000 of cash and owed about $1.125 million of liabilities, including the federal and state estate taxes. The estate borrowed $700,000 from the decedent's ex-wife for a secured note bearing interest at the short–term AFR (4.85%). The court allowed the amount of interest that had accrued up to the time of trial. The IRS's arguments and the court's responses are as follows.

Loan was bona fide debt. The IRS argued that the lender never intended to create a genuine debt because she never demanded repayment and because she benefited from the estate being able to pay its estate taxes (otherwise she would have been liable for some of the estate taxes because of transferee liability). The court responded that she did not demand payment when the loan became due because that would have exhausted the estate's funds and prevented the estate from being able to challenge the IRS's estate tax determination. The court also agreed with the estate that the ex-wife's benefiting from the estate's payment of its taxes and did not mean that she did not intend to collect the loan.

Loan was actually and reasonably necessary. The IRS argued that the estate could have recovered from the ex-wife a portion of the estate tax liabilities to pay them on the due date. The court disagreed, stating that the estate did not have a right of contribution from her for estate taxes at the time they were due because the residuary estate value at that time was sufficient to pay the taxes. In addition, the IRS maintained that the estate could have sold its illiquid assets in time to pay the taxes. The court again disagreed, finding that it would have had to sell the medical practice and its receivables at a deep discount.

Interest will be paid by the estate. The IRS believed the estate had not shown that it could pay the interest, but the court accepted the estate's counter that based on other findings in the case, the estate taxes would be reduced to the point that it could pay the interest.

(ix) Estate of Koons, In Estate of Koons, T.C. Memo. 2013-94, the court disallowed a $71 million interest deduction on a $10.75 million note. The estate had about $19 million of liquid assets and the return positions indicated that it owed about $21 million of estate tax and the decedent's revocable trust owed about $5 million of GST tax. (The IRS position was that those liabilities were $64 million and $20 million, respectively.) The estate borrowed the cash in 2006 from an LLC owned 71% by the estate. Payments under the note were paid over 8 years (2024-2031) beginning **18 years** after the loan was made

from an LLC The court reasoned that the estate could have forced a distribution from the LLC to pay the estate tax, and that the loan merely delayed the time for such a distribution because the estate's only ability to repay the loan was from eventual distributions from the LLC. The estate argued that a loan from the LLC was preferable to a cash distribution because a cash distribution would leave the LLC with less cash to buy businesses. However, the court noted that the loan also depleted the LLC of cash. Furthermore, the court noted that the estate would have to remain active long enough to repay the loan, and keeping the estate open 25 years "hinders the 'proper settlement' of the Estate."

(x) Impact on §2036 Issue. Some IRS agents have indicated informally that claiming an interest deduction on a Graegin loan for borrowing from a family limited partnership will draw close scrutiny as to whether §2036 applies to include the partnership assets in the estate (without any discount).

(5) Timing of Interest Deduction For Interest on Loan Borrowed to Pay Federal Estate Tax.

(i) *Estate of Graegin* Approved Up-Front Deduction. 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 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.

For an excellent general discussion of the use of Graegin notes, see Harrison, Borrowing to Pay Estate Tax, TRUSTS & ESTS. 46 (May 2009).

(ii) Key: Reducing Payment to IRS 9 Months After Date of Death. The same ultimate estate taxes would be paid whether the interest deduction is allowed at the outset, or as each interest payment is made. This phenomenon results because administrative expense deductions are not limited to the present value of payments made years after the date of death. **However, for estates facing a liquidity crunch, obtaining an up-front deduction and dramatically reducing the dollars that the estate must come up with to pay the IRS nine months after date of death is critical**.

(iii) Approval by IRS; Subsequent Cases. The IRS approved a Graegin-type situation in Letter Ruling 199903038. Letter Ruling 199952039 reached the same conclusion in a very similar fact situation involving a ten year note providing for annual interest payments with a balloon principal payment at the end of ten years. Letter Ruling 200020011 allows a current deduction for the projected interest payments after the loan is amended to provide that it cannot be prepaid and that upon default all interest that would have been owed throughout the loan term must be paid at the time of default.

The IRS's position in the letter rulings that all interest that would have been owed for the entire loan term must be paid upon default of the note may present usury problems in some states. An alternative planning possibility may be to have the lender waive the right to accelerate the note in the event of default. Therefore, if there is a default,

the terms of the note would continue to apply, and interest would continue to run to the end of the term of the loan.

Technical Advice Memorandum 200513028 refused to allow any interest deduction for amounts borrowed from a family limited partnership to pay estate taxes. The ruling reasons, in part, that "the only reason the loan transaction was entered into was to obtain an 'upfront' estate tax deduction for the interest expense….The interest deduction cannot be the justification for an otherwise unnecessary loan." (The TAM is discussed in detail in Section IV.D.2.c.(4) of this outline.)

The Tax Court refused to allow deducting the present value of interest payments to be made on a 20 year note. Estate of Lasarzig v. Comm'r, T.C. Memo. 1999-307. The court noted that no prior cases had allowed such deduction in a situation in which a taxpayer "seeks an extended delay (up to 20 years) so that a nonparty (family trusts of beneficiaries) can benefit from improved market conditions that may or may not occur."

In Estate of Gilman v. Comm'r, T.C. Memo 2004-286, the estate borrowed funds to pay (1) federal and state estate taxes, (2) compensation to executors (who were also employees of the estate's closely held business and the will specified that they were not to receive executor's commissions but should continue to receive compensation from the business), and (3) miscellaneous expenses. In a series of complicated transactions, the estate restructured the business, and as part of the restructuring, the estate received notes that would be paid in full on January 1, 2004, and the residuary beneficiary (a foundation) received the member interests in the restructured entity (an LLC). The IRS argued that the loan was unnecessary because the estate had enough liquid assets to pay its taxes and administration expenses. The court disagreed, because the estate's assets were illiquid. The court allowed the estate to deduct interest up to January 1, 2004 (the date the notes were due) on amounts borrowed to pay federal and state estate taxes. However, it did not allow deducting interest on amounts borrowed to pay the compensation (because the estate was not required to pay the compensation) or the other miscellaneous expenses (because there was no evidence as to what expenses were included in that amount).

Various cases over the last several years have addressed Graegin loans from partnerships in which the estate owned an interest. Estate of Murphy v. U.S., 104 AFTR 2d 2009-7703 (W.D. Ark. 2009) (interest deduction allowed); Keller v. U.S., 104 AFTR 2d 2009-6015 (2009) and 106 AFTR2d 2010-6309 (2010) ($114 million borrowed after death from FLP on a 9-year note; deduction allowed). The deduction for interest on amounts borrowed from the family partnership was denied in Estate of Black v. Commissioner, 133 T.C. 340 (2009) and Estate of Koons, T.C. Memo. 2013-94. These cases are discussed above in detail.

Another recent Graegin loan case is Estate of Duncan, T.C. Memo 2011-255, also discussed above, in which the court allowed 10.7 million of interest deduction on a $6.5 million 15-year balloon note.

IRS officials have stated informally that the IRS is continuing to look for vehicles to contest Graegin loans, particularly in situations involving family limited partnerships. Part of the IRS's concern is that a deduction will be allowed but the interest in fact will not have to be paid over the entire term of the note.

(iv) Example of Extremely Favorable Results of Up-Front Deduction. The economics of this up-front deduction can be staggering. For example, assume a $10 million taxable estate. If sufficient lifetime gifts have been made so that the estate is in a

40% bracket, the estate would owe $4.0 million in estate taxes. However, assume the estate borrows $1.434 million [this amount is calculated in an interrelated calculation] from a closely-held company under a 15 year note, at 12.0% interest, with a balloon payment at the end of the 15 year period. The accumulated interest payment due at the end of the 15 years would be $6.415 million. Under the Graegin analysis, the interest expense would be currently deductible, yielding a taxable estate of $10 - $6.415 or $3.585 million, which would result in a federal estate tax (at a 40% rate) of $1.434 million. The $6.415 million of interest would be paid to the company (which in turn, is owned primarily by family members.) The overall result is a very considerable estate tax savings. **The estate tax that is due 9 months after the date of death is reduced from $4.0 million to a little under $1.5 million.**

The interest income would be subject to income tax over the 15-year period, and the IRS will take the position that the interest on loans to pay taxes is nondeductible personal interest. However, many families are willing to pay income taxes over the payment period if they can reduce the estate taxes that are due nine months after the date of death. Be aware that if a QTIP trust or funded revocable trust is the borrower rather than a probate estate, the IRS may argue that under §2503(b) only interest actually paid within the estate tax statute of limitations period may be deducted.

(v) New Regulation Project Considering Applying Present Value of Administration Expenses and Claims; Graegin Loans. The §2053 final regulations do not seem to impact Graegin loans at all. However, the Treasury Priority Guidance Plans for 2009-2012 include a project to address when present value concepts should be applied to claims and administration expenses (including, for example, attorneys fees, Tax Court litigation expenses, etc.). Graegin notes are also in the scope of that project.

(6) Possibility of Income Tax Recognition With No Offsetting Deduction If Estate Tax Interest Deduction Is Denied For Some or All of Graegin Loan. The IRS often tries to settle cases involving Graegin loans by allowing an estate tax interest deduction for some but not all of the years of the loan. This can create a potential income tax issue where the amount is borrowed from a family entity rather than borrowing it from a bank. For the remaining years, the interest payments to the lender will still be taxable income, and there may be no offsetting income tax deduction for the estate's payment of the interest. Some planners indicate that they have been able to negotiate the estate tax settlement to provide that there will be no income recognition of the interest income in years for which an estate tax interest deduction is not allowed.

3. Valuation of Disputed Claims Against Estate—Case Law.

One possible debt deduction is for claims against the estate that are uncertain in amount at the date of death. 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). Older cases in the First, Second, Fifth, and Eighth Circuits have considered post-death events in valuing uncertain claims.

The line of cases on the opposite side strictly follow the 1929 Supreme Court decision in Ithaca Trust Co. v. U.S., 279 U.S. 151 (1929), and its general rule that post-death events must not be considered in valuing the amount of the deduction, because so far as possible, the estate must be settled as of the date of the testator's death.

Cases in the Fifth, Tenth, and Eleventh Circuits now agree in refusing to consider post-death events (such as settlement agreements) in valuing claims against the estate that are uncertain in value at the date of death. Estate of Smith v. Comm'r, 198 F.3d 515 (5th

Cir. 1999), nonacq. 2000-19 IRB; Estate of McMorris v. Comm'r, 243 F.3d 1254 (10th Cir. 2001); Estate of O'Neal v. U.S., 258 F.3d 1265 (11th Cir. 2001).

Ninth Circuit cases refused to consider post-death events in valuing claims that are "sum certain and legally enforceable as of the date of death," even though a lower amount is actually paid in settlement of the claim. However, those Ninth Circuit cases have suggested a different result for disputed or contingent claims. Estate of Van Horne v. Comm'r, 720 F.2d 1114 (9th Cir. 1983) (allowed deduction for $596,387 actuarial value of spousal support obligation for ex-husband's lifetime, even though he died after receiving only $35,000; dicta that post-death events are relevant in cases where the claims are potential, unmatured, contingent, or contested at the date of death); Propstra v. U.S., 680 F.2d 1248 (9th Cir. 1982) (allowed deduction for full amount of past due assessments and penalties to Water Association even though the claims were settled for a lower amount after the estate tax return was filed; court observed in dictum that "[t]he law is clear that post-death events are relevant when computing the deduction to be taken for disputed or contingent claims"). Some of the subsequent decisions in other circuits have specifically rejected that distinction between those two different types of claims. A more recent Ninth Circuit case held directly that no deduction was available for the estimated amount of California income tax that an estate *might* owe, because the estimated claim was not ascertainable with reasonable certainty at the date of death. The California income tax claim's value became certain when a settlement was reached, and the deduction was limited to the actual settlement amount as the value of the claim. Marshall Naify Revocable Trust v. United States, 109 AFTR 2d 2012-969 (9th Cir. 2012), *aff'g,* 106 AFTR 2d 2010-6236 (N.D. Cal. 2010).

In a case appealable to the Ninth Circuit, the Tax Court refused to allow an estate tax deduction for a claim against an estate, other than the amount actually paid, based on a strict reading of the standard under the prior § 2053 regulation in Estate of Saunders v. Commissioner*,* 136 T.C. No. 18 (April 28, 2011)(opinion by Judge Cohen). The prior regulation stated that "An item may be entered on the return for deduction though its exact amount is not then known, provided it is ascertainable with reason able certainty, and will be paid. No deduction may be taken upon the basis of a vague or uncertain estimate." Treas. Reg. § 20.2053-1(b)(3). The case involved potential malpractice claims against a decedent and the court concluded that even the estate's experts' varying estimates of the value of the claim against the estate ($30 million, $25 million, $19.3 million, and $22.5 million) are prima facie indications of the lack of reasonable certainty. Under the court's analysis, even under the prior § 2053 regulation, claims against an estate where there is an ongoing lawsuit will likely be limited to amounts that are actually paid. This result is not surprising, because the case is appealable to the Ninth Circuit Court of Appeals, and prior Ninth Circuit cases (unlike the courts of appeal in the Fifth, Tenth, and Eleventh Circuits) have stated that no deduction is allowed for contingent or contested claims.

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

Observe that this factor can also benefit the IRS. For example, one attorney reported having an estate audit over property worth $700,000 with known environmental problems and reported on the Form 706 an estimated value net of the clean-up costs of $250,000. Within two years after the date of death, the estate had actually spent $2.5 million of clean up costs. The IRS objected to considering the actual expenditure. (The preamble to the final regulations discussed below confirms that the Treasury and IRS believes that the general principle described in the regulation, providing generally that a deduction is allowed for the amount actually paid, "is binding on both estates and the Commissioner.")

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

Some of the changes made from the proposed regulations in the final regulations are as follows.

a. Effective Date of Regulations. The regulations apply to decedents dying on or after October 20, 2009.

b. Exceptions.

(1) Claims and Counterclaims in Related Matter. If the estate includes a claim or cause of action or other particular asset and there is a claim against the estate in the same matter or that is "integrally related to that asset," the claim may be deducted on the estate tax return if the claim meets the other requirements for deducting administration expenses other than the "reasonably ascertainable" requirement and if (i) the value of the claim is determined from a "qualified appraisal" by a "qualified appraiser" (using the rules under §170(f)(11)(E)) and (ii) the aggregate value of the related claims or assets included in the gross estate exceed 10 percent of the gross estate. The claim may be deducted only up to the value of the related claim or asset value. The value of the claim is subject to adjustment for post-death events. Treas. Reg. §20.2053-4(b).

(2) Claims Totaling Not More Than $500,000. The estate may deduct any non-ascertainable claim (that meets the other general requirements for deductions under §2053) up to $500,000 (in addition to claims that can be deducted under the "counterclaim exception" described above). However, the "full value" of each such claim must be within the aggregate $500,000 limit for the estate. For example if there are three claims against the estate valued at $200,000 each, two of the claim could be deducted under this exception, but not the third claim because the full value of the third claim would not be covered by the $500,000 limit. Treas. Reg. §20.2053-4(c)(3)Ex. 2. As with the "counterclaim exception," there must be a qualified appraisal by a qualified appraiser of each such claim deducted under this exception, and the value of the claim is subject to adjustment for post-death events. Treas. Reg. §20.2053-4(c).

(3) Practical Effect of Exceptions. Notice 2009-84, issued in conjunction with the release of the final regulations to §2053, state that "[a]s a result of these exceptions, the Treasury Department and the Service anticipate that the number of protective refund claims filed to preserve a deduction under section 2053 will be significantly smaller that was anticipated by commentators to the proposed regulations." However, few estates may elect to use these two exceptions. Planners generally recommend not taking an estate tax

deductions for non-ascertainable claims while litigation is still ongoing or threatened for fear the value placed on the estate tax return would be used in the underlying substantive litigation. This fear would be exacerbated if the return not only places a value on the claim but also is supported by a "qualified appraisal." Furthermore, it may be difficult to find "qualified appraisers" who have the expertise to value contingent claims in litigation. In the past, trial attorneys or judges with substantial experience in litigating claims have been used at trial to support the date of death estimated value of claims against an estate. In many situations, they would seem to have the best experience in evaluating such claims in litigation, but they probably do not meet the detailed requirements of a "qualified appraiser" under §170(f)(11)(E)(ii) (i.e., they probably do not have an appraisal designation from a recognized professional appraiser organization or regularly perform appraisals for which the they receive compensation).

c. Settlements. There is no requirement (as there was in the proposed regulations) that a settlement be within the range of reasonable outcomes (as long as there is a bona fide issue in an active and genuine contest and adverse parties negotiate at arms' length in reaching the settlement). The IRS can consider the cost of defending a lawsuit or the effects of delay arising from litigation would impose a higher burden than paying the settlement amount, but unenforceable claims may not be deducted despite any settlements.

d. No Affirmative Duty to Report. The regulations provide that the IRS "will take into account events occurring after the decedent's death" even for claims that can be ascertained and deducted on the return or claims that come within the exceptions that are deducted currently. While the regulations do not explicitly impose an affirmative duty on the executor to report to the IRS if the full amount of any such deducted claim is not paid, the preamble to the final regulations noted that "[s]ome commentators questioned whether the proposed regulations would impose a duty on the executor to report amount that were claimed as deductions on the estate tax return, but were subsequently not paid or not paid in full, and whether such a duty could be enforced after the period of limitations on assessment has expired." The preamble's response is that "[t]he Treasury Department and the IRS did not intend for the proposed regulations to impose a duty on the executor that could be enforced after the expiration of the period of limitations on assessment," and the final regulations eliminate the duty to report provision.

e. Claims by Family Members, Related Entities or Beneficiaries. The proposed regulations created a rebuttable presumption that claims by family members, related entities or beneficiaries are not legitimate and bona fide. The final regulations remove the rebuttable presumption. It also adds a non-exclusive list of factors that may be considered in determining that such a claim is legitimate and bona fide. Those factors include whether the claim is: (i) In the ordinary course of business; (ii) Not related to an expectation of inheritance; (iii) Substantiated by contemporaneous evidence; or (iv) Made pursuant to an agreement that can be substantiated. Treas. Reg. §20.2053-1(b)(ii-iii).

fg. Recurring Noncontingent Obligations. The proposed regulations provided that only the date of death (or alternate valuation date) present value of recurring noncontingent obligations (such as an obligation under a divorce decree to make alimony payments) could be deducted under §2053. The present valuing concept does not apply for contingent payments after the contingency is resolved—the actual amount of those payments can be deducted in full without any present value limitation. To be consistent, the IRS dropped the present value limitation for recurring noncontingent obligations in the final regulations, and they can be deducted in full on the return. A claim subject to a contingency related to death or remarriage is till treated as a noncontingent claim for this purpose. Treas. Reg. §20.2053-4(d)(6)(i) & 20.2053-4(d)(7)Ex. 8. However, the preamble to the final regulations

notes that the Treasury and IRS believe that the appropriate use of present value in determining §2053 deductions merits further consideration, and there is an ongoing project on the Treasury Priority Guidance Plan for that issue.

5. Valuation of Disputed Claims Against Estate—Protective Claim for Refund Procedures.

a. Section 2053 Regulation*.* The IRS issued final regulations on October 20, 2009, taking the general approach that a deduction is allowed for contingent or uncertain claims only as payments are actually made by the estate. This general rule does not apply to estimated amounts for claims that the IRS is satisfied are "ascertainable with reasonable certainty" and "will be paid." Treas. Reg. §20.2053-1(d)(4). A protective claim for refund can be filed for contingent or uncertain claims before the statute of limitations runs on refunds, and a deduction is allowed when the claim is resolved, even if that is after the general period of limitations on refunds has expired. Treas. Reg. §20.2053-1(d)(5).

