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**No Quiet on the Wealth Transfer Tax Front: The Issues Which Make the IRS and Taxpayers Go to War (Or at Least to Court)**

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* **Valuation**
* Good Appraisals

For assets of other than nominal value, or assets which have a clear value, such as cash in the bank or listed stocks, secure an appraisal or at least present a credible basis for the valuation. The depth (and cost) of the appraisal or the extent of the research necessary to substantiate a value will vary, depending upon the nature and estimated value of the asset. The more supporting information that can be given to the classifier regarding the returned values of assets, the more likely it will be that the classifier will accept the returned values.

* Discounts

The IRS looks closely at discounts of entity interests when the combined discounts exceed 35%. A return on which discounts exceed 35% is more likely to be selected than a return with discounts at or below that amount. Of course, the total returned value is also a factor. A relatively small interest in an entity or even a large interest in an entity where the value of the whole entity is small, could probably slip by with discounts above the suggested threshold. But if the preparer is of the opinion that higher discounts are justified, they should be claimed, but should be supported by a particularly well-credentialed appraiser. Of course, discounts at 35% or below should not simply be claimed without support. An appraisal will still be necessary.

* **FLP and LLC Planning**
* IRC Sec. 2036

Estate of Purdue v. Comm’r

The Tax Court rejected the application of IRC Sec. 2036 and allowed discounts for included membership interest. The decedent had “legitimate and significant nontax motive” for LLC’s creation, satisfying the “bona fide sale” prong of the exception to Sec. 2036 based on the following:

* + - Consolidation of investments in LLC avoided continued management by multiple firms;
    - Sufficient funds retained outside of the LLC enabled decedent to maintain lifestyle;
    - Avoided commingling of personal and LLC funds;
    - Annual meetings held and LLC’s formalities observed by family members; and
    - Decedent in good health at the time assets contributed to the LLC.

T.C. Memo 2015-249 (Dec. 28, 2015)

Estate of Holliday v. Comm’r

IRC Sec. 2036 applied to include assets contributed by decedent (via power of attorney) to partnership in her estate. Decedent lacked “legitimate and significant nontax motive” for its creation necessary to satisfy the “bona fide sale” prong exception based on the following:

* + - Purported use to avoid “trial attorney extortion” was “merely theoretical justification” given no previous litigation, minimal risk of future litigation, and exposure of significant wealth held outside of partnership;
    - Purported use to avoid “undue influence of caregivers” was a “theoretical justification” given children’s management of the decedent’s affairs, weekly visits by one of the children, and lack of evidence that decedent personally had any undue influence concerns;
    - Children’s inability to justify use of partnership over alternate structures (e.g., trusts, favored by the decedent’s deceased husband) undermined partnership’s purported use as a wealth transfer vehicle; and
    - Family’s failure to actively manage partnership assets or maintain books and records, hold meetings, or otherwise generally follow formalities undermined purported intended benefits.

Implied understanding that decedent retained enjoyment of or right to income from contributed assets substantiated by testimony that distributions would be made as needed by decedent.

T.C. Memo 2016-51 (Mar. 17, 2016)

Estate of Beyer v. Comm’r

IRC Sec. 2036 applied to include investments contributed via decedent’s newly-formed management trusts to partnership in return for general and limited partnership interests in his estate (the latter being subsequently sold during the decedent’s life to an irrevocable trust). Decedent lacked “legitimate and significant nontax motive “for partnership’s creation necessary to satisfy the “bona fide sale” prong of exception based on the following:

* + - Purported objective of maintaining block of employer stock and investment portfolio more easily achieved via trust amendment and easily undermined due to lack of restrictions on general partner’s investment discretion; and
    - Purported objectives of ensuring continuity of investment management and transitioning it to nephew via his appointment as co-trustee of new management trust serving as general partner more easily achieved by retention of investments in existing management trust and nephew’s appointment as co-trustee and ultimately sole trustee.

Court found decedent failed to receive “adequate and full consideration in

money or money’s worth” due to lack of evidence that partnership established

and maintained capital accounts necessary to document interests acquired by

contributors.

Implied understanding that decedent retained enjoyment of or right to income

from contributed assets evidenced by failure to retain sufficient funds to

maintain lifestyle and meet his obligations (e.g., gift and estate taxes paid with

partnership funds).

T.C. Memo 2016-183 (Sept. 29, 2016)

Estate of Powell v. Comm’r

The Tax Court, in a reviewed decision, determined that the assets that had been transferred to an FLP were included in the decedent’s gross estate in a fact pattern reminiscent of prior bad facts FLP cases.

