Estate & Gift Tax Law Update

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ESTATE & GIFT TAX UPDATE

Adjusted figures for 2017.

Unified Credit. The basic exclusion amount for estate tax, and gift tax and GST tax exemptions are increased to $5,490,000.

Annual gift tax exclusion. The §2503 gift tax annual exclusion remains at $14,000.

Annual exclusion for gifts to a noncitizen spouse. The §2523(i)(2) annual gift tax exclusion for gifts made to a noncitizen spouse is increased to $149,000.

Special use valuation. The maximum value reduction allowable as a result of a §2032A special use valuation election for decedents dying in 2017 is increased to $1,120,000.

§6166 estate tax installment payments. The portion of the taxes being paid in installments that bears interest at the 2% rate is increased to $1,490,000.

Projected for 2018: $5,600,000 for the basic exclusion amount for estate tax, gift tax and GST tax exemptions.

Annual gift tax exclusion projected to increase to $15,000 for 2018.

CCA 201650017 (October 14, 2016)

The Chief Counsel for the IRS stated that if the taxpayer had a gross estate of more than $5 million, then no relief is available to the estate, even if the estate is nontaxable. The estate had an absolute obligation to file and having failed to do so within 9 months of date of death, the election for portability is missed.

Extension of Time to File a Portability Election.
There have been several Private Letter Rulings issued by the Service that grant estates that missed the deadline for filing a portability election additional time to file Form 706 to make a portability election. For example, **Ltr. 2017370004, June 5, 2017 and Ltr. 201737009, June 5, 2017.** These estates' values are less than the applicable exclusion amount in the years of the decedents' dates of deaths, including any taxable gifts made.

On June 26, 2017, the Service issued **Rev. Proc. 2017-34, 2017-1 C.B. 1282** which provides a simplified approach. Rev. Proc. 2017-34 provides an automatic extension until the later of (i) January 2, 2018, or (ii) two years after the decedent's death to file a Form 706 for the purpose of making a portability election. This only applies to estates that were not required for file a Federal Estate Tax Return. The executor needs to write on the top of the Form 706 "filed pursuant to Rev. Proc. 2017-34 to elect portability."

Revenue Procedure 2016-49, 2016-42 IRB 462 (9/27/2016)
In some cases, executors inadvertently make QTIP elections that are not necessary to reduce the estate tax liability to zero, either because the value of the estate is less than the applicable exclusion amount or because the executor makes the election for both the credit shelter trust and the marital trust. Generally, Rev. Proc. 2001-38 provided that the IRS will disregard the QTIP election and treat it as null and void in those cases. As a result, the property for which the QTIP election was made will not be included in the estate of the surviving spouse, the spouse will not be treated as making a gift of the property if the spouse disposes of the income interest with respect to the property, and the spouse will not be treated as the transferor for GST tax purposes with respect to the property.

With the availability of portability, however, an executor of a decedent's estate might wish to make a QTIP election, even if it is unnecessary to reduce the estate tax to zero, to increase the DSUE amount. Rev. Proc. 2001-38 is modified to provide that a QTIP election will not be treated as void when the executor of the estate made, or was considered to have made, the portability election under §2010.

Estate of Sower v. Commissioner, 149 T.C. No. 11 (2017).
Upon first spouse's death, the Return reported a deceased spousal unused exclusion of over $1 million. The IRS issued an Estate Closing Letter to the estate. Upon the surviving spouse's date of death, her estate filed a timely estate tax return claiming the DSUE from the first spouse's return. As a part of the surviving spouse's audit, the IRS redetermined the amount of the DSUE from the first spouse's return and reduced the amount because certain lifetime gifts were not taken into account when determining the DSUE. The surviving spouse's estate challenged the IRS's actions but the Tax Court ruled in the IRS's favor.

Estate of Powell v. Commissioner, 148 T.C. No. 18 (5/18/2017).
Nancy Powell was terminally ill with substantial cash and other marketable securities valued at $10 million. Her son, using a power of attorney granted to him by his mother, caused her living trust to transfer $10 million in assets to a newly formed limited partnership. In return, Nancy's living trust received a 99% limited partner interest. Her sons contributed 2 unsecured promissory notes for their 0.5% limited partner interests and the one son was the general partner.

Using the power of attorney, the son then had the living trust transfer its 99% limited partnership interest to a charitable lead annuity trust (CLAT). The CLAT then payed a fixed dollar amount to Nancy's private foundation for her life. At her death, the total amount of CLAT would pass to the two sons. Nancy passed away 7 days later. The assets were included in her estate. The case is a prime example of aggressive deathbed tax planning.

Both the majority and concurring opinions agreed that §2036(a)(2) applied to the facts such that the partnership assets were part of the taxable estate. The majority opinion reasoned that since (1) the decedent together with all the other partners could dissolve the partnership and (2) that the decedent could control the amount and timing of distributions, the value of the gross estate shall include the value of all of the property.

The majority opinion addresses how §2043 applies in light of §2036 for FLP cases. Many practicing attorneys have been concerned about the possibility of double-inclusion of a decedent's assets where the decedent would have to include the value of the partnership interest under §2033 and the value of the property transferred to the FLP. The majority opinion stated the gross estate includes both the value of the partnership interest ($8.5 million) under §2033 and the amount of the discount ($1.5 million) under §2035, 2036, and §2043. The $1.5 million comes from §2043 partial consideration rule, where the estate reduces the $10 million of contributed assets by the $8.5 million of limited partner interest in the FLP.

The majority opinion's §2043(a) analysis avoids double taxation of the same value if the assets have not appreciated (and because the decedent died only 7 days later, the parties stipulated that the contribution values were also the date of death values). But if the assets have appreciated, footnote 7 of the majority opinion acknowledges that "duplicative transfer tax" would apply because the date of death asset value is included in the gross estate under §2036 offset only by the date of contribution discounted value of the partnership interest. The date of death value of the LP interest would also be included under §2033, so all of the post-contribution appreciation of the assets would be included under §2036 and the discounted post-contribution appreciation would also be included under §2033. More value may be included in the gross estate than if the decedent had never contributed assets to the FLP.