The § 2053 regulation briefly addressed protective claims for refund regarding § 2053 deductions. It identified issues involving timing of filing protective claims (before the statute of limitations runs on refunds), identification of claims (requiring a description of the reasons and contingencies delaying actual payment of the claim but not requiring listing of actual amounts), and consideration of the claim after the contingency is resolved (requiring notification to the IRS "within a reasonable period that the contingency has been resolved").

The regulations also address that the possibility of a contingent claim against an estate will not reduce the amount of marital or charitable deduction available on the estate tax return even if the contingency is payable out of a marital or charitable share. However, after the contingency is resolved and the amount is paid, the marital or charitable deduction will be reduced (but generally would be offset by the § 2053 deduction for that same amount). Treas. Reg. §20.2053-1(d)(5)(ii).

The preamble to the final regulations indicates that the IRS will issue further guidance regarding the process of using protective claims for refund. Two years later, we have received that guidance.

b. Overview of Rev. Proc. 2011-48*.* Rev. Proc. 2011-48, 2011-42 IRB 527 describes procedures for filing § 2053 protective claims for refund (in § 4) and procedures for notifying the IRS that a § 2053 protective claim for refund is ready for consideration (§ 5).

The procedures described in § 4 for filing and processing the protective claim include the timing of filing the protective claim, who can file the protective claim (and documenting the authority of such person), two alternative methods for filing the protective claim (a separate filing is required for each separate claim), the required manner of specifically identifying of the particular claim or expense, the processing of a protective claim by the IRS (filing a protective claim does not delay the estate tax audit or issuance of a closing letter), the advisability of contacting the IRS if the filer does not receive acknowledgement from the IRS that it has received the protective claim within a specified period of time, and the opportunity to cure an inadequately identified claim or expense.

Procedures in § 5 for giving "notification of consideration" of the claim after it has been paid or after contingencies have been resolved include procedures and time period for notifying the IRS, alternatives for "perfecting" the claim when multiple or recurring payments are part of the protective claim, who can perfect the claim if there is no longer an executor or personal representative for the estate, limits on reviewing other aspects of the estate tax return in considering the claim, and necessary adjustments to the marital and charitable

deduction if the claim was paid from a charity or surviving spouse's share of the estate.

c. Time Period For Filing Protective Claim. The protective claim for refund may be filed at any time within the period of limitations for filing a claim for refund under §6511(a) (i.e., the later of three years after the return was filed or two years after the payment of tax). Rev. Proc. 2011-48, § 4.01.

d. Who Can File Protective Claim? There must be documentary evidence (such as certified copies of letters testamentary) of the authority of the person filing on behalf of the estate. If the same fiduciary that filed the Form 706 also files the protective claim for refund, a statement affirming that the person is still acting in a representative capacity will suffice. Rev. Proc. 2011-48, § 4.03.

e. Alternative Methods of Filing Protective Claim for Refund. For estates of decedents dying after 2011, two alternatives are available — (1) attaching Schedule PC to the Form 706 at the time of filing the estate tax return (Schedule PC will be part of the 2012 Form 706), or (2) Form 843 with the notation "Protective Claim for Refund under Section 2053 "written at the top of the form. (Using the Schedule PC approach may be somewhat simpler in that it does not require filing a separate form. However, the IRS apparently will process the Form 843 quicker, because § 4.06(2) contemplates that the IRS will acknowledge receipt of the Form 483 within 60 days but may not acknowledge receipt of the Schedule PC for 180 days. Rev. Proc. 2011-48, § 4.04(1).

For estates of decedents who die between October 20, 2009 and December 31, 2011, the Form 843 method must be used. (The 2011 Form 706 has already been issued without Schedule PC attached, so that procedure cannot be used for 2011 decedents.)

If a protective claim for refund has been filed previously and if there is any concern that it does not meet the requirements of this Revenue Procedure, the protective claim may be re-filed in accordance with the requirements of the Revenue Procedure as long as the re-filing occurs before the expiration of the statute of limitations on refunds. Rev. Proc. 2011-48, § 4.04(1). The Revenue Procedure provides certain procedures for curing inadequately identified claims, sometimes even after the expiration of the statute limitations, and it provides that there will not be a review of the entire estate tax return when the claim is considered, but those very favorable effects are available only if the procedures described in Rev. Proc. 2011-48 are followed. Rev. Proc. 2011-48, §§3, 4.06(3).

f. Separate Filling Required For Each Separate Claim or Expense. A separate protective claim for refund for each separate claim or expense should be filed on a separate Schedule PC or a separate Form 843. Rev. Proc. 2011-48, § 4.04(2). (The IRS will want to be able to match each notification to perfect a claim for refund with the original protective claim form.)

g. Identification of the Claim or Expense; Ancillary Expenses. Each claim or expense for which a protective claim for refund is made must be clearly identified with "an explanation of the reasons and contingencies delaying the actual payment to be made in satisfaction of the claim or expense." Rev. Proc. 2011-48, § 4.05(1). For contested matters, the protective claim must identify the contested matter and potential liability by including the name of the claimant, the basis of the claim, "the extent or amount of the liability claimed," and a brief statement of the status of the contested matter. (A copy of relevant court pleadings generally will be sufficient to identify the claim.) Rev. Proc. 2011-48, § 4.04(3).

There is no necessity that the protective claim "state a particular dollar amount." The 2009 § 2053 regulation confirms that even though the "specific dollar amount" issue is not addressed in the Revenue Procedure. Treas. Reg. § 20.2053-1(d)(5). This is a very

important consideration in crafting the protective claim because a request for a specific high dollar amount of deduction would likely be a "smoking gun" in the underlying litigation about the contingent claim.

Ancillary expenses (such as attorneys' fees, court costs, appraisal fees, and accounting fees) "related to resolving, defending, or satisfying the identified claim or expense" are automatically included as part of the claim for refund without the need for separate identification of these ancillary expenses. Rev. Proc. 2011-48, § 4.04(2).

CCA 200845045, provides a general overview of protective claims. While Rev. Proc. 2011-48 does not specifically refer to this Chief Council Advice, it may nevertheless assist in understanding the type of information that the IRS is seeking in identifying claims. CCA 200848045 says that Reg. § 301.6402-2 does not require that a particular dollar amount be asserted but the claim must "identify and describe the contingencies affecting the claim." This requirement "is interpreted liberally by the Service. So long as the claim is sufficiently clear and definite [to] apprise us of the essential nature of the claim, it will be accepted as having met the requirement." (This is important because providing too much detail about what makes the claim contingent may give the other side in the litigation insight into the taxpayer's perceived weaknesses in its case.)

h. Processing of Protective Claim After It Is Filed. The IRS will not perform a substantive review of a protective claim for refund until the IRS is notified that the claim has been paid or the amount ascertained. However, the IRS may reject the protective claim initially if preliminary procedural requirements are not satisfied. If the claim is not initially rejected, the IRS will send an acknowledgment to the filer that the claim has been received, but the acknowledgment does not constitute a determination that the preliminary procedural requirements have been satisfied. Rev. Proc. 2011-48, § 4.06(1). If the filer does not receive the acknowledgment within 180 days of filing a Schedule PC or within 60 days of filing a Form 843, the filer should contact the IRS within 30 days after the expiration of those periods (or else the opportunity of curing inadequately identified claims after the period of limitations on refunds has expired will not be available). Rev. Proc. 2011-48, § 4.06(2). The failure to contact the IRS timely in this circumstance would also appear to cause the estate to lose the limited scope of review as discussed in Item 10 below. *See* Rev. Proc. 2011-48, § 3.

i. Opportunity to Cure Inadequately Identified Claims. If "preliminary procedural requirements" for a valid protective claim for refund, are not satisfied (including the penalty of perjury statement), the protective claim may only be cured before the expiration of the statute of limitations on refunds. However, if the protective claim is valid except that it fails to sufficiently identify the claim or expense, the protective claim may be corrected even after the expiration of the period of limitations on refunds "by submitting a corrected (and signed) protective claim for refund" before the last to occur of (1) the expiration of the period of limitations, or (2) within 45 days after the IRS gives notice of the defective identification. Rev. Proc. 2011-48, § 4.06(3). (As described above, this cure opportunity does not apply if the IRS fails to acknowledge receipt of the protective claim and the taxpayer fails to contact the IRS within the time frame described in the preceding paragraph.)

CCA 299848005, discussed above, provides that a "general" claim may be amended following the running of the statute of limitations to supply missing information that caused the claim to be "general," but an untimely new claim may not be filed after limitations have expired. The distinction is that the claim is treated as a time-barred new claim "if it would require the investigation of new matters that would not have been disclosed by the investigation of the original claims" or if it asserts a different legal ground

for the refund. Rev. Proc. 2011-48 does not mention the possibility of amending "general" protective claims for refund after the period of limitations on refunds has expired. The more specific procedure described in the Revenue Procedure of being able to correct inadequately identified claims within 45 days of receiving notice from the IRS of an inadequate claim will likely be the only opportunity available to cure the description in the claim after the period of limitations has expired.

j. Audit Not Delayed. Filing a protective claim for refund does not suspend the estate tax audit or delay the issuance of a closing letter. Rev. Proc. 2011-48, § 4.06(4)

k. Perfecting Protective Claim by Notifying IRS of Payment or Resolution of Contingency. The IRS must be notified within 90 days after the date on which the amount of the claim or expense is paid or becomes certain and is no longer subject to any contingency. (The Revenue Procedure refers to this as a "notification for consideration.") If the IRS is not advised within that 90 day time period, the person seeking the refund may provide an explanation in an attempt to establish a reasonable cause for the delay.

The Revenue Procedure does not explicitly say so, but apparently, the claim for refund is forever barred after the expiration of the general period of limitations if the taxpayer does not meet the 90-day deadline or establish reasonable cause for the delay. This could be problematic, because it may not always be easy to determine exactly when the claim becomes deductible. Treas. Reg. §20.2053-1(d)(4) says that the claim is deductible when it is "ascertainable with reasonable certainty" and "will be paid." If there is any question whether a claim has become ascertainable with reasonable certainty, presumably the estate would want to go ahead and file the notice for consideration to make sure that the 90-day deadline is satisfied. If the IRS determines that the claim is not yet deductible, the notice could be refilled at a later date when it becomes more "ascertainable."

For multiple recurring payments, the notification for consideration can be given within 90 days of either the date of the last and final payment or annually with respect to payments made since the last notification for consideration. Rev. Proc. 2011-48, § 5.02(2). Thus, the estate has the option of waiting until all of the payments have been made to request the full refund or it can request a partial refund as payments are made (but no more often than annually).

The notification must also "indicate whether other notifications for consideration are being filed contemporaneously or were previously filed and the approximate date of each such filing." Rev. Proc. 2011-48, § 5.03(2).

The methods for filing the notification for consideration are similar to the methods for making the initial protective claim for refund. For estates of decedents dying after 2011, the notification may be given by filing either:

(1) a supplemental Form 706 including each schedule affected by the allowance of the deduction with an updated Schedule PC for each claim that has become deductible (certain verbiage must be written at the top of the supplemental Form 706 and a copy of the initial protective claim for refund must be attached); or

(2) Form 843 (with similar verbiage written at the top of the form) identifying the claims or expenses that have become deductible, together with a copy of the originally filed protective claim for refund. Rev. Proc. 2011-48, § 5.02(1). A computation of the amount to be refunded must be included with the Form 843 (there would obviously be a recomputation of the estate tax if the supplemental Form 706 approach were used). Rev. Proc. 2011-48, § 5.05.

For estates of decedents dying between October 20, 2009 and December 31, 2011, the Form 843 approach must be used.

l. Limited Scope of Review. Rev. Proc. 2011-48 confirms that "generally the Service will limit its review of the Form 706 to the deduction under section 2053 that was the subject of the protective claim." Rev. Proc. 2011-48, § 5.01, referencing Notice 2009-84. However, very importantly, the limited review described in Notice 2009-84 and in § 5.01 does not apply to "[a] taxpayer that chooses not to follow or fails to comply with the procedures set forth in this revenue procedure." Rev. Proc. 2011-48, § 3.

The explicit reference to Notice 2009-94 is important, because that Notice provides insight into why the IRS inserted the word "generally" in the sentence about limiting the scope of review. The Supreme Court has held that the IRS can examine each item on a return to offset the amount a refund claim, even after the period of limitations on assessment has run. Lewis v. Reynolds, 284 U.S. 281, 283 (1932). However, the IRS in Notice 2009-84 agreed that it would limit the review of protective claims for refund to preserve the ability to claim a deduction under §2053 "to the evidence relating to the deduction under section 2053," and not exercise its authority to examine each item on the return to offset a refund claim. This limitation does not apply if the IRS is considering a claim for refund not based on a protective claim regarding a deduction under §2053 in the same estate. Also, the Notice says the limitation applies "only if the protective claim for refund ripens after the expiration of the period of limitations on assessment and does not apply if there is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact." The Revenue Procedure is not as explicit but makes a passing reference to this requirement about the refund ripening after the period of limitations has run. It says the limited scope of review applies when determining "whether there is an overpayment of tax based on a timely-filed section 2053 protective claim for refund *that becomes ready for consideration* after the expiration of the period of limitation on assessment …" (Accordingly, there may be an advantage in not having resolved the underlying lawsuit regarding the claim against the estate until after the period on additional assessments has run—to the extent that there may be items on other parts of the estate tax return that the IRS might question if it could.)

m. Authority of Person Other Than Executor or to Pursuit Claim for Refund. If an executor is no longer acting on behalf of the estate, one or more persons who receive probate or nonprobate assets may establish "under applicable local law" that person's authority to pursue the claim on behalf of the estate. Such person must attach to the notification for consideration "documentary evidence" that substantiates that person's authority. However, the IRS "will pay the refund of tax to the person or individual who paid the tax, as required by section 6402(a) and subject to regulations under that section." Rev. Proc. 2011-48, § 5.04.

n. Coordination With Marital or Charitable Deduction. The § 2053 regulations solved a terrible potential liquidity timing problem by providing that the possibility of a contingent claim against an estate will not reduce the amount of marital or charitable deduction available on the estate tax return even if the contingency is payable out of a marital or charitable share. Instead, the marital or charitable deduction will be reduced when the contingency is resolved (but generally would be offset by the §2053 deduction for that same amount). Treas. Reg. §20.2053-1(d)(5)(ii). Rev. Proc. 2011-48, § 5.05 confirms that "[t]he computation of the amount to be refunded under section 2053 … should identify any necessary adjustment to the marital and charitable deductions claimed by the estate, as well as any other arithmetic adjustments that result from the allowance of the deduction."

o. Effective Date. The Revenue Procedure applies to protective claims for refund under § 2053 for decedents dying on or after October 20, 2009.

6. Circular Calculation Often Required Because of Deduction for State Death Taxes. Beginning in 2005, there is a 100% deduction for state death taxes. §2058. The state death tax is typically calculated based on the federal taxable estate and the federal taxable estate is determined after all deductions, including the deduction for state death taxes. An interrelated circular calculation is required in those circumstances.

E. Marital Deduction Planning.

1. QTIP Planning Considerations.

a. General Requirements. The executor may elect to claim a marital deduction with respect to "qualifying terminable interest property." §2056(b)(7). The basic requirements for qualifying for QTIP treatment are (i) the property must pass from the decedent, (ii) the surviving spouse must be entitled to all of the income from the property for life, payable annually or in more frequent intervals, and (iii) no person may have the power, exercisable during the spouse's life, to appoint the property to any person other than the spouse. §2056(b)(7)(B)(ii). In addition, if the property meets the above requirements, QTIP treatment will be allowed only if an election is made by the executor on the federal estate tax return. §2056(b)(7)(B)(v). The IRS may grant "9100 relief" to allow a late election for a testamentary QTIP trust, but the IRS takes the position that it cannot grant 9100 relief to allow a late QTIP election for an inter vivos QTIP trust. Ltr. Rul. 201109012 (revoking Ltr. Rul. 201025021).

Uncertainties may arise if assets pass not directly to a surviving spouse but to the "survivor's trust" that is revocable or amendable by the surviving spouse under a revocable trust arrangement. The marital deduction may not be allowed, for example, if any trust benefits can be paid to anyone other than the surviving spouse, if there are restrictions on the spouse's benefits, or if any other marital deduction disqualifying provision exists. See generally Keith Schiller and Paula Leibovitz Goodwin, "Back to the Future Dangers, or When Direct Transfers to a Grantor's Trust Are Confused with Outright Distributions to a Surviving Spouse," LEIMBERG ESTATE PLANNING NEWSLETTER #2262 (Dec. 17, 2014).

b. Impact of Defective QTIP Election at Surviving Spouse's Subsequent Death. If the QTIP election following the first spouse's death is valid, the trust must be included in the surviving spouse's estate under §2044, and the surviving spouse's estate (and its beneficiaries) cannot elect to "undo" the QTIP election. Warner v. United States, 98 AFTR2d 2006-6136 (C.D. Calif. 2006). However, if a QTIP election is made on the original federal and state tax return in a defective manner, but the marital deduction nevertheless was allowed, the IRS takes the position that the trust assets will be includible in the estate of the surviving spouse under §2044. One court of appeals has agreed with the IRS's approach. Estate of Lucille Shelfer v. Comm'r, 86 F.3d 1045 (11th Cir. 1996); Estate of Mildred Letts v. Comm'r, 109 T.C. 290 (1997), aff'd, 212 F.3d 600 (11th Cir. 2000).

The duty of consistency was not applied where the taxpayer and the IRS made a mutual mistake of law as to whether or not the surviving spouse had a general power of appointment. Estate of Posner v. Comm'r, T.C. Memo 2004-112. In a detailed historical review of the duty of consistency, the court concluded that it does not apply to a mutual mistake by the taxpayer and the IRS on a pure question of law, and that the duty did not apply because of the mutual mistake of law as to how the husband's will would be construed under state law.

The IRS relied on the "duty of consistency" in Tech. Adv. Memo. 200407018, where the decedent's will had left his wife a life estate in his oil paintings and left her a life estate with a general power of appointment in his other tangible personal property. The executor had claimed the marital deduction for a particular artwork, believing it to be a pastel that would subject to the general power of appointment. However, it was later determined to be a painting, so the wife's executors (at her later death) argued that the general power of appointment should not apply to the pastel. The IRS ruled that the wife's executors were estopped from denying the existence of a general power of appointment under the duty of consistency, because the husband's and wife's estate were in privity.

The IRS is asserting the "duty of consistency" argument with more frequent consistency. Cluck v. Comm'r, 105 T.C. 324, 331-336 (1995); LeFever v. Comm'r, 103 T.C. 525, 541-545 (1994), aff'd, 100 F.3d 778 (10th Cir. 1996) (beneficiaries who consent to special use valuation will be estopped from later disavowing the election); Janis v. Comm'r, T.C. Memo 2004-117 (inconsistent valuation positions for estate tax vs. income tax basis purposes), aff'd, 461 F.3d 1080 (9th Cir. 2006).

c. Effect of Unnecessary QTIP Election. An unnecessary election of QTIP treatment for a credit shelter trust can be disregarded pursuant to Rev. Proc. 2001-38, 2001-1 C.B. 1335. The QTIP election is disregarded if it is not needed to reduce estate tax at the first spouse's death. The IRS's position is that Rev. Proc. 2001-38, which treats a QTIP election as null and void where it is unnecessary, only applies where the QTIP election is unnecessary in its entirety for a particular trust. In Letter Rulings 200219003 and 200422050, the IRS ruled that a taxpayer cannot partially revoke a QTIP election under the procedure described in Rev. Proc. 2001-38.

Letter Ruling 201131011 applied Rev. Proc. 2011-38 to treat a QTIP election for a QTIP trust as null and void. It involved an estate that was under the federal estate tax exclusion amount, so there was no federal estate tax whether or not there was a QTIP election. Apparently, that situation involved a plan to save state estate taxes. The state apparently allowed a QTIP election for state purposes only if there was a federal QTIP election. Under a formula clause, a Family Trust was funded with the state exemption amount, and the balance was distributed to the Marital Trust. Presumably after the statute of limitations ran for state estate tax purposes, the estate requested that the IRS recognize that the QTIP election was null and void for federal purposes.