* + - Decedent’s sons transferred $10 million of cash and marketable securities from her revocable trust to the FLP.
    - The sons were the general partners, the only other partners in the FLP. Their interests were received for the contribution of unsecured promissory notes
    - The transactions were consummated about a week before decedent’s death, and when the taxpayer was incapacitated.
    - The same day the FLP was formed the son, acting under a durable power of attorney, transferred decedent’s 99% LP interest into a charitable lead annuity trust (“CLAT”). That power of attorney, however, only permitted gifts to descendants (not a CLAT), and in amounts no more than the annual exclusion (well under the amount given).
    - The CLAT annuity was to be paid to decedent’s private foundation. At the end of the CLAT term the remainder would pass to trusts for each of the sons. The transfer reflected a 25% valuation discount and was supported by an independent appraisal.
    - A gift tax return was filed reporting the gift to the CLAT.
    - The IRS argued that the assets were included in the decedent’s estate under IRC Sec. 2036(a)(1) and (2) on the basis of an implied agreement entitling the decedent to possession and enjoyment of the assets during her lifetime. The IRS also argued that the decedent, acting with her sons, could dissolve the FLP and thus designate the persons who would possess and enjoy the property that had been transferred to the FLP. The decedent’s estate conceded this argument.

The Tax Court held that the assets were includible in the taxpayer’ gross estate under IRC Sec. 2036(a)(2). The validity of the gift to the CLAT wasn’t an issue because even if the gift was valid, it was made within three years of decedent’s death, and since IRC Sec. 2036(a)(2) otherwise applied, IRC Sec. 2035 would include the assets contributed to the FLP in decedent’s estate even if the gift was valid. The Tax Court also provided a new approach to avoid duplication of the value of the FLP interest and the underlying assets when estate tax inclusion occurs under Sec. 2036(a). The gross estate should include two components of value: (1) the value of the decedent’s FLP interest under IRC Sec. 2033 (this value should reflect any valuation discounts taken); and (2) the value of the assets transferred to the FLP reduced by the value of the FLP interest the decedent received. Further, the Tax Court indicated that state law fiduciary duties would be disregarded as illusory in family situations.

148 T.C. No. 18 (May 18, 2017)

Tips to Avoid Sec. 2036

* Have actual legitimate and significant nontax objectives for creating the entity.
* Outline those nontax objectives in partnership or company agreement.
* Ensure post-creation actions are consistent with stated nontax objectives (e.g., actually consolidate investments if this is a stated nontax objective).
* Retain sufficient funds outside of entity to maintain lifestyle.
* Do not postpone the creation and funding of the entity until a time when client is in poor health and do not implement the FLP transactions in a very compressed time frame.
* Follow the formalities. Avoid commingling individual and entity funds; hold family meetings or in lieu execute written consents (preferably not pro forma).
* Do not allow decedent to have any power over distributions from the FLP or the ability to participate in a decision to dissolve the FLP.

Estate of Cahill v. Comm’r

At issue in *Cahill* was a split dollar arrangement involving two trusts, the

“Survivor’s Trust” and the “MB Trust.” The Richard F. Cahill Survivor’s Trust (the

“Survivor’s Trust”) was a revocable trust created by Richard Cahill. At all relevant

times, Richard’son, Patrick, was trustee of the Survivor’s Trust. The Morrison

Brown Trust (the “MB Trust”) was an irrevocable trust created by Patrick as

Richard’s attorney-in-fact on September 9, 2010. William, Patrick’s cousin and

business partner, was trustee of the MB Trust. Throughout all times relevant to the

litigation, Patrick was Richard’s attorney-in-fact.

Sometime after September 9, 2010, the MB Trust acquired three whole life

insurance policies, one on Patrick’s life and two on the life of Patrick’s wife,

Shannon. To fund lump-sum premiums on these policies, the MB Trust entered into

split-dollar agreements with the Survivor’s Trust under which the Survivor’s Trust

advanced $10 million to the MB Trust. The Survivor’s Trust obtained the $10

million from a $10 million, interest only 5 year loan from a bank and the bank was

not required to extend the loan at the end of the five-year term. These split-dollar

agreements were entered into between the Survivor’s Trust and the MB Trust while

Richard was 90 years old and lacking capacity. Patrick executed the split-dollar

agreements as trustee of the Survivor’s Trust. William signed on behalf of the MB

Trust.

The split-dollar agreement provided that the Survivor’s Trust would be reimbursed

for the $10 million advance to the MB Trust. The reimbursement would be made

(i) at the termination of the agreement if the two trusts agreed to terminate the

agreement early, or (ii) following the deaths of the insureds. The opinion refers to

the decedent’s reimbursement rights in these two events as the “termination rights”

and the “death benefit rights.” If the agreement was terminated early, the MB trust

could keep the policies and pay the decedent the greater of the premiums paid or the

cash surrender values of the policies or could transfer the policies to the bank in full

or partial satisfaction of the decedent’s obligation to the bank and the decedent

would receive any excess of the cash surrender value over the loan balance (the

“termination rights”). Otherwise, at the insureds’ respective deaths, the decedent

would receive the greater of the loan balance, premiums paid, or cash surrender

value (the “death benefit rights”).

