ELECTRONICALLY REPRINTED FROM JANUARY 2021

TRUSTS & ESTATES

The WealthManagement.com journal for estate-planning professionals

By **Charles A. Redd**

2020 Leaves an Indelible Imprint on Estate Planning

Statutory, regulatory and case law developments.

Last year produced statutory, regulatory and case law developments that, coupled with a tumultuous national election, will reverberate in the estate-planning profession for years to come. Summarized below are a few highlights.

Election Results

As of this writing, the results of two Senate races in the Nov. 3, 2020 election haven't been finally determined. If one or both of the Republican U.S. Senate candidates in the Georgia runoffs prevail, it would appear that, at least within the next two years, significant modifications in tax law that would impact estate planning are unlikely to occur. On the other hand, if both Democratic candidates in the U.S. Senate race in Georgia are victorious, the stage will be set for some dismantling of the 2017 Tax Act[1] and quite possibly other tax law changes as well.

Included in an overhaul of tax law that could flow from a Biden presidency and a Congress controlled by the Democrats are: a reduction of the basic exclusion amount (BEA);[2] an increase in the estate, gift and generation-skipping transfer tax rate;[3] an increase in the long-term capital gains tax rate;[4] restrictions on grantor retained annuity trusts (GRATs)[5] that would eliminate an individual's ability to create a zeroed-out, short-term GRAT; a limit on the effectiveness of an allocation of GST exemption[6] to 90 years; and elimination of the step-up in basis to fair market value (FMV) at a property owner's death.[7]

As 2020 drew to a close, some clients were engaged in a mad scramble to implement plans by which they could make lifetime taxable gifts to avail themselves of whatever remained of their full BEA. Some techniques incorporated features enabling retention, directly or indirectly, of some level of enjoyment of transferred

property.[8] Additionally, some approaches included flexibility to reverse or change the effect of a transaction[9] if it became clear early this year that a dramatic impending reduction in the BEA wasn't likely. Most advisors believe that, if tax law changes are to occur under a Biden administration and are made retroactive, the earliest effective date that could withstand constitutional scrutiny would be Jan. 1, 2021. Perhaps yet to be determined is whether certain before-year-end strategies could be rendered ineffective by an "anti-abuse rule" mentioned in the comments appended to the "no clawback" final regulations[10] but not yet formulated.

Deductions for Estates and Trusts

The 2017 Tax Act added subsection (g) to Internal Revenue Code Section 67. Subsection (g) says, notwithstanding subsection (a), which allows miscellaneous itemized deductions to an individual, subject to the 2% floor, miscellaneous itemized deductions are no longer allowed until after Dec. 31, 2025. IRC Section 67(e) provides that the adjusted gross income (AGI) of an estate or trust is to be determined in the same way as for an individual except that expenses that wouldn't have been incurred outside the context of fiduciary administration are to be treated as allowable in arriving at an estate or trust's AGI. Thus, those expenses can't be itemized deductions, and so, obviously, Section 67(g) doesn't impede Section 67(e) at all.

Nevertheless, there was wailing and gnashing of teeth when some trusts and estates professionals first saw new Section 67(g) and irrationally jumped to the conclusion that estates and trusts could no longer deduct any administration expenses. Calming the waters, the Internal Revenue Service issued Notice 2018-61, confirming that unique fiduciary administration expenses would indeed remain deductible by estates and trusts and promising that regulations would be forthcoming.[11] Proposed regulations (proposed regs) under Section 67(g) and IRC Section 642(h) followed a couple of years thereafter.[12]

On Oct. 19, 2020, just slightly more than five months after the proposed regs were published, the IRS promulgated final regulations (final regs).[13] The final regs, largely following the proposed regs, not only reiterate that estates and trusts may continue to deduct expenses unique to estate and trust administration but go even farther in saying that, in the year of an estate or trust's termination, if there are excess deductions that are passed out to the beneficiaries under Section 642(h) (2), depending on their character (as an amount used in determining AGI, a non-miscellaneous itemized deduction or a miscellaneous itemized deduction), the beneficiaries may be able to use them. A helpful refinement to Proposed Regs. Section 1.642(h)-5(b), Example 2, clarifies that a fiduciary has discretion to decide which deductions to allocate to estate or trust income and which ones to carry out to the beneficiaries.