The IRS will likely clarify that Rev. Proc. 2001-38 does not preclude an estate from using a QTIP trust in connection with a portability election, even if the estate is under the filing threshold and would not need any marital deduction in order to avoid estate tax at the first spouse's death. See Section IV.E.4.d of this outline.

d. Rev. Rul. 2006-26—Impact of Accounting Rules on Marital Deduction for Retirement Plans. Under the Uniform Principal and Income Act, the portion of retirement plan distributions that is income is 10% of the minimum required distribution. For example, assume the only asset in a marital trust (requiring mandatory income payments to the surviving spouse) is a $1 million IRA. Assume the IRA has a 20 year payout, and in the first year, $50,000 is distributed. How much is income to be distributed to the spouse? Ten percent of the $50,000, or $5,000. The spouse will not be happy with that answer, and the IRS agrees that amount is too low. The Ruling says that acceptable income from an IRA is either the actual internal income of the retirement plan or a unitrust percentage between 3-5%.

This will not create problems for most plans because since 1989, the IRS has made clear that they view the marital trust and the IRA payable to the marital trust as totally

separate and both must satisfy the "all income" requirement. Since 1989, planners have drafted marital trusts to add a clause requiring the trustee to distribute the income of the trust AND to distribute all income of any retirement plan of which the trust is the beneficiary. The Revenue Ruling makes clear that if the trust contains that provision, nothing has to be changed. Also, the Ruling makes clear that if the spouse has the right to force the trustee to withdraw the IRA income, the trust can qualify for the marital deduction.

2. Funding Issues; Consider Discounts in Funding Marital Bequests and Credit Shelter Bequests.

For a general discussion of the complex issues that may arise in funding marital trusts, see Soled, Wolf & Arnell, Funding Marital Trusts: Mistakes and Their Consequences, 31 REAL PROP., PROB, & TR. L.J. 89 (1996).

Comply with funding provisions in the will designed to comply with Rev. Proc. 64-19, 1964-1 C.B. 682, which generally requires that pecuniary marital deduction bequests use one of three types of funding strategies.

If the will provides for a pecuniary bequest to a surviving spouse and is silent on the method of funding the bequest or specifically provides for the use of assets based on their date of distribution values, the executor should be very careful in selecting assets to avoid generating taxable gain to the estate on funding (to the extent possible). See Reg. §1.1014-4(a)(3).

If a pecuniary marital deduction bequest has been used, with the residuary estate passing to a bypass trust, if date of distribution funding is used, any depreciation in the estate will reduce the amount passing to the bypass trust. Similarly, any appreciation in the estate will inure entirely to the benefit of the bypass trust. A delay in funding the marital/bypass trust bequests will raise questions as to whether any adjustments should be made. In Technical Advice Memorandum 8746003, the IRS took the position that a delay in funding a pecuniary marital bequest would not cause loss of the marital deduction, but the IRS might deem the funding to have occurred at a reasonable time and then allocate appreciation after that time on a pro rata basis between the marital and non-marital bequests. The IRS failed to sustain its position of deemed funding and pro rata sharing of appreciation in Estate of de St. Aubin v. Comm'r, 76 T.C.M. 409 (1998). In that case the marital bequest was not funded prior to the spouse's subsequent death. At that time, the executors funded the marital bequest with cash (borrowed), and funded the nonmarital trust under the first spouse's will with a business interest that had accumulated over $23 million during the funding delay. The court found that the underproductive property statute did not apply under state law, and that the funding provision precluded any sharing of the appreciation with the marital bequest. The court remanded to determine the reasonableness of the delay in funding for purpose of the interest statute to determine if interest should be paid on the marital pecuniary bequest. In Estate of Olsen v. Commissioner, T.C. Memo 2014-58, the court addressed how much was in a family trust at the surviving spouse's subsequent death when two marital trusts and a family trusts were never funded. The court concluded that some payments to charity were deemed to have been made from the family trust (because the martial trust was not authorized to make distributions to charity), but that other distributions to the surviving spouse were deemed to have come from the marital trusts, leaving the family trust with substantial assets at the surviving spouse's death.

There are various approaches to handling an unfunded bypass trust at the surviving spouse's subsequent death. One approach is to treat the property as being held in a "constructive trust" by the surviving spouse, thereby excluding it from his or her estate. See

Stansbury v. United States, 543 F. Supp. 154 (N.D. Ill. 1982), aff'd, 735 F.2d 1367 (7th Cir. 1984). Another approach is to treat the property as being misappropriated by the surviving spouse, thereby resulting in a debt to the remaindermen of the bypass trust. See Bailey v. Comm'r, 741 F.2d 801 (5th Cir. 1984). See generally, Davis, "Funding Unfunded Testamentary Trusts," HECKERLING INST. ON ESTATE PLANNING, ch. 8 (2014).

If a controlling interest in an asset is left to the marital share, a control premium may be appropriate in determining the value of that asset. See Estate of Chenowith v. Commissioner, 88 T.C. 1577 (1987) (bequest of 51% of stock of family company to surviving widow entitled to premium "control element" to increase marital deduction). However, this principle may also work in reverse. The IRS has taken the position in several Technical Advice Memoranda that valuation discounts should be considered in funding marital bequests.

A 1999 Tax Court Memorandum case is the first case recognizing that the value of assets passing to a spouse must take into account minority interests for purposes of determining the marital deduction. In Estate of Disanto v. Commissioner, T.C. Memo. 1999-421 the surviving wife signed disclaimers so that only a minority interest in closely held stock passed to the wife. The court held that the stock passing to the wife must be valued as a minority interest for purposes of determining the amount of the marital deduction.

See also Estate of Schwan v. Comm'r, T.C. Memo. 2001-174 (discussion of this issue in charitable deduction case).

If a marital bequest is under-funded, the surviving spouse may be treated as having made a gift. Tech. Adv. Memo. 9116003. See Rev. Rul. 84-105, 1984-2 C.B. 198. But see Katherine Bergeron v. Commissioner, T.C. Memo. 1986-587 (surviving spouse who failed to assert her rights to claim proper share of estate, which resulted in overfunding of bypass trust, did not make current gift because probate court decree could be amended). Furthermore, the amount "over-funded" to a bypass trust for the surviving spouse's benefit would probably be included in the surviving spouse's estate under §2036(a)(1).

Various interesting questions can arise at audit with respect to an alleged under-funding of a marital bequest (and particular issues are raised if a QTIP trust is under-funded). See generally Lewis, Marital Deduction Planning for Family Business Owners, ABA Section of Real Property, Probate and Trust Law 11th Annual Spring CLE Symposia (2000).

Gift Tax. If the IRS determines that an excess amount is allocated to the non-elected portion (to reduce the estate tax that will be due at the donee-spouse's subsequent death), is the original donor treated as having made an additional gift? Is the donee-spouse treated as making a gift—because a lesser amount will be in the donee-spouse's gross estate under Section 2044 at his or her subsequent death than if the elected portion had been fully funded? If the spouse makes a gift, how would the value of the gift from the QTIP trust be determined in light of the spouse's identical retained interest in the "non-elected" and "elected" portions of the QTIP trust? Would section 2519 have any application, to cause a deemed gift of the entire QTIP trust? Does section 2702 have any application in light of the fact that the spouse's retained rights under the QTIP trust would not constitute "qualified payments" under section 2702? Is the "deemed gift" portion valued as a minority block or as a "swing vote" block if the asset transferred to the QTIP trust is stock of a closely-held entity?

GST Tax. What are the GST implications of any deemed gift? GST exemption cannot be allocated to the non-elected portion of the QTIP trust, because of the ETIP rule.

(The exception from the ETIP rule for QTIP trusts applies only if the "reverse" QTIP election is made. Reg. § 26.2632-1(c)(2)(ii)(C).) Does the donee-spouse become the transferor with respect to a portion of the non-elected portion if the elected portion is under-funded—or is the original donor still treated as the transferor for both the elected and non-elected portions of the trust for GST purposes? What if the original donor's GST exemption is allocated to the non-elected portion of the trust at the spouse's death, only to find out years later that the original donee-spouse is a partial grantor of a portion of the non-elected portion of the QTIP trust so that it is no longer fully GST exempt?

Estate Tax. The donee-spouse will have a mandatory income interest in the non-elected potion. If the donee-spouse is deemed to be a contributor to the non-elected portion of the trust, does this subject the entire non-elected portion to the spouse's gross estate under section 2036 or only a portion of the trust?

Gift Statute of Limitations. The donee-spouse presumably can begin the statute of limitations with respect to an allegation of a deemed gift due to underfunding of the elected portion of the QTIP trust by filing a gift tax return and making disclosure of the funding issues on the gift tax return. Treas. Reg. § 301.6501(c)-1(f)(4). Is the gift tax return filed for the year in which the elected portion is funded or when the spouse's right to object to the under-funding is lost? See Rev. Rul. 84-105, 1984-2 C.B. 198 (no gift by surviving spouse because of overfunding of credit shelter trust until order of probate court approving the funding became final).

Consider the situation (which may be fairly typical in a split family situation) where the decedent wishes to leave the surviving spouse one-half of his or her assets but wishes to leave the other one-half of his or her assets into a QTIP trust (to assure that one-half of the assets will end up passing to the decedent's children). If the assets funded to the two bequests are valued separately, how can the estate fund the bequests if it consists primarily of one major asset (such as an interest in a closely held business?) After taking into consideration minority discounts, the value passing to the two separate bequests may be substantially less than the gross estate (even though the entire estate qualifies for the estate tax marital deduction), ostensibly requiring the payment of substantial estate taxes.

In some situations, funding a specific pecuniary amount may be very difficult. For example, there may be a pecuniary bequest (formula or otherwise) of $1.4 million. A 51% interest in the closely held business may be worth $1.8 million, and a 49% interest in the business may be worth $1.2 million.

Observe that the problems of funding marital bequests with discounted assets that are valued lower than the gross estate values of the assets are diminished where the assets used to fund the marital bequests are limited partnership interests in a family partnership. The limited partnership interests typically are discounted whether they represent 1% or 99% of the limited partnership interests (assuming the decedent did not own a general partnership interest that gave the decedent the power to liquidate the partnership or to force the liquidation of the decedent's interest in the partnership.) Therefore, the gross estate value and the marital deduction value of the limited partnership interests would be the same. (Query, if the partnership assets are included under §2036, will the transfer of a portion of the limited partnership interests in satisfaction of a marital bequest be treated as a transfer of a proportionate portion of the assets for marital deduction purposes?)

Possible methods of avoiding the difficult valuation problem, in the appropriate circumstances, may include the following:

* Have the executor to fund the marital bequest with a note. The residuary estate would then be burdened with the note as a liability that would be distributed along with the residuary assets to the residuary beneficiaries.

A strategy that may have worked previously: Have someone purchase a minority interest from the estate within the first six months, and elect the alternate valuation date. If the remaining interest is a minority interest, the alternate valuation date values would reflect minority interest values in the estate. Alternatively, consider merely distributing minority block of stock, and value the block distributed (minority interest) and the remaining block of stock in the estate at the end of the six month period (which might also be a minority interest). See Treas. Reg. §20.2032-1(c)(1)(phrase "distributed, sold, exchanged or otherwise disposed of" includes surrender of stock in complete or partial liquidation of a corporation but not "mere changes in form" such as a transfer of assets to a corporation in a manner that no gain or loss is recognizable under §351); Kohler v. Comm'r, T.C. Memo 2006-152, *nonacq.* AOD 2008-001 (tax-free reorganization is not a disposition that accelerates alternate valuation date). Proposed regulations prohibit this strategy; initial proposed regulations were issued in 2008, with an effective date of when the regulation was finalized, but revised proposed regulations were issued in 2011 without that harsh effective date provision. Prop. Treas. Reg. §20.2032-1(f). The regulation is discussed in section IV.A.5 of this outline.

* For fractional interests in real estate, use a co-ownership agreement at the first spouse's death that will eliminate the discount, by providing that either co-tenant can sell the property and distribute the proceeds pro rata.

* For stock, use a pro rata funding but have a shareholder agreement that will eliminate the discount (by giving the marital legatee the right to liquidate the company or otherwise have control).

* Sell the majority interest to a Family Trust for a note, then fund the Marital Trust with a part of the note, and fund the Family Trust with the balance of the note (which the Family Trust would then owe to itself).

* Distribute a majority interest in an asset (that exceeds the marital bequest amount) to the Marital Trust, and have the Marital Trust give the estate back a note for the excess value. (For example, assume there is a $2MM Family Trust and a $8MM Marital Trust and the only asset is a 51% interest in a closely held company that is worth $10MM. If the Marital Trust is funded with 8/10 of the 51% interest, it will not be worth $8MM. Fund the Marital Trust with the entire 51% controlling interest, and have the Marital Trust give a note back to the estate for $2MM. The Marital Trust might later end up paying off the $2MM note with an interest in the company (which would be valued at a discount, thus requiring more shares than if there were no discount).

* Fund the bequest using a "defined value" formula conveyance. For example, a pecuniary bypass trust bequest could be funded by a conveyance having a defined value—reduced only by the amount necessary that will not result in an increased estate tax.

* To avoid the valuation problem on funding marital bequests, make the marital gifts during lifetime. In that event, there would not be a mismatch between the amount of the gift and the allowed marital deduction. (But lifetime gifts would lose the benefit of a basis step-up at death.)

For a general discussion of the valuation problems in funding marital bequests, see Moore, Honey, Who Shrank My Deduction?, 11 PROB. & PROP. 8 (1997).

3. Consider Appropriate Discounts at First Spouse's Death Even if No Estate Taxes are Due.

If no estate taxes are due at the first spouse's death (because of the marital deduction), very often no valuation adjustments for minority/marketability purposes are listed in the first spouse's estate tax return in order to achieve a higher basis step-up. Alternatively, assets may be included in the first spouse's estate without a discount in order to avoid the necessity of obtaining expensive appraisals in a "no tax" estate. This approach may lead to an inconsistency when, at the surviving spouse's subsequent death, his or her executor attempts to take a minority/marketability discount. Query whether the over-valuation penalty might apply if the asset is sold during the surviving spouse's lifetime and the income tax return is filed based on the step-up in basis without taking into account the valuation discount. No cases or rulings have addressed that issue.

4. Portability Considerations.

a. Brief Background. Any unused "basic" exclusion amount (changed to "applicable" exclusion amount in ATRA) of a decedent who dies after 2010 can be made available to the surviving spouse if the decedent's executor makes a portability election on a timely filed estate tax return that computes the unused exclusion amount. The unused exclusion amount is referred to in the statute as the "deceased spousal unused exclusion amount" (referred to as the "DSUE amount"). The surviving spouse can use the DSUE amount either for gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her "last deceased spouse."

b. Filing Required to Make Election. Section 2010(c)(5)(A) requires that the portability election be made on an estate tax return for the decedent whose unused exclusion amount is being made available to the surviving spouse, and for the election to be effective a "complete" return must be filed within the time prescribed by law (including extensions) for filing the estate tax return. (Rev. Proc. 2014-18 allowed a relief procedure for certain estates through December 31, 2014.)

In most cases there will be no need to list values of assets passing to a surviving spouse or charity on the "timely and complete" Form 706 if the estate was not otherwise required to file an estate tax return (but the return must include an estimate of the total value of the gross estate within specified ranges, including assets passing to a spouse or charity).

Because there is no statutory filing deadline for estates under the filing threshold, the IRS has the authority to grant extensions of time for filing the return under §301.9100-3 to make the portability election. The IRS has granted various such extensions for estates under the filing threshold who have made formal letter ruling requests for extensions pursuant to §301.9100-3. While 9100 relief is available, that requires a formal PLR request and is expensive.

c. Regulations. Highlights of some of the more important provisions of the regulations (§§ 20.2010-1T, 20.2010-2T, and 20.2010-3T, which are temporary regulations that were released on June 15, 2012 and will expire in three years [June 15, 2015], under §7805(e)(2) but the IRS will likely finalized the regulations before that time) include:

The surviving spouse's DSUE amount is not subject to being reduced if Congress later reduces the basic exclusion amount;

The regulations adopt the "Example 3" approach of the Joint Committee Technical Explanation, negating any "privity" requirement in calculating the DSUE amount (an approach adopted legislatively by ATRA);

If the decedent made gifts requiring the payment of gift tax, the excess taxable gift over the gift exemption amount (on which gift tax was paid) is not considered in calculating the DSUE amount;

The surviving spouse can use the DSUE amount any time after the decedent's death, assuming the portability election is eventually made by the executor;

Any gifts made by the surviving spouse are first covered by the DSUE amount, leaving the spouse's own exclusion amount to cover later transfers;

DSUE amounts from multiple spouses may be used to the extent that gifts are made to utilize the DSUE amount from a particular spouse before the next spouse dies; and

If the estate leaves assets to a QDOT, the surviving spouse cannot use the DSUE amount until the QDOT is fully distributed (or terminates at the surviving spouse's death).

For a detailed discussion of the temporary and proposed regulations see Item 6(h-q) of the December 2012 summary, "Estate Planning Current Developments and Hot Topics" available at www.bessemer.com/advisor.

For a more detailed discussion of portability planning (including the advantages and disadvantages of various approaches) see Item 8 of the Hot Topics and Current Developments Summary (December 2013) available at www.Bessemer.com/Advisor.

d. Portability Decision is Complex; Often is a Post-Mortem Planning Election**.** Because the portability provisions have now been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. A tax advantage to portability is that a basis adjustment is available at both spouses' deaths. From the planner's perspective, this is a more complex decision involving a wide variety of factors that might apply at the first spouse's death (including the surviving spouse's age and life expectancy, whether assets will likely appreciate substantially, whether assets may be sold during the spouse's lifetime, whether assets will be held long-term even after the surviving spouse's death, whether the assets are those kinds that have larger than normal capital gains rates, the states where the beneficiaries live and their estate and income tax rates, whether there will likely be net consumption of the estate, whether it is important to use trusts that allow both the surviving spouse and children to be potential beneficiaries, etc.).

Clients living in states with state estate taxes may use a combination of a credit shelter trust (up to the state exemption amount) and portability.