Since neither party in Powell brought up the double-inclusion issue, the concurring opinion didn't understand why the majority formulated a more difficult two-step process anyway. Judge Lauber writing the concurring opinion stated that he believed the existing precedent is easier to enforce.

Estate of Eva Kollsman v. Commissioner, TC Memo 2017-40 (2/22/2017).
This case involved the valuation of two Brueghel paintings. The Decedent died in August 2005. Sotheby wrote to the Decedent's executor proposing terms for the sale of the Brueghel paintings at auction, and providing "preliminary estimates" of the sales price of $600,000 to $800,000 for Maypole and $100,000 to $150,000 for Orpheus. About a month later, Sotheby's sent the executor two documents. The first was a letter stating that the fair market value of Maypole was $500,000 and the fair market value of Orpheus was $100,000.

These values were reported by the executor on the estate tax return. The valuation was based on the appraiser's "firsthand inspection" but did not cite comparables or explain how the value was derived. The estimated sales prices in the Sotheby's consignment agreement were greater: $600,000 to $800,000 for Maypole and $100,000 to $150,000 for Orpheus. At about the same time, the executor consulted with a framing and restoration service to have the paintings reframed and to have surface dirt removed.

The Maypole painting was sold by Sotheby's for $2,100,000. The Orpheus was not sold. The IRS issued a notice of deficiency against the estate, initially valuing the Maypole at $1,750,000 and the Orpheus at $300,000. The IRS later increased its valuations to $2,100,000 and $500,000 in an amended answer to the estate's petition in Tax Court. The estate bore the burden of proving that the values in the notice of deficiency were incorrect. The IRS bore the burden of proof with respect to the increased values and the increased deficiency asserted in its amended answer.

The IRS's expert, Mr. Cardile, identified comparable paintings by Pieter Breughel for Maypole and adjusted the values for their artistic quality, condition, provenance, and size. The court accepted the valuation of $2,100,000, but allowed a 5% discount for the risk of cleaning, for a resulting value of $1,995,000. Cardile also found comparables for the Orpheus painting, and adjusted them for similar factors. The court accepted the valuation of $500, 000, but allowed a 10% discount for the risk of cleaning and slight bowing, for a resulting value of $375,000.

Estate of James Heller v. Commissioner, 147 TC No. 11 (9/26/2016)
James Heller died on January 31, 2008. He owned a 99% interest in James Heller Family, LLC, which held only one asset: an account with Bernard L. Madoff Investment Securities, LLC.

After the Madoff Ponzi scheme became public, the remaining Madoff account became worthless. The estate filed the estate tax return on April 1, 2009, reporting a date of death value for the 99% interest in the LLC at $16,560,990. The estate also claimed a $5,175,990 theft loss deduction relating to the Madoff Ponzi scheme. The loss amount equaled the difference between the $16,560,990 value of the estate's interest in the LLC reported on the estate tax return and the estate's share of the amounts withdrawn from the Madoff account in 2008. The IRS determined that the estate was not entitled to the $5,175,990 theft loss deduction because the estate did not incur a theft loss during its settlement.

The Tax Court first noted that whether an estate is entitled to a §2054 theft loss deduction relating to property held by an LLC was an issue of first impression, and was not addressed by either regulations or legislative history. The court noted that while the LLC lost its sole asset as a result of the Ponzi scheme, the estate, during its settlement, also incurred a loss because the value of its interest in the LLC decreased from $5,175,990 to zero. The nexus between the theft and the value of the estate's LLC interest is direct and indisputable. The loss suffered by the estate relates directly to its LLC interest, the worthlessness of which arose from the theft. The court held that the estate was entitled to a section 2054 deduction relating to its LLC interest.

Estate of Victoria Dieringer v. Commissioner, 146 TC 117 (3/30/2016)
Mrs. Dieringer died in April 2009. At the time of her death, she, together with other family members, owned Dieringer Properties, Inc., a closely held real property management corporation that managed commercial and residential properties in Portland, Oregon.

She owned 425 voting shares (81% of the voting shares) and 7,736.5 nonvoting shares (84% of the nonvoting shares). The voting shares were valued on her estate tax return at $1,824 per share, and the nonvoting shares were valued at $1,733 per share, for a total of $14,182,471. The fair market values included no discount for the voting shares and only a 5% discount for the nonvoting shares. Pursuant to her estate plan, all of the shares would be distributed to a private foundation at her death.

Pursuant to a redemption agreement, all of the estate's voting shares and 5,600.5 nonvoting shares were redeemed in exchange for two promissory notes, at a price to be determined by an independent appraisal. For purposes of the redemption, the voting shares were valued at $916 per share and the nonvoting shares were valued at $870 per share. The appraiser applied discounts of 15% for lack of control and 35% for lack of marketability, plus an additional 5% discount for the nonvoting shares for lack of voting power. The executor testified that the share price was also reduced from the April 2009 value because of a declining real market. The redemption was approved retroactively by the local circuit court, and promissory notes for $5,218,462 were issued by the company. The estate claimed a charitable deduction of $14,182,471 for the Company's shares included in the estate.

The IRS argued that the value of the charitable deduction should reflect the value of the property that actually passed to the foundation ($5.2 million of promissory notes rather than $14.2 million of stock) and take into account the post-death redemption of the shares for a significantly lesser amount. The Tax Court noted that the appraiser who determined the fair market value of the stock for purposes of the redemption was instructed by the Company to value the stock as a minority interest, even though the shares represented over 60% of the equity and 80% of the vote.

The court found that decedent's majority interest was redeemed for a fraction of its value without any independent and outside accountability. As a result, the estate was not entitled to a charitable deduction for the full fair market value of the stock as of the date of death.

PLR 201647001 (11/18/2016)

The Grantors created a grantor trust. The Grantors allocated GST exemption to the transfers to Trust so that the Trust has an inclusion ratio of zero for GST tax purposes. Due to unforeseen and unanticipated circumstances, payment by the Grantors of the income taxes on Trust's income became unduly burdensome. The Independent Trustee sought court approval to modify the Trust, contingent on obtaining a favorable ruling from the IRS.

