The Tax Adviser

Recent Developments in Estate Planning (Part 1)

By Justin Ransome, J.D., MBA, CPA; with contributions by David Kirk, Marianne Kayan, Ben Wright, Ashley Weyenberg, Caryn Gross, and Corey Glass

September 1, 2015

EXECUTIVE SUMMARY

- The Tax Court held that gifts to a trust with an *in terrorem* clause prohibiting the beneficiaries from challenging any distributions were nonetheless completed gifts.
- The Tax Court held that a trucking company had no goodwill that it could have transferred to its owner, and thus the owner did not make a gift of the goodwill to his sons' company.
- The IRS ruled that a taxpayer's power of appointment was not a general power of appointment and, therefore, the value of the trust property would not be included in the taxpayer's gross estate.
- The Ninth Circuit reversed and remanded a Tax Court decision over its valuation for estate tax purposes of an interest in a partnership that invested in timberland.
- The Tax Court addressed the question of when income will be considered permanently set aside for charitable purposes, allowing an estate to take a charitable contribution deduction for the income.

This is the first part of a two-part article examining developments in estate, gift, and trust income tax between June 2014 and May 2015. Part 1 discusses gift and estate tax developments. Part 2, which will be published in the October issue, covers trust taxation, President Barack Obama's estate and gift tax proposals, inflation adjustments for 2015, and the final regulations on the portability of a deceased spouse's unused exclusion amount.

Gift Tax

Annual Exclusion

In *Mikel*,[1] the Tax Court concluded that taxpayers were entitled to annual exclusions under Sec. 2503(b) for gifts made to a trust, despite the IRS's argument that the withdrawal powers were illusory and did not confer present interests in the property because the trust's *in terrorem* clause could deter beneficiaries from exercising their legal rights.

The taxpayers transferred real property to an irrevocable trust, the beneficiaries of which were the couple's children, lineal descendants, and their spouses. The trust made discretionary distributions for the beneficiaries' health, maintenance, education, and support. At the time of the gift, the trust had 60 beneficiaries, many of whom were under 18. The beneficiaries had a right to withdraw immediately some or all of a transfer to the trust within 30 days of the transfer, which was designed so that the transfers qualified for the Sec. 2503(b) annual gift tax exclusion. The trust also contained an *in terrorem* clause that excluded any beneficiary who filed a claim challenging the trustee's absolute discretion.

On their federal gift tax returns, the taxpayers claimed annual exclusions for the trust's 60 beneficiaries, each of whom possessed withdrawal rights, for total exclusions of $720,000 by each spouse. The IRS argued that the Mikels were not entitled to the annual exclusions because the beneficiaries did not receive a present interest (as required by Sec. 2503(b)). The IRS claimed that they did not receive a present interest because their withdrawal rights for the transfers were not "legally enforceable in practical terms" due to the *in terrorem* clause, and thus were not "unrestricted." The Tax Court clarified that, under the rule in *Crummey*,[2] "all that is necessary is to find that the demand could not be resisted."[3] Thus, the analysis is not whether the beneficiaries are likely to actually receive present enjoyment of the property but whether they have a legal right to demand payment from the trustee.

While the IRS has acquiesced to the position taken in *Crummey*, it has stated it would continue to disallow annual exclusions where there is no bona fide gift of a present interest in property, such as when there is a prearranged understanding not to withdraw, or when the exercise of withdrawal rights would result in adverse consequences to the beneficiaries. Consistent with this position, the IRS argued that the withdrawal rights were illusory because any attempt to enforce the right legally would result in adverse consequences under the *in terrorem* clause.

The Tax Court disagreed. Instead, the court viewed the *in terrorem* clause as consistent with the trust's overall intent—to provide absolute discretion for the trustee to make distributions. First, the court noted that the *in terrorem* clause prevents suits "challenging a distribution" and that a suit to compel the trustee to honor a timely withdrawal would not be covered by that language. Second, the provision was intended to ensure that no beneficiary challenges discretionary distributions made to other beneficiaries and that the right to withdraw is not a discretionary distribution. Accordingly, the court held that the beneficiaries' withdrawal rights could not be legally resisted and were both literally and practically available such that a present interest in the property was created and the annual exclusions were proper.

Observation: Withdrawal powers have become common fixtures in modern estate planning, with relatively little IRS interference. However, as this case makes clear, the IRS will still challenge annual exclusions if it believes that there has been no bona fide gift of a present interest because the withdrawal right is illusory. Thus, when drafting and administering a trust with withdrawal provisions, it is imperative to ensure that the rights are in substance what they purport to be in form.

Sec. 2701

In Chief Counsel Advice 201442053, the IRS ruled that the recapitalization of a limited liability company (LLC) was a transfer from a donor to her two sons under Sec. 2701, constituting a gift for gift tax purposes.