Richard Cahill died on December 12, 2011. On his date of death, the aggregate cash

surrender value of the policies equaled $9,611,624. Richard’s estate tax return

reported a value of Richard’s rights in the split-dollar agreements of $183,700, less

than 2% of the original $10 million advance. The estate’s theory regarding its

valuation was that the estate’s interest was limited to a right to payments at the

insureds’ deaths because the MB Trust essentially would never agree to a

termination of the split-dollar agreement. Given the ages of the insureds, Patrick

and Shannon, the present value of the estate’s right based on the current cash

surrender value of the policies would equal $183,700. The IRS issued a Notice of

Deficiency adjusting the value to $9,611,624, the cash surrender value on Richard’s

date of death.

After filing a Petition with the Tax Court, Richard’s estate filed a Motion for Partial

Summary Judgment regarding certain issues, including the application of IRC

Section 2036, 2038, and 2703. The IRS did not file any cross-motion seeking

summary judgment in its favor.

IRC Sections 2036(a)(2) and 2038(a)(1)

The IRS argued that the decedent’s ability to participate in an agreement to

terminate the split-dollar agreements and to obtain the policies’ cash surrender

values of $9,611,624 was a right causing inclusion of this value in decedent’s estate

under IRC section 2036(a)(2) as in *Powell* and under IRC section 2038(a)(1) which

also includes transferred assets where a decedent is at least a participant in a

decision to revoke, alter, amend, or terminate the transfer. Under both sections, it

doesn’t matter that the other party(ies) to such an agreement to terminate the split-

dollar agreement would not agree to that termination. The adequate and full

consideration exception under both sections did not apply because the Survivor’s

Trust transferred $10 million to the MB Trust and received in return only $183,700

(cash surrender value of the policies at the insureds’ deaths, discounted for the time

value of money).

The court refused to grant the estate’s motion for summary judgment that IRC

sections 2036(a)(2) and 2038(a)(1) did not apply.

IRC Section 2703

The IRS argued as an alternative to Sections 2036(a)(2) and 2038(a)(1) that Code

Section 2703 applied to the transaction. The MB Trust had to agree to the

termination of the split-dollar agreements. The IRS argued that Section 2703(a)(1)

applies to disregard, for purposes of valuation “any option, agreement, or other right

to acquire or use the property at a price less than” fair market value. Section

2703(a)(2) applies to disregard, for purposes of valuation, “any restriction on the

right to sell or use such property.” Section 2703(b) provides that Section 2703(a)

does not apply if the arrangement is a legitimate arms-length business transaction

and not a device to pass wealth to family members for less than adequate and full

consideration.

The court held that Section 2703(a)(1) applied due to the fact that MB Trust was

granted the rights under the split-dollar agreements at a price less than the full fair

market value of what was transferred (MB Trust obtained the use of $10 million in

exchange for what the estate argues to be valued at $183,700 to the Survivor’s

Trust). Under Section 2703(a)(2), the court held that “it is clear that … the split-

dollar agreements, and specifically the MB Trust’s ability to prevent termination”

restricted Richard’s rights to use his termination rights and withdraw his

investments. As such, Section 2703(a) applies and the estate’s motion for summary

judgment that it didn’t was denied. The court left for trial, however, whether the

exceptions under Section 2703(b) may apply.

T.C. Memo. 2018-84 (June 18, 2018)

Other cases involving the treatment of intergenerational split-dollar arrangements

which are scheduled for trial in the near future are Estate of Morrissette, Docket No.

4415-14, and Estate of Levine, Docket No. 9345-15. These cases also involve the

determination of the value for estate tax purposes of the value of the decedent’s

reimbursement rights under intergenerational split-dollar arrangements. As in

Cahill, the application of Code Section 2036, 2038 and 2703 is at issue.

* Annual Exclusions

The IRS begins to take serious notice of discounts when they exceed 35%. Sometimes discounts which exceed 35% are claimed and an attempt to justify them is based upon factors such as: the entity in which an interest has been given holds only non-income producing assets and/or, even if the entity produces income, the donor of the gift (as general partner of an FLP or managing member of an LLC) has complete discretion over the payment of income and/or, the donee of the gifted interest cannot transfer the interest without first offering it to the entity and/or the other owners. These may, in theory, be reasons for increasing the size of the discount, but they are also reasons why the IRS may be able to make a credible argument that the donee’s use and enjoyment of the property is restricted or non-existent because of the limitations similar to the ones mentioned above and thus that the gift does not qualify for the annual exclusion. The *Hackl* case philosophy remains available for IRS use.