Valuation

In *Grieve v. Commissioner*,[14] Pierson Grieve made gifts of a 99.8% member interest in Rabbit 1 LLC to a GRAT on Oct. 9, 2013 and a 99.8% member interest in Angus MacDonald LLC to the Grieve 2012 Family Irrevocable Trust on Nov. 1, 2013. These gifted member interests were non-voting. PMG, a management company that was the general partner of the Grieve Family Limited Partnership, owned the 0.2% voting member interests in both limited liability companies. Pierson's eldest child, Margaret, was the sole owner of PMG. The IRS issued a notice of deficiency regarding the donor's 2013 gifts. The taxpayer's valuations and the IRS' determinations of value differed by an aggregate of about $11 million.

The opinion contains a great deal of analytical data that the dueling experts compiled and presented to the Tax Court. In the end, however, the case boiled down to whether the IRS' expert, Mark Mitchell, when valuing the gifted non-voting member interests, properly took into consideration the theoretical possibility that the holder of those interests would purchase the voting member interests. Mark said "economic realities have to be taken into consideration," and the economic stake of the non-voting member interest holder "dwarfs" that of the voting member interest owner. Margaret testified, however, that she had no intention of selling the voting member interests.

The court ruled that the non-voting member interests couldn't be valued by hypothesizing that the holder of those interests would buy the voting interests. Such a valuation methodology would involve engaging in impermissible speculation concerning an event that was by no means certain to occur. The court ruled that the value of the gifted interests should be based on the entities' underlying net asset values, and the court accepted the taxpayer's expert's proposed discounts: lack of control: 13.4% for Rabbit and 12.7% for Angus MacDonald; and lack of marketability: 25% for both Rabbit and Angus MacDonald.

Defined Value Clauses

Nelson v. Comm'r[15] involved transfers of limited partner interests in Longspar Partners, Ltd. to a trust. One transfer was a gift; the other was an installment sale. A "Memorandum of Gift and Assignment of Limited Partner Interest" (Memorandum of Gift) stated that Mary Nelson, the donor, was making a gift of a limited partner interest having an FMV of $2.096 million as of Dec. 31, 2008, as determined by a qualified appraiser within 90 days of the effective date of the gift. Similarly, a "Memorandum of Sale and Assignment of Limited Partner Interest" (Memorandum of Sale) provided that Mary, the seller, was selling a limited partner interest having an FMV of $20 million as of Jan. 2, 2009, as determined by a qualified appraiser within 180 days of the effective date of the sale.

The appraisals required by the Memorandum of Gift and the Memorandum of Sale concluded the gift to be a transfer of 6.14% of Longspar's equity and the sale to be a transfer of 58.65% of Longspar's equity. The IRS selected Mary and James Nelson's 2008 and 2009 gift tax returns[16] for examination. The IRS asserted that Mary had gifted limited partner interests representing 6.14% of the value of Longspar and that such interests were worth more than $2.096 million on the effective date. The IRS likewise claimed that Mary had sold limited partner interests representing 58.65% of the value of Longspar and that such interests were worth more than $20 million. Mary and James countered that, pursuant to the Memorandum of Gift, Mary had gifted limited partner interests with an FMV on the effective date of $2.096 million and no more, and, pursuant to the Memorandum of Sale, Mary had sold limited partner interests with an FMV on the effective date of $20 million and no more.

