

South Plains Trust & Estate Council Market Center, Texas Tech University

Recent Developments in Wealth Transfer Taxation

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American Taxpayer Relief Act of 2012

- Permanent inflation adjusted \$5 million Estate, Gift, and Generation-Skipping Transfer Tax Exclusions. Exclusion for 2013 is \$5.25 million.
- Adjustment to date of death basis restored.
- Maximum Estate, Gift, and Generation Skipping tax rates capped at 40% (from 35% top rate – the first increase in wealth transfer tax rates since 1941).
- Portability of Estate and Gift Tax exclusion made permanent. Surviving spouse may use unused exclusion from last pre-deceased spouse. Election must be made on pre-deceased spouse's timely filed estate tax return. If surviving spouse remarries and new spouse dies, access is lost to the unused exclusion of the first pre-deceased spouse. Portability is not available for the GST tax exemption.

2013 annual gift tax exclusion amount is \$14,000.

2013 Section 2032A maximum reduction in value amount is \$1,070,000.

Estate Tax Matters

Estate of Morgens, (9th Cir., May 3, 2012), 2012-1 USTC 60,645

Within three years of her death surviving spouse relinquished her residual income interests in two QTIP trusts and trustees paid the gift tax. Even though the trustees paid the gift tax, the gift tax liability was the decedent's and thus Section 2035(b) required the inclusion of the gift tax in decedent's estate. In accordance with *V. Diedrich*, SCt, 82-1 USTC 9419, and *B. Brown*, 9th Cir., 2003-1 USTC 60462 the trustees acted as a conduit of funds for the decedent, who actually paid the gift tax for the purposes of Section 2035(b).

Estate of Lockett, TC Memo. 2012-123

The decedent's revocable trust and the decedent, individually, contributed assets to a limited partnership, and both received limited partnership interests. At a later date, the trust was terminated and the decedent became the owner of the trust's limited partnership interest. Although the decedent's two sons were identified as general partners in the partnership agreement, neither son contributed assets to the partnership in exchange for a general partnership interest. The parties disagreed as to whether the partnership was valid under applicable state (Arizona) law. Pursuant to the partnership agreement and Arizona law, the sons were not general partners because they did not contribute cash, property, or services in exchange for their general partnership interests. The sons did not receive gifts of general partnership interests under the partnership agreement or from the decedent when she made a contribution to the partnership as evidenced by the facts that (1) the decedent never reported gifts of partnership interests on her federal gift returns; (2) the estate could not introduce evidence memorializing the gifts; and (3) the partnership agreement left the sons' interests in the partnership blank. The revocable trust was a partner in the limited partnership because transfers were made from the trust in exchange for partnership interests. When the trust was terminated, however, and the decedent received the trusts' partnership interests, the decedent became the sole partner. Under Arizona law and the partnership agreement, the partnership dissolved and the decedent became the legal owner of all of the partnership assets. Because the decedent was the legal and beneficial owner of the

partnership assets, the full value of the assets was includible in the decedent's gross estate under Sections 2031 and 2033.

Estate of Sommers, TC Memo. 2013-8

In order to facilitate gifts of art to his nieces, decedent contributed 12 works of art to an LLC in which the terms restricted the transfer of capital interests. The gift documents were executed and signed in December of 2001 and January of 2002. The amount of units to be transferred, however, was left blank because the amount was dependent on the pending appraisal. After the parties received the appraisal, the number of units transferred was added to the gift documents. In June 2002, following the decedent's marriage to his second wife, the decedent sued his nieces, alleging that there had been no transfer of his art collection to the LLC or his nieces. The issue was arbitrated and later confirmed by the Indiana Court of Appeals. The gifts were complete and irrevocable. In 2007 the decedent's estate filed a separate claim in New Jersey regarding the validity of the gifts. The court also found for the nieces. Because the New Jersey and the Indiana litigation involved the same issues and legal principles, the decedent's estate was collaterally estopped from arguing that the gifts were not gifts for federal tax purposes and that the decedent retained the power to revoke, alter, terminate, or amend the gifts pursuant to Section 2038. Furthermore, even if the decedent's estate's arguments were not subject to collateral estoppel, the gifts were taxable gifts under the federal tax law and were not includible in the decedent's gross estate.