The donor and her two sons formed an LLC, the sole asset of which was real property the donor contributed. Under the terms of the operating agreement, each member's capital account was credited with the amount of that member's capital contribution, with profits and losses allocated based on that member's pro rata interest. Soon after formation, the donor gifted LLC membership interests to her sons and grandchildren. Later, the LLC was recapitalized. In exchange for the two sons' agreement to manage the company, the operating agreement was amended to provide that all future profits and losses, including gains attributable to company assets, would be allocated between them equally. After the recapitalization, the donor's and the grandchildren's equity interests were based solely on their capital account balances as they existed immediately before the transaction. As a result, all future income and appreciation in the LLC inured solely to the two sons' benefit, instead of pro rata based on percentage of ownership.

Sec. 2701 provides special valuation rules to determine the amount of a gift when an individual transfers an equity interest in a family-controlled corporation or partnership to another family member, even if the transfer is for full and adequate consideration. This section applies to a recapitalization of a corporation or partnership if the transferor holding an "applicable retained interest" before the redemption surrenders an equity interest that is junior to the retained interest and receives property other than the retained interest. An "applicable retained interest" includes any equity interest in a controlled entity for which there is a distribution right.

The IRS noted that the LLC was family controlled and that the donor held an applicable retained interest (i.e., a distribution right) both before and after the recapitalization. Further, the IRS stated that the donor's interest, which was based on her existing capital account balance, was senior to the transferred interests, which carried only a right to distributions based on future profit and gain. In addition, the donor received property in the form of the agreement by the sons to manage the company. Consequently, the redemption fell under Sec. 2701 and, as such, the amount of the transferor's gift, if any, was determined using the subtraction method contained in Regs. Sec. 25.2701-3.[4]

The regulations under Sec. 2701 use a very broad definition of "recapitalization." Merely changing the rights in an operating agreement will trigger application of the section.

Scrivener's Error

In Letter Ruling 201442042, the IRS ruled that it would allow a trust modified to correct a scrivener's error to have retroactive effect for federal tax purposes when the trust provision being modified was contrary to the settlor's original intentions. Specifically, the IRS was asked to rule that the modification would not cause the settlor to make an additional gift, would not result in the trust's assets being included in the settlor's estate, and would not cause any current or future beneficiary to make a gift to any other beneficiary.

The settlor created two grantor retained annuity trusts (GRATs) with different terms and remainders that passed to a trust created for his four children (Children's Trust). The drafting attorney mistakenly drafted the Children's Trust as a revocable trust, which defeated the purpose of creating the GRATs. In the following year, the settlor's accountant who prepared the GRAT's gift tax returns noticed the Children's Trust was revocable and told the settlor that the mistake would cause the gifts to the GRATs to be incomplete, the GRATs' remainder interests to be includible in the settlor's estate, and any distributions from the Children's Trust to the children to be taxable gifts.

When the settlor's accountant contacted the drafting attorney, he insisted the Children's Trust was properly executed and noted that the accountant lacked the necessary expertise to determine otherwise. The accountant memorialized his communications with the attorney and filed the settlor's gift tax returns showing completed gifts. Years later, the settlor's company hired a financial planner, who also noticed the mistake and contacted the drafting attorney who again insisted it was properly drafted. The financial planner engaged another attorney to provide an opinion, and that attorney confirmed the mistake and reformed the Children's Trust under state law.

The local court approved the modification to correct the mistake, conditioned upon the IRS's issuance of a favorable ruling that it would respect the court's retroactive reformation of the Children's Trust for federal gift and estate tax purposes.

In the letter ruling, the IRS cited *Bosch*,[5] stating that a lower state court decision was not binding on the IRS. Instead, the Service must apply what it finds to be state law (looking to decisions of the highest state court) after giving proper regard to the state trial court's determination. Thus, in effect, the IRS may be said to be "sitting as a state court." Looking to state law, the IRS recognized that the state had adopted Section 415 of the Uniform Trust Code, which allows reformation of trust terms retroactively to correct mistakes if proved by clear and convincing evidence.

Applying state law to the facts, the IRS found that the affidavits from the settlor, the drafting attorney, the accountant, the financial planner, and the second attorney, together with contemporaneous correspondence, memoranda, and emails, provided clear and convincing evidence that the revocable provision in the Children's Trust did not conform to the settlor's intent and was due to a scrivener's error. Concluding that the reformation was consistent with state law and effective retroactively, the IRS issued the rulings that the taxpayers had asked for.

In this case it was clear that the settlor did not intend to have the Children's Trust be a revocable trust because revocability would have sabotaged the estate planning benefits of the GRATs.

Trust reformations or modifications to correct scrivener's errors are one of the few instances in which the IRS will give retroactive effect to a trust reformation or modification. Usually, the IRS gives only prospective effect to trust reformations or modifications that have federal tax consequences. Because the government was not a party to the state court proceeding, it sat as the trier of fact and applied the standard in*Bosch*.

Indirect transfers

In *Bross Trucking*,[6] the Tax Court determined that a trucking company owned by a father did not distribute goodwill to the father who, in turn, did not transfer the goodwill to his sons' trucking company. Therefore, it determined that the father owed no gift tax.