In sustaining the IRS' position, the Tax Court noted that the operative language of the Memorandum of Gift and the Memorandum of Sale "hang[s] on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes." The court cited and favorably discussed cases in which the efficacy of language defining FMV as that "finally determined for federal [estate][gift] tax purposes" was upheld.[17] The court stated it wouldn't disregard the "by a qualified appraiser within [a fixed period]" language of the Memorandum of Gift and the Memorandum of Sale and replace it with "for federal estate and gift tax purposes."

It seems clear that the taxpayers' position crashed and burned because the defined value provisions embedded in the Memorandum of Gift and the Memorandum of Sale were seriously flawed. Those who design and use defined value clauses should closely follow the models provided in the several cases in which the taxpayers have been victorious.[18]

Double Inclusion Revisited

Moore v. Comm'r[19] starts out as a classic family limited partnership (FLP) case. Howard Moore, shortly after he emerged from the hospital after having had a heart attack, created five trusts and an FLP. He transferred 80% of his farm to the FLP. Five days later, he sold the farm to an unrelated party pursuant to a pre-existing contract. Nevertheless, he retained a life estate in the farm and continued to live on the farm and manage it. He used FLP funds to pay his legal bills and his living expenses. He died within four months after the transfer.

The Tax Court held the value of the farm was includible in Howard's gross estate under IRC Section 2036(a)(1). The transfer of the farm to the FLP wasn't a bona fide sale for full and adequate consideration because the FLP wasn't created for a legitimate and significant non-tax reason. There was no business to run after the farm was sold, and there was no proof that the decedent or his children had any legitimate creditor concerns. Furthermore, the decedent retained possession and enjoyment of the farm after the transfer by continuing to live on the property and manage the farm.

In addition, the court took up the double inclusion question that it had addressed in *Estate of Powell v. Comm'r*.[20] The court embarked on an exceptionally detailed discussion, accompanied by numerous examples, of how the estate tax law mandates inclusion in the gross estate of both the value of property a decedent had transferred into an FLP[21] plus the value of FLP interests held by a decedent at death[22] and then subtraction of any consideration that had been received by the decedent in exchange for his transfer(s) into the FLP.[23] The court admits that some of its examples "lead to what may seem odd results" and "might be thought to be less sensible" but doesn't offer any solution to the often anomalous interaction of the relevant statutory provisions.

Finally, the court ruled that a "zero-out-the-estate tax" charitable deduction formula in the decedent's

revocable trust instrument was ineffective. The court's reasoning is largely fallacious. If carried to its logical conclusion, all "zero-out-the-estate tax" marital deduction formulas would fail.

Late Filed Estate Tax Return

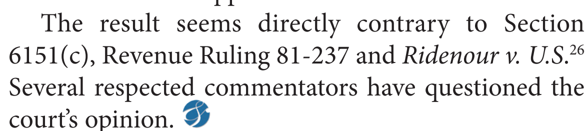
In *Agnes R. Skeba v. United States*,[24] the decedent died on June 10, 2013, leaving an estate having a value of over $14 million. The estate tax return due date was March 10, 2014. On March 6, 2014, the estate filed a Form 4768 seeking a 6-month extension of time within which to file the estate tax return and pay the estate tax. Along with the Form 4768, the estate paid $725,000 and eight days later paid another $2.745 million.[25] These payments would render a zero balance due on the estate tax return when it was later filed.

The 6-month extension period passed. The estate tax return was filed nine months thereafter. The IRS assessed, under IRC Section 6651(a), a 25% late filing penalty of $450,959. The estate's response to the assessment was that the late filing was due to reasonable cause and not willful neglect. The IRS wasn't impressed, and the penalty remained. The estate paid the penalty and sued for a refund in U.S. District Court.

The case turned on an interpretation of Section 6651. The court ruled in favor of the estate, holding that, reading Section 6651(a)(1) and (a)(2) together, the failure-to-file penalty applies only when there's an underpayment of tax within the extended time to pay. The court acknowledged the validity of the government's point that, if a penalty for failure to file timely can't be imposed in a case such as this, a taxpayer may unilaterally impede conclusion of tax matters, but the court answered that it was Congress' job to solve that problem.