* Defined Value Clauses

The IRS has attacked defined value clauses, where any excess value determined by the IRS or the court would pass to charity, as against public policy because they would discourage examinations and that any interest so passing to charity would be a contingent interest or a non-qualifying split interest so that any amount actually passing to charity would be non-deductible. The IRS, however, lost all of these charity overflow cases (*McCord, Petter, Hendrix, Christiansen*). The *Wandry* case, decided in 2012, presented new facts. Based on the formula in *Wandry*, any excess value above the amount determined by the donor would flow back to the entity for reallocation among the donor and the other owners. The IRS said that this made *Wandry* like *Procter* (a 1940’s case where the defined value clause provided that any excess value finally determined reverted to the donor – held to violate public policy and the clause could be ignored), but the court in *Wandry* said no to the IRS’s comparison of *Wandry* to *Procter*. The court agreed with the donor that he could make a gift of a defined dollar amount and that if later, because of an IRS examination, the exact percentages of the interest given decreased, with the excess interests to be reallocated among the donor and the other owners, this did not change the fact that the donor intended to make a gift of property in a defined amount, and that even though the interests in the entity given to the donees were reduced, the donor still made gifts of his desired defined amounts. Nevertheless, the IRS has been looking for another *Wandry*-type case, and may have found it in the *True* cases (Karen and H. A., separate petitions filed in Tax Court on October 11, 2016).

Mr. True made gifts of interests in a family business to one of his daughters and made sales of the business interests to all of his children and a trust. The transfers were made based on an appraisal from a recognized reputable national appraisal firm. The transfers to his children were subject to a “transfer agreement” with a defined value/price adjustment provision. The spouses made the split gift election, so any gift was made one-half by each spouse, which is why each filed a separate Tax Court petition.

A gift of units in the family business was made to one daughter (Barbara True), and the transfer agreement provided that if the transfer of those interests is determined for federal gift tax purposes to be worth more than the anticipated $34,044,838 amount of the gift, “(i) the ownership interest gifted would be adjusted so that the value of the gift remained at $34,044,838, and (ii) Barbara True would be treated as having purchased the ownership interests that were removed from her gift.”

Sales of business interests were made to that daughter, the other two children, and a trust. According to the petition, the transfer agreement for the sales to his children “provided that if it is determined for federal gift tax purposes that the interests were undervalued by FMV Opinions, the purchase price would be increased to reflect the finally-determined fair market values.”

The IRS has alleged a gift tax deficiency of $16,591,418 by each of Mr. and Mrs. True. The taxpayers contend that the valuations were correct, but if the transferred interests are determined to have a higher value, no gift should result because of the price adjustment provision in the transfer agreement.

As can be seen, the *True* cases are distinguishable from *Procter* because any “excess” transferred units are not re-transferred back to the donor/seller.

* Indirect Gifts

The IRS says indirect gifts occur when a donor forms an entity, makes gifts of interests in the entity, and then funds the entity with assets. If the sequence of events is as given above, then the donor would, because of Reg. section 25.2511-1(h)(1) make gifts of the assets contributed to the entity because the donees already own interests in the entity and their interests would be enhanced by the value contributed to the entity be the donor. This would result in limited or no discounts for the donor because the gifts would not be treated as gifts of entity interests. The issue arises in those cases in which the sequence of events between funding of the entity and gifts of interests in the entity is not clear. For example, in a case where the documents reflecting the gifts of the interests in the entity and the documents reflecting the funding of the entity have the same date, the IRS is likely to argue, in the absence of contrary evidence, that the events were either simultaneous or the gifts of the interest occurred first, followed by funding, but that, in either event, if donor could not prove which happened first, the gifts would be treated as interests in the contributions, thus eliminating or reducing discounts. The IRS has had some success with this argument (*Shepherd, Senda, Linton*), and I would expect that returns would be selected where the sequence of creation/funding is not clear, or where the gifts of interests in the entity clearly came first. The issue could also arise during examination of a return initially selected for another issue, such as the size of the discount, but questions nevertheless could be asked about the sequence of events regarding funding and gifts of the interests. It is not original with me, but I have heard and read planners’ advice that the gap between funding of the entity and the gifts of interests ideally should be sixty days. Such a separation would force a classifier or an estate tax attorney to focus on the size of the discount.

* IRC Sec. 2703

Some taxpayers attempt to enhance the marketability discount for gifts of interests in entities because of a requirement in the entity agreement that any owner who wants to transfer his or her interest must first offer the interest to the entity and/or to the other entity owners. An enhancement to the marketability discount was claimed in the *Holman* case (Dell stock only asset held by the FLP) and in the *Fisher* case(unproductive land used by the family for recreation and otherwise held for investment). The courts in both cases held that since the entities did not hold active business assets, that such restrictions on transferability would not be recognized as enhancing the marketability discount. Both courts said that such restrictions on transferability would be more appropriate among owners of an active business who would have a legitimate reason for controlling who they would be in business with. The courts in *Holman* and *Fisher* found that the restrictions on transferability in those cases were motivated by value reduction for wealth transfer purposes and thus that the taxpayers were tripped up by one or more of the hurdles of section 2703.