In *Bross Trucking*, the father (Mr. Bross) owned a road construction company and also organized several other companies to provide services and equipment to his construction company. Mr. Bross was knowledgeable about the industry and developed important relationships with government entities and customers. Mr. Bross created Bross Trucking, a wholly owned company, to haul construction-related materials and equipment for road construction projects. Mr. Bross did not have an employment contract and never signed a noncompete agreement with Bross Trucking. All of Bross Trucking's main customers were companies owned by Bross family members. However, Bross Trucking did not have any formal written service agreements with its customers.

After facing a series of audits and investigations, Bross Trucking received an unsatisfactory safety rating. The business was in jeopardy because of heightened scrutiny from inspectors and faced the possibility of having its hauling authority revoked. In response to the negative attention and a possible shutdown, Bross Trucking ceased operations but remained a viable company to address any potential regulatory claims and obligations. To ensure continued trucking services to the Bross family businesses, Mr. Bross's three sons created LWK Trucking. Mr. Bross did not own and was not involved in managing LWK Trucking. Nothing was transferred from Bross Trucking to LWK Trucking, and LWK Trucking met all regulatory requirements on its own. However, about 50% of LWK Trucking's employees had worked for Bross Trucking.

LWK Trucking leased equipment from the same family business as Bross Trucking had while it was active. While LWK Trucking employed a similar business model as Bross Trucking, it expanded into other service lines. In the beginning, some of LWK Trucking's equipment still displayed Bross Trucking logos, which attracted heightened scrutiny from inspectors. Recognizing this problem, LWK Trucking used magnetic signs to cover Bross Trucking's logo until it could afford to have the trucks repainted.

Mr. Bross did not report any gifts for the year in which LWK Trucking began operations. The IRS issued notices of deficiency determining a distribution of corporate intangible assets to Mr. Bross and a subsequent transfer of these assets to his sons. The notice described these intangible assets with the following "attributes": (1) goodwill; (2) established revenue stream; (3) developed customer base; (4) transparency of the continuing operations between entities; (5) established workforce including independent contractors; and (6) continuing supplier relationships. The notice was unclear as to whether each "attribute" was a separate intangible asset or whether it was aggregated into goodwill as a whole. The key issue before the Tax Court was whether appreciated intangible assets were distributed by Bross Trucking to Mr. Bross who, in turn, made a gift of these assets to his sons.

Preliminarily, the Tax Court determined that the intangible asset that was being transferred was goodwill, which is often defined as the expectation of continued patronage. The competitive advantage that constitutes goodwill is represented by a number of property rights or interests. Accordingly, the court understood the "attributes" listed in the notice as separate interests or rights that the IRS believed made up Bross Trucking's goodwill.

After dispensing with the preliminary issue, the court held that there was no corporate distribution of goodwill from Bross Trucking to Mr. Bross because a business can distribute only corporate assets, not assets that it does not own. Specifically, a corporation cannot distribute intangible assets owned individually by its shareholders—in this case, Mr. Bross.

The court cited three reasons for its determination. First, Bross Trucking's goodwill was limited to a workforce in place. At the time, Bross Trucking had lost most of its goodwill and reputation with customers because of its unsatisfactory safety rating, the heightened regulatory scrutiny from inspectors, and the possibility of a forced shutdown. The Tax Court classified these circumstances as "the antithesis of goodwill," which was demonstrated by the need to hide the Bross name on LWK trucks. Bross Trucking could not expect continued patronage because its customers did not trust it and did not want to continue doing business with it. The court admitted that Bross Trucking employed several mechanics and administrative staff and may have held them in the corporation and transferred them to Mr. Bross, but indicated that the record was unclear on whether independent contractor drivers could be counted as part of Bross Trucking's workforce.

Second, nearly all the goodwill used by Bross Trucking was part of Mr. Bross's personal assets. Bross Trucking's established revenue stream, its developed customer base, and the "transparency of the continuing operations" were all a result of Mr. Bross's work in the road construction industry and the personal relationships he developed. A company does not have any corporate goodwill when all of the goodwill is attributable solely to an employee's personal ability.

Third, Mr. Bross did not transfer his goodwill to Bross Trucking partly because he did not have an employment contract or a noncompete agreement with the company. An employer has not received personal goodwill from an employee where an employer does not have a right to the employee's future services. Therefore, Mr. Bross's personal goodwill remained a personal asset separate from Bross Trucking's corporate assets.

The court concluded that because Mr. Bross did not give the intangible assets to his sons, he was not required to file a gift tax return. Because Bross Trucking did not distribute intangible assets to Mr. Bross, the court determined that the remaining issues were moot. The court also determined that Bross Trucking did not transfer intangible assets because what the IRS was alleging was transferred, Bross Trucking never owned—it was owned by Mr. Bross.

Observation: The IRS might assert a gift tax deficiency because Mr. Bross transferred his personal goodwill. The court certainly seems to say that is what was transferred.