Under state law, a court may modify the administrative terms of a trust if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration, or if, because of circumstances not anticipated by the settlor, modification will further the settlor's stated purpose or, if there is no stated purpose, the settlor's probable intention.

The modified Trust provides that Grantors will not be entitled to any right of reimbursement under any applicable law for their tax liability. If in any calendar year, the Trust is treated as a grantor trust as to either Grantor, an Independent Trustee may from time to time, distribute to a Grantor so much of the income or principal of the trust as may be sufficient to satisfy all or part of the Grantor's personal income tax liability attributable to the inclusion of all or part of the trust's income in the Grantor's taxable income in excess of the taxes that would have been imposed if the Trust's income, gains, losses and deductions had not been included in the determination of the Grantor's income tax liability. Assuming there is no understanding between either Grantor and the Independent Trustee regarding the Independent Trustee's exercise of discretion, the Independent Trustee's discretion to satisfy either of the Grantor's obligation would not alone cause the inclusion of the trust in either of the Grantor's gross estate for federal estate tax purposes.

The IRS further ruled that the proposed modifications were administrative in nature and would not be considered to shift a beneficial interest to a lower generation or extend the time for vesting of any beneficial interest in the trust. Therefore, the modifications would not cause the Trust to lose its zero inclusion ratio for GST purposes.

PLR 201737001, June 14, 2017 and PLR 201737008, June 14, 2017

Grantor created irrevocable trust to benefit the grantor's spouse and descendants. One provision of the Trust was entitled "Special Power of Appointment.' However, the language was such that it created general power of appointment in favor of the spouse. The grantor filed a petition with state court to reform the language such that the power of appointment be construed as a special power of appointment. The state court entered such an order.

After the state court order was entered, the grantor requested the private letter rulings which were granted by the Service. The Service held that after the modification of the power of appointment language, the spouse's power of appointment was not a general power of appointment and the property subject to the power would not be included in the spouse's gross estate and the modification of the trust was not a release of a general power of appointment for gift tax purposes.

Estate of Edward Beyer v. Commissioner, TC Memo 2016-183 (9/29/2016).

Edward Beyer created a family limited partnership in October 2003. One revocable trust was the sole initial general partner, and a second revocable trust was the sole initial limited partner. At the time of formation, Mr. Beyer intended to create an irrevocable trust at a later time, which would eventually purchase the limited partnership interest from the Trust.

The limited partnership agreement contained a laundry list of 28 separate purposes. The partnership was funded in April 2004 with about $41 million of marketable securities. In December 2005, the Trust sold its 99% LP interest to the irrevocable trust in exchange for a $20,866,725 promissory note, bearing interest at 4.4%. At the time of the sale, the irrevocable trust had only $10 of other assets. The note was secured by a security agreement, giving Mr. Beyer a security interest in all "accounts and accounts receivable, . . . and all other tangible personal property" of the irrevocable trust.

After the sale, the Trust was no longer a partner. Nevertheless, the partnership made several distributions to the trust or Mr. Beyer. He received $660,000 in April 2006 for gift tax payments. Interest payments on the promissory note owned by the irrevocable trust were paid directly from the partnership account. After Mr. Beyer's death, checks were drawn on the partnership account to pay administration expenses and over $9.3 million of estate taxes.

Generally, capital accounts and partnership records of the Limited Partnership were not accurately kept. The general partner did not receive its 1% of distributions until a catchup distribution was made in 2009. The IRS asserted that the assets held by the partnership were includible in Mr. Beyer's gross estate under §2036(a). Section 2036(a) has an exception for any transfer of property which is a "bona fide sale for an adequate and full consideration in money or money's worth." The bona fide sale exception is satisfied where there is a "legitimate and significant nontax reason" for creating the family limited partnership.

The estate failed to demonstrate that Mr. Beyer received an adequate and full consideration in money or money's worth for his transfer to the partnership, because the capital accounts were no properly maintained which credited contributions proportionately to the contributing partners, and distributions were made on a non-pro rata basis. In addition, although Mr. Beyer had retained $4 million outside of the partnership when it was formed, he shortly thereafter made a gift of $2,500,000 to his nephews, leaving only $1,500,000. The court found that he had not retained sufficient assets outside the partnership to meet his anticipated financial obligations, including gift and estate taxes. The estate argued that if the partnership assets were includible under §2036(a), the assets held in the RMA should be discounted to account for restrictions under the RMA agreement. The Tax Court disallowed any discount.

Estate of Natale Giustina v. Commissioner, TC Memo 2016-114 (6/13/2016)
At his death, Natale Giustina owned a 41.128% limited partner interest in Giustina Land & Timber Co. The company owned 47,939 acres of actively managed timberland in Oregon. The value of the estate's interest in Giustina Land & Timber was reported as $12,657,500 on the estate tax return.

The IRS challenged the valuation and issued a notice of deficiency based on a value of $35,710,000. The estate and the IRS agreed that the value of the company's timberlands was $143 million. The Tax Court previously had examined in detail the valuation reports produced by both the estate's and the IRS's experts, including the weight given to the discounted cash flow and net asset value valuation approaches.

The Tax Court concluded that the value of the estate's interest was $27,454,000, based on an assumption that there was a 25% likelihood of liquidating the partnership, even though Natale was not a general partner and could not have unilaterally decided to liquidate. The Ninth Circuit disagreed with the Tax Court's assumption and held that it was a clear error to assign a 25% likelihood to the liquidation of the business. The Ninth Circuit remanded the case to the Tax Court to recalculate the value of the estate's interest based solely on the partnership's value as a going concern. On remand, the Tax Court reduced the value of the 41% partnership interest to $13,954,730.