The IRS asked the court to reconsider. On reconsideration, the court didn't change the result but added its finding that the estate had reasonable cause—likely making it more difficult for the case to be reversed on appeal. Nevertheless, the government has appealed to the U.S. Court of Appeals for the Third Circuit.

The result seems directly contrary to Section 6151(c), Revenue Ruling 81-237 and *Ridenour v. U.S.*[26] Several respected commentators have questioned the court's opinion.



Endnotes

1. An Act To Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97.
2. The term "basic exclusion amount" is defined in Internal Revenue Code Section 2010(c)(3). The current basic exclusion amount is $11.7 million. It could perhaps decline to $5 million, indexed by the cost-of-living adjustment referenced in IRC Section 2010(c)(3)(B), or to $3.5 million.
3. The current rate under IRC Section 2001(c) is effectively a flat rate of 40%. That rate might increase to 45%. A maximum rate of 55% could be imposed.
4. The current rate under IRC Sections 1(h) and 1411 is between 0% and 23.8%. For individuals with taxable income of $1 million or more, long-term capital gains could be taxed at the maximum bracket for ordinary income.
5. The current grantor retained annuity trust rules are set out in IRC Section 2702 and Treasury Regulations Section 25.2702-3.
6. The term "GST exemption," introduced into the tax law in 1986 by IRC Section 2631, refers to the exemption from generation-skipping transfer tax.
7. The current rules providing for basis step-up at death are set out in IRC Section 1014.
8. For example, some clients established potential qualified terminable interest property (QTIP) trusts with a view to deferring until Oct. 15, 2021 a decision as to whether to make the QTIP election.
9. For example, some clients made gifts that were structured so that, if the donee disclaimed, the gifted property would be returned to the donor.
10. Treas. Regs. Section 20.2010-1(c), REG-106706-18, 84 Fed. Reg. 64995 (Nov. 26, 2019).
11. Notice 2018-61, IRB 2018-31 (July 13, 2018).
12. Proposed Regulations Sections 1.67-4, 1.642(h)-2 and 1.642(h)-5, REG-113295-18, 85 Fed. Reg. 27693 (May 11, 2020).
13. Treas. Regs. Sections 1.67-4, 1.642(h)-2 and 1.642(h)-5, REG-113295-18, 85 Fed. Reg. 66219 (Oct. 19, 2020).
14. Grieve v. Commissioner, T.C. Memo. 2020-28 (March 2, 2020).
15. Nelson v. Comm'r, T.C. Memo. 2020-81 (June 10, 2020).
16. James was Mary's husband. Mary and James elected to split gifts under IRC Section 2513.
17. Estate of Christiansen v. Comm'r, 130 T.C. 1 (2008), aff'd, 586 F.3d 1061 (8th Cir. 2009); Estate of Petter v. Comm'r, T.C. Memo. 2009-280, aff'd, 653 F.3d 1012 (9th Cir. 2011).
18. Ibid. *See* also Hendrix v. Comm'r, T.C. Memo. 2011-133; Wandry v. Comm'r, T.C. Memo. 2012-88.
19. Moore v. Comm'r, T.C. Memo. 2020-40.
20. Estate of Powell v. Comm'r, 148 T.C. No. 18 (May 18, 2017).
21. *See* IRC Section 2036(a).
22. *See* IRC Section 2033.
23. *See* IRC Section 2043(a).
24. Estate of Agnes R. Skeba v. United States, No. 3:17-cv-10231 PGS TJB, 2020 WL 70962 (D.N.J. 2020).
25. The total amount due on March 10, 2014 was $2,528,838.
26. Ridenour v. U.S., 98 A.F.T.R.2d 2006-7965 (S.D. Ohio 2006).

Copyright © 2021 by Informa.
For more information on use of this content, contact Wright's Media at 877-652-5295.