Apart from gifts of interests in entities, the IRS continues to look for applications of section 2703 in other contexts, as they did in a case where a family which collectively owned fractional interests in art entered into an agreement in which they all effectively agreed to give up their right to partition and that they all had to agree to a sale of any piece of art. Upon the death of the major fractional interest owner, the IRS argued that the agreement could be ignored under section 2703. The Tax Court agreed and limited the discount, but the Fifth Circuit did not uphold the Tax Court (*Elkins*). In another case (*Edwards*), the IRS argued that oral long-term leases of land, allegedly granted by the decedent to her children shortly before her death, did not have a depressing effect on the value of the land because the leases could be ignored under section 2703. The case was decided in the IRS’s favor on other grounds, so the section 2703 argument was not passed on by the court.

* Graegin Loans

FLP and LLC planning has as its overriding purpose the movement of estate assets to the next generation(s) at a reduced tax cost. The reduced tax cost is achieved through the use of discounts, for both lifetime and at death transfers of the FLP and LLC interests possessed by the taxpayer after the creation of the entities. Sometimes the IRS is successful, as discussed above, in arguing that the creation of the LLC or FLP and the decedent’s transfer of the assets to it should be ignored under Section 2036. Often, however, the entity survives scrutiny and the assets are moved to the next generation(s) at a reduced tax cost, although the IRS may still want to argue about the size of the discounts. Sometimes the funding of the LLC or FLP by the decedent may not leave the decedent’s estate with enough property to pay the estate tax and any state death taxes. Thus, the estate may have to borrow the funds necessary to pay the taxes and one likely place to obtain a loan would be the FLP or LLC that the decedent largely funded. This is the basic composite factual scenario of a “Graegin Loan,” named after a case where the decedent’s estate borrowed from a family corporation to pay the estate tax. Of course, when funds are borrowed, interest must be paid and the borrowing estate will want to deduct this interest as an administration expense under Code Section 2053(a), just as the Graegin estate did. Sometimes the IRS objects to the deduction of the interest, however, on a number of grounds: (1) the estate is essentially borrowing from itself, i.e., the persons who will ultimately benefit from the assets in the FLP or LLC are decedent’s children or other close relatives and they are using estate property, which they own or will become entitled to, to pay the tax, but characterizing the payment as consisting of borrowed funds, thus generating interest.; (2) the “loan” will never be repaid; (3) even if it is repaid, or at least there is paperwork reflecting this, the interest, which has been deducted as an expense of administration of the estate tax return, will not be reported by anyone since the children or other close relatives owe the interest to themselves. The technical explanation was furnished in TAM 200513028, involving a factual pattern in which the estate beneficiaries had the same proportionate interests in the partnership:

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). … .

…

Further, we do not believe that the interest expense is deductible under Section 2053 because: (1) it is questionable whether the Estate will actually make the payments in accordance with the terms of the arrangement; and (2) even if the Estate makes the payments in accordance with the terms of the arrangement, the payments (whether characterized as interest or principal) will have no economic impact on the parties involved.

…

… . Thus, the same parties owned and controlled both the borrower and the lender, and were essentially dealing with themselves and “sitting on both sides of table.” The circular flow of funds presented is readily apparent. The netting effect presented either obviates the need to actually pay the interest (and principal) when due or if in fact the funds are transferred in payment of interest, the payment will have no economic effect on the parties. After any such payment, the parties will be in the same economic position as they were before the payment. … .

Many Graegin loans are structured so that interest and principal are payable far in the future, say ten or fifteen year, with no possibility of prepayment of, especially the interest. The new Regulations under Code Section 2053 provide that post-death events can be considered in determining the amount of an expense or claim that is deductible, but also provide that as long as an amount is ascertainable with reasonable certainty, it is deductible as long as it will be paid. Reg. sec. 20.2053-1(d)(4)(i). The interest payable on a Graegin loan can be calculated, but the question remains as to whether the interest will be paid at the end of ten or fifteen years. If it is not, even though paperwork might show that it was, and no one reports the interest income, what is to be done about reversing the estate tax deduction of the interest? The answer is nothing because the period for assessment of estate tax would have expired. The best the IRS could hope for in this scenario would be the establishment of a system where a referral is made by the estate tax people to the income tax people to check the returns of the partnership or estate beneficiaries in ten or fifteen years to make sure the interest on the borrowed funds is reflected on their returns for the year when the principal and interest come due. The problem with this “remedy” is that coordination and communication between the estate people and the income tax people has not been, in my experience, effective.

The IRS does not like Graegin loans and often includes them as part of a Sec. 2036 argument regarding the creation of the FLP or LLC. The IRS might argue that the Graegin loan is not a real transaction and is part of a pattern of other illusory transactions, such as the creation of the FLP or LLC. I would expect that the IRS will continue to litigate the Graegin issue along with or even independently of a Sec. 2036 argument regarding an FLP or LLC.