The Ninth Circuit had also held that the Tax Court erred by failing to adequately explain its basis for cutting the company-specific risk premium determined by the estate's expert from 3.5% to 1.75%. The Tax Court explained that it had assumed that a hypothetical buyer would have been able to eliminate some of the partnership-specific risk associated with owning the 41% partnership interest, because the buyer could have been an entity owned by multiple owners, who each could have held a diverse portfolio outside of the timberlands investment. On remand, the Tax Court concluded that the hypothetical buyer must be a permissible transferee of a partnership interest. Transfers were permitted only to another limited partner or to a person approved by the general partners. The Tax Court concluded that it was not likely that a multiple owner investment entity would have been approved as a buyer, and therefore a hypothetical buyer would not have been able to diversify the partnership specific risk as they had originally assumed. As a result, the 3.5% discount was allowed in full.

Notice 2017-15, 2017-6 IRB 783 (1/17/2017)
After the *Windsor* and *Obergefell* cases*,* the IRS issued Regulation §301.7701-18, defining terms related to marriage for federal tax purposes. Notice 2017-15 provides special administrative procedures allowing certain taxpayers and the executors of certain taxpayers' estates to recalculate a taxpayer's remaining applicable exclusion amount and remaining GST exemption to the extent an allocation was made to certain transfers made while the taxpayer was married to a person of the same sex. Same sex spouses will now be assigned to the same generation, and descendants of those spouses will be assigned to a generation based on familial relationships rather than age.

The taxpayer should include a statement at the top of the Form 706 or Form 709 that the return is "FILED PURSUANT TO NOTICE 2017-15". As applicable, the taxpayer must attach a statement supporting the claim for the marital deduction and detailing the recalculation of the taxpayer's remaining applicable exclusion amount, or stating that the allocation of GST exemption in a prior year is void and computing the allocation of GST exemption. If a QTIP or QDOT election is required in order to obtain the marital deduction, 9100 relief must be separately requested.

PLR 201615004 (4/8/16) Termination of GPA Marital Trust.
Decedent's revocable trust created Trust B at his death for the benefit of the decedent's children from a prior marriage and their descendants. The trust also created two marital trusts for his Spouse: a general power of appointment marital trust (Trust C), which granted her a testamentary general power of appointment to decedent's issue or her estate, and a QTIP marital trust (Trust C-1). The estate mistakenly made a QTIP election for both Trust C and C-1.

The Spouse and children entered into a settlement agreement to terminate both of the marital trusts, pay cash and securities to the Spouse, pay any of the Spouse's income tax liability on the distribution, pay any gift tax liability with respect to the termination, and distribute the balance to Trust B. The termination of the Spouse's interest in the GPA marital trust was a release of her testamentary general power of appointment. The value of the Trust C property in excess of the consideration Spouse received was a taxable gift. In addition, Spouse was treated as the transferor of Trust C for GST purposes to the extent that she made a taxable gift.

Estate of Clara Morrissette v. Commissioner, 147 TC 171 (4/13/2016).
Clara Morrissette established three dynasty trusts for her three sons, Arthur, Donald, and Kenneth (Dynasty Trusts). Clara Morrissette's revocable trust (CMM Trust), the three sons, the Dynasty Trusts, and other shareholders of Interstate Group entered into a buy-sell agreement that provided for the purchase of the shares held by each son and his Dynasty Trust upon that son's death.

To fund the buyout, each Dynasty Trust purchased two universal life policies – one on each other brother. To fund the purchase of the policies, each Dynasty Trust and the CMM Trust entered into split-dollar life insurance arrangements. The CMM Trust contributed almost $10 million to each Dynasty Trust. The Dynasty Trusts then used that money to pay a lump-sum premium on each policy to maintain that policy for the insured's projected life expectancy. Under the split-dollar agreements, upon the death of an insured the CMM Trust would receive a portion of the death benefit from the policy insuring that person equal to the greater of (i) the cash surrender value (CSV) of that policy, or (ii) the aggregate premium payments on that policy.

From 2006 to 2009 Mrs. Morrissette reported gifts to the Dynasty Trusts totaling $637,000, using the economic benefit regime to value the gifts. The amount of each gift was the cost of the current life insurance protection as determined using IRS Table 2001 4, less the amount of each premium paid by the Dynasty Trusts.

Mrs. Morrissette died in September 2009. The value of the receivables from the Dynasty Trusts under the split dollar agreements reported on the estate tax return was $7,479,000. The IRS issued a notice of deficiency in the amount of $13,800,179 (plus a penalty of $2,760,036) for gift tax liability for 2006. The IRS determined that Mrs. Morrissette had failed to report total gifts of $29.9 million, the total amount of the policy premiums paid for the six split-dollar life insurance policies in 2006. The final regulations under §61 provide two mutually exclusive regimes for taxing split-dollar life insurance arrangements entered into after September 17, 2003, either the economic benefit regime or the loan regime.

Under this general rule, the Dynasty Trusts would be considered the owners of the policies and the loan regime would apply. An exception to the general rule provides that if the only economic benefit provided under the split-dollar life insurance arrangement to the donee is current life insurance protection, then the donor will be the deemed owner of the life insurance contract, and the economic benefit regime will apply. If the done receives any additional economic benefit, other than current life insurance protection, then the donee will be considered the owner and the loan regime will apply. The issue in this case was whether the lump-sum payment of premiums on the policies made indirectly by the CMM Trust generated any additional economic benefit other than current life insurance protection to the Dynasty Trusts.

The Tax Court found that there was no possibility of the Dynasty Trusts receiving any additional benefit because the CMM Trust would receive the greater of the aggregate premiums paid or the CSV of the policy. The IRS argued that the Dynasty Trusts had an interest in the CSV of the policies because under the terms of the CMM Trust, the receivables owed by the Dynasty Trusts would pass to the Dynasty Trusts on her death. The court determined that the Dynasty Trusts did not have current access to the CSV of the policies or a legally enforceable right to the CSV, because the CMM Trust was revocable by Mrs. Morrissette. Because the Dynasty Trusts received no additional economic benefit beyond that of current life insurance protection, the CMM Trust was the deemed owner of the life insurance contract and the economic benefit regime applied.