Plans are often structured to leave the flexibility to wait until after the first spouse's death to decide with to use a portability approach or a credit shelter trust. Thus, the complex decision making process of whether to utilize portability (with a bequest outright to the surviving spouse or to a QTIP trust) or whether to use a credit shelter trust becomes a post-mortem planning election.

e. Portability Approach Becomes More Predominant. Unless there are strong reasons to use credit shelter trusts in $10 million estates, an approach of using portability to take advantage of the first spouse's estate exemption will become more prominent. There are some factors favoring the creation of a credit shelter trust at the first spouse's death (discussed below), but unless one of those apply, a fairly good tax plan is in place for

couples with estates under $10 million before the client comes to the planner's office—there would likely be no estate tax at either spouse's death (although future appreciation may conceivably result in some estate taxes at the second spouse's death) and there is a basis adjustment at both spouses' deaths. Some planners refer to this as the "do no harm" approach.

f. Planning Is More Difficult for Planners. Planners must discuss the portability concepts and various factors impacting the decision of whether to rely on portability rather than using credit shelter trusts with clients and document those discussions. While the portability concept is intended to simplify planning, it has not made life simpler from the planner's standpoint.

g. Major Factors**.** Unless the couple owns assets close to double the exemption amount and still have significant growth years ahead, the couple will likely not owe any federal estate tax, whether the credit shelter approach or portability approach is used. For these clients, the major issues are:

- Use a credit shelter trust up to the state exclusion amount (if the state has an estate tax and if the state does not recognize portability [Delaware and Hawaii (and Maryland beginning in 2019) do recognize portability for their state estate taxes]);
- Leave qualified retirement plan and IRA benefits outright to surviving spouses (to take advantage of the longer-term payout opportunities afforded to spouses);
- Trust vs. no trust planning (*i.e.*, are the non-tax advantages of trusts important to the client—but trust planning can be used either with credit shelter trust or with portability and QTIP trusts);
- Blended family concerns—this is one reason to use the credit shelter trust to avoid complexities that might otherwise apply if conditions change such that estate taxes are owing at the surviving spouse's subsequent death (in which event the QTIP trust may end up substantially "underpaying" or "overpaying" the estate taxes and using a credit shelter trust would avoid that complexity);
- If trusts will be used, is it important for both the surviving spouse and descendants to be discretionary beneficiaries after the first spouse's death? (if so, use credit shelter planning unless the clients live in a "self-settled trust state" in which the surviving spouse could create a trust for himself/herself and the descendants without opening the trust to the spouse's creditor's claims—assuming domestic asset protection trusts work);
- Remarriage possibility—a significant possible disadvantage (especially for younger clients) is that the surviving spouse may remarry and the new spouse may die before the surviving spouse, resulting in a loss of the DSUE amount from the first deceased spouse (unless the surviving spouse made a gift utilizing that DSUE amount before the new spouse predeceased the surviving spouse);
- Asset protection significance—assets that are protected from creditor claims under state law (such as retirement accounts, homestead property and life insurance) can be left in those forms to maintain the asset protected status of the assets;
- Basis issues—the second basis step up is a major advantage of the portability approach (but ways of obtaining basis step up even with credit shelter trust planning may be possible and the second basis step-up may not be overly significant if the credit shelter is funded with fixed income assets or if appreciated assets funded to the credit shelter trust will be sold during the surviving spouse's lifetime);
- State estate and income tax impact—If there is no state estate tax for the surviving spouse and a high state income tax for the children, portability may be favored; if there is a state estate tax for the surviving spouse and no state income tax for the children,

the credit shelter trust may be favored; the results may be different for particular children depending on whether they are living in a high income tax state or not (some children may prefer the CST-at least up to the state exemption amount- and some may prefer portability); and

- For clients with estates substantially larger than the double the exemption amount, traditional creditor shelter trust planning is still appropriate. Advantages of the credit shelter approach include (i) omitting future appreciation from the estate, and (ii) maximizing use of the GST exemption.

For a more detailed discussion of the advantage and disadvantages of the credit shelter trust approach and the portability approach, as well as a detailed discussion of complexities and inequities that can arise in a blended family situation if a credit shelter trust is not used at her first spouse's death, see Item 5.d-f of the Hot Topics and Current Developments Summary (December 2014) available at www.Bessemer.com/Advisor.

h. Blended Family Situation. In a "non-standard" family situation Potential problems can arise if there is hostility between the executor (perhaps a child by the decedent's prior marriage) and the surviving spouse's family. The executor may try to "extort" consideration for making the portability election. Or the executor may be unwilling to bear the expense of filing an estate tax return to make the election. (The will could be drafted to provide that the executor would not be required to make the portability election unless the surviving spouse pays the expenses of filing the estate tax return.)

If assets are left outright to the surviving spouse, the spouse may give or bequeath the assets to persons other than the first decedent-spouse's descendants (or may favor some over others of those descendants in ways that the decedent-spouse would not have wanted). Even if a QTIP trust is used, the surviving spouse may be able to take steps that would significantly disadvantage the decedent-spouse's descendants—even though the assets are "protected" in a QTIP trust. The assets of the QTIP trust will be included in the surviving spouse's gross estate, and the surviving spouse's estate is entitled to reimbursement under §2207A for estate taxes attributable to the QTIP trust (determined on a marginal basis: the amount of estate taxes with the QTIP trust included in the gross estate minus the amount of federal estate tax if the QTIP trusts were not included in the gross estate). This could occur if the surviving spouse makes gifts utilizing the DSUE amount or even if the spouse makes no gifts but has his or her own assets that are large enough to cause the payment of estate taxes even if the QTIP trusts were not included in the estate.

Reverse fact scenarios could arise in which the surviving spouse's family would be disadvantaged and pay more than their fair share of the estate tax due at the surviving spouse's death if the surviving spouse waives the reimbursement right. Accordingly, if the surviving spouse waives the reimbursement right with respect to a QTIP trust, the spouse may want to place a maximum cap on the reimbursement right that is waived. For example, assume the QTIP is funded with $2 million of land that happens to be in an "oil play" that ends up being worth $60 million when the surviving spouse dies. The $60 million would be in the spouse's gross estate and if the spouse has waived all reimbursement rights with respect to that trust, the surviving spouse's family might pay many millions of dollars of estate tax with respect to assets that will pass to the first decedent-spouse's family (possibly even wiping out the surviving spouse's estate). For example, a clause similar to the following might be used:

> I, Mary Doe, in exchange for the Executor making a portability election in the Estate of John Doe, hereby waive any right of reimbursement under Section

2207A of the Internal Revenue Code with respect to the Mary Doe Marital Trust (the "Marital Trust"), but only to the extent of the federal estate tax assessed against my estate attributable to the value of the Marital Trust assets equal to an amount up to but not exceeding the amount of the deceased spousal unused exclusion amount (the "DSUE amount") as finally determined from the estate of John Doe (whether or not such DSUE amount is available to my estate at the time of my death). The amount of the reimbursement right from the Marital Trust that is waived shall be determined by the following calculation process. (1) First, determine the amount of reimbursement that would be due to my estate from the Marital Trust under Section 2207A but for this waiver (the "Section 2207A reimbursement amount"). (2) If the value of the Marital Trust assets for estate tax purposes at my death is equal to or less than the DSUE amount, the full Section 2207A reimbursement right is waived. (3) If the value of the Marital Trust assets for estate tax purposes at my death is more than the DSUE amount, the amount of the reimbursement right that is waived is the Section 2207A reimbursement right multiplied by a fraction, the numerator of which is the DSUE amount and the denominator of which is the value of the Marital Trust for estates purposes at my death. [**ALTERNATE APPROACH FOR CLAUSE (3)**: (3) If the value of the Marital Trust assets for estate tax purposes at my death is more than the DSUE amount, enough of the Section 2207A reimbursement amount is waived such that my estate will bear no more federal estate tax than if (i) the Marital Trust assets were not included in my gross estate for federal estate tax purposes, and (ii) only my applicable exclusion were used not including the DSUE amount.]

In light of the fact that §2207A requires that any waiver of the reimbursement right be in "his will (or revocable trust)," the spouse would contractually agree to waive the reimbursement right, but the actual legal waiver of the reimbursement right from the QTIP would need to be in the surviving spouse's will or revocable trust.

In summary, in a complex blended family situation, having the assets pass to a credit shelter trust to assure that the first decedent-spouse's descendants are treated fairly avoids those complexities.

i. Revenue Procedure 2001-38**.** Some have questioned whether Rev. Proc. 2001-38, 2001-1 CB 1335 precludes the use of QTIP trusts in connection with a portability election if the estate tax return was filed only to elect portability. It provides that the estate may elect a procedure under which the IRS will ignore a QTIP election "where the election was not necessary to reduce the estate tax liability to zero." However, for various reasons Rev. Proc. 2001-38 does not appear to preclude making a QTIP election even though the estate is relying on portability. The IRS may provide guidance by June 15, 2015 in connection with its issuance of the portability final regulations. See Item 2 above.

j. Optimal Approach for Flexibility**.** An optimal approach may be to utilize planning that leaves the surviving spouse with the decision of whether or not to rely on portability. Alternatives are:

(1) Disclaimer approach - rely on a disclaimer provision (allowing a surviving spouse to disclaim an outright bequest with a provision that the disclaimed assets pass to a bypass trust), or

(2) QTIPable trust approach - portability would be used if a full QTIP election is made (and the first deceased spouse's GST exemption could be used by making a reverse QTIP election under §2653(a)(3)), and a bypass trust approach would be used if a

partial QTIP election is made with a "Clayton" provision (so that the unelected portion would have more flexible distribution provisions than a single–beneficiary mandatory income interest trust for the surviving spouse).

As between those two approaches, the disclaimer approach seems simpler, but the QTIP approach offers more planning flexibilities in many situations.

Disclaimer Approach Disadvantages. There are several significant disadvantages of relying on the disclaimer approach. The most important is that the spouse may refuse to disclaim assets, even though a disclaimer would be appropriate based on the tax situation. However, that is much more of a concern where property passes outright to a spouse, and where the spouse may not want to give up full ownership of the asset. Another significant disadvantage to the disclaimer approach is that the surviving spouse cannot retain a limited power of appointment over disclaimed assets. Reg. §25.2518-2(e)(2) & §25.2518-2(e)(5)(Ex. 5). However, a family member other than the surviving spouse-disclaimant (such as the spouse's brother or sister) could have a power of appointment that could be exercised at the spouse's death (or earlier if that is desired). In addition, there is the risk that the surviving spouse inadvertently accepts benefits, making a disclaimer impossible, or that the spouse dies before signing a written disclaimer. *See generally* Zaritsky, *Disclaimer-Based Estate Planning—A Question of Suitability*, 28 EST. PL. 400 (Aug. 2001). Also, under the laws of some states, disclaimers may not be recognized for fraudulent transfer purposes with respect to the disclaimant's creditors (*e.g.*, Fl. Stat. §739.402(d)) and may be treated as disallowed transfers for Medicaid qualification purposes.

QTIPable Trust Approach Additional Flexibilities. Even though the QTIP approach may seem more complicated to clients, in many ways, the QTIPable trust approach affords greater flexibilities.

- Fifteen months. The executor has up to 15 months to decide whether to make the QTIP election and over what portion of the trust.
- Formula election. The QTIP election could be made by a formula, thus providing a "savings clause" to assure that no estate tax would be paid at the first spouse's death.
- GST "reverse-QTIP" election. If the QTIP election is made, the executor could make the "reverse-QTIP" election and allocate the decedent's GST exemption to the trust.
- State estate tax. If the state recognizes a "state only QTIP election," having assets in the QTIP trust may make the planning easier to fully utilize the first spouse's exemption amount without paying any state estate taxes at the first spouse's death.
- Clayton provision. Any unelected portion could pass to a standard bypass trust under a "Clayton" provision. (Some planners believe that the surviving spouse should not be the executor making the QTIP election if there is a Clayton provision. The IRS might argue that if the spouse makes the election, the spouse makes a gift of some or all of the assets that would have been in the QTIP trust. Panelists take the position that there *should* be no gift tax consequences; this should be no different than other post-death tax elections [such as where to deduct administrative expenses] that have a direct impact on the amount of assets that pass to the credit shelter trust and to the surviving spouse [or QTIP trust]). However, if the surviving spouse is the executor making the Clayton election, uncertainty would exist for years as to whether a gift results and whether that causes §2036 inclusion issues for some portion of the credit shelter trust.) (As an aside, Jeff Pennell thinks the preferable plan is generally to structure the credit shelter so that it has "QTIPable terms"—mandatory income interest for spouse as the exclusive beneficiary. That would, for

example, facilitate getting a PTP credit if the surviving spouse were to die shortly after the first spouse to die. Other panelists observe that clients like being able to make transfers to children and the use of the children for income shifting purposes.

- Spouse can retain limited power of appointment. The surviving spouse can have a testamentary limited power of appointment over the assets in the QTIP trust (or the Clayton bypass trust).
- Delayed QTIP election decision (even for many years). A possibility suggested by some planners is the flexibility to delay making the CST/QTIP decision for many years, even until soon before the surviving spouse dies, if there are no estate tax concerns and the QTIP election would afford a basis step; the QTIP election may be made at any time on the first estate tax return that is filed late, Reg. §20.2056(b)-7(b)(4). If the trust assets have exploded in value and the surviving spouse would have to pay estate tax if the trust assets were included in his or her estate, the QTIP election would not be made at the later time. Portability would not be allowed with this strategy (because the portability election must be made by filing a timely return). This strategy might be used if the surviving spouse does not need the first spouse's exemption to avoid estate taxes at the second spouse's death; making the late QTIP election would allow a basis adjustment for all assets in the QTIP without increasing federal estate taxes.
- Section 2519 deemed transfer. Another possible flexibility with a QTIP trust is the ability of the surviving spouse to make a gift or release a small portion of the income interest (say 1%), and be treated as making a gift of the remainder interest under §2519. This may be a way that the surviving spouse could make a taxable gift to make use of the DSUE amount to guard against losing the DSUE amount in the event of a remarriage with the new spouse predeceasing. Because the spouse retains 99% of the income, 99% of the QTIP assets would be included in the estate under §2036, which would mean that the §2519 gift of the remainder interest would be excluded from the adjusted taxable gifts in the estate tax calculation. §2001(b)(last sentence); Reg. §20.2044-1(e), Ex.5. (While the adjustment in the amount of adjusted taxable gifts may roughly offset the §2036 inclusion (without regard to subsequent appreciation), the surviving spouse would be able to add to his or her applicable exclusion amount the DSUE amount that was applied in the gift transaction. Reg. §20.2010-3T(b).) The deemed gift would not eliminate the benefit of GST exemption allocated to the trust under a "reverse QTIP election." Reg. §26.2652-1(a)(3). (This approach does not make the most efficient use of the gift exemption because the QTIP trust (that constitutes the deemed gift) is not a grantor trust, but this §2519 approach may be all that the willing spouse is willing to do in terms of making gifts.) Additional steps may be required regarding tax allocation to make sure that the first spouse's family benefits from the first decedent's DSUE amount.
- QTIPable trust with delayed power of withdrawal. If the clients want to have the flexibilities afforded by using a QTIP trust (*i.e.*, to have 15 months to decide what QTIP election to make, to make a formula QTIP election, etc.) but still wants the spouse to have an unlimited withdrawal power, consider creating a standard QTIP trust with a delayed withdrawal power. The trust is a general power of appointment trust qualifying for the marital deduction only if the surviving spouse's power of appointment exists immediately following the decedent's death. Reg. §§20.2056-5(a)(4)("must be exercisable in all events"); 20.2056-5(g)(1). For example, provide that the power of withdrawal arises sometime after estate tax filing date. Any limitations desired on the amount of the withdrawal right could be added (*e.g.,* up to 20% each year). Prof. Jeffrey Pennell suggests that this perhaps should be the default approach for QTIP trusts, to be removed if the clients don't want the provision. (Jeff observes that most attorneys trust their own spouses after they are dead but think their clients do not trust their spouses.)

- Trust protector; exculpation. If the QTIP approach is used, in light of the wide ranging factors that must be considered and the inherent uncertainties involved with the portability decision, consider using a "trust director" or "trust protector" to make the decision about how much of the QTIPable trust will be covered by the QTIP election or provide broad exculpation to the fiduciary who must make the QTIP election.
- Additional creative approaches using both disclaimers and QTIP trusts. For creative ideas of further ways to build in flexibility using both disclaimers and QTIP trusts, see Item 5.i of the Hot Topics and Current Developments Summary (December 2014) available at www.Bessemer.com/Advisor.

k. Alternative Ways to Use First Spouse's Estate Exemption**.** Even if a credit shelter trust is not created at the first spouse's death, there are several ways to make use of the first decedent's exemption during the surviving spouse's lifetime.

(1) Gift by Surviving Spouse. One possibility is for the surviving spouse to make a gift equal to the amount of the DSUE amount received from the first spouse. Under the portability regulations, the first spouse's estate exemption is allocated automatically to cover that gift. The advantage of this approach is that the resulting trust is a grantor trust as to the surviving spouse. The first spouse's GST exemption can still be used if assets are left to QTIP trust with a "reverse QTIP" election and the surviving spouse uses other assets to make the gift to the trust. The disadvantage is that the surviving spouse cannot be a beneficiary of that trust (unless the trust is protected by the spouse's creditors by a DAPT statute).

(2) Deemed Gift Under §2519. Another possibility is for the surviving spouse to make a gift of a small portion of the income interest of the QTIP trust, which results in a deemed gift of the remainder interest in the QTIP trust. See the discussion of "Section 2519 deemed transfer" in Item 5.h above.

(3) Supercharged Credit Shelter Trust[SM]. Another possibility of having the first decedent-spouse's exemption amount end up in a trust that is a grantor trust as to the surviving spouse is using a "Supercharged Credit Shelter Trust[SM]." *See generally* M. Gans, J. Blattmachr, & D. Zeydel, *Supercharged Credit Shelter Trust[SM],* 21 PROBATE & PROPERTY 52 (July/August 2007).

l. Should the Portability Election be Mandated? Who Pays the Filing Expense? Estate plans for couples generally should address whether the portability should be made and who will pay for filing the estate tax return to make the election. This is particularly important for second or (or third) marriages. Professor Stanley Johanson (University of Texas School of Law) suggests the following clause:

> If my husband survives me and my husband or his representative requests that my executor make a portability election with respect to all or a portion of my "deceased spousal unused exclusion amount," I direct my executor to make the election in the amount and under the terms provided to my executor by my husband or his representative. The cost of preparing and filing a Form 706 federal estate tax return making the portability election shall be [charged against my estate as an administration expense] [borne and paid for by my husband].

Similarly, consider these issues in pre-marital agreements.

Walton v. Estate of Swisher, 3 N.E.3d 1088 (Ind. App. 2014) is an example of negotiations that may arise regarding the portability decision if the decedent's will does not address the portability election. In that case the surviving husband agreed with the decedent's daughter to pay some of the deceased wife's medical expenses and to pay her

estate $5,000. The husband died the following year. When the daughter learned of the estate tax savings that resulted from the use of the wife's unused exclusion amount, she sued his estate for $500,000 under an unjust enrichment theory. The court concluded that no additional amount was owed, and the original agreement with the daughter was unambiguous and did not result in unjust enrichment.

The fact that this claim was even made raises interesting issues for planners:

- The importance of covering the filing/ portability issue in the couple's estate planning documents or marital agreement, including who pays for the cost of filing the return if it will be filed just to make the portability election;

- The possibility of opening a probate estate for the purpose of having an executor who can negotiate for the preparation of an estate tax return;

- Whether the surviving spouse is the appropriate person to serve as executor;

- The value of the right to file the estate tax return and make the portability election and whether the executor should negotiate to receive payment for making the election (a surviving spouse's counter argument is that the spouse may claim the available family allowance or spousal allowance that may be available to the spouse under applicable state law if the portability election is not made; the spousal allowance may be relatively small [e.g., $25,000 in Indiana] or can be fairly large [e.g., amount needed for the spouse's and minor children's maintenance for one year without regard to other resources available for the spouse's support in Texas, Tex. Estates Code §353.102]); and

- The importance of the surviving spouse disclosing the potential benefits of portability when negotiating a payment for filing the return.

m. Financial Impact. Diana Zeydel (Miami, Florida) draws various conclusions from financial modeling (using a "Monte Carlo analysis" to take into consideration the volatility of possible outcomes) of likely outcomes with a diversified portfolio.

- A key element of any planning is to give the clients assurance that sufficient assets will be available for their lifestyle needs for life. Financial modeling can examine the effects of planning strategies if there are "down" markets in the future. Realize that for everyone, cutting back on lifestyle is extremely difficult, whether someone is used to living on $50,000 per year or $2 million per year.

- Surviving spouses typically have an "overlife" of 10 years of more. That is long enough for assets to have substantial appreciation and making the right choice can have a significant financial impact on the family.

- The financial impact to a family of doing planning vs. no planning and the effects among various different strategies is not nearly as dramatic as before ATRA—because of the large indexed exemptions.

- The credit shelter trust vs. portability decision can vary greatly depending on the state estate tax on the spouses and the state income tax that applies to the children. If there is no state estate tax for the surviving spouse and a high state income tax for the children, portability may be favored. If there is a state estate tax for the surviving spouse and no state income tax for the children, the credit shelter trust may be favored.

