estate planning briefs

AUGUST 2016

Extensions for portability elections

Because Decedent's estate was smaller than the federal estate tax exemption, his executor did not file an estate tax return—none was required. The problem with that failure to file, if there is a surviving spouse, is that the deceased spouse's unused exempt amount (DSUEA) then goes to waste. The surviving spouse's counsel in this case discovered the oversight, and asked the IRS for an extension of time to file Decedent's estate tax return for the sole reason of making the portability election, preserving the DSUEA.

When the estate is large enough to require a federal estate tax return, the due date for the return is prescribed by statute. For a smaller estate, the date is prescribed by Regulation. Reg. §301.9100-3 provides the standards that the IRS will use to determine whether to grant an extension of time to make an election whose due date is prescribed by a regulation (and not expressly provided by statute). The IRS has more flexibility and discretion in granting extensions in those cases.

Here, the taxpayer reasonably relied upon the advice of a professional, and acted in good faith. The extension of time was granted.

—Private Letter Ruling 201630001

COMMENT: The private rulings in this area are coming fast and furious. See also PLRs 201630007, 201630010, 201630005, and 201630012, all with essentially identical facts. Perhaps as the estate planning community becomes more familiar with portability, the oversights will diminish.

Executor personally liable for taxes

Robert Reitano left his family a big mess at his death. He owned 100% of Sophia Gale, a corporation that owned a fishing vessel, and 50% of RR Fishing Corp., which owned a second boat. His wife, Marci, owned the other 50% of RR Fishing. Together they operated a charter fishing business.

Shortly after Robert's death in 2002, Marci transferred all the shares of Sophia Gale to herself. In 2003, after she was named executrix of Robert's estate, Marci transferred the RR Fishing shares to herself as well. At the time Marci was aware that Robert had unresolved income tax issues, but she may not have known their magnitude.

That became clear later in 2003, when the IRS issued an assessment of $342,538.93 for unpaid income taxes.

The Service made its claim in probate court. The claim went unpaid. Eventually,

suit was filed against the estate and against Marci personally.

Under IRC §3713 a "claim of the United States Government shall be paid first 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." Three elements trigger its application. The executor must transfer assets (which Marci did in taking the stocks), at a time when the estate was insolvent (the income tax liability was larger than the value of the estate), and the debts must be known to the executor, which she admitted.

The lower Court found for the IRS, and the First Circuit Court of Appeals affirms. The Court stated that Marci "serves up a salmagundi of reasons why she should not be subject to section 3713(b) liability at all or, alternatively, why she should be subject to such liability only in a lesser sum." Chief among these reasons was that the executor may pay certain administrative expenses before the taxes. Unfortunately for Marci, none of the transfers to her were shown to be related to estate administration.

—U.S. v. Marci McNicol, individually, and Estate of Reitano and Marci McNicol as executrix (CA-1, July 18, 2016)

COMMENT: The vessel owned by Sophia Gale, Inc., was eventually sold for $80,000. The vessel owned by RR Fishing Corp. was eventually sold for $107,500, but it was subject to a lien of $61,562. One-half of the difference, plus $80,000, was the amount of the judgment against Marci.

Tax-free reimbursements

A major natural gas leak was discovered in California in October 2015. The leak was not capped until the following February. Nearby residents lodged a variety of complaints, and many required temporary relocation. The utility was ordered to pay for or reimburse certain cleanup and relocation expenses.

The IRS has now announced that the reimbursements will, in general, not be taxable income to the affected homeowners. That includes hotel costs, food costs, expenses of renting another home, or expenses of up to $150 per day for staying with friends or family.

— Announcement 2016-25; 2016-31 IRB 1

COMMENT: However, the friend or family who accepted that $150 per day *will* have taxable income, unless the rules for short-term rental of a residence are met.

Presumption of a gift is limited.

Cohen got along famously with his son-in-law Raymond, who went to work in his father-in-law's scrap metal company. Raymond became one of Cohen's most valuable assistants. In 2006 Cohen sold the company. He and Raymond each received three-year employment contracts. However, they were not very happy working for the successor, and began to seek other business opportunities. The pair traveled to Germany together to observe scrap metal operations in that country.

Cohen wanted Raymond to become familiar with the world of investing. To that end, he created a brokerage account in Raymond's name at Merrill Lynch, depositing $250,000 in the account. Apparently, there were no formalities observed in this transaction, such as a loan agreement. Cohen later testified that he thought the account would be "seed money" for a future venture.

Unfortunately, Raymond and Cohen's stepdaughter divorced two years later. Next, Raymond withdrew $50,000 from the Merrill Lynch account. Cohen demanded that Raymond repay the entire $250,000 and filed a lawsuit to get it. The trial court ruled that there is a "weak" presumption that a transfer of assets to an in-law is a gift, which shifted the burden of proof to Cohen to show that there was no gift.

On appeal, the New Hampshire Supreme Court held that the presumption of a gift applies only to transfers to a spouse or children, not to transfers to in-laws. Upon remand, Raymond will have the burden of proof to show that a gift was intended at the time of the transfer.