Estate Tax

Power of Appointment

In Letter Ruling 201444003, the IRS ruled that a taxpayer's testamentary power of appointment (POA) over the principal and accumulated income of a trust was not a general POA, and the existence, exercise, failure to fully exercise, or partial or complete release of the POA would not cause the value of the trust property to be included in the taxpayer's gross estate.

The taxpayer was a beneficiary of a trust created by his grandfather. The trust stated that during the taxpayer's life, the trustees would make discretionary payments of the net income and principal to or for the benefit of the taxpayer and the taxpayer's issue. The trust also stated that upon the taxpayer's death, the trustees were to pay the principal and accumulated income of the trust "to such among [Settlor's] issue" as the taxpayer shall validly appoint in the taxpayer's last will and testament.

Under Sec. 2041(a)(2), the value of the gross estate includes the value of all property for which the decedent has at the time of his death a general POA or for which the decedent has at any time exercised or released a general POA in a transaction in which the property would be includible in the decedent's gross estate under Secs. 2035 through 2038. Sec. 2041(b)(1) defines a general POA as a power exercisable in favor of the decedent, his or her estate, his or her creditors, or the creditors of his or her estate. A POA is not a general POA if, by its terms, it is exercisable only in favor of one or more designated persons or classes other than the decedent, his or her creditors, his or her estate, or creditors of his or her estate.

The IRS noted that the taxpayer's POA allowed him to appoint the trust principal and accumulated income to the class consisting of settlor's issue, and the reference to "such among [Settlor's] issue" is a class of appointees that does not include the taxpayer's estate or the creditors of the taxpayer's estate after his death. In addition, the taxpayer could not appoint the property during the taxpayer's life to himself or his creditors.

Therefore, the IRS concluded that the taxpayer's testamentary POA was not a general POA, and the existence, exercise, failure to fully exercise, or partial or complete release of the taxpayer's POA would not cause the value of trust property to be included in the taxpayer's gross estate.

Observation: The need to seek a letter ruling could have been avoided easily if the POA had been drafted to include language limiting the power to appoint property. For example, drafting the power to appoint the property "to the Settlor's issue other than the taxpayer, the taxpayer's creditors, the taxpayer's estate or the creditors of the taxpayer's estate" clearly creates a limited POA. Similarly, a POA limited by an ascertainable standard is not a general POA, and Sec. 2041(b)(1) provides clear guidance on the language required to create an ascertainable standard (i.e., health, education, support, and maintenance). Where the Code, the regulations, or the IRS has provided specific language to use to avoid unintended tax consequences, it behooves the estate planner to use that language or run the risk that the language will be ineffective for tax purposes.

Property Valuation

In *Giustina*,[7] the Ninth Circuit reversed and remanded the case to the Tax Court to reconsider its determination of the method it used to value a partnership interest for estate tax purposes. In doing so, the Ninth Circuit admonished the Tax Court about its assumptions in applying the hypothetical willing-buyer/willing-seller test for valuing assets that do not have a readily ascertainable value.

The decedent owned a 41.128% limited partner interest in a partnership that owned timberland and conducted a forestry operation. The valuation dispute was over which valuation method should be applied: One method used cash flow assuming continued operations (the income method), while the other used asset values assuming the partnership assets would be sold (the net asset value (NAV) method). The estate's appraiser relied entirely on the income method while the IRS's appraiser relied on both methods.

The Tax Court reasoned that the income method was appropriate to reflect the value of the partnership if it was operated as a timber company, and the asset method was appropriate to reflect the partnership's value if its assets were sold. Accordingly, it determined that the percentage weight to be accorded the income method should be equal to the probability that the partnership would continue to be operated as a timber company, which the court determined was 75%. The court noted that the family had a long history of acquiring and retaining timberland.

While taking this into account, the court also assumed that the owner of the 41.128% limited partnership interest was a hypothetical willing seller who would seek the maximum economic advantage from the asset. The estate's expert testified that the optimal strategy to maximize the partnership's value would be to sell the timberland and immediately generate $143 million, while continuing to operate the partnership would generate only about $52 million. However, the estate's expert opined that the timberland's value is irrelevant because a holder of the decedent's interest could not unilaterally force the sale of the partnership's assets (i.e., the NAV method should be disregarded). The court stated that while it was true that the owner of a 41.128% limited partner interest could not alone cause the partnership to sell the timberland, there were various ways in which a voting block of limited partners with a two-thirds interest in the partnership could force the sale.

The court reasoned that members of a voting block could replace the two general partners, who have the power to sell assets and make distributions. Alternatively, it reasoned that a two-thirds voting block could dissolve the partnership, an act that must be followed by the distribution of the partnership's assets. While it determined that uncertainty existed as to how many partners would share the view that the timberland should be sold, that uncertainty did not prevent the court from estimating the probability of a sale, which it determined to be 25%. Accordingly, the partnership interest's value would be 75% using the income method and 25% using the NAV method.