Of course, even if a Graegin loan is used by an estate, the normal threshold tests for deductibility of interest would still apply. In *Estate of Koons*, 686 Fed. Appx. 779 (11th Cir, April 27, 2017), taxpayer, through a revocable trust, owned 70.42% voting control of an LLC. The revocable trust borrowed $10,75 million from the LLC to pay the decedent’s estate and GST taxes. Under the terms of the loan, the revocable trust was to make interest and principal payments in installments beginning 18 years after the loan was executed. The terms of the loan prohibited prepayment. The estate claimed a deduction under Section 2053(a)(2) for the total amount of interest due on the loan.($71.4 million). Under the cases and Reg. section 20.2053(a) interest payments are not a deductible expense if the estate would have been able to pay the debt using the estate’s liquid assets but instead elected to obtain a loan that will eventually be repaid using those same liquid assets.

The Eleventh Circuit found that it was not necessary for the revocable trust to borrow from the LLC because at the time of the loan (1) the LLC had over $200 million of liquid assets, and (2) the revocable trust had 70.42% voting control over the LLC, which would allow the trust to compel the LLC to make a pro rata distribution to its members. That is, the estate had sufficient liquid assets to pay the estate tax liability. Additionally, the Eleventh Circuit reasoned that the lending merely postponed the necessity for the LLC to make a distribution because the revocable trust would have to rely on future distribution from the LLC to repay the loan. Further, the Eleventh Circuit rejected the estate’s argument that courts must defer to an executor’s business judgment in all instances. Finally, the Eleventh Circuit concluded that a pro rata distribution from the LLC to pay the estate tax liability, compelled by the revocable trust, would not violate the trust’s fiduciary duties to minority shareholders under applicable state law.

* **Transfer of Assets in Return for Insufficient Consideration**
* Installment Sales to Grantor Trusts

Husband and Wife Estate Cases (*Woelbing)*

In 2006, Mr. Woelbing sold that number of shares of non-voting stock in Carma Laboratories (a closely-held company located in Wisconsin) having a value of $59 million to his grantor trust in return for a $59 million note. The IRS questioned the value of the assets and the value of the note for gift tax purposes. It also argued that the stock was includible in the estate under Sections 2036 and 2038.

A stipulated decision was entered in the cases in March, 2016 resulting in no additional gift tax for Donald or Marian Woelbing’s estate and no additional estate tax for Mr. Woelbing’s estate. It is reported that the IRS recognized the “Wandry-like” provision in the sales agreement (selling that number of shares equal to $59 million), and that Sections 2702, 2036, and 2038 did not apply because 10% equity existed in the grantor trust that purchased the shares. The apparent result is that more shares were retained by Donald, and passed from his estate to Marian (qualifying for the marital deduction at Donald’s death). The settlement likely included an agreement as to the number of additional shares that were included in Marian’s estate, and the date of death valuation of those shares, even though the pending Tax Court cases do not address her estate tax.

The IRS made a similar Section 2036 argument regarding a sale of limited partnership interests to grantor trusts in *Estate of Beyer*. The Tax Court held that the FLP assets were included in the estate without specifically addressing the sale transaction. *Estate of Beyer v. Commissioner*, T.C. Memo. 2016-183.

* Self-Canceling Installment Notes

Estate of William Davidson v. Commissioner, Tax Court Cause No. 013748-13 (filed June 14, 2013).

The decedent (age 86) entered into various gift and sale transactions in December 2008 and January 2009, including large sale transactions for self-canceling installment notes. Soon after these transactions, he was diagnosed with a serious illness and he died on March 13, 2009 before he received any payments on the notes. The major issues in the case were valuation and whether the self-canceling installment notes constituted bona fide consideration that is considered as providing any value whatsoever, or if they are bona fide, whether they provide consideration equal in value to the stock transferred in return for the notes. The IRS expressed its positions regarding this case in CCA 201330033.

The IRS argued that the SCINS were not bona fide loan transactions (perhaps reasoning that no reasonable expectation of repayment existed) and the SCINS should therefore be valued at zero. The government’s answer in the case stated that the burden of proof is on the estate to prove that the SCINS were bona fide debt, that the decedent intended or expected to collect all payments due under the SCINS, and that the trusts would be able to make payments on the SCINS when due.

The IRS also argued that Section 7520 does not apply in valuing SCINS, reasoning that Section 7520 does not apply to SCINS because Section 7520 applies only in valuing annuities and life estates. The estate maintained that Section 7520 applies in valuing “any interest for life or a term of years,” and that a SCIN requires valuing an interest that involves both a term of years and an interest for life

A stipulated decision was entered on July 6, 2015. The total deficiencies were over several hundred million dollars (but much lower than the amount of deficiency alleged in the Notice of Deficiency of over $2.6 billion).

The Davidson estate filed a malpractice lawsuit against Deloitte Tax LLP relating to the sale transaction. It was dismissed on August 11, 2016, based upon limitations, but the estate filed a notice of appeal on September 13, 2016.