- For a couple with $10 million that spends 4% annually, leaving assets outright to the surviving spouse or in a QTIP trust and relying on portability will likely result in no estate tax being payable at the surviving spouse's subsequent death (the median

result is that the assets will decline to about $9 million). However, there is no certainty of this. In 5% of the cases, the assets could grow to $18-20 million. Using a QTIP trust to make use of the first spouse's GST exemption means that most of the couple's assets would likely end up in GST exempt trusts.

- For a couple with $30 million (or more), the likelihood of achieving significant estate tax savings by using a credit shelter trust rather than relying on portability is very high, even if the spending level is 5%.

- A key result of using these approaches is that substantially more of the wealth passes to descendants in a GST exempt nature. As a practical matter, the portion of the estate that is non-exempt will likely be consumed by the children-generation (as discussed below).

For clients with a diversified portfolio with typical turnover for a diversified portfolio, whether or not a basis step-up is available at the second spouse's death is not overly significant. (Gains are realized significantly during the surviving spouse's lifetime, and there is not a great deal of unrealized appreciation that would lose the benefit of a basis step-up.)

F. Filing of Estate Tax Return and Payment of Estate Tax.

1. General Filing and Payment Requirements; Portability Election.

The executor is required to file an estate tax return if the gross estate plus adjusted taxable gifts exceeds the estate tax applicable exclusion amount ($5 million in 2010 and 2011; $5.12 million in 2012; $5.25 million in 2013; $5.34 million in 2014, $5.43 million in 2015, and $5.45 million in 2016). Estate tax returns must be filed within nine months after the date of death. §6075. Extensions of time to file may be made on Form 4768. An extension of time to file will not operate as an extension of time to pay, and vice versa. Reg. §§20.6081-1(c) & 20.6161-1(c). The maximum extended filing date is fifteen months from the decedent's death. § 6081(a); Treas. Reg. § 20.6081-1(a).

Final regulations provide for an automatic six-month extension of time to file an estate tax return. Treas. Reg. § 20.6081-1(b), effective for estate tax returns due after July 25, 2001. The executor may request an extension on Form 4768 even if the request is made after the due date and a request for automatic extension had not been filed (but the request must contain an explanation showing good cause for not requesting the automatic extension). Treas. Reg. §20.6081-1(c). There is no appeal from a denial by the Service Center of a request for extension of time to file.

Separate failure to file and failure to pay penalties apply unless the failure is due to reasonable cause. A number of cases have held that reliance on professional to file an estate tax return does not constitute reasonable cause for purposes of the failure to file penalty. E.g., United States v. Boyle, 469 U.S. 241 (1985); Knappe, Executor of Estate of Patee v. U.S., 713 F.3d 1164 (9th Cir. 2013)(accountant got automatic extension for filing estate tax return but told the estate it was for one year rather than the correct period of 6 months; estate filed after the 6 month extended due date but before the one year deadline they had been told was the extended due date); Estate of Liftin v. United States, 110 Fed. Cl. 119 (Ct. Fed. Cl. 2013); Estate of Young v. United States, 110 AFTR 2d ¶2012-7065 (D. Mass. 2012); Freeman v. U.S., 109 AFTR 2d ¶2012-403 (D. Pa. 2012). The Ninth Circuit has extended that same approach to the failure to pay penalty. Baccei v. U.S., 107 AFTR 2d 2011-898 (9th Cir. 2011) (reliance on CPA, who filed an extension request for filing the estate tax return but did not request a payment extension).

Under §6161(a)(2), the federal estate tax may be extended upon a showing of reasonable cause for up to ten years. Regulations under prior law provided that the

extension could not be granted for more than one year at a time. Reg. §20.6161-1(a)(2)(i). Presumably this limitation is continued under §6161(a)(2) in its present form. A request for extension of time under section 6161 is filed on Form 4768.

The estate tax is due nine months after the date of death. §6075. An extension of time to file does not grant an extension of time to pay. §6151(a). However, payment extensions may be requested under §6161 or 6166. Filing and payment extensions are requested by filing Form 4768; a separate Form 4768 is filed for each of the extension of time to file and time to pay. Some states tie their payment extensions to the federal extension, and may impose a state tax if no federal extension of time to pay was requested. Some IRS agents have stated informally that the IRS is no longer returning automatic filing extension requests as approved, even if a payment extension is included with the request.

Some attorneys routinely request an extension of time to pay in any filing extension, in case the amount (if any) tendered to the IRS with the extension request turns out being less than the total amount of tax due when the return is ultimately filed. One attorney suggests the following example: "The personal representative has made good faith efforts to determine the amount of tax due. An extension of time to pay is requested in the event that it is determined that additional tax is due when the return is filed."

The instructions to the Form 706 issued in include a summary list of documents that must be attached to the Form 706, as well as a list of necessary steps that should be followed to complete the Form 706. The 2006 Form 706 included a new question on Part 4, Question 12e: "Did decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in question 12a or 12b?" The 2007 Form 706 (dated September 2007) added several new requirements: (1) The instructions to Schedule F requires including detailed information about discounts; (2) Part 4 requires checking a box if the decedent held any power over any foreign accounts; and (3) Part 4 requires reporting any private annuities, even if they are not included in the gross estate.

The IRS has announced that for all estate tax returns filed on or after June 1, 2015, estate tax closing letters will be issued only upon request by the taxpayer. Taxpayers are asked to wait at least four months after filing the estate tax return to make the closing letter request "to allow time for processing."

Portability. The portability provision applies for decedents dying after 2010. The executor of the first spouse's estate must file an estate tax return on a timely basis to make the portability election (as discussed in Section IV.E.4.b of this outline) permitting the surviving spouse to utilize the deceased spouse's unused exemption. (Therefore, even small estates of married persons must consider whether to file an estate tax return for the first deceased spouse's estate.) Rev. Proc. 2014-18 granted an extension through the end of 2014 for filing a return to make the portability election in certain cases if the estate was not otherwise required to file an estate tax return. (See Section IV.E.4.b of this outline.)

2. Extension of Time to Pay Tax Attributable to Closely-Held Business Under §6166.

If the estate qualifies for an extension of time to pay estate taxes over 14 years (5 years interest only) under section 6166, that deferral is typically extremely advantageous. If the estate is illiquid, it typically would have no ability to borrow funds from a third party on as favorable terms. The advantages of a section 6166 extension include the long term (14 years) of the extension, only interest payments are required for the first five years, the interest rate is low, and there is very little interference with the estate's activities (there are no restrictive covenants on amounts of compensation, distributions, loans etc. for the entity, and the IRS does not contact the estate periodically to inquire as to the entity's operations

and financial health). As a practical matter, an estate would never be able to borrow from a bank 50% of the value of the collateral for 14 years, and only have to deal with the bank once a year when payments are made. Section 6166 borrowing gives a better economic result than borrowing from a bank.

Although section 6166 deferral is a very convenient if it is available, realize that planning so that the estate can continue to qualify for section 6166 can hamstring transfer planning with the business interest (which is often the most highly appreciating asset in the estate). It may be much better to do transfer planning with the business interest and give up on section 6166 deferral.

If the tax estimate that is paid with the extension request is more than the actual non-deferred amount, the taxpayer cannot get back the excess payment or have it applied to the first installments. The excess payment simply pays down the deferrable tax liability, and the remaining deferrable liability is deferred over 14 years.

For an outstanding review of section 6166 and issues in paying estate taxes, see Blattmachr, Gans, Madden, Untangling Installment Payments of Estate Tax Under Section 6166, 36 EST. PL. (July 2009); Harrison, Borrowing to Pay Estate Tax, TRUSTS & ESTS. 46 (May 2009); Belcher, Paying the Estate Tax Attributable to a Private Business Using IRS Section 6166, IRC Section 303, and *Graegin*-Style Promissory Notes, 39TH ANNUAL HECKERLING INST. ON EST. PL. ¶600 (2005).

a. Length of Deferral; Due Dates for Payments; Amount of Tax Deferrable; Manner of Election; Interest.

Length of Deferral. An extension of time to pay under §6166 allows payment of the estate tax in two or more, but not more than ten, equal annual installments commencing at the end of the fifth year after the due date on which the estate tax return would otherwise be due. §6166(a)(3).

Due Dates for Payments. The date for each payment is based on the original due date for the payment of tax without regard to extensions. The first principal payment is due five years after that date and subsequent annual installments are required on the same date in later years, up to ten years. §6166(a)(3). Therefore, payments could be made over a fourteen year period (the last payment would be due at the end of the fourteenth year after the initial tax due date).

Amount of Tax Deferrable. The amount of the estate tax that may be deferred under §6166 bears the same ratio to the total tax that the estate's interest in the closely held business bears to the adjusted gross estate (as defined in §6166(b)(6)). §6166(a)(2).

Manner of Election. The executor must attach a "notice of election" to a timely filed estate tax return (including extensions) to obtain §6166 deferral. §6166(d); Reg. §20.6166-1(b). If the return is not timely filed, there cannot be a valid section 6166 election, as a matter of law. Estate of Hinz v. Comm'r, T.C. Memo 2000-6. The election is made by checking the box for part three, line three on the second page of the Form 706. A notice must be attached to the return containing the items described in Reg. §20.6166-1(b). The Instructions to the Form 706 do not specifically mention the special elections under Section 6166(b)(7) or 6166(b)(8). Presumably, a special notice should be attached making those elections.

Interest. The first installment of tax under a §6166 deferral is five years from the date the estate tax return is due. During this initial five year period, only interest on the deferred portion of the tax must be paid. §6166(f)(1). (However, the interest only rule for the first five years does not apply to the portion of the deferred tax attributable to a holding

company or to interests in qualifying lending and financing businesses. §6166(b)(8)(A)(ii), 6166(b)(10)(A)(ii).)

Two/Four Percent Interest Rate. For estates of decedents dying after 1997, the 2% interest rate will be imposed on the amount of deferred estate tax attributable to the first $1,000,000 (inflation adjusted) in taxable value of the closely held business in excess of the effective exemption provided by the unified credit and any other exclusions). §6601(j)(1-2).

The 2% portion steadily increased because of increases in the applicable exclusion amount (from $625,000 in 1998 to $5.0 million indexed beginning in 2011) and because the $1,000,000 amount is adjusted for inflation, rounded down to the next lowest multiple of $10,000, after 1998. The $1,000,000 amount has increased to $1,140,000 in 2004, $1,170,000 in 2005, $1,200,000 in 2006, $1,250,000 in 2007, $1,280,000 in 2008, $1,330,000 in 2009, $1,340,000 in 2010, $1,360,000 in 2011, $1,390,000 in 2012, $1,430,000 in 2013, $1,450,000 in 2014, $1,470,000 in 2015, and $1,480,000 in 2016. Rev. Proc. 2015-53, 2015-44 I.R.B.; Rev. Proc. 2014-61, 2014-47 I.R.B. 860; Rev. Proc. 2013-35, 2013-47 I.R.B. 537; Rev. Proc. 2012-41, 2012-45 I.R.B. 539; Rev. Proc. 2011-52, 2011-45 I.R.B. As a result, the maximum amount of tax which can be deferred at 2 percent interest to the following amounts in some recent years: $532,200 in 2004, $546,600 in 2005 (taking into account both the $1.0 million inflation adjusted amounts for those respective years and the applicable exclusion amount of $1,500,000), $552,000 in 2006, $562,500 in 2007, $576,000 in 2008, $598,500 in 2009, $469,000 in 2010, $476,000 in 2011, $486,500 in 2012, $572,000 in 2013, $580,000 in 2014, $588,000 in 2015, and $592,000 in 2016. (Observe, that under the current rate structure, the amount is 40% times the inflation adjusted amount described above.)

The 2% interest rate is intended to provide an additional benefit to owners of closely held businesses. An anomaly under the current low interest climate is that the interest rate on the 2% portion of the tax (i.e., 2%) exceeds the interest rate that is payable on the balance of the deferred estate tax when the general underpayment interest rate is 4% (i.e., .45 x 4% = 1.8%) or lower. (The underpayment rate was 4% since the second quarter of 2009 through the third quarter of 2011, except for the first quarter of 2011 when it was 3%. The rate was 3% from the fourth quarter of 2011 through the first quarter of 2016, and increased to 4% for the second quarter of 2016. See Rev. Rul. 2016-06.) At a 4% or lower underpayment rate, the special 2% rate is higher than the interest rate on the balance of the deferred tax under §6166.)

Interest on Balance of Deferred Amount. For estates of decedents dying before 1998, the balance of the deferred estate tax bears interest at the normal statutory rate charged on deficiencies. §§6601, 6621. For estates of decedents who die after 1997, the interest rate on the balance of the estate tax is 45% of the normal rate in underpayments (and the interest is not deductible). §6601(j)(1)(B). In effect, the 45% factor grants the benefit of being able to deduct the interest payments at a 55% marginal rate (which applied in 1997). For example, if the ordinary tax underpayment rate is 4%, the interest rate on the estate tax deferred under § 6166 that does not qualify for the special 2% rate is 1.8%. Interest on a §6166 deferred amount is not deductible for estate tax purposes.

b. Requirements for Qualification. (1) The decedent must be a citizen or resident of the United States. §6166(a)(1). (2) The value of the decedent's interest in a closely held business must exceed 35% of the "adjusted gross estate" (defined in §6166(b)(6)). (Gifts made within three years of death are considered in determining whether the 35% requirement is satisfied, but not for purposes of determining the amount of tax that may be deferred. §2035(d)(4).) (3) The deferral only applies to an "interest in a closely held

business." There must be a business (as opposed to passive investments) that is closely held (with detailed statutory rules).There are specific objective tests (highlighted below) to determine whether the business is "closely held." There are other special rules in applying these tests with respect to passive assets in a business and for holding companies (i.e., entities that own an interest in another entity that actually conducts the business activities). If the IRS denies (or terminates) a §6166 election, the taxpayer has the right to petition Tax Court for a declaratory judgment under §7479. See Rev. Proc. 2005-33, 2005-24 I.R.B. 1231.

c. Interest in Closely Held Business.

Trade or Business Requirement for Real Property Interests; Rev. Rul. 2006-34.

A number of letter rulings have addressed whether real estate management activities are sufficient to constitute a trade or business for purposes of §6166. Revenue Ruling 2006-34 is the first time the IRS has given public guidance since 1975 on whether real property interests owned by a decedent or an entity in which decedent had an interest qualifies under §6166. The ruling addressed 5 different situations.

Guiding Principles. Some of the principles gleaned from the new ruling are:

(i) To qualify, the decedent must conduct an active trade or business or hold interests in a partnership, LLC or corporation that carries on an active trade or business as opposed to "the mere management of passive investment assets." (When the IRS or a court uses the word "mere," bad news follows.)

(ii) The activities of agents or employees are properly considered in determining if an active trade or business exists. The use of independent contractors will not disqualify the interest so long as the decedent has not ceded so much of the day-to-day operations that the decedent's activity is reduced to "merely holding investment property." The IRS is acknowledging that the use of an independent contactor is not fatal. The Ruling broadens the way the IRS will look at facts and circumstances.

(iii) When an unrelated management company is employed to perform most of the management activities, the ruling says that suggests that an active trade or business does not exist. Reading between the lines, you are "dead in the water" if you use an independent management company to perform most of the activities.

(iv) The IRS is offering a **new safe harbor** we did not have before. If the decedent owns at least 20% of the management company that performs most of the management activities, the decedent will likely meet the trade or business requirement. There is no requirement that the decedent be actively involved in the management activities of the management company—it is just a 20% ownership test. This is not the same 20% test as in 6166(b)(1), which refers to the portion of the business that is in the estate. This 20% rule has nothing to do with the ownership of the business for which §6166 treatment is sought. It is just the ownership of the management company that is managing that interest.

(v) One of the situations allows 6166 treatment in the common situation where the real estate is owned separate from the operation of the business (an auto dealership in that example).

(vi) Revokes portions of prior rulings. The IRS is changing some of the positions that it took in the earlier 1975 Rulings. In Rev. Rul. 75-365, the decedent owned a fully equipped business office that handled management of the decedent's real estate. (It collected rental payments, received payments on notes receivable, negotiated leases, made occasional loans, directed maintenance of the properties by independent contractors,

maintained a records and kept regular office hours.) The prior ruling said section 6166 was not available. That prior ruling is revoked.

Rev. Rul. 75-367 concluded among other things that where the decedent owned residential tracts and performed daily repairs, maintenance, etc, the residential tracts did not qualify for section 6166. That portion of Rev. Rul. 75-367 is revoked.

PLR 201343004 applied the non-exclusive list of factors in Rev. Rul. 2006-34 and concluded that a real estate corporation and a division that managed personal property both were actives trades or businesses.

Closely Held Requirement. The business must be (i) a sole proprietorship, (ii) a partnership with either at least 20% of the capital interest includible in the gross estate or 45 or fewer partners, or (iii) a corporation with either at least 20% of the voting stock includible in the gross estate or 15 or fewer shareholders. For purposes of determining whether the number of partners or shareholders exceeds 45, attribution rules are applied so that all property owned by a decedent and any member of his or her family, within the meaning of section 267(c)(4), is treated as owned by the decedent. §6166(b)(1). These requirements must be satisfied as of the time immediately prior to the decedent's death. §6166(b)(2)(A). The 45 or fewer partners or shareholders requirement was "15 or fewer" for decedents dying before January 1, 2002. §§ 6166(b)(1)(B)(ii) & 6166(b)(1)(C)(ii). There are other special attribution rules that apply regarding the 20% of capital interest/voting stock test. §§6166(b)(7)

d. Acceleration of Payments. The entire balance of deferred payments may be accelerated in three situations: (1) a default in timely payment; (2) early disposition or withdrawal of the estate's interest in the business, or (3) if the estate has undistributed net income (in which event the estate must pay an amount equal to the "undistributed net income" each year in payment of the unpaid portion of the estate tax, or else the entire tax will be accelerated). §6166(g)

The deferred tax was accelerated in Estate of Adell v. Comm'r, T.C. Memo. 2013-228. In that case the IRS granted various extensions of time to make payments, but the deferred tax that was accelerated with payments went unpaid and further extensions were not granted (even though there was a continuing dispute regarding the valuation of the business interests).

e. IRS Requires Security as a Condition for Granting Section 6166 Extension. Internal Legal Memorandum 200627023 addresses the §6166(k)(1) security , §6165 surety bond, and §6324A installment lien provisions. It takes the position that the government can demand a surety bond or special lien any time that tax being deferred under §6166 is still unpaid, and that there is no statute of limitations on its rights to seek security. The issuance of a closing letter will not affect the IRS's right to seek or increase its security. The Memorandum takes the position that the IRS can terminate a §6166 election whenever it is unable to obtain appropriate security and that the taxpayer has no §7479 declaratory judgment right of appeal to the Tax Court (and §7479(b)(2) requires exhausting all administrative remedies within the IRS.)

Following the implementation of this policy, practitioners have reported that it is almost impossible (or inordinately expensive) to obtain a bond to the federal government to cover the 14-year period of the section 6166 deferral. If the IRS requests posting of a bond or lien, and if the estate is not able to post a bond, the IRS at one time required a lien on real estate. IRS agents assumed that there was substantial leeway as to how much real estate collateral was required. The real estate did not have to be owned by the estate.

Requiring a real estate lien can be particularly difficult if the closely held business does not own the real estate on which the business is located, but rents it from other family entities. Some attorneys reported being successful convincing the IRS agent to accept a lien on the business interest itself (which is the asset in the gross estate) rather than requiring a lien on hard assets. However, some attorneys report that some agents required hard assets as collateral. One attorney reports of a case in which such a lien on hard assets of the business would disrupt the business, and the family refused to give a lien in order to obtain a §6166 deferral. The attorney was able to use the inability to qualify for a §6166 deferral to justify lengthy Graegin notes. (The difficulties in the bond/lien procedures have been relaxed as a result of IRS guidance beginning in 2007, as discussed below.)