This is where the Ninth Circuit took the Tax Court to task. It disagreed with the court in assigning a 25% weight to the probability of the sale of the partnership's assets or liquidation. For liquidation to occur, the court must assume that (1) a hypothetical buyer would be admitted as a limited partner by the general partners, who have repeatedly emphasized the importance that they place upon continued operation of the partnership; (2) the buyer would then turn around and seek dissolution of the partnership or removal of the general partners who just approved his admission to the partnership; and (3) the buyer would manage to convince at least two (or possibly more) other limited partners to go along, despite the evidence that no limited partner ever asked about or ever discussed the sale of an interest in the partnership. Alternatively, it must assume that the existing limited partners, or their heirs or assigns, owning two-thirds of the partnership, would seek dissolution. The Ninth Circuit concluded that it was clear error to assign a 25% likelihood to these unlikely events and remanded the case to the Tax Court to recalculate the value of the decedent's estate based on the partnership's value using the income method. The Ninth Circuit sustained the court's determination of a 25% discount for lack of marketability.

This is not the first time that the Ninth Circuit has admonished the Tax Court for making certain assumptions about the hypothetical willing buyer and willing seller. In *Simplot*,[8] the decedent ran a successful potato farming business, and the Tax Court made certain assumptions regarding the potential sale of the business in valuing it. This case should serve as a warning to appraisers who make assumptions regarding their valuations. In reviewing appraisals, tax practitioners should also make sure that the assumptions made in the appraisal are hypothetical and not indicative of any particular willing buyer or willing seller.

In *Elkins*,[9] the Fifth Circuit affirmed in part and reversed in part the Tax Court's determination that the decedent's estate was entitled to a discount for fractional interests in artwork the decedent owned at his death. While the Fifth Circuit agreed with the court that a discount was appropriate, it disagreed with the court's determination that the discount should be 10%.

When he died, the decedent owned a 73.055% interest in 61 works of art, and a 50% interest through a grantor retained income trust in three works of art that he and his late wife had acquired throughout their marriage. The decedent's children collectively owned the remaining minority interests in the artwork, over which they, along with their father, had executed a co-tenant agreement prohibiting the sale of any of the art unless all the parties agreed. The decedent's estate claimed a combined fractional interest discount of 44.75% for its interest in the art on its estate tax return. The IRS refused to allow any discount for the fractional ownership interest and assessed an estate tax deficiency of $9,068,266.

The court applied the willing-buyer/willing-seller test to determine the fair market value (FMV) of the decedent's interest in the works of art and whether, and to what extent, any discount was appropriate. The decedent's estate offered several credible expert witnesses to support its claimed discount percentage, as well as one of the decedent's children attesting to the artwork's sentimental nature and desire to retain the interest in its entirety within the family at any cost. To counter, the IRS offered virtually no evidentiary basis for its "zero-discount" position. The court reasoned that the hypothetical willing seller and willing buyer would pay a price close to the artwork's undiscounted FMV given the decedent's children's stated intentions of spending whatever amount necessary to obtain 100% ownership. However, due to the uncertainty inherent in any fractional ownership arrangement, the court determined that some discount was appropriate. Accordingly, it applied a nominal 10% discount.

The Fifth Circuit agreed with the Tax Court that the decedent's estate was entitled to a discount for its fractional ownership in the artwork, but disagreed with the court's unexplained 10% discount. In reversing the Tax Court, the Fifth Circuit noted that given the total absence of substantive evidence from the IRS on value, the court should have accepted the uncontradicted value of the partial-ownership discounts that the decedent's estate proved at trial. Further, the Fifth Circuit stated that the Tax Court's reasoning that the subjective intentions of the decedent's children would drive the price a hypothetical willing buyer would pay closer to the undiscounted value was flawed, since, as the Fifth Circuit pointed out, the potential willing buyer would undoubtedly insist that the willing seller *further* discount the sales price to account for the virtual impossibility of making an immediate "flip" of the art. Noting that a discount was proper and that the IRS failed to prove that the size of the discount was not proper, the Fifth Circuit agreed with the decedent's estate that the 44.75% discount used on the decedent's estate tax return was proper.

While the 44.75% discount upheld by the Fifth Circuit was a big victory for the taxpayer, prudent tax planners should interpret *Elkins* only to mean that *some* discount is appropriate for fractional interests in artwork. The appellate court made it clear that the estate's discount was applied because the IRS presented no alternative evidence—a litigation mistake the Service is unlikely to repeat in future cases. Expect the IRS to challenge substantial discounts in fractional interests in art as vigorously as it has historically challenged discounts of limited interests in family limited partnerships.

In *Adell*,[10] the Tax Court rejected both the IRS's valuation and the estate's valuation of stock of a closely held corporation the decedent owned when he died. It ruled that the estate's appraisal originally filed with its estate tax return was correct and was in fact an admission by the estate regarding its tax liability.