Estate of Edward Beyer v. Commissioner, TC Memo 2016-183 (9/29/2016)

In 2001 Edward Beyer created a 529 plan for ten family members and contributed $10,000 to each Section 529 account in December 2001 and $55,000 in January 2002. Mr. Beyer did not file a gift tax return for 2002 to elect to treat the $55,000 gifts in 2002 as having been made over 5 years.

In 2004, he created a 529 plan for eight additional family members, and contributed $11,000 to each in December 2004 and $55,000 in January 2005. Mr. Beyer filed a 2005 gift tax return, but did not report the gifts to the 529 plans. The estate tried to argue that although Mr. Beyer had not reported the gifts in 2002 and 2005 to the 529 plans, he intended to treat the gifts as having been made over 5 years, and as result, he did. The tax court found the argument unpersuasive, and held that the gifts to the 529 plans increased his taxable gifts in 2002 and 2005.

William Cavallaro v. Commissioner, 118 AFTR 2d 2016-6684 (1st Cir. 11/18/2016), affirming in part, reversing in part, and remanding TC Memo 2014-189 (9/17/2014)
In 1979 Mr. and Mrs. Cavallaro started Knight Tool Co., a contract manufacturing company that made specialized, custom tools and machine parts for other companies, primarily in the defense, aerospace and industrial industries. The Cavallaros' three sons also worked in the family business. In 1982 Mr. Cavallaro and his son Ken found an opportunity to create and produce on a mass basis a computerized liquid-dispensing machine for use in the production of computer circuit boards. Mr. Cavallaro and Ken developed the machine with the assistance of Knight employees and called the machine CAM/ALOT. In 1987 the three sons incorporated Camelot Systems, Inc. ("Camelot"), a business dedicated to selling the CAM/ALOT machines, which would be produced by Knight. However, there was no evidence that any intellectual property rights related to the CAM/A LOT machine had been transferred from Knight to Camelot.

A key issue in the case was the relationship between the two-family companies. The Cavallaros' position was that Camelot was the owner of the machine technology and Knight produced the CAM/ALOT machines for Camelot as a contractor as it did with its other third-party customers. The IRS's position was that Knight manufactured the machines and Camelot sold them to third parties. In 1995 Knight and Camelot merged, with Camelot as the surviving company.

Each company was valued by Ernst & Young, using the assumption that the CAM/ALOT technology resided with Camelot, and not Knight. Camelot was sold in 1996 for $57 million, with about $11 million in proceeds going to the parents, and $46 million going to the sons. The IRS initially determined that the pre-merger value of Camelot was $0, so that the parents had made a taxable gift of $46 million upon the merger. By the time of trial, the IRS's expert determined that the combined value of the companies was $64.5 million, Knight's share was 65% or $41.9 million, so that the gift was 46% of the total value, or $29.6 million.

The tax court had noted that the IRS's notice of deficiency was presumed to be correct, and the taxpayers had the burden of proof. Because the taxpayers' appraisals of the companies assumed that the CAM/ALOT technology was owned by Camelot, the tax court concluded that their appraisals had to be disregarded completely and they had not met their burden of proof. As a result, the tax court adopted the IRS's value of the companies, although noting that it was also flawed.

On appeal, the First Circuit agreed that the value shown in the IRS's deficiency noticed was presumed to be correct and that the Cavallaros' had the burden of proof to show by the preponderance of the evidence that the value was incorrect. However, the Tax Court was incorrect in its conclusion that the Cavallaros also had the burden of proof to show the proper amount of their tax liability. The Tax Court had refused to allow the taxpayers to challenge the valuation methodology used by the IRS's appraiser after concluding that the taxpayer's experts' appraisals were fatally flawed. However, they should have had the opportunity to rebut the report of the IRS's appraiser. If the taxpayer was successful, the Tax Court should have determined for itself the proper value rather than simply relying on the IRS's position.

CCA 201643020 (10/21/2016)
Taxpayer filed a gift tax return that reported the gifts made in the current tax year, but did not report taxable gifts from prior years. This resulted in an under assessment of the gift tax due, because the tax was calculated at a lower rate. Because the gift made in the current year was properly reported, the statute of limitations for assessing gift tax on that gift was not extended by the failure to report prior taxable gifts. The rules under Section 6501(c)(9) for extending the statute of limitations for assessing gift tax did not apply to the current years' gift, because that gift was reported and it was adequately disclosed.

Section 2704 Proposed Regulations IRS issues proposed regulations under Sections 2701 and 2704.
On August 2, 2016, Treasury issued proposed regulations under §§2701 and 2704. The regulations provide new rules for the valuation of equity interests in family-controlled entities for all transfer tax purposes. The effect would be to increase the value of family-controlled entity interests for gift, estate, and GST tax purposes, by valuing interests based on the net asset value or liquidation of the entire entity, rather than the actual fair market value of the interests. The proposed regulations would create an additional category of restrictions ("disregarded restrictions") that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family.

Many of the new rules are controversial, and there is now little expectation that the rules will be finalized in the near future.

PLR 201633023 (8/12/2016)
Prior to September 25, 1985, Grandfather created an irrevocable trust for the benefit of his grandchildren. A separate share was created for each grandchild. The trustees have the power to distribute income and principal to a grandchild from their share as they may determine. A grandchild may withdraw half of their share at age 25, and the share will terminate and be distributed to the grandchild when they reach age 35. If the grandchild dies before reaching age 35, their share will be distributed among Grandfather's issue (other than the grandchild) or spouses of issue as the grandchild appoints, otherwise to the grandchild's issue, or if none, to the issue of the child who is the grandchild's parent, or if none, to Grandfather's issue, or if none, to Charity.

One grandchild has cognitive deficits and other disabilities, and does not have the capacity to exercise the power of appointment over his share. The trustees wish to modify the trust terms as they apply to the disabled grandchild. State law permits a court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust. In addition, state law permits a court to modify the administrative terms of a trust if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration. The IRS ruled that the trust would remain exempt from the application of GST tax after the modifications took effect.