Some practitioners report that making the process as easy as possible on the special procedures group within the IRS may help in getting a cooperative attitude. Otherwise, they may just lien all of the real property in the estate regardless of how many multiples of the liability that represents. Typically, however, most local IRS offices are comfortable with a lien on real estate that equals or exceeds the amount of the deferral.

A federal bankruptcy case, which addressed the effect of a tax lien on the owner of a business, may have impacted the way that the IRS approached liens. In re: Roth; IRS v. Skiba, 93 AFTR2d 2004-1663 (W.D. Pa. 2004) In that case, the business went into bankruptcy, and the court held that the IRS was just an unsecured creditor of the corporation because the IRS only held a lien on the taxpayer's stock in the corporation, not the corporation's assets. In light of this case, there has been a concern that the IRS may become even more inclined than ever to require a lien on real estate and not just the stock of the closely held business.

The Tax Court held that the IRS does not have the authority to impose an absolute bond or special lien requirement by merely revising the Internal Revenue Manual. Estate of Roski v. Comm'r, 128 T.C. 113 (2007). The case outlines the history of the Commissioner changing his mind four times over the last 15 years regarding whether a bond is required for a §6166 election. Interestingly, the IRS argued that the Tax Court did not have jurisdiction to review this administrative decision regarding §6166 under the authority in §7479 to bring declaratory judgments relating to §6166. The court noted the obvious "glaring contradiction" of the IRS's argument that §7479 only gives the Tax Court authority to review the eligibility requirements of §6166 (which does not include a bond requirement) while simultaneously taking the position that the provision of a bond or special lien is required. The court reasoned that the substantive requirements of §6166 are in §§6166(a) and (g), and none of the requirements include securing a bond or special lien. Rather than imposing a substantive requirement, §6166(k)(1-2) incorporates the IRS's discretionary authority under §6165, which says that the IRS "may" require a bond. "Implicit in this grant of discretion is a statutory obligation to exercise discretion." The court concluded that "[b]y adopting a bright-line rule in every case, the Commissioner has shirked his administrative duty to state findings of fact and reasons to support his decisions that are sufficient to reflect a considered response to the evidence and contentions of the losing party and to allow for thoughtful judicial review." The court denied the IRS's motion for summary judgment. In footnote 9, the court specifically declined to address whether the IRS could have exercised its discretion through the promulgation of a regulation as opposed to just amending the Internal Revenue Manual without any opportunity for notice and comment. See generally Haxton, The Section 6166 Balancing Game: An Examination of the Policy Behind *Estate of Roski v. Commissioner*, 62 TAX LAWYER 525 (2009).

The IRS issued Notice 2007-90, 2007-46 IRB in response to Roski. The Notice clarified that the IRS's general concern is that the general estate tax lien under §6324(a)

extends for only 10 years after the date of death. Therefore, a 14 year deferral under §6166 would be secured only for 9 years and 3 months (after the due date of the estate tax return). The IRS intends to issue regulations regarding the appropriate standards to be applied by the IRS in exercising its discretion of whether a bond or special lien is required for a §6166 extension, and requests comments as to appropriate standards. As interim guidance, the IRS indicates that it will apply the following factors: (a) duration and stability of the business, (b) ability to make payments timely, and (c) compliance history of that business.

If the executor elects to grant a special lien for estate tax deferred under §6166, the lien is governed by §6324A. A Chief Counsel Memorandum filed February 25, 2009 and Internal Legal Memoranda 200747019 and 200903016 describe the procedures for determining the appropriate collateral under §6324A. In light of the significant uncertainty and differing treatment across the country regarding the amount and type of collateral that is required for a §6166 election, a detailed discussion from the IRS regarding the collateralization requirement is most welcome.Internal Legal Memorandum 200747019, "Taking Stock as Collateral for the Special Estate Tax Lien Under Section 6324A". ILM 200747019 has a detailed discussion of the statutory authority regarding collateralization requirements and provides helpful answers to a number of questions regarding the amount of collateralization required, when stock of the closely held business may be used as collateral, and procedures for perfecting the lien and for monitoring the sufficiency of the collateral over time.

(a) When Must the IRS Accept Closely Held Stock as Collateral? The closely held stock may be used as collateral (and must be accepted by the IRS) when the three requirements in §6324A are satisfied.

(1) The stock must be expected to survive the deferral period. §6324A(b)(1)(A). To make this determination the IRS should first value the business, using the most relevant financial information supplied by the estate (including appraisals, annual reports and other relevant financial documents). Based on the valuation, the IRS must next judge whether the business can be expected to survive the deferral period. "There is a risk that the Service may err in its conclusion, but Congress intended that the Service bear such a risk."

(2) The closely held stock must be identified in the written agreement. §6324A(b)(1)(B). This means that the executor must file a written agreement showing that all of the persons having an interest in the collateral agree to the creation of the special lien and those persons must be bound by the agreement. §6324(c)(1).

(3) "The value of the stock as of the agreement date must be sufficient to pay the deferred taxes plus the required interest." (While the ILM does not cite Code support for this statement, it is consistent with the "maximum value of required property" described in §6324A(b)(2). The "required interest" means the aggregate amount of interest payable over the first four years of the deferral period. §6324A(e)(2); Reg. §20.6324A-1(e)(2).)

The ILM then makes perfectly clear that the IRS *must* accept only the closely held stock as collateral if these requirements are met. (While the ILM does not cite Code support for the statement that the collateral must be sufficient to pay the deferred taxes plus the required interest, it is consistent with the "maximum value of required property" described in

§6324A(b)(2). The "required interest" means the aggregate amount of interest payable over the first four years of the deferral period. §6324A(e)(2); Reg. §20.6324A-1(e)(2).)

(b) What Criteria Are Used to Determine the Adequacy of the Stock? Whether a stock will retain its value is a factor to be considered in determining whether the company will survive the deferral period. However, "[t]he Service should not assume that a stock's failure to retain its value automatically means that a company will not survive the deferral period. Indeed stock accepted as collateral may decrease in value, requiring the Service to request additional collateral under §6324A(d)(5).

(c) What Requirements May Be Imposed to Determine Whether There Has Been a Disposition or Withdrawal of Funds That Triggers Acceleration? Section 6324A(d)(5) states that if the value of the collateral is less than the unpaid portion of the deferred amount and the required interest, the IRS may require additional collateral (but not exceeding such unpaid portion). If additional collateral having a value equal to such unpaid deficiency is not added to the lien agreement within 90 days of demand, such failure will be treated as an act accelerating payment under §6166(g). The ILM states that the Service has statutory rights under §6324A to determine whether there has been a disposition of interest or withdrawal of funds that would trigger the acceleration of payment under §6166(g)(1). [I do not find that authority that broad in §6324A, but merely to determine if the value of the collateral falls below the unpaid deferred amount and the required interest.] The IRS can require relevant financial information from the estate to monitor the value of the collateral. "Specifically, the Service could require the estate to provide annual reports or certified financial statements on or before April 15 of each year during the term of the deferral period."

(d) How Should the IRS Secure Its Interest in Stock Pledged As Collateral? The IRS should file a Notice of Federal Tax Lien (NTFL), Form668-J, in the office mandated by applicable state law. §6324A(d)(1); 6323(f). Stock is generally considered personal property and is situated at the residence of the taxpayer at the time the NTFL is filed. §6323(f)(2). "Since the taxpayer in this case is an estate, applicable state law will determine where the NTFL will be filed." (The ILM does not suggest whether this will typically at the place of the residence of the decedent or at the place of residence of the executor.) In addition to filing the NTFL, the ILM recommends that the Service take possession of the stock certificates. While purchasers of the stock would take it encumbered with the special estate tax lien (because purchasers are not listed as having a superpriority in §6324A(d)(3)), the ILM recommends that the IRS take possession o f the certificates to avoid potential litigation.

(e) What Steps Should the IRS Take to Protect Its Interest in Other Assets In the Gross Estate That Are Not Used as Collateral for the §6324A Special Lien? The recording of a §6324A special lien divests the IRS of any lien under §6324 for that same property with respect to the same estate—but not other assets. §6324A(d)(4).

There are two other lien provisions, other than the §6324A special estate tax lien on designated collateral for §6166 extensions. One is the general estate tax lien under §6324(a), which attaches to all assets of the gross estate that arises at the date of death and lasts for 10 years (which period of time cannot be extended). The other is the general tax lien under §6321 that arises only after estate taxes become due and following assessment, demand and refusal or neglect to pay. The general tax lien does not have priority over a purchaser or certain others until a Notice of Federal Tax Lien is filed.

> "Accordingly, to protect its interest in the remainder assets of the gross estate more than 10 years after decedent's death, the Service could file a NFTL under section 6321…Whether the Service should file a NFTL in a particular situation is a business decision to be made by the Service."

(f) Should Full Audits be Required of All Estates That Propose Using Closely Held Stock as Collateral? There is no legal requirement to do so; this is a business decision for the Service.

(g) What Procedure Should be Used to Determine If the Closely Held Business Interest Collateral Is Adequate Security? The proper procedure to follow is a business decision to determine if the three statutory requirements in §6324A (as discussed in Item 1 above) are met. If the IRS decides to reject the closely held business interest as collateral, it "should detail, in writing, the basis for the rejection."

(h) What Procedure Should be Used to Deny or Terminate a §6166 Election If the Property Initially Proffered As Collateral Is Insufficient? If the proffered collateral is less that the unpaid deferred amount and required interest, the IRS may require additional security, and if the estate does not provide the additional security requested within 90 days after notice and demand, the estate's refusal will be treated as an event accelerating payment of installments under §6166(g). The IRS will issue a preliminary determination letter, "such as Letter 950, which contains a notice of Appeal rights." Following the enactment of §7479 in 1997, this decision may be contested in the Tax Court (for example, if the estate thinks the value of the property is greater than the amount of unpaid deferred tax plus required interest) by filing a timely petition after exhausting administrative remedies. (After receiving the Letter 950, the estate must request an Appeals conference to exhaust administrative remedies. After that conference, the IRS will issue a final determination letter "such as Letter 3570." The estate may then petition the Tax Court for a declaratory judgment under §7479. The procedures are described in Rev. Proc. 2005-33, §4.01(1), 2005-24 I.R.B. 1231.

(i) What Procedure Should Be Used to Review the Continuing Sufficiency of Collateral? The IRS has the implicit right to monitor the value of the collateral to determine if the value has become less than the unpaid deferred tax and required interest. If so, the IRS can ask for additional collateral. While the decision of whether to monitor and the procedure for monitoring the value is a business decision for the IRS, the report strongly recommends that the IRS does monitor the sufficiency of the collateral.

Internal Legal Memorandum 200803016, Considerations for Using LLC Interest as Collateral. ILM 200803016 is a similar Notice addressing when LLC interests may be used as collateral to secure a §6166 deferral. The Notice is similar to ILM 200747019 in providing that the IRS *must* accept the LLC interest itself as collateral if certain conditions are satisfied. The analysis is similar to ILM 200747019.

Chief Counsel Memorandum Dated February 25, 2009

A Chief Counsel Memorandum (CC:PA:B03:LUDaly, POSTS-113182-07) dated February 25, 2009 describes various procedures regarding bonds and liens as security for §6166 deferrals. Conclusions reached in the memorandum include the following.

(a) A *bond* to secure a §6166 deferral can be required up to double the amount of tax due. (Therefore, the bond amount can include the deferred tax plus interest as long as the interest does not exceed the amount of tax deferred.) A *lien* to secure a §6166 deferral can be requested for collateral having a value equal to the deferred tax and the aggregate amount of interest payable over the first 4 years of the deferral period (i.e., the "required interest" as defined in §6324A(e)(2).)

(b) The IRS does not have to request the maximum bond or lien amount. The IRS must use its discretion to determine on a case-by-case basis the appropriate amount reflecting the amount of estate tax payable in installments that is at risk of default. (The IRS cannot accept an alternate form of security, such as a personal guarantee; that "would

frustrate Congress's intent.")

(c) The Office of Appeals can determine the value of property proffered by the estate as collateral for the special estate tax lien under §6324A. IRS Appeals can also determine whether the type of property proffered as collateral is adequate.

> "Under section 6324A(b)(1), 'section 6166 lien property' means interests in real and other property to the extent such interests can be expected to survive the deferral period and are designated in the agreement referred to in the lien agreement defined in section 6324A(c)…. We note that the IRS has the statutory right to monitor the value of the section 6166 lien property and the creditworthiness of the estate throughout the deferral period. Whether property may be expected to survive the deferral period is based on all facts and circumstances and made on a case-by-case basis. For example, a decrease in the value of corporate stock may be an indication that the company may not survive the deferral period, but that factor alone, does not automatically mean that the company will not survive. In addition, property encumbered by liens may not be expected to survive the deferral period if there is little equity in the property. Should Appeals determine that the property proffered by the executor is inadequate section 6166 lien property, Appeals may negotiate with the estate to secure acceptable section 6166 lien property. The property designated as section 6166 lien property is not required to be property included in the estate of the decedent and may, in fact, be property of another person, so long as each person having an interest in the property is a party to the section 6324A(c) lien agreement."

Observe that this language is not as direct as Internal Legal Memoranda 200747019 and 200803016 (discussed below) in indicating that the closely held business interest itself may generally be used as the collateral for the §6324A lien, but the language does not contradict the directions in the 2007 and 2008 Memoranda.

(d) The value determination is based on the fair market value of the collateral on the date the §6324A lien agreement is signed by all interested parties (which may obviously be different than the date of death value or the value reported on the estate tax return. What if property valued under the special use valuation rules of §2032A or an FLP interest or other discounted asset is the collateral? The conclusion states "The value of the collateral should be based on the property's current and anticipated use and on the interest which the government would have in the property if the lien were foreclosed on." If the land is being used as farmland, it would seem likely that the government would not continue to farm the land but would sell it for its highest and best use value. Nevertheless, the body of the memorandum provides that "[i]f property is being used as farmland under a section 2032A election, then the value should reflect that use." The body of the memorandum makes very clear with respect to discounts that "if a FLP interest was discounted on the Form 706, the same discounts may apply to the interest given as collateral."

(e) Any encumbrances on the property should be taken into account, so that the property is valued at its net value for purposes of determining if the property is adequate collateral.

Legislative Lien Proposal Would Greatly Simplify These Complications. For the last several years, the Administration's Budget Proposals (summarized in the "Greenbook") have included a proposal to extend the special estate tax lien under §6324(a)(1) for the full period that estate tax is deferred under §6166 rather than being limited to just 10 years after

the date of death. That would simplify much of the complexity that has arisen around the bond/lien procedures for §6166 deferrals.

3. Transferee Liability of Beneficiaries. Even if the IRS fails to assert a tax deficiency against the transferor prior to the running of the statute of limitations against the transferor, a transferee may nevertheless be liable for estate, gift or generation-skipping transfer tax. The beneficiaries of an estate have personal liability for unpaid estate taxes. §6901(a)(1); §6324(a)(2) (non-probate assets [more specifically, assets included under §§2034-2042] included in the decedent's gross taxable estate). Section 6901(c) allows one year after the expiration of the limitation period against the transferors for the IRS to determine a liability against the transferees under §6324(b). U.S. v. Geniviva, 16 F.3d 522 (3rd Cir. 1994); O'Neal v. Comm'r, 102 T.C. 666 (1994). ; Bentley v. Comm'r, T.C. Memo. 1997-119. See generally Raby & Raby, Transferee Liability and Innocent Recipient, TAX NOTES (Jan. 13, 1999) (discussing state law fraudulent transfer rules applicable in determining transferee liability for income taxes and contrasting with transferee liability for estate and gift taxes). Furthermore, fiduciaries may be personally liable for payment of transfer taxes under the transferee liability doctrine. See Tractenberg, Transferee Liability Can Reach Trustee as Well as a Beneficiary, 21 EST. PL. 259 (1994).

The general rule is that the IRS has an additional year to make assessments for transferee liability under §6901, after the statute of limitations has run on the tax against the transferor. §6901(c)(1). Accordingly, for gift or estate transfers, this would generally mean four years after the date of the return. However, there is a separate personal liability provision for transferees under §6324(a)(2) for non-probate property that is included in the gross estate that is not so limited (as discussed below).

There is a limit on the amount of the liability. For transferee liability under §6901, federal courts have generally held that the transferee's liability is the value of the transferred assets on the date of transfer. E.g., Commissioner v. Henderson's Estate, 147 F.2d 619 (5th Cir. 1945). For non-probate transfers, §6324(a)(2) limits the liability to "the extent of the value, at the time of the decedent's death, of such property, received from the decedent."

Transferee liability applies to the donee of a gift within three years of the decedent's death under §2035(c)(1)(C) even though the gifted asset itself is not brought back into the decedent's estate under §2035. E.g., Armstrong v. Comm'r, 114 T.C. 94 (2000). Personal liability arising from this provision only applies to estate tax under §6324(a)(2) as opposed to gift tax under §6324(b).

Section 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. (as discussed below, however, the IRS may pursue collection proceedings against transferees under § 6324(a)(2) and not be subject to the four-year limitation period under § 6901).

It is clear that interest on unpaid estate tax is subject to the transferee liability rules. However, the cases have not been consistent with respect to whether the limit on liability to the value of property at the time of the decedent's death applies to interest as well as the unpaid principal of the tax itself. Some cases have held that the liability for interest when added to the tax can exceed the amount transferred at the time of the transfer. Richard M. Baptiste v. Commissioner, 29 F.3d 1533 (11th Cir. 1994)(estate tax; life insurance beneficiary's total liability for tax and interest may exceed the estate tax value of the property received). (This position was also followed in United States v. MacIntyre,109 AFTR 2d 2012-

2469 (S.D. Tex. 2012).) The Eighth Circuit has reached the opposite result in a case involving Richard Baptiste's brother, Gabriel (who was an equal beneficiary of the same life insurance policy). Gabriel Baptiste, Jr. v. Commissioner, 29 F.3d 433 (8th Cir. 1994) (limitation on liability to the value of property at the date of death applies to tax and interest), cert. denied, 513 U.S. 1190. See also Poinier v. Commissioner, 858 F.2d 917 (3rd Cir. 1988) (transferee liability for gift taxes; transferee liable under §6324(b) for gift tax and interest, but only to the extent of the value of the gift).

There has been an interesting history as to the interest issue in the Fifth Circuit. A 2014 opinion sided with the 11th Circuit in concluding that interest for gift tax transferee liability, when added to the gift tax, can exceed the value of the gift. United States v. Marshall, 771 F.3d 854 (5th Cir. 2014)(gift tax) (dissent by Judge Owen). The Fifth Circuit withdrew that opinion on August 19, 2015, and substituted a new opinion concluding that the transferee liability for gift tax plus interest is limited to the value of the gift. United States v. Marshall, 116 AFTR 2d 2015-5694 (5th Cir. August 19, 2015) (dissent by Judge Prado). (Apparently, on this three-judge panel, Judge Reavley changed his position; Judges Owen and Prado maintained the same positions as in the prior opinion).

For estate tax purposes, there is no "transferee," and no therefore no transferee liability unless the transfer occurs within the statute of limitations period for assessing additional estate taxes against the estate. If no transfers are made to beneficiaries within the 3-year statute of limitations on additional assessments, there will be no transferee liability if there had been no assessment of estate taxes against the decedent's estate during that 3-year period.. See Illinois Masonic Home v. Comm'r, 93 T.C. 145 (1989) ("Section 6901 does not create a separate liability for the transferee. Instead, it merely provides for a secondary method of enforcing the liability of the transferor [citation omitted]. The transferee cannot be held liable for the transferor's tax if the expiration of the period of limitations has extinguished the transferor's liability before the assets were transferred.") Query whether this applies to the liability of a transferee under §6324(a)(2)(estate tax with respect to assets included in the gross estate under §§2034-2042) or §6324(b)(gift tax)? Illinois Masonic Home was premised on §6901 not creating a separate liability for the transferee, but §6324(a)(2) and §6324(b) specifically provide that the transferee from an estate or of a gift is "personally liable for such tax" (referring to estate tax or gift tax).