The decedent and his son created The Word Network (The Word), a nonprofit corporation with the purpose of broadcasting religious programs. In addition, they organized STN.Com (STN), a corporation created to provide satellite uplinking services so that The Word's programing could be transmitted to DirecTV and broadcast nationally. The decedent was STN's sole shareholder and placed these shares, as well as other estate assets, in a revocable trust for the benefit of his three children. STN and The Word signed a services and facilities agreement (the agreement) under which The Word would pay STN a fee equal to the lesser of the actual cost or 95% of the net programming revenue The Word received monthly. Also, the agreement established that programming fees would not exceed actual direct costs and allowable indirect costs and would be reasonable in all respects.

Due to the son's contacts, The Word's programming became increasingly successful, and it paid substantial monthly fees to STN. The son did not have an employment or a noncompete agreement with STN, although his expertise and contacts were essential to the business's success. Also, despite the cost provisions in the agreement, The Word consistently paid 95% of its revenue to STN. These payments allowed the decedent and his son to benefit from the programming revenues from The Word (STN's only customer), live lavishly, and receive high executive compensation. As officers of The Word, a nonprofit, the decedent and his son received $50,000 a year, while their STN compensation rose to seven figures. In 2006, the decedent paid a $6.6 million judgment against the son using his STN compensation. The decedent died in August 2006.

The estate filed its estate tax return reporting a total tax of approximately $15.3 million. It paid $8.1 million of the tax and made an election to defer the balance. The payment of the $6.6 million judgment against the son was initially characterized as an estate loan receivable, and the decedent's STN shares were valued at $9.3 million. However, in 2008 the estate amended its original estate tax return, recharacterizing the $6.6 million judgment payment as a gift instead of a loan (the IRS collected the gift tax liability in a separate case), which reduced the estate's total tax liability. In addition, in 2010 the estate amended its tax return again, reporting its percentage interest in the STN shares as zero. Shortly thereafter, the IRS issued a notice of deficiency valuing the STN shares at $92.2 million, proposing a tax liability of $39.7 million and applying valuation-understatement penalties.

The estate had submitted three appraisal reports for the STN shares. The original appraisal filed with the original estate tax return included a $9.3 million value based on a discounted cash flow approach under the income method of valuation because the appraiser determined that STN was an entity expected to produce positive cash flows in the future. Also, this valuation included an economic charge discount of 43.7% to 44.1% over the projection period for the son's personal goodwill due to the lack of an employment contract or noncompete agreement.

The second and third appraisals (submitted at trial) used the NAV method, which accounted for a new understanding regarding the agreement restrictions. These appraisals valued the STN shares at $4.3 million and stated that the NAV method was more appropriate because the restrictions impeded STN from making a profit and "a hypothetical buyer would not place any weight on historical performance given the terms of the agreement." In addition, the amended appraisals stated that the NAV method was preferable (over the income method) because STN's goodwill was personal to the son, who could set up a new company and make STN profits uncertain. On the opposing side, the IRS trial appraiser used the income method but made significantly fewer adjustments than those used by the appraiser for the valuation that was originally filed by the estate and supported a valuation of $26.3 million (far less than the $92.2 million as determined in the deficiency notice).

The Tax Court dismissed the estate's trial appraisals as well as the IRS valuation and accepted the estate's original appraisal as correct and as an admission by the estate concerning its tax liability. The court rejected the estate experts' claim that the original appraisal should be reduced to NAV due to the (never followed) limitations in the agreement or the risk that the son would leave STN. The court concluded that despite the agreement's limitation on programming fees, STN was a profitable company at the decedent's death, and it was reasonable to conclude that it would sustain profitability in the future. Therefore, the income method, as admitted in the original estate filing and appraisal, was the most appropriate valuation method.

In the eyes of the court, a hypothetical buyer would not place much weight on the agreement's limitations vis-à-vis STN's profitability record when assessing STN's value. Also, the court concluded that even though the IRS used the correct valuation method, its appraisal failed to adequately discount for the value of the son's goodwill, which did not belong to STN and caused a considerable discount to the value of STN's shares.

Basis for 2010 Estates

On May 11, 2015, the IRS published proposed regulations[11] that provide guidance for the modified carryover basis rules of Sec. 1022. These regulations would apply on and after the date they are published as final in the *Federal Register*.

Generally, under Sec. 1014(a), the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent is the FMV of the property at the date of the decedent's death. However, if the decedent died in 2010 and the decedent's executor made a Sec. 1022 election, then the basis of property in the hands of a person acquiring the property from that decedent is governed by Sec. 1022 and not by Sec. 1014.

Sec. 1022(a)(1) generally provides that property acquired from a decedent (within the meaning of Sec. 1022 (e)) is treated as having been transferred by gift. If the decedent's adjusted basis is less than or equal to the property's FMV determined as of the decedent's date of death, the recipient's basis is the adjusted basis of the decedent. If the decedent's adjusted basis is greater than the FMV, the recipient's basis is limited to FMV. Although Sec. 1022 applied only to decedents dying in calendar year 2010, basis determined for those purposes will continue to be relevant until all of the property whose basis is determined under those rules has been sold or otherwise disposed of. Accordingly, the long-term effects of a Sec. 1022 election could be relevant for taxpayers for decades to come.