Rev. Rul. 2011-28, 2011-49, I.R.B. 831

If grantor of a trust has a non-fiduciary power to acquire trust property by substituting other property of equivalent value and the trust holds life insurance policies on the power-holder's life, the power to acquire the life insurance policies will not be considered an incident of ownership in the life insurance policies as long as the trustee has a requirement under the trust instrument or state law of "satisfying itself that the properties acquired and substituted by the grantor were, in fact, of equivalent value", and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

Estate of Sylvia Bates, TC Memo. 2012-314

After the decedent's death, two separate wills were submitted to probate. Under the terms of the first will, the residue of the estate passed to a family trust, which was to be divided equally between the decedent's grandchildren. The first will also made a specific bequest to the decedent's caretaker. Under the terms of the second will, only the decedent's incarcerated grandson received the trust property, and the grandson and the caretaker split the trust income. Eventually, the parties settled the dispute, and the caretaker was paid a lump sum amount. In addition, the caretaker received the proceeds from the decedent's life insurance policy because he had been named the beneficiary. Deductions were claimed for the lump sum payment and payments made

to a private investigator who was hired by the incarcerated grandson to monitor the litigation. The settlement payment was not deductible because it lacked adequate consideration and it was not consistent with the decedent's intent. Furthermore, the payment was the satisfaction of a beneficiary's distributive share, and not a claim against the estate. In addition, the insurance proceeds that the caretaker received were not deductible because the decedent had an "incident of ownership" in the insurance policy at the time of her death. The payments to the private investigator were not deductible because they were expenses incurred to protect a beneficiary's personal interest.

Letter Ruling 201216034

The primary beneficiary of a trust possessed a general power of appointment because he had a power, in a non-fiduciary capacity, to acquire the trust corpus by substituting other property of an equivalent value as determined by an independent appraiser selected by the trustee of the trust. The primary beneficiary may exercise this power without the consent of any fiduciary and no fiduciary duty may be asserted as a defense against the exercise of this power by the primary beneficiary. This was part of a plan to make the trust eligible to hold "S" Corporation stock that the grantor intended to give to it.

Estate of Nancy P. Young, (D.C., Mass.), CIV No. 11-11829-RWZ

The estate timely requested and was granted a six-month extension of time to file its return and a one-year extension of time to pay the estate tax. Prior to the extended due date for the return, but after the original due date, the estate paid its full estimated estate tax liability. The return was prepared and ready to be filed on time. However, the appraised values of the estate's real estate holdings were high. The estate's advisors believed that because the estate had already paid its estate tax liability, it would not be subject to a penalty. Following that erroneous advice, the estate delayed filing until the properties were sold, so as to not file an inaccurate return. Because the estate had a legal obligation to timely file the return based on the best information available, the reasonable cause exception did not apply. Reliance on an attorney or an accountant is not reasonable when a taxpayer is advised that it is not necessary to comply with the law because it will not be subject to a penalty. Furthermore, because the estate deliberately filed a late return, the late filing constituted willful neglect. Accordingly, the late filing penalty was properly assessed.

Finrock v. U.S., 109 A.F.T.R. 2d 2012-1439 (C.D. Ill. 2012)

Reg. section 20.2032A-8(a)(2) held invalid. An election under Section 2032A does not include a requirement that, once eligible, an estate must elect special use valuation for real property representing at least 25% of the adjusted value of the gross estate. No deference under *Chevron* because the statute is "neither silent nor ambiguous" and thus court did not reach the issue of whether the regulation would be a "permissible construction of the statute."