In *Estate of Johnson v. Commissioner,* T.C. No. 11708-16, the IRS again questioned the valuation of a self-canceling installment note. In 2005, Mrs. Johnson sold shares of a closely-held company in exchange for a SCIN. The SCIN provided for current interest payments, but a balloon principal payment on April 28, 2013. Ms. Johnson died in January, 2012, about one year before the maturity date, and the principal payments were cancelled pursuant to the terms of the SCIN. The face amount of the SCIN was $5,532,589, of which $2,941,356 represented a principal premium to compensate for the actual risk of Ms. Johnson’s premature death and the cancellation of the note. The risk premium “was determined by actuarial computations based on the life expectancy factors of Treasury Regulation Section 1.72-9 (Table V).” In addition, the interest rate on the note was 4.28% per annum, which was greater than the applicable AFR of 4.09%. According to the petition, the IRS refused to treat the SCIN “as bona fide consideration equal in value to (i) the fair market value of such units, plus (ii) the fair market value of the risk associated with the possibility of cancellation in the event that Decedent did not survive the term of the SCIN.”

An additional issue is that the estate reported the gain on the cancellation of the note as gain on the decedent’s final income tax return rather than on the estate’s first fiduciary income tax return. (Reporting the gain on the decedent’s final income tax return resulted in a substantial debt reduction for estate tax purposes). The IRS’s position is that the gain should be reported on the fiduciary income tax return, based on the Eighth Circuit Court of Appeal opinion in *Estate of Frane v. Commissioner* (998 F.2d 567), and the IRS’s published position in Revenue Ruling 86-72. The taxpayer’s position is that the Tax Court decision in *Estate of Frane* (98 T.C. 341) remains the controlling law in the Tenth Circuit, despite its reversal by the Eighth Circuit.

This case also had an issue related to $10 million and $5 million life insurance policies financed by a third-party lender and a private split-dollar arrangement.

This was a somewhat “good facts” case from the standpoint of the SCIN transaction and, probably for that reason, the case has been settled, largely in the taxpayer’s favor. The IRS settled for a $969,761 deficiency in a stipulated decision entered in the Tax Court on August 30, 2017.

* **Portability**

Portability of a decedent’s “DSUE” amount to a surviving spouse was enacted in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and made permanent by the Taxpayer Relief Act of 2012. Section 2010(c)(5)(A) requires that the executor of the deceased spouse’s estate make a portability election on an estate tax return, which must include a computation of the DSUE amount. Under Section 2010(c)(5)(A), a portability election is effective only if made on an estate tax return that is filed within the time prescribed by law (including extensions) for filing such return.

Rev. Proc. 2014-18, 2014 I.R.B. 513, allowed relief for certain estates through December 31, 2014. Namely, relief was allowed for late elections of “portability only” estate tax returns, or estate tax returns that are filed to elect portability but would not otherwise be required if the decedent’s estate did not exceed the estate tax exemption amount. While the due date for filing estate tax returns for estates that are required to file due to the estate exceeding the exemption amount is statutory, found in Code Section 6018(a), the due date to file a return for portability when the estate does not exceed the exemption amount is regulatory, found in section 20.2010-2(a)(1) of the Treasury Regulations. Therefore, an extension of time to elect portability would be available under Treas. Reg. section 301.9100-3 for portability only returns but not required returns.

Rev. Proc. 2017-34 states that, since December 31, 2014 “the Service has issued numerous letter ruling under section 301.9100-3 granting an extension of time to elect portability under Section 2010(c)(5)(A) in situations in which the decedent’s estate was not required by section 6018(a) to file an estate tax return.” Further, “the considerable number of ruling requests for an extension of time to elect portability received since December 31, 2014, indicates a need for continuing relief for the estates of decedents having no filing requirement under Section 6018(a)”, and “the considerable number of ruling requests received has placed a significant burden on the Service.”

Therefore, provided that certain requirements are met, Rev. Proc. 2017-34 provides for another simplified procedure for estates with no filing requirement under Section 6018(a) to obtain an extension of time under Reg. section 301.9100-3 to elect portability. The relief period is “the later of January 2, 2018, or the second anniversary of the decedent’s date of death.” January 2, 2018 has now passed, but the two year anniversary provision is permanent, meaning that so long as a portability only estate tax return is filed within two years of a decedent’s death, an extension will be granted under Reg. section 301.9100-3 without having to request a letter ruling and pay the substantial user fee otherwise required for “9100 relief”, provided that certain requiremts are met:

1. the decedent (i) was survived by spouse, (ii) died after December 31, 2010, and (iii) was a citizen of the United States;
2. the executor was not required to file an estate tax return under Section 6018(a) based on the value of the gross estate and adjusted taxable gifts and without regard to the need to file for portability purposes;
3. the executor did not file an estate tax return within the time required under Reg. section 20.2010-2(a)(1):
4. the election is made on a complete and properly prepared Form 706 that is filed on or before the second anniversary of the decedent’s date of death; and
5. the following statement appears at the top of the Form 706 – “FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER SECTION 2010(c)(5)(A)”.