—Cohen v. Raymond, 128 A.3d 1072 (N.H. 2016)

GSTT exemptions were automatically allocated

Grantor established two trusts. In a series of transactions over two years, Grantor transferred to the trusts limited partnership interests, nonvoting corporate stock, and several promissory notes. Professionals were hired to prepare the gift tax returns for Grantor and his spouse. Unfortunately, the gift tax

returns were not prepared correctly. Specifically, the transfers created indirect generation-skipping transfers, and they were not reported as such. What is more, the allocation of the GSTT exemption was not reported on Schedule C.

No matter, the IRS holds. To the extent that they are available, the GSTT exemptions are allocated automatically in the absence of instructions to the contrary.

—Private Letter Ruling 201628007

COMMENT: Compare and contrast *Private Letter Ruling 201628018*. Grantor created an irrevocable trust that had the potential to incur GST tax liability. When Grantor's tax professionals reported the taxable gift, they did not elect out of the automatic allocation of the GSTT exemption. As it happens, Grantor does not want the exemption to apply to this trust, and he has asked for an extension of time for opting out of the deemed allocation with respect to past or future transfers to this trust. The IRS concluded that Grantor had acted in good faith, and it allowed the extension.

How to value timber land

Decedent owned a 41.128% interest in an Oregon family limited partnership that owned approximately 48,000 acres of timber land. Valuing such an interest presents many problems. Should the interest be valued as a going concern, or on the value of the underlying assets? What discounts are appropriate for lack of marketability and minority interest? The estate valued the interest at $12.6 million on the estate tax return. The IRS issued a notice of deficiency valuing it at $35.7 million. In the initial Tax Court trial, the Court chose to weight the value 75% based on cash flow and 25% on underlying asset value. (The tract of land was estimated to be worth $150 million.) That led to final value for the interest of $27.5 million [*Est. of Giustina v. Comm'r*, T.C. Memo 2011-141].

However, the Tax Court offered no rationale for the 75%-25% split. Estate planner Paul Hood observed at the time: "The Tax Court employed a unique proportionality method in that the court assumed a 75% chance that the subject company would continue its timber operations as is and a 25% chance that the limited partners would force the liquidation of the subject company. The Tax Court seemed to come up with those percentages out of thin air. I can't recall another case or situation where such a method was used." [Steve Leimberg's *Estate Planning Email Newsletter*—Archive Message #1829.]

The Ninth Circuit Court of Appeals evidently felt the same, and reversed the Tax Court decision [586 F. App'x 417 (9th Cir. 20140]. There was no way that a hypothetical willing buyer could force a liquidation of the company with only a minority interest, given the partnership structure. Accordingly, the estimated value of the land cannot be used to value the estate's interest in the partnership.

On remand, using only the cash flow method for valuing the interest, the Tax Court concluded that it was worth $13.9 million, very close to the estate's original reported value.

—Est. of Giustina v. Comm'r, T.C. Memo 2016-114

Extension granted for proving that a surviving spouse has become a U.S. citizen

Decedent's surviving spouse was not a U.S. citizen. In order to secure the marital deduction from the federal estate tax, his will created a Qualified Domestic Trust (QDOT) for her lifetime benefit. Some time later, the surviving spouse became a U.S. citizen, but she didn't mention this development to the QDOT trustee. Under §2056A(b)(12) and §20.2056A-10(a)(1) and (2) of the Estate Tax Regulations, a QDOT is no longer subject to the estate tax imposed under §2056A(b) if the surviving spouse becomes a citizen of the United States, and the spouse was a resident of the United States at all times after the death of the decedent and before becoming a United States citizen, and the U.S. trustee of the qualified domestic trust notifies the Internal Revenue Service and certifies in writing that the surviving spouse has become a United States citizen. Notice is to be made by filing a final Form 706-QDT on or before April 15 of the calendar year following the year that the surviving spouse becomes a citizen, unless an extension of time of up to six months for filing is granted under §6081. The trustee did not timely file the final Form 706-QDT.

Now that the Trustee knows, he has asked the IRS for an extension of time to file the Form. As

granting the extension of time will not prejudice the interests of the government, the extension was granted.

—Private Letter Ruling 201628011

Advanced age does not excuse late tax payment

Mark and his wife sent the IRS a check for $10,000 on April 15, 2012, and requested an extension of time to file their tax return. They made another payment of nearly $11,000 on October 26, 2012, after filing their tax return on October 15. That was enough to cover the income taxes due, but the IRS also assessed a late filing penalty and a late payment penalty, as well as interest.

Mark contested the penalties and the interest. He contended that in earlier years he had overpaid his taxes, but had never received interest on his refunds. To charge him interest now is unfair. The reason for his late filing? He is old, and the tax code is too hard to understand. The Tax Court was sympathetic, but Mark's excuse is not acceptable.

—Mark Alva West v. Commissioner; T.C. Memo. 2016-134