Windsor v. U.S., 699 F.3d 169 (2d Cir. 2012), cert. granted

District Court and Second Circuit held DOMA unconstitutional on equal protection (intermediate scrutiny) grounds. Lower court held that decedent's marriage in Canada to a same sex spouse would be recognized in New York and thus that decedent's estate was entitled to a marital deduction. Supreme Court may decide issue or may decide that there is no controversy since Executive Branch agrees DOMA is unconstitutional and that House of Representatives lacks standing. Another case before the Court involves an equal protection challenge to California's definition of marriage.

FLP Cases

Estate of Stone, T.C. Memo. 2012-48

Decedent and her husband owned woodland parcels near a lake developed by their family. After creating an FLP and transferring the woodland parcels to the partnership, the Stones gave all of the limited partnership interests to their children, their spouses, and their grandchildren over a four-year period. The gifts of limited partnership interests were completed about five years prior to the decedent's death. No distributions were ever made from the partnership and most partnership formalities were followed. The IRS argued that the portion of the property's value represented by the contribution from the decedent was included in the decedent's estate under Section 2036.

The court agreed with the IRS that making transfers to an FLP for the sole purpose of simplifying gift giving was not a sufficient non-tax motive for purposes of the bona fide sale exception to Section 2036, but concluded that simplifying gift giving was not the only purpose for creating the FLP. The court concluded that the "decedent's desire to have the woodland parcels held and managed as a family asset constituted a legitimate non-tax motive for her transfer of the woodland parcels to [the partnership]."

The court rejected the IRS' arguments that (1) the decedent "stood on both sides of the transaction" and (2) the full consideration requirement of the bona fide sale exception was not satisfied. The court reasoned that both of those arguments failed because there was a legitimate non-tax purpose and the decedent received partnership interests proportional to her contributions to the partnership. Thus, the existence of a legitimate non-tax purpose was central to satisfying the bona fide sale exception.

Estate of Kelly, T.C. Memo. 2012-73

The guardianship court entered an order allowing the decedent's guardianship estate to contribute operating quarries and other real estate and other assets to limited partnerships with a corporation owned 100% by the decedent the sole general partner. The primary concern "was to ensure the equal distribution of the decedent's estate thereby avoiding litigation." In addition, the plan provided for effective management of these types of assets requiring active management that "would lead any prudent person

to manage these assets in the form of an entity.” Furthermore, there were concerns about specific types of potential liabilities (e.g., a prior lawsuit against the decedent, dynamite blasting, etc.). The decedent retained \$1.1 million out of the partnerships, and no distributions from the partnerships (or apparently from the corporation) were used to pay any of the decedent’s living expenses. The court held that those purposes were legitimate and significant non-tax reasons, and the Section 2036 bona fide sale for full consideration exception applied so that the contributions to the partnerships were not treated as transfers causing inclusion in the gross estate under Section 2036.

The decedent made gifts of limited partnership interests in the several years prior to her death. The IRS argued that “the parties had an implied agreement that decedent would continue to enjoy the income from the family limited partnerships,” and that the partnership assets attributable to those gifted interests were includible in the gross estate under Section 2036(a)(1). Their argument was bolstered by the fact that the petition to the court for authority to implement the plan on behalf of the ward specifically observed that the ward would own all of the outstanding stock of the corporate general partner and that the reasonable management charge “will ensure that the ward will be provided with adequate income to cover the ward’s probable expenses for support, care and maintenance for the remainder of the ward’s lifetime”

The court disagreed, observing among other things that the parties respected the entities and entity formalities, the decedent retained assets for paying living expenses (and the management fee dollars paid to the corporation were not used to pay the decedent’s living expenses), fiduciary duties prevented paying more than a reasonable management fee, and the management fee paid to the company was in fact reasonable. The comment in the guardianship petition about the management fees providing adequate income to cover living expenses was “merely an expression of financial benefits decedent could receive” and not a legally binding directive. Assets attributable to the gifted limited partnership interests were not included in the estate under Section 2036(a)(1). This is one of the few cases to hold that Section 2036 does not apply (even as to part of the case) without relying on the bona fide sale exception to Section 2036 (the other being *Mirowski*, T.C. Memo. 2008-74).