PLR 201641020 (10/7/16)
Prior to September 25, 1985, Settlors created an irrevocable GST exempt trust for the primary benefit of their daughters, Daughter 1 and Daughter 2. The trustee may, in his absolute discretion, pay income or principal of the trust to Daughters. The trust will continue for the life of the Daughters and upon the death of the last to die, the trustee will distribute all the remaining trust property to the then surviving children of Daughters. Daughters are currently the co-trustees of the trust. At the death of one of the Daughters, the surviving daughter will become the sole trustee and sole current beneficiary of the trust. Daughters were concerned that the surviving daughter may be deemed to have a general power of appointment.

Daughters propose to jointly resign as trustees and petition a state court to name two independent successor co-trustees who are not related or subordinate to either Daughter (X and Y) and to approve an amendment to the successor trustee provisions. The proposed amendments to the successor trustee provisions would provide that if X ceases to act as a trustee, Daughter 1 shall appoint a successor trustee who is not related or subordinate to her. Similarly, if Y ceases to act as a trustee, Daughter 2 shall appoint a successor trustee who is not related or subordinate to her.

The IRS ruled that the joint resignation of Daughters as co-trustees, the appointment of X and Y as successor trustees, and the court approval of the proposed amendment to the successor trustee provisions (1) will not cause either Daughter to be treated as having possessed, exercised or released a general power of appointment, (2) will not cause a Daughter's interest in the trust to be includible in her gross estate; and (3) will not cause the trust to lose its grandfathered GST tax exempt status.

PLR 201626016 (2/5/2016)
Prior to September 25, 1985, Grantor created an Irrevocable Trust, under which separate trusts were created for the Grantor's six children. Upon the death of a child, the child has a testamentary power of appointment to the child's spouse and the Grantor's descendants. Any unappointed property is to be allocated per stirpes among the child's descendants. Child 1 died without a surviving spouse or living descendants. Child 1's estate plan provides for all of her own assets to be used for animal welfare, and does not make any gifts to individuals or trusts for individuals. Child 1 did not exercise her testamentary power of appointment. The Irrevocable Trust is silent as to the disposition of the trust property in a child's trust if she dies without having exercised the power of appointment or leaving a spouse or descendants. Family members negotiated for two years and finally entered into a settlement agreement on the disposition of Child 1's trust, subject to state court approval and a favorable IRS ruling.

A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes. In this case, the parties were represented by separate counsel, and the agreement was the product of arm's length negotiations. The fact that the Irrevocable Trust did not contain a distribution provision in the event Child 1 died with no surviving spouse or descendants created a bona fide issue regarding the construction of the Irrevocable Trust. The IRS concluded that the terms of the settlement agreement represented a compromise between the positions of the litigating parties and reflected their assessments of the relative strengths of their positions, and therefore was within the range of reasonable outcomes. As a result, the termination of Child 1's trust and distribution of the trust assets pursuant to the terms of the settlement agreement would not result in GST tax.

PLR 201626016 (6/24/2016)
Trust was created prior to September 25, 1985. Trust currently has 18 beneficiaries, including 13 adults and 5 minors. The number of living beneficiaries and potential beneficiaries makes the administration of Trust unwieldy, and it is very difficult for the trustees to determine and weigh the relative needs of the beneficiaries and potential beneficiaries for the purpose of making all distributions. As a result, the time and cost expended in the administration of Trust has become disproportionate to the value of Trust and made it difficult to maintain the intended purposes of Trust. State law permits the termination of a trust by a court-approved nonjudicial settlement agreement, if the court concludes that the continuance of the trust is not necessary to achieve any clear material purpose of the trust. The court may order the trust property to be distributed as agreed by the parties or otherwise as the court determines to be equitable, consistent with the purpose of the trust.

The 13 adult beneficiaries of Trust entered into a nonjudicial settlement agreement, under which the entire trust property will be distributed in equal shares to 12 of the current adult beneficiaries, each of whom is either a grandchild or great-grandchild of the grantor. The remaining adult beneficiary and the five minor beneficiaries, each of whom is a great-great grandchild, will not receive a distribution.

The IRS ruled that the termination and distribution of the trust pursuant to the nonjudicial settlement agreement was a permissible modification because it did not shift any beneficial interest in the trust to a lower generation beneficiary of the trust.

PLRs 201634016 and 201634017 (8/19/2016)
Prior to September 25, 1985, Settlor created an irrevocable trust for the benefit of Beneficiary and Beneficiary's descendants. The trust is grandfathered from GST tax. The IRS ruled that the proposed modifications would not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person who held the beneficial interest prior to the modification. In addition, the modification did not extend the time for vesting of any beneficial interest in the trust beyond the original perpetuities period. Accordingly, the modification would not cause the trust to lose its GST exempt status.

Notice 2017-12, 2017-5 IRB 742 (1/6/2017)
The IRS changed its policy of issuing a closing letter for every estate tax return filed (other than returns filed solely to elect portability) as of June 1, 2015, and announced that it will no longer issue estate tax closing letters unless they are requested. Executors are directed to wait at least four months before making the request, to allow time for processing the return. The estate tax closing letter confirms that the estate tax return has either been accepted by the IRS as filed, or has been accepted after an adjustment by the IRS to which the estate has agreed. Thus, the receipt of an estate tax closing letter generally has indicated that the IRS examination of the estate tax return is closed, although it does not prevent the IRS from reopening or reexamining the estate tax return.

In lieu of an estate tax closing letter, the executor may obtain an account transcript, which reflects current account data, including the acceptance of the Form 706 and the date on which the examination was closed. An account transcript presents this account data by including transaction codes together with the descriptions of those codes. An account transcript that includes transaction
code "421" and the explanation "Closed examination of tax return" indicates that the IRS's examination of the estate tax return has been completed and that the IRS examination is closed. Thus, an account transcript showing a transaction code of "421" can serve as the functional equivalent of an estate tax closing letter.