Observe that the transferee liability for gift tax attaches even as to annual exclusion property. The donee is personally liable up for gift tax up to the value of the donee's gift even if the donee received only an annual exclusion gift which did not contribute to the unpaid gift tax. See Bauer v. Comm'r, 145 F.2d 338 (3d Cir. 1944).

Fiduciaries may be personally liable for payment of transfer taxes under similar concepts. See generally Tractenberg, Transferee Liability Can Reach Trustee as Well as a Beneficiary, 21 EST. PL. 259 (1994). Fiduciaries can be liable as "trustees" under §6324(a)(2), not as "transferees," which is a separate category under that section. Trustees under §6324(a)(2) are included within the definition of "transferee" for purposes of §6901. §6901(h)(cross referencing persons who are personally liable under §6324(a)(2)). E.g., U.S. v. Johnson, 109 AFTR 2d. 2012-2253 (D. Ut. 2012) (beneficiaries were not "transferees" under the statute because they did not receive or hold property immediately upon the death of the decedent, trustees were personally for the unpaid estate taxes). The Johnson case is discussed below.

Even if the IRS fails to assert a tax deficiency against beneficiaries within the general four-year period that would be allowed under §6901(c)(1), a transferee may nevertheless be liable for transfer taxes in some situations in which §6324(a)(2) applies (keeping in mind that

it applies only to assets included in the decedent's gross estate under §§2034-2042). Various cases have reasoned that § 6901(c) and § 6324(a)(2) are "cumulative and alternative — not exclusive or mandatory." Therefore, the IRS may proceed against a transferee under §6324(a)(2) even if an assessment is not made against the transferee within 4 years as required under the §6901(c) alternative. The rationale for the longer time under §6324(a)(2) is that it has no time limits (the special estate tax lien under §6324(a)(1) lasts for 10 years, but §6324(a)(2) has no time limits specified), so the general collection provisions of §§6501 and 6502 control. 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. These principles are illustrated by the recent Johnson, Kulhanek and Mangiardi cases.

Collection Action Against Trustee-Transferee Even Though No Assessment; U.S. v. Johnson. In U.S. v. Johnson, 109 AFTR 2d. 2012-2253 (D. Ut. 2012), the trustee of a trust that received stock from a decedent's estate and that distributed the trust assets to beneficiaries (subject to their payment of the unpaid estate tax) was personally liable for estate tax. Transferee liability did not extend to the beneficiaries. The trustee was personally liable even though no assessment had been made against the trustee within the four-year time period prescribed in §6901. If the IRS brings a collection proceeding against a transferee under §6324(a)(2), it is not subject to the time deadlines of §6901 and is only subject to the general limitations periods for collection. The effect is that the IRS can avoid assessment against a transferee entirely if it proceeds against the transferee under §6324(a)(2) (which applies to non-probate property that is included in the gross estate) by moving straight to collection of the tax debt.

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. Section 6901(c) effectively requires assessment against the transferee of an estate within four years after the return was filed in a transferee liability proceeding under § 6901, but that is not the exclusive way that the IRS can pursue a transferee liability claim. It may proceed directly to collection proceedings under § 6324(a)(2). The Kulhanik 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.

No Necessity for Assessment Against Transferee, Estate of Mangiardi v. Comm'r, T.C. Memo. 2011-24, *aff'd in unpublished opinion*, 108 AFTR 2d 2011-6776 (11th Cir. 2011). 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. In a subsequent collection action against the decedent's daughter based on transferee liability to collect estate taxes from IRA benefits that had been paid to the daughter, a district court confirmed that the collection action is timely. United States of America v. Mangiardi and Mangiardi, 112 AFTR 2d 2013-5344 (S.D. Fl. 2013).

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."

The 2013 Florida District court case cites various other cases that have similarly held that §6901 is not the exclusive procedure to assess liability against a transferee. Culligan Water Conditioning of Tri-Cities, Inc. v. U.S., 567 F.2d 867, 870-71 (9th Cir. 1978); United States v. Russell, 461 F.2d 605, 606 (10th Cir. 1972).

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 $3,433,007 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) A belief that the transferees' concern about liability lasts for only four years after the estate return was filed because of the limitations period for assessment under § 6901(c) is wrong under the reasoning of these cases. Transferees may have potential liability for estate tax many years beyond that. In many ways, the §6901(c) time limit is meaningless.

4. Special Automatic Estate Tax Lien. The general estate tax lien arises under §6324(a) on all property includible in the decedent's estate for 10 years. The general estate tax lien does not have to be recorded; it is automatic. If the collateral for the lien is property of the estate, the automatic estate tax lien under §6324(a) on that property is extinguished by the special estate tax lien for §6166 deferred tax under §6324A.

For PROBATE assets, property that is purchased or transferred is still subject to the lien in that person's possession, except that if property is transferred to a purchase or holder of a security interest and if the executor has been discharged from personal liability for the estate tax under §2204, the lien no longer applies to the transferred property but the lien attaches to the consideration received from the purchaser. §6324(a)(3). For that reason, any purchaser of probate property should request documentation that the executor has been discharged from personal liability under §2204 or request that the IRS release the lien. A release of lien is requested by filing Form 4422, and can be allowed if—

i. the remaining property in the estate is double the value owed the IRS,

ii. payment is made to the IRS equal to the value of the property being discharged,

iii. the government does not have a valuable interest in the specific property, or

iv. sale proceeds are to be substituted for the discharged property.

The general estate tax lien divests when the sale proceeds are "for the payment of charges against the estate and expenses of its administration, allowed by any court having jurisdiction thereof." This exception was addressed in First American Title Insurance Company v. United States, 95 AFTR2d 2460 (W.D. Wash. 2005), aff'd 520 F.3d 1051 (9th Cir. 2008). The court applied a strict tracing requirement described in Northington v. United

States, 475 F.,2d 720 (5th Cir. 1973). The court granted the IRS's motion for summary judgment because it determined that the title company could not affirmatively demonstrate that the payments were used for charges against the estate, and that the taxpayer must petition a court for allowance and that non-intervention powers do not qualify as allowance. See generally Note, 59 TAX LAWYER 901 (2006).

For NONPROBATE assets, the rules are quite different, as illustrated in Legal Advice Issued by Field Attorneys (LAFA) 20061702F. Nonprobate property transferred to a purchaser or holder of a security interest is no longer subject to the lien; however a like lien attaches to all of the transferor's property. IRS §6324(a)(2). The specific issue in LAFA 20061702F was whether pledging property was a "transfer" for purposes of this special rule that divested transferred property of the lien. The LAFA held that it was. It pointed out, though, other special rules that apply for nonprobate property under §6324(a): (1) The beneficiary is personally liable for the estate tax; (2) The lien remains to the extent that the value of the collateral exceeds the balance of the loan to the lender; and (3) There is a lien against the beneficiary's property.

a. Example of Application of Lien. The First American Title Insurance Co. v. U.S. case illustrates how scary the special estate tax lien can be. 2005-1 USTC ¶60,501 (W.D. Wash. 2005), aff'd, 520 F.3d 1051 (9th Cir. 2008). This case illustrates that even sophisticated parties (such as title companies) they can still get caught by this special lien. The decedent died in 1981, owing several major assets, including Frisko Freeze that runs hamburger joints. The decedent's daughter filed the estate tax return and paid part of the estate tax and received an extension on the excess. The estate distributed three houses to the daughter, which she subsequently sold to three purchasers who each obtained title insurance. The IRS revalued Frisko Freeze and assessed more estate taxes. The daughter and estate filed for bankruptcy. The IRS sent letters to the purchasers of the homes threatening foreclosure, unless the taxes were paid. The title insurance companies paid the increased taxes and sued the government for refund, arguing that the sale proceeds were used to pay taxes so the estate tax lien should be divested. The title insurance companies lost that argument because they could not "trace" the use of the proceeds to the payment of taxes, and even if they could, the court held that the payment had not been approved by the court as required by §6324(a)(1). The title companies were left "holding the bag."

b. Practical Problems and Lessons in Dealing With the Estate Tax Lien. Ed Manigault suggests the following practical aspects of dealing with the estate tax lien.

(1) Last Minute. Invariably, the estate tax lien issue comes up last minute in deals.

(2) Hard to Spot; Transferee As Seller. The seller may not be a decedent's estate, but the child of decedent, who within the prior 10 years received assets from the estate.

(3) Hard to Spot; Disregarded Entity. If assets were purchased from an LLC that either is or was a disregarded entity previously owned by a decedent, the IRS may take the position that the LLC is disregarded for all tax purposes and that all assets of the LLC are subject to the estate tax lien, even if the LLC *at the time of the sale* was taxed as a partnership.

(4) Practical Problem of Obtaining Sensitive Information. The attorney for a prospective purchaser may approach the estate. "I cannot identify my client, but I need to know information about when the decedent died, the assets of the estate, the amount of the estate taxes, when estate taxes have been paid, etc." What is the likelihood of receiving that information until the transaction has proceeded far down the line? In some situations,

sellers may be unwilling to share sensitive estate tax information with counsel for the purchaser or perhaps even with the corporate attorney handling the sale transaction for the seller.

(5) IRS Will Not Accept Wire Transfers. As discussed below, it may be possible to get a release of lien by payment of the estate taxes from the purchaser (i.e., the purchaser may pay part of the purchase price directly to the IRS in partial payment of the estate taxes), but the IRS only accepts checks. It will not accept a wire transfer. The transaction may have to be delayed several days until the check clears. This is particularly difficult when the lien issue arises, as it often does, at the last minute.

(6) Drafting Cannot Solve the Problem. Just adding representations and warranties in the sale documents does not solve the problems. The documents will say that the seller is getting marketable title, and that estate taxes are paid or provided for. However, if taxes in fact are not paid, the purchaser of the asset may still be responsible.

(7) Due Diligence. The purchaser should ask for a copy of the Form 706 if the asset is being sold by an estate. However, even that will not necessarily highlight problems. In the First American Title case, the purchaser was primarily interested in the houses, but the estate tax problem arose over the closely held corporation in the estate. It is hard for the purchaser to know what is going on with all of the other assets of the estate. Even if the advisor is comfortable with assets shown on the estate tax return, what about assets that might have been omitted?

(8) Joint and Several Liability. As a result of the inherent uncertainties, sale agreements generally put all sellers in the position of being jointly and severally liable for the taxes. Therefore, all beneficiaries would be on the hook if there is an estate tax problem.

(9) Escrow for All Proceeds? It is not surprising that funds may need to be placed in escrow in order to obtain the release of the estate tax lien. However, the transactional attorneys may be quite surprised to find that the IRS may require all, not just a portion, of the sale proceeds to be placed in escrow before the IRS grants a certificate of discharge of the lien.

(10) Consider Owning Assets in Revocable Trust or Entity. As discussed below, there are fewer restrictions on the lien if assets are held in a revocable trust or entity.

c. Release of the Estate Tax Lien. There are various methods of releasing the lien, but often they take time and may not be helpful in a time-sensitive M&A deal.

(1) Release of Lien from IRS. The IRS may release the lien entirely or as to specific assets. §6325. The IRS has discretion to issue a certificate of discharge if it is otherwise protected (meaning that other assets subject to the lien are twice the tax liability (§6325(b)(1)), or if an amount equal to the IRS interest in the property is paid to the IRS, or if the proceeds are held in escrow. The escrow approach is often required in the context of business transactions, but negotiating the agreement can take considerable time. Ed Manigault was recently involved in a case where three months was required to negotiate the arrangement with the IRS — and all of the proceeds were placed in escrow, not just 45% (because the lien attaches to all of the asset).

(2) Payment of Estate Expenses. The lien is released if (i) proceeds of the purchase are used to pay charges against the estate or administration expenses, AND (ii) those expenses are allowed by a court with jurisdiction. (The First American Title Insurance Company case discussed above, emphasizes the importance of both the tracing and court order requirements.) This method has limited utility in many corporate deals because of the

time requirement of obtaining a court order. (This method applies to both probate property and non-probate property.)

(3) Discharge Under §2204. If the executor has been discharged from personal liability under §2204, a transfer of property to a purchaser for full consideration, or a holder of the security interests will divest the lien from the transferred property. §6323(h)(6), 6326(h)(1). (Instead, a substitute lien is placed on the consideration received from the sale. §6324(a)(3).) (This method applies to both probate property and non-probate property.)

(4) Non-Probate Property Exception for Bona Fide Purchasers. A transfer of non-probate property to a purchaser or holder of the security interest divests the lien from the transferred property. §6324(a)(2)(first sentence). However, a lien is then placed on all of the property of the transferor (not just the consideration received in the transfer). §6324(a)(2); Rev. Rul. 56-144.

(5) Exception for Purchasers of a "Security". If someone pays full value for a "security", they receive the security free of the estate tax lien; that sounds like BFP protection. However, an important concern is that this exception only applies to stock or other securities, not to a partnership or LLC interest. Also, it does not apply if the purchaser had "actual knowledge or notice" of the existence of the lien. In light of the uncertainties surrounding the "actual notice or knowledge" requirement, purchasers cannot rely on this exception.

d. Mitigating the Lien Using Revocable Trusts or Entities. If there will be substantial sales after an individual's death, various steps can be taken to mitigate lien problems that may arise in making sales.

(1) Revocable Trusts. Assets in revocable trusts would be non-probate assets that could be sold to a purchaser for full value divested of the estate tax lien.

(2) Assets in Entities. In Beaty v. U.S, 937 F.2d 288 (6th Cir. 1991), the estate sold its partnership interest to the partnership in return for land owned by the partnership, and the land was distributed beneficiaries. The estate tax lien did not attach to that land. Under the reasoning in this case, the estate tax lien only attaches to property included in the estate, i.e., the partnership interest and not the assets in the entity.

V. DISCLAIMER PLANNING.

A. General Requirements.

Section 2518(b) defines a qualified disclaimer as an irrevocable and unqualified [yes, a "qualified" disclaimer must be "unqualified"] refusal by a person to accept an interest in property if—

1. such refusal is in writing,
2. such writing must be delivered to the transferor of the interest, his legal representative or the holder of the legal title to the property to which the interest relates or the person in possession of the property
3. such delivery is made no later than the date which is 9 months after the later of—
   a. the date on which the transfer creating the interest in such person is made, or
   b. the day on which such person attains age 21,
4. such person has not accepted the interest or any of its benefits,

5. as a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer,

6. the interest passes either—

   a. to the spouse of the decedent, or

   b. to a person other than the person making the disclaimer.

If the disclaimer is not a "qualified disclaimer", it typically is treated as a gift. If property passes as a result of the disclaimer to a pre-September 25, 1985 irrevocable trust that is grandfathered from the GST tax, the transfer is treated as an addition to the trust after September 25, 1985, which will cause a pro rata portion of subsequent distributions from the trust to be subject to the generation-skipping transfer tax. Ltr. Rul. 200001012.

For a detailed discussion of state property law issues regarding disclaimers, see Hirsch & Gans, Perfecting Disclaimer Reform: Suggestions for a Revised Uniform Act, 31 EST. PL. 185 (April 2004); LaPiana, Some Property Law Issues in the Law of Disclaimers, 38 Real Prop., Prob. & Tr. L.J. 207 (2003).

B. Nine Months Time Limit Requirement.

The nine-month period is applied very strictly. The disclaimer must be filed within nine months after the later of the date on which the transfer creating the interest is made or the date on which the disclaimant attains age twenty-one. Reg. §25.2518-2(c)(1). *Cf.* PLR 201403005 (disclaimer of contingent remainder interest within nine months of beneficiary reaching age 18); PLR 201407009 (disclaimer of interest in trust created before 1977).

C. Planning Flexibilities with Partial Disclaimers.

1. Can Disclaim Specific Assets From Trust.

After a specific trust asset is disclaimed, it must "leave" the trust and pass to someone other than the disclaimant. Reg. §25.2518-3 (a) (2); Ltr. Ruls. 9244012, 9038031, 8922036. A removal of the disclaimed property to another trust under the same instrument is sufficient. Ltr. Rul. 8951041. The same rule applies if a person merely wishes to disclaim income derived from a specified trust asset - that trust asset must leave the trust if the beneficiary continues to accept income from remaining properties in trust.

2. Formula Disclaimers are Permitted.

The regulations and various private letter rulings indicate that a formula disclaimer may be a qualified disclaimer. Reg. §25.2518-3(d), Ex. 20 (fractional disclaimer; numerator of fraction is the smallest amount which will allow estate to pass free of federal estate tax and denominator is the value of residuary estate); Ltr. Ruls. 200420007 (approved disclaimer of fractional share of residuary estate by child, with disclaimed assets passing to foundation; numerator of fraction is $X and denominator is value of residue determined on the basis of values, deductions, and other information reported on the federal estate tax return), 9646010, 9435014, 9338010 (pecuniary formula disclaimer of amount sufficient to utilize estate's unified credit). A number of rulings have permitted disclaimers under reverse pecuniary formulas. E.g., Ltr. Ruls. 200130034, 200001045, 9437029, 9435014, 9319022, 9310020, 9115062, 9014005, 9009007, 8502084. See Estate of McInnes v. Commissioner, 64 T.C.M. 840 (1992). For an example of various formula disclaimer clauses, see Horn, Enhancing the Use of Spousal Disclaimers That Salvage Exemptions but Do Not Forgo Enjoyment, 29 ACTEC J. 265 (Spring 2004).

Using formula disclaimers may afford interesting planning opportunities. The use of a disclaimer to pass a defined value to family members, with the excess passing in a manner that is not subject to gift or estate tax, is not new. See Akers, An Overview of Post-Mortem

Tax Planning Strategies, 34th ANN. UNIV. OF MIAMI PHILIP E. HECKERLING INST. ON EST. PL. ¶1217.7 (2000). However, this use of disclaimers has been receiving increasing attention. See Handler & Chen, Formula Disclaimers: *Procter*-Proofing Gifts Against Revaluations by IRS, J. TAX'N (April 2002).

3. Bequest With Disclaimed Assets Passing to Charity or Spouse; Disclaim Excess Over Specified Amount.

An appropriately structured will may permit using formula disclaimers to transfer assets under a defined value type approach. For example, a will might make a bequest to beneficiaries other than the decedent's spouse. The will would provide that any disclaimed assets would pass to a donor advised fund at a Communities Foundation (or other charity) or to the surviving spouse in a manner that would qualify for the estate tax marital deduction.

The beneficiaries could disclaim all of the estate over a specified dollar value, based on federal estate values. If the IRS asserted that the values on the estate tax were too low, the excess value would pass to charity (or to the spouse) and would not generate additional estate tax. A case involving this type of plan was Estate of Lowell Morfeld, Tax Court Docket # 012750-03. In that case, the residuary beneficiaries disclaimed the remainder of the estate exceeding "x" dollars (before payment of debts, expenses and taxes) in which the decedent's will provided that any disclaimed assets would pass to a Community Foundation to fund a Donor Advised Fund in the name of the disclaiming child. The estate consisted in part of a 49% limited partnership interest that the estate's appraiser valued with a 45% discount for lack of marketability and lack of control. The IRS agent refused to allow any discounts, citing Procter. In that case, the charity negotiated a fixed payment for their rights to the disclaimed formula share of the estate. The case was settled before trial.

This type of clause was also addressed in Estate of Christiansen v. Commissioner, 586 F.3d 1061 (8th Cir. 2009), *aff'g* 130 T.C. 1 (2008). The decedent's will left her entire estate to her daughter. Any disclaimed assets would pass 75% to a CLAT and 25% to a foundation. (Apparently the annuity amount and term were designed so that the present value of the charitable lead interest was equal or almost equal to the full value passing to the trust.) The daughter made a formula disclaimer, in effect disclaiming a fractional share of the estate exceeding $6.35 million, and the estate tax return reflected an estate value of slightly over $6.5 million. The specific formula disclaimer clause provided, in part, as follows:

> "Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton, hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty Thousand and No/100 dollars ($6,350,000) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001…."