Estate of Turner II, 138 T.C. No. 14

In the original Estate of Tuner, T.C. Memo. 2011-209, the court held that the bona fide sale exception to Section 2036 did not apply, and assets that the decedent contributed to the partnership were included in the gross estate under Section 2036. In Turner II, the estate asked the court to reconsider the Section 2036 issue and address a new marital deduction issue.

The court left intact its finding applying Section 2036. The marital deduction issue concerned the argument that since decedent’s will contained a formula marital deduction clause, could the marital deduction be increased to include the 21.7446% limited partnership interests that the decedent had given to various family members (other than his spouse) during his lifetime. The court concluded that because the

surviving spouse did not receive those 21.7446% limited partnership interests, no marital deduction is allowed for the value of assets attributable to those interests that are included in the gross estate under Section 2036. The purpose of the marital deduction is to defer the estate tax until the death of the surviving spouse or until the surviving spouse transfers the property. Thus, the marital deduction will not be allowed in the predeceased spouse's estate if the surviving spouse is not able to include the assets in her gross estate or transfer them as gifts.

Estate of Keller, 2012-2 USTC 60,653 (5th Cir. 2012), aff'g DC, Tex.

Because of her daughter's divorce, decedent was concerned about protecting family assets. She was engaged in planning the formation of an FLP at her date of death. Instructions had been given to her advisors regarding funding of the FLP and FLP and LLC filings had been made with the Texas Secretary of State. The FLP had not been funded at decedent's date of death so a Form 706 was filed reporting the value of the assets (primarily bonds) decedent had intended to be placed in the FLP. After filing the Form 706, one of decedent's advisors attended a seminar at which the *Church* case (DC, Tex., 2001-1 USTC 60,369, aff'd 5th Cir., 2001-2 USTC 60,415) was discussed. In *Church* the court recognized the post-death completion and funding of an FLP as being retroactive, based on decedent's intent, to the date of death. Based on this case and information, the remaining steps to formalize and fund decedent's FLP were taken and a claim for refund was filed on the basis that decedent's assets were owned by an FLP at decedent's death, that discounts of the FLP interests of decedent should be recognized, and that decedent's estate was entitled to a substantial refund. Citing Texas law, the court found that decedent's intent, prior to death, to create the partnership was of primary importance and would be given retroactive effect. The court also held that since bonds sold by the estate to pay the estate tax were partnership property, the transaction could be re-characterized as a loan from the FLP to the estate, entitling the estate to claim interest on the loan as an estate tax deduction. The estate tax refund would allow the estate to repay the loan.

There are Proposed Regulations under Section 2032 (alternate valuation) that would deem the contribution of cash or other property, during the alternate valuation period, to a corporation, partnership, or entity as property "distributed, sold, exchanged, or otherwise disposed of", and thus to be valued at the property's fair market value on the date of the contribution. Query as to whether these regulations, if adopted, would change the results of *Church* and *Keller*? Perhaps not, at least under Texas law if, based on decedent's intent, the partnership will be treated as created before death and the funding after death treated as a merely ministerial function.