New IRS Requirements for Release of Estate Tax Lien on Real Estate IRS
Section 6324(a) imposes an estate tax lien on a decedent's property, which attaches automatically at the decedent's death. If real estate included in the estate is sold, the purchaser may insist on that the estate obtain a Release of Lien from the IRS. Before June 2016, the executor could obtain a Release of Lien by filing a Form 4422 with the IRS and providing information about the estate and the real estate to be sold, including the sales contract and a proposed closing statement. An IRS agent reviewed the Form 4422 and generally issued the Release of Lien within a relatively short period. The IRS now appears to be insisting on additional requirements beyond those listed in the Form 4422. The IRS is now requesting an appraisal of the property to be sold. In addition, the IRS is now requiring that, for taxable estates, that the net sale proceeds be paid to Treasury or held in escrow with an escrow agent until an estate tax closing letter is issued.

Specht v. U.S., 118 AFTR 2d 2016-5906 (6th Cir. 9/22/2016), affirming 115 AFTR 2d 2015-357 (S.D. Ohio 1/6/2015)
Janice Specht was appointed as the executor of the estate of her cousin Virginia Escher, who died in December 2008 with an estate of approximately $12.5 million. Specht was 73 years old, had only a high school education, and had no experience serving as an executor. Specht hired Mary Backsman to help her administer the estate, since she was Escher's estate planning attorney. Unknown to Specht, Backsman was suffering from brain cancer.

Although the estate tax return was due in September 2009, it was not filed until January 2011, after Specht had retained new counsel. Backsman had informed Specht that an estate tax return would be due in September 2009, but Specht did not follow up with her on filing the return or an extension. Specht began to receive indications that the estate was not being handled properly by Backsman. She received multiple notices from the probate court, beginning before September 2009, that the estate had missed several deadlines. She received notice from the Ohio Department of Revenue in 2010 that the state tax return had not been filed. Friends of Virginia Escher who had engaged Backsman for other matters called Specht to inform her that Backsman was incompetent.

Specht finally hired a new attorney in November 2010, who prepared and filed the estate tax return. In this case, the estate unsuccessfully requested an abatement of the penalties assessed by the IRS for late filing of the return and late payment of the estate tax. Penalties can be waived under §6651(a) if the failure is "due to reasonable cause and not due to willful neglect." Reliance on the attorney to file an extension or file the return is not reasonable cause, even in a case like this where the executor appeared to be very unsophisticated in business and tax matters, the attorney on which she relied had a serious medical condition, and the executor "was the victim of staggeringly inadequate legal counsel."

On appeal to the Sixth Circuit, the estate argued that Specht's continued reliance on Backsman did not constitute willful neglect of her duty to file the estate tax return and pay the estate tax due. However, Specht had multiple warnings that should have put her on notice that Backsman was unable to fulfill her responsibilities as attorney for the estate. In addition, Specht's reliance on Backsman was not a substitute for meeting her non-delegable duty to ensure that the estate tax return was filed by the deadline.

Estate of Hake v. U.S., 119 AFTR 2d 2017-727 (DC Pa. 2/10/2017)
Esther Hake died on October 2, 2011. Two of her sons Ricky and Randy Hake were appointed as executors. The executors relied on long-time family attorneys, Douglas France and Jennifer Galloway, who had previously advised the family on business affairs. At her death, Mrs. Hake's five children were in the midst of an intrafamily dispute over her care and the value of her assets. Because of the need to resolve these issues during estate administration, France recommended extending the period for filing the estate tax return and paying the estate tax for as long as possible.

Galloway prepared the Form 4768, seeking a six-month extension to file the return and a one year extension to pay the tax. The IRS approved the requests, but Galloway then mistakenly informed France, who then informed the executors, that the time for both filing the return and paying the tax were extended for one year. The executors paid the tax on February 12, 2013 (five months before it was due), and filed the return on July 2, 2013, when they had been told it was due. The IRS assessed a late filing penalty of about $200,000.

The court found that the executors' reliance on the attorneys' advice on the due date for the return constituted reasonable cause, based on the court's view of the difficulty in determining the correct due date in what it described as "a specific, unusual, and narrowly defined set of facts." The court found that "with respect to payment and filing deadlines, the legal terrain requires a subtle multifaceted analysis. First, one must determine the initial filing and payment deadlines. Next one must negotiate a series of deadline extension rules. Some of these extensions are automatic; others are discretionary. Further, one must be alert to the fact that the application of these differing rules can lead to different deadlines for payment and filing. Finally, one must remain mindful of the fact that the filing rules themselves change depending upon the residency status of the executors."

The court found that executors' reliance on the advice of the attorneys with respect to the due date for the return was "objectively reasonable" due to the difficulty in determining the extended due date. In addition, the executors were careful to ensure that the estate tax was paid timely, and even paid the tax several months before it was due. The court held that the executors had exercised "ordinary business care and prudence" in relying upon their attorney's erroneous advice, and that the late filing penalty should be waived.

U.S. v. Estate of Espinor, 118 AFTR 2d 2016-5479 (D. CA 8/11/2016)
Cipriano Espinor died in 2004. On his death, Michael Espinor and Toni Espinor Hicks were appointed as co-executors. His will contained a pour-over clause directing that residuary assets were to be transferred into a Family Trust. Michael Espinor and Toni Hicks also were the successor co-trustees after Espinor's death. The total estate tax liability was $1,586,551. The executors elected to defer $622,563 for five years, and pay the remaining tax liability in ten installments. In 2012, the estate was in default under the installment agreement, and the IRS sent a notice and demand for payment for $621,850, which was the remaining amount due.

As executors and trustees, Michael Espinor and Toni Hicks made multiple distributions to themselves and other beneficiaries from the estate and trust assets, at a time when the estate did not have sufficient assets to pay its outstanding liabilities, including estate taxes. The Federal priority statute provides that when the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor, a claim of the U.S. government must be paid first. An executor who pays any part of a debt of the person or estate or distributes property to a beneficiary of the estate before paying a claim of the government is liable to the extent of the payment for unpaid claims of the government. Under §6901, the executor is personally liable for the unpaid claims of the United States to the extent of a distribution from the estate when (1) the executor distributed assets of the estate; (2) the estate was insolvent at the time of the distribution or the distribution rendered the estate insolvent; and (3) the executor had notice of the government's claim.