These proposed regulations incorporate into the existing regulations, as appropriate, references to Sec. 1022 to ensure that references to basis also include basis as determined under Sec. 1022. More than 30 amendments are scattered throughout Chapter 1 of the Code.

One of the more substantive provisions is the modification to Regs. Sec. 1.684-3(c). Sec. 684 generally requires gain to be recognized on any transfer of appreciated property by a U.S. person to a foreign nongrantor trust or foreign estate. For decedents dying in 2010, Sec. 684 also applies to certain transfers of property by reason of death to nonresident aliens. Gain is determined by reference to the FMV of the property over the adjusted basis of the property in the transferor's hands. Regs. Sec. 1.684-3(c) provides that, in a transfer of property by reason of a U.S. transferor's death to a foreign nongrantor trust, no gain recognition is required if the basis of the property in the trust's hands is determined under Sec. 1014(a). If the executor of a U.S. decedent does not make a Sec. 1022 election, the proposed regulations confirm that the general exception to gain recognition will apply. If the executor makes a Sec. 1022 election, the proposed regulations provide, consistent with Rev. Proc. 2011-41 and Notice 2011-66, that there is gain recognition. Any basis increase that the executor allocates under Sec. 1022 will reduce the amount of gain in that property for Sec. 684 purposes.

Interestingly, the proposed regulations do not amend Regs. Sec. 1.1367-1(j) relating to the basis of shares in an S corporation with "income in respect of a decedent" assets, although they do amend the companion provision for partnerships in Regs. Sec. 1.742-1. Additionally, the proposed regulations do not address references to Sec. 1014 in outstanding proposed regulations or temporary regulations. The omission was likely intentional because those other regulation projects could insert the Sec. 1022 cross-reference when they are finalized.

However, in some instances, this may be problematic for taxpayers. For example, taxpayers are left with ambiguity in long-standing proposed regulations, such as Prop. Regs. Sec. 1.465-69(a) (which has been in proposed form since 1979), that is unlikely to be finalized in the future. A similar case exists in Temp. Regs. Sec. 16A.1255-2(b)(2) (which has been in temporary form since 1981). The government has not indicated whether Sec. 1022 should be inserted in provisions such as these.

Transferee Liability

In *Stiles*,[12] a district court granted judgment against the executor of an estate for unpaid income tax liabilities, finding that he depleted the estate's assets before paying its tax liabilities. The court also held that the government is entitled to foreclose a tax lien on the executor's property.

After the decedent died in 2002, her son was named executor of her estate. The son filed an estate tax return in 2008, and the IRS assessed income taxes, interest, and penalties of $2,093,091 against the estate. During the administration of the estate, the son distributed $775,000 to himself and $425,000 to each of his two sisters. The estate paid most of the taxes. However, in 2014, the IRS issued a claim for $71,762.39 for unpaid estate and income taxes for 2007 through 2010. Subsequently, the IRS filed a tax lien on real property the son and his wife owned.

When the government filed a motion for summary judgment, the couple failed to file the required response, which resulted in the factual record the IRS presented being presumed correct. So, the government needed to establish only that the elements required to attach personal liability to an executor (under Sec. 6901(a)(1)(B) and 31 U.S.C. Section 3713(b)) were present: (1) The fiduciary distributed assets of the estate; (2) the distribution rendered the estate insolvent; and (3) the distribution took place after the fiduciary had actual or constructive knowledge of the liability for the unpaid taxes.

Because the IRS had given notice to the son of the taxes, and as executor he made distributions to himself and his sisters, he was personally liable for the remaining tax liability. His only defense was that he detrimentally relied on advice of his counsel when making distributions, and the court pointed out that Sec. 3713(b) does not provide an attorney-reliance exception. In addition, the "knowledge" requirement that has been read by the courts into Sec. 3713(b) exists to protect innocent representatives, which the son was not. Because the son neglected to pay the assessed taxes, the court also approved the IRS's order to foreclose a tax lien placed upon the couple's real property.

As this case highlights, fiduciaries of estates and trusts should avoid making distributions if obligations to the government remain outstanding (or at least make sure sufficient assets remain to satisfy these obligations). If there are outstanding government obligations of which a fiduciary is aware or of which he or she should have been aware, the government will seek payment from the fiduciary if the assets of the estate or trust are insufficient to satisfy these obligations.

Income Tax Charitable Deduction

In *Belmont*,[13] an estate was denied a charitable deduction on its income tax return because the amount of income was not permanently set aside for charitable purposes.

The decedent's will provided that the residue of her estate was to be left to a charity. The proceeds from the decedent's retirement account, which was income in respect of a decedent (IRD) under Sec. 691, was paid to the estate. On its income tax return, the estate claimed a charitable deduction of $219,580 under Sec. 642(c)(2) for amounts of gross income permanently set aside for charity.