Gift Tax

Wandry v. Comm., T.C. Memo. 2012-88

Donors transferred gifts of specific dollar amounts of membership units in an LLC. Pursuant to gift documents, units of the donors' LLC were transferred to their children and grandchildren. The documents specified that the fair market value of the units was unknown at the time of the transfer, but the donors were transferring the number of units required to equal certain specified amounts. In addition, the document stated that if the IRS challenged the eventual valuation of the units, the number of units transferred would be adjusted so that they still equaled the specified amounts. An independent appraiser determined the value of the LLC and the donors' C.P.A. used the appraisal to report the number of units transferred on the donors' gift tax returns. The donors received a notice of deficiency based on the IRS' determination of the value of the LLC, and the parties eventually settled on a value. Because the gift tax returns were consistent with the gift documents, the donor's intent to transfer a specific dollar amount was established. Furthermore, there was no evidence that the LLC's capital accounts reflected gifts of specific percentage interests, as opposed to a set amount. In any case, capital accounts do not control the nature of gifts. Moreover, under the terms of the gift documents, the children and grandchildren were always entitled to a predefined number of units, which was expressed in terms of a specific amount. When the value of the units was increased, under the adjustment clause, the number of units that the children and grandchildren were entitled to decreased, but that did not alter the transfer. Instead, the adjustment clause corrected the allocation of membership units so that they accurately reflected the fair market value. Finally, formula clauses are not against public policy. Thus, the donors were not liable for a gift tax deficiency.

Nonacquiescence Announcement in *Wandry*, I.R.B. 2012-46

The IRS believes that because the final determination of the value of the gifts was beyond the donors' control, the gift was complete on the date that the donors transferred the LLC units. Thus, it could not later be altered by the language in the gift agreement. Accordingly, the IRS believes that the Tax Court erred when it determined that the property transferred for estate and gift tax purposes was anything other than the original fixed percentage interests in the LLC.

Estate of Wimmer, T.C. Memo. 2012-157

From 1996 – 2000 gifts of limited partnership interests were made to decedent's children and grandchildren and the children and grandchildren of decedent's sister-in-law. The FLP's primary purpose was to invest in property on a profitable basis and, to that end, the FLP was funded with publicly traded stock and dividend-paying stock. The FLP agreement restricted the transfer of partnership interests and limited the circumstances under which a transferee could become a substitute limited partner. The agreement provided, however, for an exception for transfers to "related parties". Based

on *A. Hackl*, 118 T.C. 279 (2002), *aff'd* 335 F.3d 664 (7th Cir. 2003), for a gift to qualify as a present interest, the gift must confer a substantial economic benefit by reason of the use, possession, or enjoyment of the property or the income from the property.

Due to the transfer restrictions articulated in the partnership agreement, the donees did not receive unrestricted and noncontingent rights to the immediate use, possession, or enjoyment of the partnership interests. But, the right to the income was a present interest within the meaning of Section 2503(b) because, on the basis of the facts and circumstances, the estate proved that on the date of each gift, (1) the partnership expected to generate income as it received quarterly dividend distributions; (2) because the general partners were obligated to distribute income to the trustee of the grandchildren's trust to satisfy the trust's annual income tax liabilities, these distributions required distributions to the other partners pursuant to the FLP agreement; and (3) the limited partners could estimate their allocation of quarterly dividends based on the stock's dividend history and each partner's percentage ownership in the FLP.

Dickerson v. Comm. T.C. Memo. 2012-60

A waitress was given a lottery ticket (from Florida lottery) by a customer as a tip. Unbeknownst to the customer, the ticket was a winner. The waitress, with her family, formed an "S" corporation and contributed the ticket to the corporation. IRS said the waitress made a gift to the other shareholders when she contributed the ticket to the corporation. The waitress and her family claimed consideration by the other family members based on a preexisting agreement to share the lottery winnings of any family member. The Tax Court said the agreement was too vague and that the waitress made a gift. The value of the gift was discounted by 67%, however, because the waitress' co-workers claimed that they were entitled to 80% of the proceeds based on a tip sharing agreement. Even though the claim of the co-workers was eventually rejected by the Alabama Supreme Court because it related to gambling proceeds and gambling is illegal under Alabama law, the Tax Court said the claim was a concern as of the date of the gift and would have had an effect upon the fair market value of the lottery ticket.