The following should be noted:

* + - Relief under Rev. Proc. 2017-34 is not available if a return was filed.
    - If a return was not filed within two years of a decedent’s death, relief may still be available by filing a letter ruling request asking for 9100 relief. If two years have not passed since the decedent’s death, a letter ruling will not be issued and the exclusive relief is the procedure contained in Rev. Proc. 2017-34.
    - Relief under Rev. Proc. 2017-34 is null and void if it is later determined that a return was required to be filed under Section 6018(a).

When a portability election has been made, Section 2010(c)(5)(B) allows the IRS to re-examine the first estate tax return, even after the statute of limitations has run, for the limited purpose of determining the correct DSUE amount available to the surviving spouse. If that statute of limitations has run, the IRS is permitted in such re-examination only to reduce or eliminate the surviving spouse’s DSUE amount. It cannot, for example, assess additional estate tax with respect to the first return. In Estate of *Sower v. Commissioner*, 149 T.C. No. 11 (Sept. 11, 2017), a surviving spouse’s executor resisted the re-examination of the first return, asserting among other things, that (i) the first estate had received a closing letter, (ii) this was an “impermissible second examination”, and (iii) it was an unconstitutional denial of due process. Not surprisingly, the Tax Court rejected all these arguments, allowed the re-examination, and reduced the DSUE amount on the basis of the findings of that examination.

In *In re Vose*, 390 P.3d 238 (Okla. 2017) (January 17, 2017), a unanimous Oklahoma Supreme Court held that the executor has a duty to make an available portability election and may not refuse a surviving spouse’s request to do so.

Mr. Vose was the surviving spouse of the decedent and the executor was (not surprisingly) a child of the decedent from a prior marriage. Mr. Vose had signed a prenuptial agreement in 2006 (predating portability) waiving any rights to a share of the estate, and had no interest in the estate other than the potential benefit of the portability election.

Despite having no other interest in the estate, the court wrote that the availability of a portability election under Section 2010 of the Internal Revenue Code “grants Vose a potential interest in a part of Decedent’s estate … . Vose may have a pecuniary interest as the surviving spouse in the portability of the DSUE, independent of his ability to take as an heir.” The court found that the prenuptial agreement did not bar Mr. Vose from claiming an interest in the DSUE because it predated the existence of portability in the federal tax code.

The executor argued that, because the DSUE is valuable only to Vose, while at the same time being an estate asset under [the executor’s] complete control, he should be allowed to demand consideration from Mr. Vose in exchange for making the election. The court rejected that argument because, indeed, the only person with an interest in and ability to use the DSUE is the surviving spouse. The court noted that Mr. Vose agreed to pay for the preparation of the return necessary to make the election.

Presumably, while Mr. Vose’s prenuptial agreement predated portability, the inference is that a prenuptial agreement could now address the issue (to require the filing of the election). Also, it is possible that any future court’s determination of whether a portability return must be filed will be conditioned upon an agreement by the surviving spouse to pay for it.

A blended family was also involved in *Walton v. Estate of Swisher*, 2014 WL 325666 (Ind. App. 2014), and the issue of what the portability election is worth to the surviving spouse, was addressed. Mary died in May 2011, leaving a $100,000 estate and a will that named her daughter Kathleen as personal representative. Four months later Kathleen (represented by counsel), entered into an agreement with Mary’s surviving husband Glenn under which Glenn waived his survivor’s allowance and paid Mary’s estate $5000, and the estate “agrees to relinquish any and all claims to any tax benefit or refunds” on any tax returns filed by Glenn, Mary, or Mary’s estate. The agreement was to be binding on the parties, their heirs and assigns. Glenn’s advisors then prepared a federal estate tax return for Mary’s estate that made a portability election. In March 2012, Kathleen filed a Closing Statement upon completion of the estate administration of Mary’s estate.

Shortly thereafter Kathleen, as personal representative of Mary’s estate, filed a claim for $500,000 against Glenn’s estate, contending that without additional compensation over the agreed-to $5000, Glenn’s estate would be unjustly enriched by reducing its tax obligation. Glenn’s estate contended that Kathleen had no standing to bring the action as personal representative because her mother’s estate had been closed. That is true, said the court, but Kathleen had standing as her mother’s heir.

Affirming the lower court’s ruling, the court held that the DSUE was a bargained-for tax benefit under the parties’ agreement for which Kathleen received consideration, and “she cannot now complain that she should have bargained for more”. Kathleen also contended that Glenn’s representatives violated the Indiana Rules of Professional Conduct when they failed to explain the tax consequences of her signing the Form 706 for Mary’s estate. The court pointed out that Glenn’s representatives did not have such a duty, as Kathleen was represented by her own counsel and Glenn’s counsel represented Glenn alone.

The spousal allowance in Indiana is $25,000 (Ind. Code section 29-1-4-1), so for a cost of $30,000 ($5000 payment + relinquishing the $25,000 spousal allowance) plus adviors’ fees and the cost of preparing Mary’s estate tax return, Glenn’s estate received an approximate $1,700,000 tax benefit (applicable credit amount of $1,730,800 for 2011, the year of Mary’s death less minimal use of the credit by Mary’s estate.).