The clause went on to define "fair market value" by reference to "as such value is finally determined for federal estate tax purposes."

Under the values as returned, about $120,000 passed to the CLAT and about $40,000 passed to the foundation as a result of the disclaimer. In the estate tax audit, the IRS and the estate agreed to increase the fair market value of the gross estate from approximately $6.5 to $9.6 million. Under the disclaimer, the additional $3.1 (i.e., $9.6 – 3.5) million value all passed to the CLAT and foundation, and if those transfers qualified for the estate tax charitable deduction, there would be *no additional estate tax*. (In this manner, the formula disclaimer operated much like "defined value" transfer clauses designed to define the amount

transferred so that there would be no (or minimal) additional gift tax over the intended amount.) The IRS agreed that it would allow an estate tax charitable deduction for the $40,000 that passed to the foundation based on the values reported on the Form 706, but it refused to allow any charitable deduction for the remaining increased value of the estate that passed to charity as a result of the disclaimer.

The Tax Court held that the disclaimer to the CLAT was not a qualified disclaimer due to technical violations of the disclaimer regulations, so no estate tax charitable deduction was allowed for amounts passing to the CLAT under the disclaimer. The estate did not appeal that finding. The Tax Court held that the disclaimer to the foundation did not have any of the technical disclaimer problems and that the disclaimer was not contingent on a subsequent event and did not violate public policy; an estate tax charitable deduction was allowed for the full increased gross estate amount that passed to the foundation under the disclaimer. The IRS appealed that determination.

The Eighth Circuit held that the formula disclaimer was recognized and all of the increased value that passed to the foundation qualified for the estate tax charitable deduction. The Tax Court decision was affirmed. The court gave broad reasons in support of its rejection of the IRS's public policy argument against clauses that reduce the incentive of the IRS to audit returns.

The IRS argued that the amount passing to charity was contingent on a subsequent event and that no charitable deduction should be allowed under Treasury Regulation §20.2055-2(b)(1). The Eight Circuit reasoned that the regulation requires the existence of *"a transfer at the date of death;"* not "the existence or finality of an accounting evaluation." The only outstanding issue was valuation, and "[t]he foundation's right to receive twenty-five percent of those amounts in excess of $6.35 million was certain." There is a difference between post-death events that change the actual value of an asset and events that "are merely part of the legal or accounting process of determining value at the time of death." Cases cited by the IRS all involved situations where the actual transfer was dependent on various contingencies (such as a daughter dying without descendents, and a trust that allowed the family beneficiary to invade corpus).

Furthermore, estate tax charitable deduction regulations regarding charitable lead annuity trusts recognize that references to values "as finally determined for Federal estate tax purposes" are sufficiently certain to be considered "determinable" to qualify as a guaranteed annuity interest. Treas. Reg. §20.2055-2(e)(2)(vi)(a). Therefore, references to values "as finally determined for estate tax purposes" are not references that are dependent upon post-death contingencies that might disqualify the availability of a charitable deduction.

In addition, the IRS argued that the clause violated public policy because it removes the IRS's incentive to audit the estate tax return. The Eighth Circuit agreed that the disclaimer of all amounts in excess of a fixed-dollar amount "may marginally detract from the incentive to audit estate tax returns." In some situations, that might permit "a charitable deduction equal to the increase in the estate, resulting in no increased estate tax." (However, footnote 2 observed that under the facts of this case, there is no offsetting charitable deduction for the 75% of the increased value that passed to the CLAT.) The IRS's argument is that strategies such as a fixed-dollar amount partial disclaimer that operate to allow an additional deduction to offset any increased value should be disallowed on policy grounds "because of the potential moral hazard or untoward incentive they create for executors and administrators to undervalue estates."

The court gave three reasons, for rejecting the IRS's public policy argument even if the effect is that increasing values in audits would not increase the estate tax collected as a

result of the audits. First, the IRS's role is to enforce tax laws, not just maximize tax receipts. Second, there is no clear Congressional intent of a policy to maximize the IRS's incentive to audit returns. (Indeed, "Congress sought to encourage charitable donations by allowing deductions for such donations.") Third, other mechanisms exist to ensure that values are accurately reported. "State laws impose personal liability on fiduciaries, and state and federal laws impose financial liability or, in some circumstances criminal sanctions, upon false statements, fraud, and knowing misrepresentations." Furthermore, "the contingent beneficiaries taking the disclaimed property have an interest in ensuring that the executor or administrator does not under-report the estate's value" and serve a "watchdog function." In this case the disclaimant was the executor and a board member of the foundation. Because of her fiduciary obligation, any self-dealing "would be a clear violation of her general state-law fiduciary obligation to put the interests of the foundation above her own interests …"

D. Passing Without Any Direction By Disclaimant; Disclaimer Involving Foundations.

Section 2518(b)(4) requires that the disclaimed property pass, as a result of the disclaimer, but "without any direction on the part of the person making the disclaimer." Disclaimers by or in favor of a spouse are not excepted from this rule.

1. Disclaimant as Fiduciary.

If the disclaimant is a fiduciary of a trust or fund to which the disclaimed property passes, he or she can exercise fiduciary powers to preserve or maintain the disclaimed property without being treated as accepting the property or any of it benefits. However, the disclaimant fiduciary cannot retain a wholly discretionary power to direct the enjoyment of the disclaimed interest. Treas. Reg. § 25.2518-2(d)(2). The disclaimant/fiduciary can retain the fiduciary power to distribute to designated beneficiaries if the power is subject to an ascertainable standard. Treas. Reg. § 25.2518-2(e)(1)(i) & 25.2518-2(e)(5)Ex.(12). Cf. Ltr. Rul. 200406038 (disclaimer recognized where mother of decedent executed an amendment to LLC agreement that removed her as LLC co-manager before disclaiming her bequest of in interest in the LLC).

2. Disclaimant Cannot Hold Power of Appointment.

A significant disadvantage to making a disclaimer is that the disclaimant cannot retain a limited power of appointment over disclaimed assets. Reg. § 25.2518-2(e)(2) & §25.2518-2(e)(5)(Ex. 5). Holding a limited power of appointment provides a great deal of indirect "persuasive influence" over family members.

3. Disclaimant as Director of Foundation Receiving Disclaimed Assets.

One situation where this issue arises is if the disclaimant is a director of a foundation that receives the assets as a result of the disclaimer. The IRS maintains that the disclaimant's participation in selecting charitable grant recipients would prevent the disclaimer from being a qualified disclaimer because of the "passes without any direction" requirement. See Rev. Rul. 72-552, 1972-2 C.B. 525. One method of allowing a disclaimer in this situation is for the foundation's bylaws to be amended to prohibit the disclaimant and his or her spouse from participating in the selection of grant recipients. See Ltr. Rulings 200649023; 200519042; 199929027; 9317039 & 9141017. Alternatively, the will could provide that disclaimed assets would pass to a separate fund of the foundation over which the disclaimant held no powers. Ltr. Ruls. 201032002; 200420007; 19992902, 200420007 & 200519042. An alternate solution is to have the disclaimed property pass to an advised fund of a community foundation E.g., Ltr. Ruls. 9532027, 9235022, 9317039, 9141017, 200518012 (disclaimer valid even though disclaimant would serve as advisor for donor advised fund and make nonbinding recommendations to the foundation regarding fund

distributions, but the foundation would have ultimate authority and control over distributions).

E. Disclaimer by Trustee of Power to Make Distributions to Beneficiaries Other Than Spouse —But Disclaimers by Trustees Are Questionable.

Various divergent cases and rulings have addressed whether a trustee can disclaim a power to make a distribution to a non-spouse beneficiary, in order to qualify the trust for QTIP treatment. In Cleveland v. United States, 88-1 U.S.T.C. ¶13,766 (C.D. Ill. 1988), a marital deduction was allowed for a trust, for which a corporate trustee had disclaimed its power to utilize income or principal for the children's college education. However, while some IRS rulings have approved disclaimers of powers, most have refused to recognize a disclaimer of a "tainted" power in order to qualify a trust for QTIP treatment. E.g., Tech. Adv. Memo. 8729002 (disclaimer by surviving spouse as trustee of power to invade corpus for children ineffective to qualify the trust for QTIP treatment).

A published revenue ruling now makes reliance upon a disclaimer of a power particularly questionable. Rev. Rul. 90-110, 1990-2 C.B. 209; see also Tech. Adv. Memo. 9818005.

One private letter ruling, however, recognized the validity of a trustee's disclaimer of the power to make distributions to an unlimited number of charities for purposes of determining that the trust (which made the ESBT election) was a qualified shareholder of an S corporation. The ruling implicitly makes the determination that the disclaimer of the power to make distributions to an unlimited number of charities is valid under applicable local law. Letter Rul. 200401011.

Another ruling that recognized renouncing of powers by a trustee is Letter Ruling 200404013. In that ruling, an irrevocable trust named the grantor's wife and a bank as co-trustees. The trust acquired a joint and survivor life insurance policy on both spouses' lives. The wife executed an instrument renouncing her right as trustee to change the policy beneficiary, to revoke any change of beneficiary, to assign the policy, and to revoke an assignment of the policy. The ruling concluded that the wife, as trustee, would have no incidents of ownership in the policy held by the trust.

The Tax Court has refused to give effect to renunciation of powers by trustees for purposes of determining whether the trust qualifies for the estate tax marital deduction. Estate of Charles Bennett v. Comm'r, 100 T.C. 42 (1993). The court observed that there was no statement of intent regarding qualification for the marital deduction in the will or trust agreement, and no extrinsic evidence of the decedent's intent was presented. The Tax Court concluded that it would not permit the trustees "to disclaim powers, duties and discretions that would amount to a renunciation of their trusteeships." See Tech. Adv. Memo 9135003.

F. Partial Disclaimer After Some Benefits Have Been Accepted; Expectation of Future Benefit as Acceptance.

1. General Rule.

One of the statutory requirements of a qualified disclaimer is that the disclaiming person "has not accepted the interest or any of its benefits". Because of this requirement, before planners are able to determine whether disclaimers would be appropriate for a particular estate beneficiary, the beneficiary should be wary of accepting any benefits from the estate.

2. Jointly Owned Assets.

In several lenient rulings, the IRS has allocated the entire amount of a withdrawal to the disclaimant's personal interest in a jointly owned asset. Ltr. Ruls. 9218015 & 9214022. However, in other cases withdrawals have been allocated one-half to the decedent's interest and one-half to the surviving joint owner's interest. E.g., Ltr. Ruls. 9214022; 9012053. The acceptance of benefits issue is a difficult issue with respect to jointly owned property (including community property assets), and the surviving joint owners should be very careful before accepting any benefits from the jointly-owned assets before the disclaimer decision has been made. An example of a well-planned strategy for leaving the flexibility to disclaim a joint account passing by right of survivorship is illustrated in Letter Ruling 199932042. This ruling suggests the following planning steps if the surviving joint account owner wants to leave open the possibility of disclaiming the decedent's interest in the account:

(1) The survivor can receive income checks after the first account owner's death, but the checks should either be deposited into a joint bank account, or preferably, be held to be placed one-half in an estate account;

(2) The executor should open an estate account as soon as possible;

(3) Thereafter, income checks should be deposited one-half into the estate account;

(4) The surviving account owner should decline to sign any authorization to transfer the entire account entirely into a new account solely in the survivor's name (although that fact alone ended up not precluding making a disclaimer in the ruling);

(5) The survivor should not withdraw any funds or income from the joint account or from the estate account which receives the estate's one-half of the account funds; and

(6) One-half of the assets in the joint account should be transferred to an account in the name of the decedent (perhaps with a specific written understanding that the funds will be transferred to the survivor's account under the survivorship arrangement if the survivor decides not to disclaim the assets.)

Hopefully, there are other assets that the survivor can use until the joint account funds can be divided in this manner. After the funds are divided, the survivor could use the funds transferred to his or her own separate account. If the survivor subsequently decides not to disclaim the account, the decedent's one-half of the funds could be transferred to the survivor.

Letter Ruling 200503024 allowed a disclaimer of the decedent's interest in a joint brokerage account held with rights of survivorship, even though the survivor re-titled the account into her name and ordered sales, purchases and withdrawals from the account. The disclaimer was allowed with respect to the decedent's interest in the securities and cash in the account that was not subject to sales, purchases, or withdrawals by the surviving wife.

Letter Ruling 200832018 also allowed a disclaimer from a joint brokerage account. Merely retitling assets did not constitute an acceptance of benefits. The surviving wife accepted some distributions from the account, but the ruling concludes that the amount that she received is a severable asset and the wife could make pecuniary disclaimer of assets originally held in the account less the amount of the prior distributions and income earned thereon. In addition, the wife was deemed to have accepted portions of the account that she authorized to be reinvested, but those newly acquired assets were severable so she could make a pecuniary disclaimer of the balance the her predeceased husband's interest in the account. A further complexity in that ruling is that the wife held a testamentary power

of appointment over trusts into which the disclaimed assets would pass, and wife disclaimed her power of appointment over the trust.

3. Expectation of Future Benefit as Acceptance.

The Tax Court has treated an implied promise by the decedent's surviving husband that the disclaimant would be better off for making a disclaimer as consideration for the disclaimer, and section 25.2518-2(d)(1) of the Treasury regulations provides that acceptance of consideration for making a disclaimer is equivalent to acceptance of the interest itself. The Fifth Circuit Court of Appeals reversed the Tax Court opinion, concluding that the mere expectation of a future benefit will not render a disclaimer invalid. Estate of Monroe v. Comm'r, 124 F.3d 699 (5th Cir. 1997). Mrs. Monroe died in 1989, survived by her husband (age 92). Wife's will left many specific bequests, with the residuary estate passing to her husband. Her estate owed estate taxes as a result of the specific bequests. Husband and his nephew approached 29 of the potential legatees about disclaimers and all of those 29 legatees signed disclaimers aggregating about $900,000 of bequests. Within a few days (or in some cases a few weeks) after signing the disclaimers, each disclaimant received a personal check from the husband, bearing the notation "gift" in the approximate amount of the respective disclaimed bequests. The disclaimants included a grandniece and her children who were the beneficiaries of a bequest in trust of $500,000 of bonds (which had a present value of $535,781). The IRS took the position that the disclaimers were invalid, reasoning that husband's subsequent "gift" payments were made in return for the disclaimers, and the acceptance of consideration for the disclaimers amounted to acceptance of the bequeathed interests.

The facts did not reflect that the surviving husband ever told the disclaimants specifically that they would receive assets in exchange for giving the disclaimers (except for one household employee who testified that the surviving husband had promised to "take care" of him if he disclaimed his bequest). All of the other legatees merely assumed certain consequences of their decisions. Some testified that they either were afraid of refusing to abide by the survivor's wishes or expected to get the money back from him later.

The Fifth Circuit concluded that mere expectation of a future benefit in return for executing a disclaimer will not render it "unqualified". Id.

4. Disclaimer of Qualified Plan Benefit After Receiving Minimum Required Distribution for Year of Participant's Death. Rev. Rul. 2005-36 answers a thorny question on which the IRS and previously given no direct guidance. Rev. Rul. 2005-36, 2005-26 I.R.B. 1368.

a. No Acceptance of Benefits of Entire IRA. If a beneficiary withdraws the minimum required distribution("MRD") from an IRA for the year in which the decedent died (often in order to avoid a 50% penalty under §4974 on the failure to withdraw the MRD), the ruling confirms that the beneficiary can still disclaim his interest in the IRA. However, the amount withdrawn may not be disclaimed (because of the "no acceptance of benefits" requirement for valid disclaimers), and the beneficiary is also deemed to have accepted income earned post-death on the MRD. This situation often arises for IRAs in which the owner died late in the year without having taken the MRD for that year. The beneficiary must act quickly to take the MRD to avoid the 50% penalty, often before the beneficiary has had time to consider whether to make a disclaimer.

b. MRD Requirement Where Multiple Beneficiaries. The ruling has an example in which a surviving spouse withdrawals the MRD. The spouse later disclaims a pecuniary amount of the IRA balance, and the disclaimed portion passes to a child as the contingent beneficiary. The ruling confirms that the spouse's withdrawal of the MRD is sufficient for

the entire IRA, and the MRD does not have to be allocated among the beneficiaries of separate accounts. (It is not clear whether this applies for all separate accounts established for multiple beneficiaries or only where the separate accounts are created as the result of a disclaimer.)

c. Effect of Disclaimer on Determining Identity of "Designated Beneficiaries". The ruling confirms that a person who disclaims his or her entire interest in an IRA is not considered a "designated beneficiary" as long as the disclaimer is made on or before September 30 of the calendar year following the year of the participant's death. Therefore, even for the situation in which a participant dies in December 31, and disclaimer within nine months (ON September 30) would still mean that the disclaiming person would not have to be counted in determining the lifespan and the move to the amount of over which post-death distributions must be made.

G. Disclaimers of Joint-Tenancy Property.

The ability to disclaim joint tenancy property at the first tenant's death is very important in many estates. An often incurred problem is that spouses, perhaps unknown to their planners, own most of their assets in joint tenancy so that insufficient assets pass under the first decedent spouse's will to fully fund a bypass trust. In such cases, a qualified disclaimer by the surviving joint tenant could be made following the death of the first joint tenant to die. The property or property interest subject to the disclaimer would pass, subject to state law, as if the surviving spouse had predeceased the decedent (e.g., to the decedent's children or to a credit shelter trust). In this manner, the decedent's unified credit could be utilized to a greater advantage.

A number of cases have addressed whether the time period for beginning the nine month measuring period runs from when the joint tenancy is initially created or from the death of the first joint tenant. For "revocable" joint-tenancy accounts, such as bank accounts, the nine-month period generally does not begin until the death of the first joint tenant. However, for "irrevocable" joint tenancies, such as real property, the IRS traditionally took the position that the nine-month period began from the date of creation of the joint tenancy. Reg. §25.2518-2(c)(4)(i) (prior to amendment effective December 31, 1997). This position was upheld in several early Tax Court cases, but various cases have now rejected it. A regulation effective December 31, 1997 adopts the more liberal position that had been recognized in the cases. Treas. Reg. §25.2518-2(c)(4).

H. Creative Planning Strategy to Allow Beneficiary to Decide Whether to Retain Unfettered Control Over Trust or be Subject to Ascertainable Standard.

Steve Gorin, (an attorney in St. Louis) suggests the following creative strategy if a client wants to make an outright bequest that might be sizable enough to justify a trust and does not want trustee discretion to impede the beneficiary's access. Consider using a lifetime trust with ascertainable standards for income and principal, as well as an unlimited withdrawal right at a specified age. (By including an age restriction, this provision could be used for children who might currently be over that age as well as for grandchildren who may be under that age.) The child then has the choice of accepting the bequest in trust with that broad withdrawal right or doing a timely disclaimer of the withdrawal right. Because the unlimited withdrawal right is a general power of appointment, it is a separate interest that can be disclaimed, with the beneficiary still receiving distributions under ascertainable standards. *See* Reg. §25.2518-3(a)(1)(iii).

VI. MISCELLANEOUS PLANNING STRATEGIES

A wide variety of other possible planning alternatives and elections may be advantageous. These include:

- GST exemption allocation.
- “Reverse” QTIP election to allocate decedent’s GST exemption to QTIP trust.
- Expanding special powers of appointment to general powers of appointment if doing so could save GST taxes.
- Reformation/construction proceedings to correct unintended results.
- Amending, revoking, splitting, or merging trusts.
- Appointments in further trust.
- Section 754 election by a partnership to achieve an inside step up in basis of partnership assets.
- Section 303 redemption to use C corporation assets for paying estate taxes, funeral expenses, and administration expenses
- Allocating IRD to marital deduction share, to be reduced by income taxes payable with respect to it.
- Testamentary estate freezes.
- Tax consequences of spousal rights of election.
- Waiver of commissions or of multiple commissions by multiple executors.