However, part of the amount set aside was depleted because the estate was involved in litigation with the decedent's brother who claimed a life tenancy interest over a condominium that belonged to the decedent. The decedent's brother was awarded a life tenancy in the condominium, and, due to litigation costs, the estate did not have sufficient funds to pay the amount previously set aside and deducted as a charitable contribution. The IRS issued a deficiency notice, stating that the deduction was disallowed because the estate had not permanently set aside the charitable contribution funds for the charity.

Estates and trusts are allowed a charitable deduction under Sec. 642(c) for income that is paid to charity. Under Sec. 642(c)(2), an estate is also allowed a current charitable deduction even though the income will not be paid or used for a charitable purpose until sometime in the future. Specifically, Sec. 642(c)(2) allows as a deduction "any amount of the gross income . . . which pursuant to the terms of the governing instrument is, during the taxable year, permanently set aside for" a charitable purpose. Thus, for an estate to properly claim a charitable deduction under Sec. 642(c)(2): (1) The charitable contribution must be an amount from the estate's gross income; (2) the charitable contribution must be made under the terms of a governing instrument; and (3) the charitable contribution must be permanently set aside for the purposes specified in Sec. 642(c)(2).

Under the third prong of the test, Regs. Sec. 1.642(c)-2(d) provides an amount will not be deemed "permanently set aside" for a charitable purpose under Sec. 642(c)(2), "unless under the terms of the governing instrument and the circumstances of the particular case the possibility that the amount set aside, or to be used, will not be devoted to such purpose or use is so remote as to be negligible." The estate argued that there was no "reasonably foreseeable possibility" that it would incur unanticipated costs associated in the litigation with the decedent's brother. The IRS disagreed, arguing that at the time the deduction was claimed, there was a substantial possibility of a prolonged and expensive legal fight that would have required the estate to dip into the funds it allegedly set aside for charity.

The Tax Court agreed with the IRS and applied case law interpreting the regulations under Sec. 170 to analyze the prima facie issue involving the definition of the "so remote as to be negligible" standard under Sec. 642(c)(2). In *885 Investment Co.*, the court defined "so remote as to be negligible" as "a chance which persons generally would disregard as so highly improbable that it might be ignored with reasonable safety in undertaking a serious business transaction."[14] In *Briggs*, the court defined it as "a chance which every dictate of reason would justify an intelligent person in disregarding as so highly improbable and remote as to be lacking in reason and substance."[15]

Applying the above standards, the Tax Court concluded that the facts and circumstances known to the estate when it filed the return were sufficient to put the estate on notice that the possibility of an extended and expensive legal fight and consequently the depletion of the funds allegedly set aside for charity was more than "so remote as to be negligible." The court pointed out that the estate was aware before filing the return that the decedent's brother might engage in prolonged and expensive litigation over his interest in the condominium because he (1) did not vacate the property and did not agree to requests to vacate in exchange for money; (2) filed a creditor's claim asserting information supporting his claim to a life tenancy interest in the property; (3) filed a *lis pendens* action; and (4) retained a prominent attorney to represent his interest in the property. All of these events occurred and were known to the estate before claiming the charitable deduction on its return. Therefore, the court held the funds to be used for the charitable contribution were not permanently set aside within the meaning of Sec. 642(c)(2). Consequently, the estate's charitable deduction was denied.

Author's note: *The author thanks Fran Schafer for her thoughtful comments to this article.*

Footnotes

[1]*Mikel*, T.C. Memo. 2015-64.

[2]*Crummey*, 397 F.2d 82 (9th Cir. 1968).

[3]Id. at 88.

[4]The CCA also contains a discussion of how the subtraction method applies for purposes of valuing the donor's gift.

[5]*Estate of Bosch*, 387 U.S. 456 (1967).

[6]*Bross Trucking*, T.C. Memo. 2014-107.

[7]*Estate of Giustina*, 586 Fed. Appx. 417 (9th Cir. 2014) (per curiam), rev'g T.C. Memo. 2011-141.

[8]*Estate of Simplot*, 249 F.3d 1191 (9th Cir. 2001).

[9]*Estate of Elkins*, 767 F.3d 443 (5th Cir. 2014), aff'g in part and rev'g in part, 140 T.C. No. 5 (2013).

[10]*Estate of Adell*, T.C. Memo. 2014-155.

[11]REG-107595-11, 80 *Fed. Reg*. 26873.

[12]*Stiles*, No. 2:13-cv-00138 (W.D. Penn. 2014).

[13]*Estate of Belmont*, 144 T.C. No. 6 (2015).

[14]*885 Investment Co.*, 95 T.C. 156, 161 (1990).

[15]*Briggs*, 72 T.C. 646, 657 (1979), aff'd without published op., 665 F.2d 1051 (9th Cir. 1981).

Contributors

Justin Ransome is a partner in the National Tax Department of Ernst & Young in Washington. He was assisted in writing this article by members of Ernst & Young's National Tax Department in Private Client Services—*David Kirk*, *Marianne Kayan*, *Ben Wright*, *Ashley Weyenberg*, *Caryn Gross*, and *Corey Glass*. For more information about this article, contact Mr. Ransome at justin.ransome@ey.com (mailto:justin.ransome@ey.com).