Michael Espinor and Toni Hicks, as co-executors and cotrustees, had distributed property of the estate prior to fully paying the federal estate tax liabilities, and were not discharged from personal responsibility under 26 U.S.C. §2204. Therefore, they were jointly and severally liable for the full amount of unpaid federal estate taxes. They were also each jointly liable as individual transferee for the value of the vehicles and cash distributed to them. Richard Espinor, John Espinor, Pauline DiBattista, and S&P Sheet Metal were each jointly liable as an individual transferee, for the value of assets distributed to each of them respectively as a beneficiary.

U.S. v. Johnson, 118 AFTR 2d 2016-6781 (D. Utah 12/1/2016)
Anna Smith died on September 2, 1991. Two of her four children Mary Carol Johnson and James Smith were named as the personal representatives of her estate and the trustees of her revocable trust. The trustees filed the estate tax return on June 1, 1992, showing $6,631,000 of federal estate tax due.

The estate elected to defer payment under §6166 of a portion of the estate tax attributable to closely held shares in the State Line Hotel, which represented about 70% of the value of the estate. In December 1992, the trustees distributed all of the remaining trust assets to the four children and entered into a distribution agreement under which each child agreed to pay his or her share of any increase in the estate tax due if the return were to be audited. The distribution was necessary because the hotel held a gaming license, and Nevada gambling law limited the ability of a trust to own stock in a casino.

In August 1997, the executors provided the IRS with an executed Agreement to Special Lien Under Section 6324A signed by all four children and additional information about the State Line Hotel stock requested by the IRS. The agreement restricted the sale of the State Line Hotel stock while the lien on the stock was in effect. Based on the 1996 Tax Court settlement, the offered shares of stock had a total value of $6,092,578. Because the unpaid balance of the tax assessment was then $1,899,970 and the amount of security needed was $2,192,365, the IRS agent Colleen Girard believed a special lien against the stock would adequately secure the liability for the remainder of the §6166 election.

However, the agent notified the executors that IRS District Counsel had advised that closely held stock should not be accepted as collateral by the IRS. The executors' counsel responded that "if an election is made under §6324A and the identified property can be expected to survive the period of deferral, the requirements of the statute have been met and the application of the special lien is mandatory." The IRS agent and the executors agreed to revisit the issue again in two years, but nothing was done.

In January 2002, the hotel filed for bankruptcy, and the bankruptcy court approved the sale of all the hotel's assets to a third party. The children received no value for their hotel shares received from the estate. In 2003, the estate defaulted on its federal estate tax liability, after having paid $5,000,000 of the total $6,872,000 due. In 2005, the IRS sent a notice and demand for payment of the tax liability to the estate and the personal representatives. First, the court reconsidered whether the Mary Carol Johnson and James Smith, as trustees of Anna Smith's revocable trust, were liable for the estate tax as a transferee pursuant to §6324(a)(2).

Section 6324(a)(2) imputes personal liability for federal estate taxes to certain individuals who receive property from an estate at the time of a decedent's death. The court concluded that the assets of the revocable trust were includible in the gross estate under §2033 because the decedent had beneficial ownership in the trust property at her death. Therefore, the trustees were not "transferees" for purposes of §6324.

Second, the court held that the executors and trustees had furnished a valid §6324A special lien. Section 6324A is a taxpayer election, and the government is not authorized to reject the election if its requirements are satisfied. In this case the executors had met the requirements that (1) the executors make an election by applying to the IRS, (2) an agreement for special lien be signed by all parties with an interest in the property stating the amount of the lien and the fair market value of the property, and (3) the lien property can be expected to survive the §6166 deferral period. The IRS could not reject the collateral offered for the special lien simply because it would prefer more marketable collateral. As a result, the executors had discharged their personal liability and were not personally liable.

U.S. v. Spoor, 118 AFTR 2d 2016-6018 (11th Cir. 10/4/2016)
Louise Gallagher died on July 5, 2004, owning 39,700 units in Paxton Media Group, LLC, a privately held and family-owned newspaper publishing company. The estate made a §6166 election to defer and pay its estate tax liability in ten equal installments. The estate made tax payments of about $8.4 million through 2008.

In August 2010, the estate agreed to the creation of a special deferred estate tax lien on the Paxton Media Group units pursuant to §6324A. By 2012 the value of the Paxton Media Group units had become less than the unpaid portion of the deferred tax and interest. The IRS demanded additional collateral from the estate, which the estate was unable to provide. The IRS then accelerated the remaining deferred tax obligations. As of September 2013, the remaining estate tax, penalties, and interest were about $10.4 million, and the value of the Paxton Media Group units owned by the estate had fallen to approximately $2 million.

The executor had claimed a $1,086,265 deduction on the estate tax return for his executor's fee, and about $486,000 of his fee was still unpaid. The executor maintained that his claim, as an administration expense, took priority over the government's tax liens. The Eleventh Circuit held that rules are different for the lien under §6324 that attaches to all assets in the gross estate and a special lien under §6324A.

The property subject to the special lien, which has been identified by the executor and is limited in value to the amount of the deferred estate tax plus interest, is not subject to claims for administration expenses before the estate tax is paid.

Estate of Backemeyer v. Commissioner, 147 Tax Court 17 (12/8/2016).
Farmer in Nebraska prepaid crop inputs in 2010. He deducted the cost of the crop inputs on his 2010 income tax return. He died in March 2011 and his property was left to his surviving spouse.

Surviving spouse continued the farming operation and used the crop inputs for the 2011 crop. She deducted the value of the crop inputs on her 2011 income tax return. The Service objected claiming that there was an impermissible double deduction.

The Tax Court rejected the Service's position and found no issue with the fact that both the decedent and surviving spouse were able to deduct the cost of the crop inputs. The Tax Court relied upon Section 1014(a) which provides for a step up in basis for such assets.
4821-5002-0433, v. 2